Bank Regulatory Developments Recap

March 11, 2021

Jeffrey P. Taft
Partner
+1 202 263 3293
jtaft@mayerbrown.com

Matthew Bisanz
Associate
+1 202 263 3434
mbisanz@mayerbrown.com

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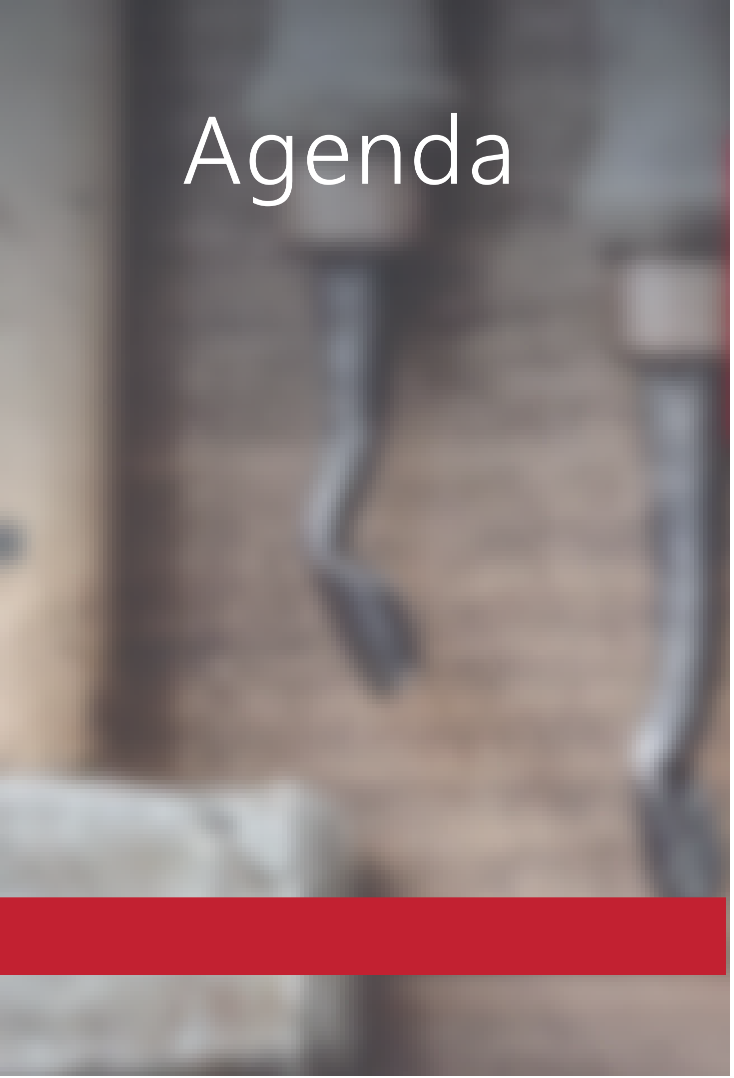

Agenda

- Amendments to the covered fund provisions of the Volcker Rule
- Implementation of the Federal Reserve's rule for determining control
- Finalization of the Net Stable Funding Ratio (NSFR) requirement
- Additional tailoring of Enhanced Prudential Standards (EPS) under the Dodd-Frank Act

Volcker Rule: Covered Fund Amendments

Volcker Rule Background

- In 2010, Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) imposed comprehensive financial reform legislation in the US in response to the financial crisis
- Section 619 of Dodd-Frank, commonly referred to as the "Volcker Rule", was intended to restrict "banking entities" from two categories of activities:
  - Sponsoring, investing in, and having certain other relationships with "covered funds"
  - Proprietary trading (significantly amended in 2019 and out-of-scope for today's presentation)
- Approach originally was "guilty until proven innocent" – terms defined very broadly, must identify and demonstrate compliance with an exclusion/exemption
  - Partially cut back by 2019 revisions to assume innocence for most banking entities
- Broad extraterritorial impact on activities outside the US
- Extensive compliance program obligations for largest banking entities
- Important interpretive issues still unresolved (e.g., applying market risk capital definitions)

