IFLR Webinar

Basel III American Style: Proposed Changes to the U.S. Regulatory Capital Framework

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Presentation
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The Banking Agencies’ New Regulatory Capital Proposals

On June 12, 2012 the Federal banking agencies (the Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation) (the “Agencies”) formally proposed for comment, in a series of three separate but related proposals (each a “Proposal, and collectively the “Proposals”), substantial revisions to the U.S. regulatory capital regimen for banking organizations that, if adopted, will have a significant impact on the entire U.S. banking industry.1 Based on the core requirements of the 2011 international Basel III Accord (“Basel III”),2 and in significant part on the “standardized approach” for the weighting and calculation of risk-based capital requirements under the 2004-2006 Basel II Accord (“Basel II”),3 the Proposals will extend large parts of a regulatory capital regime that was originally intended only for large, internationally active banks to all U.S. banks and their holding companies, other than the smallest bank holding companies (generally, those with under $500 million in consolidated assets).

In addition, the Proposals incorporate aspects of Basel III that would apply only to those banking organizations that are subject to the “advanced approaches” or market risk rules under Basel II, including qualifying Federal and state savings associations and their holding companies. Under U.S. requirements, a banking organization is subject to the advanced approaches rules if it has consolidated assets greater than or equal to $250 billion, or if it has total consolidated on-balance sheet foreign exposures of at least $10 billion.4 The market risk capital rule currently applies to any bank with aggregate trading assets and trading liabilities equal to 10 percent or more of total assets or at least $1 billion.

The Proposals do not address the global liquidity requirements that were also a part of Basel III. The Agencies have indicated, however, that they expect to propose rules implementing these requirements in the near future. In addition, the Proposals do not address the capital surcharge requirements applicable to systemically important financial institutions (banking organizations with consolidated assets of $50 billion or more) that are expected to be developed in the near future under section 165 of the Dodd-Frank Act.5

Comments on the Proposals are due by September 7, 2012.

Due to the scope and complexity of these Proposals, we expect to report separately on specific aspects of them, including their impact on financial instruments, derivatives activities, and securitization activities.

The Run-Up to the Current Proposals

In 2004, the Basel Committee published comprehensive revisions to the legacy 1988 Basel Capital Accord. Basel II retained the basic requirements of the legacy risk-based capital scheme, namely, a total capital to risk-weighted assets requirement of 8 percent, and the existing definitions of core and total capital. The new accord, however, significantly increased the risk sensitivity of assets held on the banking book, and created a framework for covered banking organizations to calculate their risk-based capital under one of two major approaches: the “standardized approach,” which would require banking organizations to calculate their risk-based capital according to quantitative inputs provided by national banking supervisors; and the “internal ratings
based” (“IRB”) approach, under which covered banking organizations would calculate their risk-based capital requirements using a combination of external credit ratings and internal risk models that would be applied to general credit exposures and securitization exposures. In turn, the IRB approach was subdivided into the “foundation IRB approach” where banking organizations would rely primarily on external regulatory inputs for the key risk-based capital calculation components, and the “advanced IRB approach” where eligible banking organizations (“advanced approaches banking organizations”) would calculate their risk-based capital requirements primarily based on internal risk models (approved for each banking organization by its national supervisor). Basel II was also configured as a “three pillar” framework requiring specific risk-based capital requirements for credit risk, market risk, and operational risk (Pillar 1), supervisory review of capital adequacy (Pillar 2), and market discipline through enhanced public disclosures (Pillar 3).

In the wake of the financial crisis that culminated in late 2008, the international banking supervisors, including the Agencies, concluded that the financial crisis revealed significant issues about the transparency, sufficiency and resilience of regulatory capital – both risk-based and leverage – that impaired the ability of banking organizations around the world to withstand financial shocks, which in turn contributed to the severity of the financial crisis. To address these concerns about the overall quality of regulatory capital, the Basel Committee undertook a review of the core components of regulatory capital, and in 2010 published Basel III, which was later revised in 2011. In addition, the Basel Committee made a number of changes to Basel II in 2009 and 2010 to address perceived shortcomings in the existing risk-weighting framework that were revealed by the financial crisis.

In contrast to Basel II, Basel III was entirely a product of the financial crisis. Basel III included a more restrictive definition of regulatory capital, higher minimum regulatory capital requirements, and capital conservation and countercyclical capital buffers, to better enable banking organizations to absorb losses and continue to operate as financial intermediaries during periods of financial and economic stress. Basel III also placed limits on banking organizations’ capital distributions and certain discretionary bonuses if they did not hold specified “buffers” of common equity Tier 1 capital in excess of the new minimum capital requirements. More specifically, Basel III redefined the components of core (Tier 1) capital by subdividing Tier 1 capital into two components: (i) “common equity Tier 1” capital, consisting of common equity and equivalent capital instruments, plus retained earnings, and (ii) “Additional Tier 1” capital, consisting of capital instruments with features of common equity but which, in the Basel Committee’s view, lacked the level of capital resilience presented by common tangible equity capital. In turn, Basel III created new quantitative requirements that would require affected banking organizations to maintain the preponderance of their Tier 1 capital in tangible common equity, and would increase the levels of Tier 1 and total risk-based capital that banking organizations would be required to hold.

In addition, Basel III proposed a general leverage capital requirement that previously had not been a part of the Basel regulatory capital framework. Moreover, to address concerns that banking organizations did not build up and maintain levels of regulatory capital that were adequate in times of financial stress, Basel III introduced a separate capital conservation buffer of up to 2.5 percent of total risk-weighted assets to consist of common equity Tier 1 capital, as well as a countercyclical buffer of potentially up to 2.5 percent of total risk-weighted assets to be implemented, on a national basis, through an
extension of the capital conservation buffer/ratios and corresponding restrictions on capital distributions and discretionary compensation payments to employees.

Finally, to address perceived lapses in banking organizations’ liquidity during the early stages of the financial crisis, as well as the failure of banking organizations to have in place liquidity and liquidity risk management practices adequate to assure the availability and proper management of liquidity in times of financial stress, Basel III introduced a twofold global liquidity standard. These liquidity requirements include (i) a liquidity coverage ratio to promote resilience to potential liquidity disruptions over a thirty-day horizon, and (ii) a net stable funding ratio that would require a minimum amount of stable sources of funding relative to the liquidity profiles of the assets, plus contingent liquidity needs arising from off-balance sheet commitments, over a one-year horizon.

Both Basel II and Basel III provided for extended transition periods in order to give affected banking organizations adequate time to develop and implement the required architectures and infrastructures. Basel II was to have been applied by covered banking organizations on a phased-in basis and fully effective for years after 2008. Implementation in the U.S., however, was substantially delayed until 2007, and was only in the early phases of implementation for U.S. banking organizations subject to the “advanced approaches” when the 2008 financial crisis overcame implementation efforts. Basel III provides for a transition period beginning in 2013 (2015, in the case of the required liquidity ratios), under which covered banking organizations are expected to comply with a series of gradually increasing risk-based and leverage capital measures, with full implementation generally expected by the end of 2018.

During the same period of time, the European Union has undertaken its own separate revisions to its regulatory capital rules. In July 2011, the EU Commission published a provisional draft of its much-awaited legislation in the form of a Capital Requirements Directive and Capital Requirements regulation (together known as CRD4), to implement Basel III into EU law. The European Parliament and the Council of the EU are still considering the EU Commission’s proposals, and have offered compromise proposals of their own. The Commission has stated its intention for CRD4 to become effective on January 1, 2013, and in line with the Basel Committee’s expectations on the implementation timing for Basel III. The EU Commission has also stated that if other jurisdictions do not follow Basel III’s implementation timetable, it will “draw all the necessary conclusions in due time.” Whereas Basel II and Basel III focus only on internationally active banks, the existing Capital Requirements Directive in Europe currently applies to all European banks, as well as to European investment firms in general. The proposed CRD4 directive and regulation will retain this approach and will require corresponding adaptations of Basel III.

The Agencies’ Proposals

Since the Basel III standards were published, the Agencies have been working to develop regulations to implement its requirements in the U.S. By its terms, Basel III applies only to large, internationally active banking organizations – in essence the same banking organizations that were subject to Basel II. At the same time, a continuing issue for the Agencies was the extent to which they believed it was necessary or appropriate to extend the Basel III elements beyond the large banking organizations to the broader banking industry.
The Proposals are a clear answer to this question: the Basel III Proposal, and much of the Standardized Approach Proposal, will apply to all U.S. banks and savings banks and almost all of their holding companies, although smaller, “non-complex” banking organizations will not need to comply with all of the Standardized Approach Proposal’s requirements. Only the Advanced Approaches Proposal is limited in its applicability to the largest U.S. banks. Accordingly, U.S. banks that previously thought that Basel II and Basel III were academic exercises for them now are confronted with the challenge of coming up to speed on these aspects of the Proposals in a short period of time.

In addition, the Proposals are intended to complete a core regulatory capital directive of the Dodd-Frank Act, namely to delineate and apply to all U.S. banking organizations “generally applicable” capital requirements as directed by section 171 of the Dodd-Frank Act (the “Collins Amendment”). In this respect, the Agencies have stated plainly that the proposed regulations, if adopted, collectively will become the generally applicable capital requirements for purposes of the Dodd-Frank Act.

A. The Basel III Proposal

Applicability

The Basel III Proposal would apply to all U.S. banks that are subject to minimum capital requirements, including Federal and state savings banks, as well as to bank holding companies other than “small bank holding companies” (generally, bank holding companies with consolidated assets of less than $500 million).

General Elements of the Basel III Proposal

The Basel III Proposal, if adopted, would apply to U.S. banking organizations the general requirements for regulatory capital previously proposed in Basel III. In fact, with some exceptions, the Basel III Proposal closely tracks the requirements of its namesake Basel III. Specifically, the Basel III Proposal would do the following:

- It would revise the definition of regulatory capital components and related calculations, and would add a new regulatory capital component, namely, common equity Tier 1 capital.
- It would require a variety of new deductions from regulatory capital and impose new and substantial limitations on the treatment of qualifying minority interests as Tier 1 capital.
- It would increase the minimum Tier 1 capital ratio requirement.
- It would incorporate the new and revised regulatory capital requirements into the Agencies’ respective Prompt Corrective Action (“PCA”) capital categories.
- It would create a new capital conservation buffer framework that would limit payment of capital distributions and certain discretionary bonus payments to executive officers and their functional equivalents if the banking organization does not hold certain amounts of common equity Tier 1 capital in addition to those needed to meet its minimum risk-based capital requirements.
- It would provide for a series of transition periods for implementation of the proposed rule, including phase-in/phase-out periods for certain non-qualifying capital instruments, the new minimum capital ratio requirements, the capital...
conservation buffer, and the regulatory capital adjustments and deductions. By 2019, the new capital requirements would be fully effective.

These changes would apply to all U.S. banking organizations, large and small (other than small bank holding companies). The changes, and some implications of these changes, are discussed below.

Revised Definitions and Calculations of Capital

A banking organization’s Tier 1 capital would consist of its common equity Tier 1 capital and its additional Tier 1 capital. Total Tier 1 capital, plus Tier 2 capital, would make up the banking organization’s total risk-based capital requirement.

Common equity Tier 1 capital would be the sum of its outstanding common equity Tier 1 capital instruments and related surplus (net of treasury stock), retained earnings, accumulated other comprehensive income (“AOCI”), and common equity Tier 1 minority interest, minus certain adjustments and deductions specified. In this regard, unrealized gains and losses on all available-for-sale securities held by the banking organization would flow through to common equity Tier 1 capital, a result that is not fully consistent with Basel III, which does not require common equity Tier 1 capital adjustments for unrealized gains and losses that are recognized on the balance sheet. Qualifying common equity Tier 1 capital would have to satisfy 13 criteria that are generally designed to assure that the capital is perpetual and is unconditionally available to absorb first losses on a going-concern basis, especially in times of financial stress (see Appendix A).

Additional Tier 1 capital would be the sum of additional Tier 1 capital instruments that satisfy 13 separate criteria (14 for advanced approaches banking organizations), related surplus, and Tier 1 minority interests that are not included in a banking organization’s common equity Tier 1 capital, minus applicable regulatory adjustments and deductions. The 14 criteria in question generally are designed to assure that the instrument is available to absorb going-concern loss and does not possess credit sensitive or other terms that would impair its availability in times of financial stress (see Appendix A). Among other things, a banking organization that issues an additional Tier 1 capital instrument must limit capital distributions on the instrument to distributions that are paid out of net income and retained earnings, and must retain the ability to cancel dividends without triggering an event of default. The instrument must be perpetual in nature, have limited call rights that are exercisable only with the approval of the issuer’s supervisory agency, must not have features that suggest or encourage redemption or discourage the issuance of additional capital instruments, and must be accounted as equity in accordance with generally accepted accounting principles (“GAAP”).

Tier 2 capital of a banking organization similarly must satisfy 10 separate criteria (11 for advanced approaches banking organizations), all of which are designed to assure adequate subordination and stability of availability (see Appendix A). An advanced approaches banking organization may include the excess of eligible credit reserves over its total expected credit losses (“ECL”) to the extent that such amount does not exceed 0.6 percent of its total credit risk-weighted assets.

The proposed criteria for common equity and additional Tier 1 capital instruments, and Tier 2 capital instruments, are broadly consistent with the Basel III criteria.
important consequence of these definitions is that non-cumulative perpetual preferred stock, which now qualifies as simple Tier 1 capital, would not qualify as common equity Tier 1 capital, but would qualify as additional Tier 1 capital. Further, cumulative preferred stock and trust preferred securities (“TruPS”) no longer will qualify as Tier 1 capital of any kind. In turn, banking organizations that have TruPS outstanding will need to evaluate and seek advice on whether the impact of the Basel III Proposal on outstanding TruPS will permit or require a call or redemption of their specific securities.

Moreover, other hybrid or other innovative capital instruments presumably will not satisfy the criteria for common equity Tier 1 capital, although some of these instruments might qualify as additional Tier 1 capital. In addition, minority interests in consolidated subsidiaries (discussed further below) would be subject to substantially stricter treatment than under the current capital rules. Certain capital instruments, however, such as those issued under the Emergency Economic Stabilization Act (e.g., TARP preferred securities) or the Small Business Jobs Act of 2010, would be grandfathered permanently from exclusion as Tier 1 capital instruments (a departure from Basel III and CRD4) and treated as additional Tier 1 capital.