Volcker Rule *(cont.)*

- Initially, regulators were highly resistant to changing the final regulation
  - One change in 2014 addressed certain collateralized debt obligations backed by trust-preferred securities
  - Many FAQs were issued by agency staff to smooth over rough spots
- In 2018, Congress amended Section 619 to exclude most smaller banking entities from the scope of the Volcker Rule
- In 2019 and 2020, the regulators implemented Congress' action <u>and</u> made other significant revisions to nearly every part of the Volcker Rule
  - 2020 revisions focused on covered fund provisions
  - Part of the "regulatory reform" effort embodied in the Treasury reports on financial regulation and the 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act

Covered Fund Prohibition

- Three prohibited activities in relation to "covered funds" (unchanged)
  - Banking entity may not, directly or indirectly, ***sponsor*** a covered fund, unless covered by an exemption
  - Banking entity may not, as principal, directly or indirectly, acquire or retain an ***ownership interest*** in a covered fund, unless covered by an exemption
  - If a banking entity serves as investment adviser, investment manager, commodity trading advisor or sponsor to a covered fund, or "organizes and offers" a covered fund pursuant to the asset management or securitization exemptions, then the banking entity and its affiliates may not enter into a ***covered transaction*** with that fund, and other transactions must be on market terms

Covered Fund Analysis

- Is the entity a covered fund?
  - Definition of covered fund (unchanged)
  - Exclusions from definition of covered fund (new and expanded exclusions)
- If not, is the entity itself a "banking entity" by virtue of being controlled by the banking entity? (new exemptions added)
- If the entity is a covered fund, is the banking entity sponsoring or acquiring or retaining an ownership interest in the covered fund? (narrower ownership interest definition)
- If so, is the sponsorship and/or investment activity exempt? (new and expanded exemptions)
- Does the prohibition on covered transactions apply, and if so does the banking entity or any affiliate engage in covered transactions with the fund? (new exemptions)
- Are exempt activities prohibited because they involve material conflicts of interest, high risk activities or risk to US financial stability? (unchanged)

Recent Changes for Covered Funds

- Narrower scope of the definition of ownership interest that allows a creditor to have certain rights that are not triggered exclusively by an event of default or acceleration and exclude senior loan and senior debt interests
- Easing of the eligibility criteria for exclusions for loan securitizations, foreign public funds, and small business investment companies
  - Loan securitizations may hold a five percent bond bucket; clarification of permissible servicing assets and cash equivalents
- Creation of four new exclusions for banking entities to invest in or sponsor (**i**) credit funds, (**ii**) venture capital funds, (**iii**) customer facilitation funds, and (**iv**) family wealth management vehicles
  - New exclusions may still be subject to proprietary trading prohibition and Super 23A restrictions

Recent Changes for Covered Funds *(cont.)*

- Codification of foreign excluded fund relief for non-US banking entities through the creation of new exemptions to the prohibitions against proprietary trading and covered fund activities (as opposed to exclusions) for qualifying foreign excluded funds
- Incorporation of some Section 23A exemptions relating to certain transactions with affiliates into the "Super 23A" restrictions
  - Addition of an exemption for riskless principal transactions with covered funds that are not a securities affiliate
- Clarification that a banking entity need not include investments made alongside a covered fund in its per-fund and aggregate funds ownership limitations calculations as long as certain conditions are met

Control Rule: Implementation of Revisions

Control Rule Background

- "Control" is a three-prong, foundational concept under the Bank Holding Company Act of 1956 and Home Owners' Loan Act
  - While the first two prongs of the definition of control are easily understood bright-line standards, the third prong of the definition (“controlling influence”) requires a facts and circumstances determination
  - A company that indirectly or directly controls a bank or savings association is a considered a bank holding company (BHC) or savings and loan holding company (SLHC), respectively
    - BHCs and SLHCs are subject to supervision and regulation by the Federal Reserve
    - Regulations include restrictions on nonbank activities, among others
  - A company that is controlled by a BHC or SLHC similarly is subject to Federal Reserve supervision and regulation and restrictions regarding its activities