The upshot of these new definitions will be to sharply reduce the capital instruments that are eligible for common equity Tier 1 capital treatment, which will make non-qualifying instruments ineligible for satisfaction of the new common equity Tier 1 capital ratio (discussed below). Some of these now-ineligible instruments may qualify for additional Tier 1 capital treatment, but they would not include instruments that are accounted for as liabilities under GAAP, inasmuch as one of the criteria for additional Tier 1 capital is that qualifying instruments must be accounted for as equity under GAAP – a financial reporting requirement on which Basel III (and CRD4 in Europe) is silent.

The Agencies believe that the impact of the new requirements on most perpetual non-cumulative preferred securities, and most Tier 2 debt instruments, should be modest, and therefore should be less of a compliance issue for affected banking organizations; whether this in fact proves to be the case, however, remains to be seen. At the same time, the Basel III Proposal suggests that the Agencies may be willing to consider the inclusion of new capital instruments – e.g., new contingent capital instruments – as additional Tier 1 capital, although it begs the question as to how much flexibility the Agencies have allowed themselves in this regard under the Basel III Proposal.

The Agencies also believe that the Basel III Proposal and U.S. law (including the requirements of the Dodd-Frank Act) are consistent with the Basel III non-viability standard, namely, that non-common stock capital instruments issued by a covered banking organization include terms that subject the instrument to write-off or conversion to common equity at the point at which the banking organization’s supervisory authority determines that a write-off or conversion is required, or that governmental or public sector capital assistance would be needed to keep the banking organization solvent. For this reason, the Agencies have not proposed specific non-viability loss absorption (or “bail in”) requirements or triggers, unlike the Basel Committee’s recommendations and the proposed European capital regulations. Advanced approaches banking organizations, however, would have to disclose in the instrument’s governing documentation that claims on such instruments may be fully subordinated to interests held by the U.S. government in the event of an insolvency or a similar proceeding.
**Leverage Requirement.** Consistent with Basel III, the Basel III Proposal sets forth separate leverage capital requirements, measured as a ratio of Tier 1 capital to average on-balance-sheet assets, for affected banking organizations. Advanced approaches banking organizations would be subject to a new and separate supplementary leverage ratio, which according to the Agencies specifically is designed to implement the Basel III leverage ratio requirement. Under this requirement, these banking organizations would maintain capital not only against their on-balance-sheet assets (less amounts deducted from Tier 1 capital), but also certain off-balance sheet assets. Covered off-balance sheet exposures would include future exposure amounts arising under certain derivatives contracts, 10 percent of the notional amount of unconditionally cancellable commitments, and the notional amount of most other off-balance-sheet exposures (excluding securities lending and borrowing, reverse repurchase agreement transactions, and unconditionally cancellable commitments).

The leverage requirement does not create any new capital obligations for U.S. banking organizations, inasmuch as U.S. banks and their holding companies have long been subject to leverage capital requirements, although it does raise the general minimum leverage ratio for all banks (including the strongest banks) to 4 percent. The supplementary leverage ratio requirement that would apply to advanced approaches banking organizations, however, could in some instances have a meaningful impact on the amount of leverage capital that a large U.S. banking organization might be required to maintain, and arguably could decrease the attractiveness of such exposures for these banking organizations. At the same time, these requirements would not appear to be “written in stone,” in that the Basel Committee has indicated that it intends to evaluate the Basel III leverage requirement through supervisory monitoring during a “parallel run” period, and presumably the Agencies would seek to coordinate their implementation efforts with the activities of their international counterparts.

**Exclusions and Deductions from Capital**

One of the significant aspects of the Basel III Proposal are the nature and scope of the exclusions and deductions from regulatory capital that would be required. Although the specific deductions again are broadly consistent with the requirements of Basel III, they would change in several important respects the current treatment of certain balance sheet items for regulatory capital purposes, especially for banking organizations that had expected (or hoped) that they would not be subject to Basel III.

The required exclusions and deductions would be:

- Deductions of goodwill and other intangibles from common equity Tier 1 capital, other than certain mortgage servicing assets.
- Deductions of carry-forward deferred tax assets, and nonrealizable carry-back deferred tax assets (subject to certain thresholds).
- Deductions from common equity Tier 1 capital of after-tax gain-on-sale associated with securitization exposures.
- Deductions from common equity Tier 1 capital of defined benefit pension fund assets other than those to which the banking organization has “unfettered access” (with supervisory approval).
• Deductions for Federal and state savings association subsidiaries engaged in activities that are impermissible for a national bank (note that this is not part of Basel III).

• Exclusion from common equity Tier 1 capital of unrealized gains and losses on certain cash flow hedges.

• Adjustments to common equity Tier 1 capital to reflect unrealized gains and losses resulting from changes in the banking organization’s own creditworthiness.

• Deductions of direct and indirect investments in a banking organization’s own regulatory capital instruments.

• Deductions of direct, indirect and synthetic investments in the capital instruments of unconsolidated “financial institutions” (a broadly defined term that is designed to capture any entity whose primary business is financial activities) where such investments exceed certain thresholds.

• Deductions of reciprocal cross-holdings in the capital instruments of financial institutions.

Investments in financial institutions are subdivided into “significant” (investments of more than 10 percent of the outstanding common shares or common share equivalents of the target entity) and “non-significant” investments (investments of 10 percent or less of the outstanding common shares and capital equivalents of the target entity). Significant common share investments would be deducted from common equity Tier 1 capital, subject to the deduction thresholds discussed below.

A potentially complicating aspect of the deductions for financial institution instruments is that the deduction applies to indirect (e.g., holdings through an equity index) and (in the case of financial institution investments) synthetic holdings, as well as direct holdings. This expansive application will pose a challenge to banking organizations that otherwise might elect to restructure their direct holdings into holdings that are not subject to deduction.

Significant unconsolidated financial institution common stock investments, non-realizable carry-back deferred tax assets, and mortgage servicing assets net of deferred tax liabilities would be deducted from common equity Tier 1 capital if they individually exceed a 10 percent common equity Tier 1 capital threshold (equal to 10 percent of common equity Tier 1 capital minus certain adjustments to and deductions from Tier 1 common equity). In addition, the sum total of the items that are not deducted under the 10 percent threshold could not exceed 15 percent of a banking organization’s common equity Tier 1 capital, after applying all required regulatory adjustments and deductions to capital.

In calculating the deductions required for reciprocal cross-holdings of capital instruments, significant non-common stock financial institution investments, and non-significant financial institution investments, banking organizations would use the “corresponding deduction” approach, under which the banking organization is required to deduct an item from the same component of capital for which the instrument in question would qualify if it were issued by the banking organization itself.
Treatment of Minority Interests. Basel III reflects the general view of the international banking supervisors that minority interests – third party capital investments in a consolidated subsidiary of a banking organization – were not sufficient to absorb losses at the consolidated parent organization level. Basel III and the Basel III Proposal therefore limit the types and amounts of qualifying minority interests that can be included in Tier 1 capital.

Minority interests would be classified as a common equity Tier 1, Tier 1, or total capital minority interest depending on the underlying capital instrument and on the type of subsidiary issuing such instrument. In addition to meeting the eligibility criteria for common equity and additional Tier 1 capital, and Tier 2 capital (whichever is applicable under the circumstances), qualifying common equity Tier 1 minority interests would be limited to a depository institution or foreign bank that is a consolidated subsidiary of a banking organization. In addition, the limits on the amount of minority interest that may be included in the consolidated capital of a banking organization would be based on a formulaic amount of capital held by the consolidated subsidiary, relative to the amount of capital that the subsidiary would have to hold in order to avoid any restrictions on capital distributions and discretionary bonus payments under the capital conservation buffer framework discussed below.

Real estate investment trust (“REIT”) preferred shares, which up to now have qualified as Tier 1 capital of the banking organization, would not qualify for common equity Tier 1 capital treatment, but could qualify as additional Tier 1 or Tier 2 capital under the same general rules as are applicable to other qualifying minority interests. The REIT would have to qualify as an operating entity that is set up to conduct business with the intention of earning a profit in its own right. In addition, since REITs must distribute 90 percent of their earnings in order to maintain their tax status, REITs would be required to have the ability to declare consent dividends (dividends that are declared but retained by the REIT) in order to qualify for additional Tier 1 capital treatment.

Minimum Capital Requirements

The Basel III Proposal would require that banking organizations satisfy the following minimum capital ratios: (i) a common equity Tier 1 capital ratio of 4.5 percent; (ii) a Tier 1 capital ratio of 6 percent; (iii) a total capital ratio of 8 percent; and (iv) a Tier 1 capital to average consolidated assets of 4 percent and, for advanced approaches banking organizations only, an additional leverage ratio of Tier 1 capital to total leverage exposure of 3 percent. As noted above, the common equity Tier 1 capital ratio would be a new minimum requirement. As discussed below, these capital levels would be phased in over a multi-year period beginning in 2013 and ending in 2018.

Capital Conservation Buffer

Consistent with Basel III, the Basel III Proposal would create a capital conservation buffer for all covered banking organizations that would be phased in starting in 2016, and would require additional regulatory capital of 2.5 percent on a fully phased-in basis by January 1, 2019. The capital conservation buffer would be applied to the lowest of the following three ratios: the banking organization’s common equity Tier 1, its Tier 1 and total capital ratio less its minimum common equity Tier 1, or its Tier 1 and total capital ratio requirement, respectively. Besides being designed to bolster the resilience of banking organizations throughout financial cycles, one primary purpose of the capital
A capital conservation buffer is to limit the ability of a banking organization to make capital distributions and discretionary bonus payments to executive officers and persons with commensurate responsibilities unless the banking organization has sufficient capital over and above its minimum capital requirements to safely make those payments.

Under the Basel III Proposal, a “capital distribution” means: (i) a reduction of Tier 1 capital (by repurchase or otherwise); (ii) a reduction of Tier 2 capital (by repurchase or early redemption or otherwise); (iii) a dividend on Tier 1 capital; (iv) a dividend or interest payment on Tier 2 (where the banking organization has discretion to suspend that payment); and (v) any substantively similar transaction. In turn, a “discretionary bonus payment” to an executive officer (generally defined as a titled executive or person with commensurate executive responsibilities) is any payment where (i) the banking organization retains discretion as to whether to pay or the amount of payment, (ii) the amount paid is determined without prior promise to, or agreement with, the officer, and (iii) the executive officer has no contractual right to the payment. Depending on the extent to which a banking organization met its capital conservation buffer requirements, capital distributions and bonus payouts would be limited to specified payout ratios.

Banking organizations that are not subject to the Basel II advanced approaches rule would calculate their capital conservation buffer using total risk-weighted assets as calculated by all banking organizations, and banking organizations subject to the advanced approaches rule would calculate the buffer using advanced approaches total risk-weighted assets. The principle behind this distinction is that internationally active U.S. banking organizations using the advanced approaches would be expected to maintain capital conservation buffers comparable to those of their foreign competitors.

**Countercyclical Capital Buffer**

The countercyclical capital buffer, which is a supplemental capital requirement that is designed to take into account the macro-financial environment in which large banking organizations operate, would be applied only to advanced approaches banking organizations, consistent with the requirements of Basel III. On a fully phased-in basis, the countercyclical capital buffer would be additional regulatory capital of up to 2.5 percent of total risk-weighted assets. The countercyclical capital buffer would augment the capital conservation buffer upon a joint determination by the Agencies. The countercyclical capital buffer amount in the U.S. would initially be set at zero, but would increase if the Agencies determined that there is excessive credit in the markets, possibly leading to subsequent widespread market failures. The Agencies expect to consider a range of macroeconomic, financial, and supervisory information indicating an increase in systemic risk. Because the countercyclical capital buffer amount would be linked to the condition of the overall U.S. financial system and not the characteristics of an individual banking organization, the Agencies propose to apply the countercyclical capital buffer amount consistently at the depository institution and holding company levels.

**Changes to Prompt Corrective Action Rules**

Although not required by Basel III itself, the Basel III Proposal would amend the Agencies’ PCA regulations under section 38 of the Federal Deposit Insurance Act to assure consistency with the new regulatory capital requirements. Specifically, the Agencies propose to:
• augment the existing five PCA capital categories (well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized) by introducing the common equity Tier 1 capital measure for four of the five PCA categories (excluding the critically undercapitalized PCA category); and
• for advanced approaches banking organizations, include in the leverage measure for the “adequately capitalized” and “undercapitalized” capital categories an additional leverage ratio based on the leverage ratio in Basel III.

All banking organizations would continue to be subject to leverage measure thresholds using the current “standard” leverage ratio of Tier 1 capital to total assets. Further, the Agencies would revise the three current capital measures for the five PCA categories to reflect the changes to the definition of capital, as provided in the proposed revisions to the agencies’ PCA regulations.9

**Transitional Periods**

The Basel III Proposal provides for a series of transitional and phase-in provisions for the new capital rules. According to the Agencies, they are intended to give banking organizations adequate time to comply with the new capital requirements and also be compliant with the Dodd-Frank Act. Almost all of the requirements proposals under the Basel III proposal would be fully effective by January 1, 2019. In general, the transition provisions are as follows:

**Phase-in of Minimum Capital Ratios.** The minimum common equity and Tier 1 capital ratios would be phased in beginning in the 2013 calendar year with a common equity requirement of 3.5 percent and a Tier 1 requirement of 4.5 percent for that year; 4.0 percent and 5.5 percent, respectively, for the 2014 calendar year; and fully effective (4.5 percent and 6.0 percent, respectively) for the 2015 calendar year and thereafter.

**Phase-in of Regulatory Capital Adjustments and Deductions.** The required regulatory capital adjustments and deductions will be phased in beginning in 2013 and fully phased in by 2018. The phase-in sequence consists of a series of formulae that would apply different phase-in requirements and transitional capital treatment of adjusted or non-qualifying items according to the specific nature of the item. For example, the transition method for several capital deduction items (such as deferred tax assets, securitization gain-on-sales, and defined benefit pension fund assets) is a straight-line percentage deduction sequence (0 percent of required deductions in 2013, 20 percent of required deductions in 2014, and so forth) that requires full (100 percent) deductions in the calendar year 2018. Deductions for goodwill from common equity Tier 1 capital, however, are subject to no transitional phase-in and must be fully deducted beginning in the calendar year 2013.

**Phase-out of Non-qualifying Capital Instruments.** The phase-out transition period for these instruments begins in the calendar year 2013. The exact phase-out period, however, is different for banking organizations with at least $15 billion in total assets than it is for banking organizations under that threshold. For the larger banking organizations, the transition method for nonqualifying capital instruments is a straight-line percentage inclusion sequence (75 percent of non-qualifying instruments may be
included in Tier 1 or Tier 2 capital in 2013, 50 percent may be included in 2014, and so forth), with full effectiveness in 2016. For banking organizations with under $15 billion in total assets, the transition period begins (again on a straight-line basis) in 2013 but is not fully phased in until 2022.