Controlling Influence

- The "controlling influence" prong of "control" involves a fact-based determination regarding whether a company has the ability to exercise a controlling influence over another company
- The meaning of the "controlling influence" prong of the definition historically was developed primarily through staff determinations on individual transactions, often without any public notice or comment
- In January 2020, the Federal Reserve issued a final rule to review and codify its approach to the controlling influence prong
  - Styled as presumptions that would be applied in control proceedings by the Federal Reserve, although such proceedings have not occurred in decades
  - Codified many existing standards, but introduced new concepts
- Final rule was to become effective on April 1, 2020, but implementation was delayed until September 30, 2020 due to COVID-19
  - Supervisory grandfathering of certain existing structures
  - Interpretive FAQs issued on September 30, 2020

Presumptions

- Centerpiece of the final rule is a tiered framework of presumptions of control based on a First Company's voting interest percentage in the Second Company
  - As the First Company's voting interest percentage in the Second Company increases, other factors through which the First Company could exercise a controlling influence generally must decrease in order to avoid triggering the application of a presumption of control
- The final rule includes several standalone presumptions of control in addition to, and separate from, the presumptions of control that comprise the tiered framework
  - The First Company is presumed to control the Second Company if it triggers any of the standalone presumptions
  - Presumptions for divestiture of control and non-control are also addressed through standalone presumptions

Tiered Framework

	(Presumption triggered if any relationship exceeds the amount on the table)			
	Less than 5%	5-9.99%	10-14.99%	15-24.99%
Directors	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
Director Service as Board Chair	N/A	N/A	N/A	No director representative is chair of the board
Director Service on Board Committees	N/A	N/A	A quarter or less of a committee with power to bind the company	A quarter or less of a committee with power to bind the company
Business Relationships	N/A	Less than 10% of revenues or expenses of the second company	Less than 5% of revenues or expenses of the second company	Less than 2% of revenues or expenses of the second company
Business Terms	N/A	N/A	Market Terms	Market Terms
Officer/Employee Interlocks	N/A	No more than 1 interlock, never CEO	No more than 1 interlock, never CEO	No interlocks
Contractual Powers	No management agreements	No rights that significantly restrict discretion	No rights that significantly restrict discretion	No rights that significantly restrict discretion
Proxy Contests (directors)	N/A	N/A	No soliciting proxies to replace more than permitted number of directors	No soliciting proxies to replace more than permitted number of directors
Total Equity	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less

Standalone Presumptions

- **Management agreements:** Control is presumed if the First Company enters into a management agreement with the Second Company
- **Investment advice and investment funds:** Control is presumed if the First Company (i) serves as investment adviser to a Second Company that is an investment fund and (ii) controls 5 percent or more of any class of voting securities or 25 percent or more of the total equity of the Second Company
  - Twelve month seeding period exclusion
  - Apparent rejection of 1999 letter permitting retention of up to 25 percent of voting securities of a mutual fund
- **Accounting consolidation:** Control is presumed if the First Company consolidates the Second Company under US GAAP

Divestiture and Non-Control Presumptions

- **Divestiture:** The First Company is no longer deemed to control the Second Company if the First Company:
  - Divests its voting interest in the Second Company to less than 15 percent or
  - Divests its voting interest in the Second Company to less than 25 percent and waits two years
  - Divestiture presumption does not apply if a majority of each class of voting securities of the Second Company would be controlled by a single unaffiliated individual or company after the divestiture by the First Company
- **Non-Control:** The First Company is presumed not to control the Second Company if the First Company (**i**) controls less than 10 percent of every class of voting securities of the Second Company and (**ii**) is not presumed to control the Second Company under any of the presumptions of control