**Phase-in of Capital Conservation and Countercyclical Capital Buffers.** The capital buffer requirements become fully effective on January 1, 2019. Each of the two buffers would be established at 0.625 percent in 2016 and then phased in on a straight-line basis up to 2.5 percent in 2019 and thereafter. Banking organizations should keep in mind that these phase-in requirements must be attained in order to avoid restrictions on capital distributions and discretionary payouts during the transition period.

**Supplemental Leverage Ratio.** Advanced approaches banking organizations would not be required to apply the supplemental leverage ratio until 2018. These banking organizations, however, would be required to calculate and report (but not comply with) using the advanced approaches definitions of Tier 1 capital and total exposure measure beginning in 2015.

**Prompt Corrective Action.** The conforming changes to the Agencies’ PCA regulations would be effective on January 1, 2015, although the proposed amendments to the current PCA leverage measure for advanced approaches banking organizations would be effective on January 1, 2018.

One of the complicating aspects of these transition periods is that a banking organization will have to incorporate and harmonize different phase-in and phase-out timelines and specifications. Because there are different transition requirements for different capital ratios (risk-based, leverage and capital buffers), as well as for divergent types of regulatory deductions and nonqualifying capital instruments, the calculation of Tier 1 and Tier 2 capital requirements during these transition periods will have to be carefully structured and executed.

**B. The Standardized Approach Proposal**

The Standardized Approach Proposal is the result of two distinct regulatory impulses. In large measure, the Standardized Approach Proposal responds to many of the asset quality problems that emerged during the financial crisis and that were not satisfactorily addressed by the regulatory capital rules. The Standardized Approach Proposal introduces more rigorous and more calibrated capital measurements in an effort to encourage prudent lending and other banking business and to discourage those activities thought to have contributed to the crisis. The Standardized Approach Proposal also represents the continuation of the Agencies’ efforts, begun even before the financial crisis, to develop more sensitive but still manageable measurements of credit risk and capital adequacy by all banks other than the largest and most internationally active banks.

**Applicability**

The rules set forth in the Standardized Approach Proposal would formally apply to the same universe of banking and thrift institutions that is subject to the Basel III Proposal. Various parts of the Standardized Approach Proposal, however, would have different effects on different types of banking organizations. The Standardized Approach
Proposal includes an Addendum 1, which highlights issues that are likely to be of greatest interest to community banks, namely, those with less than $10 billion in consolidated assets. The preamble to the Standardized Approach Proposal conversely identifies those provisions likely to have little effect on community banks. Neither discussion purports to be exhaustive. The only provisions specifically not applicable to community banks are certain disclosure requirements that would apply only to banking firms with more than $50 billion in consolidated assets.

The Standardized Approach Proposal applies even to the largest U.S. banking organizations that use the advanced approaches under Basel II. As discussed above, the Collins Amendment to the Dodd-Frank Act sets a floor to the capital requirements for these organizations, and the Standardized Approach would be this floor.

**Effective Date**

The proposal, if finalized, will take effect on January 1, 2015. Banks have the option to adopt the rules earlier. Unlike the Basel III Proposal, the Standardized Approach Proposal does not provide for any transition period. The same residential mortgage loan that was weighted at 50 percent in the fourth quarter of 2014 could, for example, be risk-weighted at 75 percent in the first quarter of 2015—an abrupt 50 percent increase in the capital charge.

**General Elements of the Standardized Approach Proposal**

The Standardized Approach Proposal revises a large number, although not quite all, of the risk weights (or their methodologies) for bank assets. The overall financial impact may or may not be substantial for a bank, but the changes will require virtually every bank covered by the proposal to review the capital charges for its asset classes across the board. For nearly every class, the Standardized Approach Proposal requires a more calibrated assessment of credit risk. As a result, a bank’s capital planning process will require more information about many asset classes than is necessary to satisfy the existing capital rules.

The Standardized Approach Proposal changes the existing risk weights and the underlying methodologies in numerous ways. For ease of analysis, we have somewhat arbitrarily distinguished between the weighting of traditional loans and extensions of credit and the assessment of risk weights for other transactions that expose a bank to the credit risk of a counterparty. The changes are, in summary, as follows:

**Traditional Loans and Extensions of Credit**

- Traditional residential mortgage loans will receive somewhat more advantageous capital treatment than the more complex loans that proved so problematic in the financial crisis. Loan-to-value ratios are critical, though, and only traditional mortgage loans with an LTV ratio of 80 percent or less will avoid a higher risk weight under the Standardized Approach Proposal. The risk weights for mortgage loan guarantees generally have not changed, which may soften the blow of these higher risk weights.

- Commercial real estate loans would require greater economic participation by developers or other borrowers. In the absence of such participation, the risk weight on a loan would increase by 50 percent.
Corporate exposures generally are assigned a risk weight of 100 percent.

Past-due commercial loans (more than 90 days past due or on non-accrual status) will be risk-weighted at 150 percent.

Off-balance sheet items will be subject to certain changes, including a new minimum 20 percent conversion factor for many short-term commitments and a new measurement of the counterparty credit risk of a repo-style transaction.

Foreign sovereign debt, as well as the debt of public sector entities ("PSEs") and banks domiciled in the country, would be risk-weighted based primarily on the country risk classification assigned by the Organisation for Economic Co-operation and Development ("OECD"). The existing risk weights are a function largely of whether a country is or is not an OECD member.

Other Transactions Involving Credit Risk

Over-the-counter derivative contracts ("OTC derivatives") would no longer be able to take advantage of a 50 percent risk weight cap. The Standardized Approach Proposal also will adjust the measurement of the exposure of an OTC derivative.

Transactions cleared through CCPs will receive more favorable treatment than transactions conducted over the counter, although the extent of the advantage would depend on the nature of the CCP.

Guarantees and collateral will receive mixed treatment. The scope of eligible guarantors will widen, and more types of collateral will be permitted, but the Standardized Approach Proposal places new limits on their terms.

Securitization exposures would be weighted according to either the current gross-up method or a new formula to replace the existing method that is based on credit ratings. The proposal also imposes new qualitative requirements, including a bank’s demonstration of its understanding of the nature and risks of its securitization exposures.

The Standardized Approach Proposal also addresses two issues not directly related to credit risk:

- Equity exposures would receive new risk weights, distinguishing between equity exposures generally and equity exposures to investment companies.
- Disclosure requirements relating to regulatory capital will apply to banks with total consolidated assets of $50 billion or more and that are not subject to the disclosure requirements under the advanced approaches capital rule.

All of these changes will affect capital planning. Efforts to maximize capital efficiency for a particular asset class will depend on the nature of the change. There are at least four general possibilities.

- For some products, modest adjustments may result in noticeably better capital treatment. For example, for some short-term unfunded commitments, a bank may be able to insist on an unconditional right to cancel, thus avoiding a 20 percent conversion factor (and resulting capital charge) for the commitment. Additionally, to the extent that a bank can clear a derivative
transaction through a CCP rather than trade it over the counter, it will realize significant capital benefits.

- For other products, the Standardized Approach Proposal imposes new and punitive capital charges that presumably will force banks to change their handling of the products. As one example, in commercial real estate lending, a bank must require greater economic participation by a borrower in a project or otherwise face a risk weight that is 50 percent higher than the current risk weight. For securitization exposures, the proposal effectively compels a bank to demonstrate its understanding of and ability to manage the risks of each type of exposure. If the bank cannot do so, it must hold capital on a dollar-for-dollar basis (a 1,250 percent risk weight) against the exposure.

- In some cases, the increased capital charges will be unavoidable and present a bank with a choice of whether to continue a particular line of business. The higher risk weights for mortgage loans that are either nontraditional or have LTV ratios above 80 percent may cause a bank to consider whether to offer such loans.

- In nearly all cases, a bank should bear in mind that the Standardized Approach Proposal expands the universe of guarantors capable of providing risk-mitigating guarantees, including private sector entities with strong credit ratings and that meet other criteria.

Several of these changes warrant further discussion. We consider the risk-weighting changes with respect to residential mortgage loans, commercial lending, OTC derivatives, cleared transactions, guarantees and credit derivatives, collateralized transactions, unsettled transactions, securitization exposures, equity exposures, and sovereign debt and foreign bank exposures.

Residential Mortgages

Originations and Loans Held in Portfolio. The Standardized Approach Proposal provides greater incentives for banks to engage in what is commonly regarded as traditional mortgage lending. It creates two categories of mortgage lending. Traditional lending constitutes category 1, where the risk weights range from 35 to 100 percent. Other, nontraditional types of loans fall within category 2, where the risk weights range from 50 to 150 percent.

In order to qualify for category 1 treatment, the lending bank or the terms of the loan will be required to satisfy eight sets of prerequisites:

- Duration of the loan does not exceed 30 years.
- The terms of the loan provide for regular periodic payments. A loan is ineligible for category 1 if the loan payments would either:
  - Result in an increase in the principal balance—i.e., loans with a negative amortization feature.
  - Allow deferral on the repayment of principal. Payment option adjustable rate mortgage loans thus are outside Category 1.
- Result in a balloon payment.

- Underwriting standards must:
  - Take into account all of the borrower’s obligations, including mortgage obligations, principal, interest, taxes, insurance (including mortgage guarantee insurance), and assessments.
  - Result in a conclusion that the borrower is able to repay the exposure using the maximum interest rate that may apply during the first five years after closing of the loan. The amount of the exposure is the maximum possible contractual exposure over the life of the mortgages as of the date of closing.
  - For adjustable rate mortgages, the rate may adjust no more than two percentage points in any twelve month period and no more than six percentage points over the life of the loan.
  - For a first-lien home equity line of credit (“HELOC”), the borrower must be qualified using the principal and interest payments based on the maximum contractual exposure under the terms of the HELOC.
  - Income must be documented and verified.
  - The bank must hold the first-lien mortgage.
  - If the bank has secured its credit exposure with both first lien and junior liens and if there is no intervening lien holder, then the full exposure must have all of the characteristics of a category 1 loan.

The Standardized Approach Proposal also imposes a continuing requirement. If, at any time after the loan has closed, the loan is 90 days or more past due or is on non-accrual status, it is re-assigned to category 2. The existing capital rules do not change the risk-weighting of a mortgage loan that become past due.

Risk weights within each category are a function of a loan’s LTV ratio. The net effect of the changes in the proposal is that all but the most conservative and traditional mortgage loans will be subject to higher risk weights. In category 1, a loan with an LTV above 80 percent—the traditional threshold for conforming loans—will require greater capital than under the current rules. If the LTV is 60 percent or less, the loan is weighted at 35 percent. For loans with LTVs of more than 60 percent and equal to or below 80 percent, the risk weight is 50 percent. If the LTV is more than 80 percent and equal to or below 90 percent, the weight is 75 percent. All category 1 loans with LTVs above 90 percent are risk-weighted at 100 percent.

A mortgage loan that does not qualify for category 1 automatically falls within category 2, where the risk weights are at least twice the weights as those under the existing capital rules. A Category 2 loan with an LTV of 80 percent or less is risk-weighted at 100 percent. Loans with LTVs equal to or below 90 percent are risk-weighted at 150 percent. Loans above the 90 percent level must be risk-weighted at 200 percent.\textsuperscript{12}

The Standardized Approach Proposal eliminates some of the benefits of private mortgage insurance (“PMI”). The current capital rules permit a bank to apply the amount of PMI against the amount of the loan for the purpose of calculating the LTV ratio. The Proposal does not allow this practice.
**Guaranteed Mortgage Loans.** For mortgage loans guaranteed by the U.S. government or one of its agencies, the risk weights have not changed. Loans unconditionally guaranteed by the U.S. government or one of its agencies carry a zero percent risk weight; conditionally guaranteed loans are weighted at 20 percent. The government entities capable of providing this type of guarantee include the Veterans Administration, the Federal Housing Administration, and Ginnie Mae. Loan guarantees by Fannie Mae and Freddie Mac continue to be risk-weighted at 20 percent.

**Restructured Loans.** The Standardized Approach Proposal gives somewhat more favorable treatment to the restructuring or modification of residential mortgage loans than do the existing capital rules. Currently, a restructured or modified mortgage loan must be risk-weighted at 100 percent, regardless of the features of the restructured or modified loan. Recognizing that restructuring or modification may reduce credit risk, rather than signal increased credit risk, banks will be able to look to the terms of a restructured or modified loan in order to assign the appropriate risk weight. Such a loan will be assigned to category 1 if the revised terms of the loan meet the category 1 conditions that apply to newly originated loans; otherwise, the loan will be placed in category 2. The presumptive risk weights in the two categories are 100 and 200 percent, respectively. A bank may apply the lower risk weights for similar newly originated loans if the bank has updated the LTV ratio at the time of the restructuring.

Loans modified pursuant to the Home Affordable Mortgage Program ("HAMP") receive even more favorable treatment. Such loans will not be treated as restructured or modified loans and will continue to carry the same risk weight as before the modification.

**Secondary Market.** The treatment of securitization exposures under the Standardized Approach Proposal is covered in greater detail below, but banking organizations should focus on one change referenced above under the Basel III Proposal: the originator may be required to deduct gains on the sale of mortgage loans from common equity tier 1 capital. This deduction may bring an end to the originate-to-sell practices that some mortgage lenders had adopted before the financial crisis, although this business model already has fallen into disuse.

**Commercial Lending**

**Residential Construction and Multifamily Loans.** The current risk-based capital rules assign a risk weight of 50 percent to certain one-to-four family residential presold construction loans and to multifamily loans. A 100 percent risk weight applies to a presold construction loan if the purchase contract is cancelled. These risk weights are fixed by statute and cannot be changed. The Standardized Approach Proposal, however, adds several new conditions to both kinds of loans in order to qualify for these risk weights.

Presold construction loans must meet several prerequisites designed to ensure that the property will in fact be sold on completion. Two notable new requirements are, first, that the builder incur at least the first 10 percent of the direct costs of construction (land, labor, and construction) before the builder may begin to draw down on the loan; and, second, that the loan amount may not exceed 80 percent of the sales price of the presold residence.
Loans secured by mortgages on multifamily properties will remain eligible for the 50 percent risk weight if several conditions are met. For example, a newly originated multifamily loan cannot be risk-weighted at 50 percent and must be weighted at 100 percent. If, after at least one year, the borrower has made all principal and interest payments on time, the loan will be eligible for the 50 percent risk weight, if other conditions are satisfied. These conditions include the following: (i) the LTV ratio does not exceed 80 percent on a fixed rate loan or 75 percent on a loan where the rate may adjust; (ii) amortization of principal and interest must occur over a period of not more than 30 years, and the original maturity for repayment of principal is not less than seven years; and (iii) annual net operating income of the property must exceed annual debt service by 20 percent for a fixed-rate loan or 15 percent for a loan where the rate may vary.