NSFR Requirement: Finalization and Implementation

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NSFR Requirement Background

- NSFR requirement is a quantitative liquidity standard that was originally adopted in October 2014 by the Basel Committee on Banking Supervision (BCBS) as part of the Basel III regime
  - Focuses on mid-range liquidity (i.e., funding required over the next year)
- US regulators adopted their version of the NSFR requirement in October 2020
  - US version differs from BCBS standard
  - US version is effective July 1, 2021
  - Federal Reserve will propose corresponding changes to the FR 2052a
  - NSFR requirement is different from the liquidity coverage ratio (LCR) and non-standardized liquidity requirement in EPS

Scope

- NFSR requirement will be for covered companies:
  - Includes Category I institutions, Category II institutions, and some Category III institutions (i.e., those with $75 billion or more in average weighted short-term wholesale funding (wSTWF))
  - A modified version of the NSFR rule will apply to the other Category III institutions and certain Category IV institutions (i.e., those with $50 billion or more in average wSTWF)
  - Some depository institution subsidiary of covered companies also will be subject to the NSFR requirement
  - Will not apply to foreign banking organizations (FBOs) or US branches and agencies of FBOs

NSFR requirement

- Covered company will need to maintain an amount of available stable funding (ASF) that is not less than the amount of its required stable funding (RSF) on an ongoing basis
  - Modified NSFR requirement for smaller covered companies sets the ASF coverage amount at 70 percent or 85 percent of the RSF
  - Calculated on a consolidated basis that accounts for transfer restrictions (e.g., Regulation W)
- Covered company must disclose information on its NSFR and components in a standardized format
  - Initial disclosure will be made 18 months after a covered company becomes subject to the NSFR rule
  - Subsequent quarterly disclosures must be made twice a year (e.g., Q1 and Q2 disclosures may be posted after Q2)

RSF Calculation

- RSF amount will be based on the liquidity characteristics of a covered company's assets, derivative exposures, and commitments
  - RSF amount calculated by multiplying carrying values of assets, undrawn amounts of commitments, and measures of derivative exposures by assigned RSF factors (scaled from 0% to 100%)
  - A 0% RSF factor will not require the asset, derivative exposure, or commitment to be supported by ASF
  - A 100% RSF factor will require the asset, commitment, or derivative exposure to be fully supported by ASF
- RSF factors assigned based on (**i**) credit quality, (**ii**) tenor, (**iii**) type of counterparty, (**iv**) market characteristics, and (**v**) encumbrance

ASF Calculation

- ASF amount will be based on the stability characteristics of a covered company's qualifying liabilities and regulatory capital elements
  - ASF amount calculated by multiplying qualifying liabilities or regulatory capital elements by assigned ASF factors (scaled from 0% to 100%)
  - 0% ASF factor for lowest stability funding
  - 100% ASF factor for most stable funding
- ASF factors assigned based on (**i**) funding tenor, (**ii**) funding type, and (**iii**) counterparty type
  - ASF factors are not linked to RSF factors, and neither one is directly linked to the LCR requirement

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Derivatives Transactions

- RSF and ASF amounts related to derivative transactions are calculated using the approach from the LCR rule:
  - Current value of a covered company's derivatives assets and liabilities;
  - Initial margin provided by a covered company pursuant to derivative transactions and assets contributed by a covered company to a central counterparty's mutualized loss sharing arrangement in connection with cleared derivative transactions
  - Potential future changes in the value of a covered company's derivatives portfolio
- If total derivative assets exceed derivative liabilities, then net amount is assigned a 100% RSF factor
- If total derivative liabilities exceed derivative assets, then net amount is not considered ASF
- Includes RSF factor add-ons for potential future changes and certain CCP arrangements

EPS: Further Tailoring Efforts

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EPS Background

- Section 165 of the Dodd-Frank Act required the Federal Reserve to adopt heightened capital, liquidity, risk management, and stress testing requirements for certain large US BHCs and FBOs
  - EPS were initially adopted in February 2014 and became effective in 2015 and 2016
    - EPS included the US intermediate holding company (IHC) requirement for certain FBOs
  - Subsequently supplemented with total loss absorbing capacity (TLAC), long-term debt (LTD), and clean holding company requirements, single-counterparty credit limits, and qualified financial contract requirements
  - EPS for certain SLHCs were added in 2019

EPS Tailoring

- Section 401 of the Economic Growth, Regulatory Relief, and Consumer Protection Act amended Section 165 to recalibrate the application of EPS
  - Raised the general threshold for application of EPS from $50 billion in total consolidated assets to $250 billion
    - Also increased the threshold for application of resolution planning requirement
  - Retained the option for the Federal Reserve to apply EPS to institutions with between $100 billion and $250 billion in total consolidated assets

Tailoring Implementation

- Federal Reserve began implementing Section 401 through series of rulemakings in 2019 and 2020
  - Federal Reserve was simultaneously tailoring the application of capital planning and stress testing requirements on its own initiative, which partially overlapped with the EPS tailoring
  - Some EPS tailoring involved joint rulemakings with the OCC and FDIC (e.g., stress testing, resolution planning)

Categories Approach

- US regulators adopted a "categories approach" for tailoring the application of EPS to larger institutions, including certain US BHCs, SLHCs, IHCs, and FBOs:
  - **Category I:** US global systemically important banks (G-SIBs)
  - **Category II:** Institutions with $700 billion or more in assets or significant cross-jurisdictional activity
  - **Category III:** Institutions with $250 billion or more in assets or significant nonbank assets, weighted short-term wholesale funding (wSTWF), or off-balance sheet exposure
  - **Category IV:** Institutions with $100 billion to $250 billion in assets
  - **Other Firms:** Institutions with $50 billion to $100 billion in assets
- Further tailoring of and within categories based on level of wSTWF and size of combined US operations

Example: Capital Requirements

Category I	Category II	Category III	Category IV	Other Firms
• TLAC/LTD • Annual capital stress testing and planning • Risk-based capital o G-SIB surcharge o Advanced approaches o Countercyclical buffer o AOCI capital impact • Leverage capital o Enhanced supplementary leverage ratio	• Annual capital stress testing and planning • Risk-based capital o Advanced approaches o Countercyclical buffer o AOCI capital impact • Leverage capital o Supplementary leverage ratio	• Biennial company-run capital stress testing • Annual supervisory capital stress testing and planning • Risk-based capital o Countercyclical buffer o AOCI capital opt-out • Leverage capital o Supplementary leverage ratio	• Biennial supervisory capital stress testing • Annual capital planning • Risk-based capital o AOCI capital opt-out • Leverage capital	• Risk-based capital o AOCI capital opt-out • Leverage capital

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Other Recent Developments with EPS

- Federal Reserve has continued to tailor EPS and related requirements under Section 401 and other regulatory reform initiatives
  - Integration of categories approach in final NSFR requirement
  - Integration of categories approach in revised capital planning and new stress capital buffer requirements, including SR 15-18/SR 15-19
  - Modification of advanced approaches capital requirements to deduct certain investments in unsecured debt instruments issued by US and non-US G-SIBs (also flows through to TLAC and LTD requirements)
  - Integration of categories approach in setting of supervisory assessments
- Further tailoring of reporting forms and stress testing and capital planning expectations is expected

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Questions?

Jeffrey P. Taft
Partner
+1 202 263 3293
jtaft@mayerbrown.com

Matthew Bisanz
Associate
+1 202 263 3434
mbisanz@mayerbrown.com

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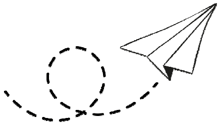

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