**Commercial Real Estate.** Most commercial loans will continue to be risk-weighted at 100 percent. The one significant change is for “high volatility” commercial real estate loans (“HVCRE loans”), a subset of ADC loans. HVCRE loans will be risk-weighted at 150 percent. A lender may be able to return an ADC loan to the 100 percent risk weight through underwriting and the imposition of certain terms, as follows:

- The LTV ratio is less than or equal to the “applicable maximum supervisory LTV ratio.”
- The borrower has contributed at least 15 percent of the appraised “as completed” value of the property. The contribution may take the form of cash or unencumbered readily marketable assets, or the borrower may have paid development expenses out of pocket.
- The borrower has paid to the bank the capital charge that the bank will have to incur on the loan and has done so before the bank advances any funds. The contributed capital, which may eventually include capital generated internally by the project, must remain in place until the project is completed, the facility converts to permanent financing, or is sold or paid in full. Permanent financing by the bank must conform to the bank’s underwriting criteria for long-term commercial mortgage loans.

An ADC loan to finance one- to four-family residential properties, however, may continue to be risk-weighted at 100 percent.

**Unfunded Commitments.** A greater number of unfunded commitments will carry a capital charge than under the existing capital rules. Unfunded commitments currently have no capital charge (technically, they are converted to an on-balance sheet asset at zero percent) in either of two circumstances: (i) the original maturity of the commitment is one year or less; or (ii) the bank may unconditionally cancel the obligation and has the contractual right (which it exercises) to make a separate credit decision before each drawing or an annual credit review to determine whether to continue the facility.

Under the Standardized Approach Proposal, only those commitments that are unconditionally cancelable by the bank are eligible for the zero percent conversion factor. Unfunded commitments with an original maturity of one year or less must be converted onto the balance sheet at 20 percent. The 50 percent credit conversion factor that has been in effect for unfunded commitments with an original maturity of more than one year and that are not unconditionally cancelable by the bank will remain in effect.
Over-the-Counter Derivatives

Under the Standardized Approach Proposal, the capital requirements for OTC derivatives contracts are fairly complex, in connection with both risk weighting and the determination of the exposure to be risk-weighted. We will discuss these requirements in greater detail in a forthcoming advisory.

The risk weights will differ for equity and credit derivatives. Equity derivatives may be treated as forms of equity exposure and will be risk-weighted according to those rules. Alternatively, for an advanced-approaches bank, the bank might treat an equity derivative as a covered transaction under the proposed market risk capital rules, in which case the derivative will be treated in accordance with the requirements for counterparty credit risks. Credit derivatives may be risk-weighted in different ways as well. If the derivative is eligible to serve as a credit risk mitigant, then it will be weighted as such (see the discussion of guarantees and credit derivatives below). A credit derivative might also be regarded as presenting a counterparty credit risk, and credit risk might also reside in the underlying reference asset.

As to the amount of the exposure to be risk-weighted, that amount depends primarily on whether the derivative is subject to a master netting agreement.

- If the derivative is not subject to a master netting agreement, then its exposure is the sum of the current credit exposure and the potential future exposure (“PFE”). While the calculation of the PFE is complex, it cannot exceed the present value of the unpaid premiums on the contract.
- For multiple OTC derivatives that are subject to a “qualifying” master netting agreement, the collective risk weight for all derivatives covered by the same agreement is the sum of the current net credit exposure and the adjusted sum of the PFE. The agreement is “qualifying” if it meets certain criteria relating to a bank’s ability to accelerate, terminate, or close out all transactions in the event of a default and to the continuing enforceability of the agreement in the event of a legal challenge, including one arising out of a bankruptcy or insolvency proceeding.

Cleared Transactions

New risk-weighting methodologies will apply to two types of “cleared transactions” derivatives contracts and repo-style transactions that a bank has entered into with a CCP. The appropriate methodologies depend on three variables: whether the CCP is “qualifying,” whether the bank is a clearing member of the CCP or a client of a CCP clearing member, and whether the cleared transaction is a derivatives transaction or a repo-style transaction. In all cases, a bank must first determine the amount of the transaction to be risk-weighted, known as the “trade exposure,” and then determine the appropriate risk weight.

Where the bank is a CCP clearing member, the trade exposure of a derivatives transaction is the exposure amount calculated in the same way as the exposure amount of an OTC derivative; the trade exposure of a repo-style transaction is calculated in the same way that the bank would calculate the exposure for the purpose of determining the value of collateral securing the exposure under the “collateral haircut approach” for collateralized transactions. In either case, if the CCP holds collateral from the bank in a
manner that is not bankruptcy remote, the fair value of the collateral is added to the trade exposure amount for risk-weighting purposes. Once the trade exposure is set, it will be risk-weighted at two percent if the CCP is qualifying. If the CCP is not qualifying, then the risk weight is determined in accordance with the general capital risk weights in the Standard Approach Proposal. The weight accordingly may vary but presumably could be as high as 100 percent.

If the bank is a client of a CCP member, the different trade exposures are calculated in the same manner as by banks that are CCP members. If the CCP is qualifying, then the bank may risk-weight its exposure at two percent, if the collateral that the bank has posted with the CCP in connection with the transaction is protected from any losses that could arise from the default or insolvency of the CCP member or any of its other clients. If the collateral is not so protected, then the bank must weight the exposure at four percent. If the CCP is not qualifying, then the risk weight is the same risk weight for any exposure to the CCP.

In order for a CCP to "qualify," the CCP must satisfy certain conditions and receive agency approval. Precisely how the regulators will handle the approval process is unclear, since the conditions are specific to the CCP but not to its members, and presumably the regulators’ first approvals would cover all later banks (unless there is some change to the CCP). In order to qualify, the CCP must be a “designated” financial market utility under Title VIII of the Dodd-Frank Act (or, if outside the United States, be subject to comparable regulation), must require that all contracts cleared by it are fully collateralized on a daily basis, and must provide certain capital information to the bank, the bank’s regulator, and the CCP’s regulator. The bank also must demonstrate that the CCP is in sound financial condition, is supervised by the Federal Reserve Board, the Commodity Futures Trading Commission ("CFTC"), or the Securities and Exchange Commission ("SEC"), and meets or exceeds the risk management standards established by the Federal Reserve Board, the CFTC, or the SEC. CCPs located outside the United States may qualify if the home-country standards are functionally equivalent to U.S. standards.

Guarantees and Credit Derivatives

The Standardized Proposal’s treatment of credit enhancement—guarantees, credit derivatives and collateral (discussed further below)—is complex. On the one hand, the Standardized Approach Proposal recognizes a wider range of guarantors and more types of collateral. On the other hand, it imposes additional conditions on the use of these enhancements.

Guarantees. The existing capital rules generally require no capital to the extent that an asset is guaranteed by the U.S. government and its agencies or by the central government of an OECD country. In certain circumstances, these rules also recognize guarantees from central governments of non-OECD countries. Guarantees by banks organized in OECD countries require only a 20 percent risk weight, as do guarantees from Fannie Mae and Freddie Mac, and guarantees from multilateral lending institutions or regional development institutions in which the United States is a shareholder or contributing member.

The Standardized Approach Proposal enlarges the set of eligible guarantors to include any sovereign, the Bank for International Settlements, the International Monetary Fund,
the European Central Bank, the European Commission, a Federal Home Loan Bank, Farmer Mac, a multilateral development bank, a depository institution, a bank holding company, a savings and loan holding company, a credit union, and a foreign bank.

Also eligible to issue valid guarantees are third-party private sector entities that meet three conditions: (i) they have issued and outstanding unsecured debt securities without credit enhancement that are investment grade; (ii) their creditworthiness is not positively correlated with the credit risk of the exposures for which they are providing protection; and (iii) they are not insurance companies predominately engaged in the business of providing credit protection.

A guarantee provided by these guarantors must satisfy several requirements designed to ensure that the guarantee is unconditional (there is one limited exception for certain conditional guarantees by the U.S. government), readily accessible, and enforceable. An affiliate cannot provide a valid guarantee.

*Credit derivatives.* The proposal also recognizes the risk mitigation that may be provided by certain credit derivatives: credit default swaps, nth-to-default swaps, total return swaps, or other swaps approved by a bank’s primary federal supervisor. These swaps must meet the same eligibility requirements as a guarantee as well as other conditions to confirm that the swap will provide the protection when needed.

*Protection.* Determining the precise protection amount provided by the guarantee or credit derivative may be a complicated undertaking. As a starting point, the amount is the effective notional amount: the lesser of the contractual notional amount or the exposure amount of the credit to be protected, multiplied by the percentage coverage of the credit risk mitigant. This amount then must be adjusted to take into account any maturity mismatches, lack of restructuring coverage, currency mismatches, and multiple credit risk mitigants.

*Collateralized Transactions*

The Standardized Approach Proposal would recognize only “financial collateral” as having a risk-mitigating effect. This collateral consists of cash on deposit, gold bullion, long-term debt securities that are not resecuritization exposures and that are investment grade, short-term debt instruments with the same characteristics, publicly-traded equity securities and convertible bonds, money market fund shares, and other mutual fund shares with a publicly-quoted daily price. Financial collateral has a risk-mitigating effect only if a bank has a perfected, first-priority interest in it. Collateral held outside the U.S. also may qualify if the bank has the equivalent of a perfected, first-priority interest.

The Standardized Approach Proposal offers two options for recognizing the risk-mitigating effect of financial collateral: a “simple approach” and a “collateralized haircut approach.” As a practical matter, the latter approach is a meaningful possibility only for complex banks; it requires sophisticated mathematics to determine the ultimate effect. However, the collateralized haircut approach must be used for collateral securing certain exposures described below.

Community banks likely will rely on the simple approach (with the proviso for certain exposures above). The principal disadvantage of the simple approach is that, while there is no haircut on the collateral, the risk weight for a collateralized exposure must be
at least 20 percent, regardless of the risk weight of the collateral on a stand-alone basis. This rule may discourage the use as collateral of items otherwise risk-weighted at zero percent, including cash on deposit and gold. The 20 percent floor does not apply to certain collateral for OTC derivatives. If the collateral is cash on deposit, there is no floor, and the exposure may be risk-weighted at zero percent. If it is sovereign debt (which otherwise has a zero percent risk weight), the exposure may be risk-weighted at 10 percent.

Under the simple approach, financial collateral has a risk-mitigating effect if a bank satisfies three conditions: (i) the bank has entered into a written agreement for the life of the loan or other exposure; (ii) the bank revalues the collateral every six months; and (iii) the collateral is designated in the same currency. Once these requirements are met, the bank may use the market value of the collateral to replace the same value in the exposure. If the collateral value covers the entire exposure, the risk weight of the collateral will apply. If the collateral covers the exposure in part, then the exposure will be risk-weighted on a pro rata basis.

With respect to the collateralized haircut approach, collateral securing “eligible” margin loans, repo-style transactions,15 collateralized derivatives contracts, and the single-product netting of such transactions will be haircut both for market price volatility and currency mismatches. The volatility haircuts will vary considerably, from 0.5 percent to 25 percent, depending on the issuer and the residual maturity of the collateral. For collateral securing repo-style transactions, the haircuts are approximately 30 percent less than the haircuts on the same collateral for other transactions. There is a standard eight percent haircut when collateral is a different currency than the underlying exposure. A bank may seek agency approval to use its own internal haircuts, but the bank must submit considerable documentation to support the validity of those haircuts.

**Unsettled Transactions**

Among the new provisions in the Standardized Approach Proposal are graduated capital requirements for transactions that have not settled on time. The new requirements apply to transactions involving the delivery of securities or commodities (known as delivery-versus-payment or DvP transactions) or the payment of foreign exchange instruments (known as payment-versus-payment or PvP transactions). Different requirements apply where a bank already has performed and is waiting for the return performance—a circumstance known as a non-DvP/non-PvP transaction.

The new requirements do not apply to cleared transactions that are marked to market daily and are subject to daily receipt and payment of variation margin, repo-style transactions, one-way cash payments on OTC derivative contracts, and transactions with a contractual settlement date that is longer than five business days after the market standard. These exempt transactions are generally subject to capital requirements related to OTC derivatives transactions.

For DvP and PvP transactions, capital requirements take effect if the transaction has not settled within five business days. The amount to be risk-weighted is the “positive current exposure” of the bank: the difference between the transaction value at the agreed settlement price and the current market price of the transaction. Capital is required if the market price has moved against the bank. The risk weights increase as settlement continues to be delayed. The proposal provides a grace period of only four days, and
after 45 days, the bank must hold capital on its credit risk exposure on nearly a dollar-for-dollar basis. The weights are as follows:

<table>
<thead>
<tr>
<th>Number of days after the settlement date</th>
<th>Risk weight</th>
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<tbody>
<tr>
<td>From 5 to 15</td>
<td>100 percent</td>
</tr>
<tr>
<td>From 16 to 30</td>
<td>625 percent</td>
</tr>
<tr>
<td>From 31 to 45</td>
<td>937.5 percent</td>
</tr>
<tr>
<td>46 or more</td>
<td>1,250 percent</td>
</tr>
</tbody>
</table>

If the bank has already made its agreed-upon payments or deliveries and is waiting for performance by a counterparty, capital requirements are triggered immediately. For the first five days after non-performance, the deliverables are risk-weighted at the standard risk weights for those assets. Beyond the five days, the deliverables must be risk-weighted at 1,250 percent.

**Securitizations**

The Standardized Approach Proposal makes several changes to the regulatory capital treatment of securitizations. Among the changes is a new method of calculating appropriate risk weights, which reflect the mandate in section 939A of the Dodd-Frank Act that the federal banking agencies cease to rely on credit ratings for capital and other purposes. Such credit ratings have been at the core of risk-weighting for securitization exposures. The overall financial impact on a bank of the new rules in the proposal may not be significant, but the changes in methodology will require a thorough review of all of a bank’s securitization exposures.

**Operational Requirements.** In connection with a securitization, a bank typically may be required to hold capital against the securitized assets themselves and against any credit risk that it retains, even if not tied to a specific asset. The proposal would allow a bank to avoid such capital requirements only if the transaction satisfies these requirements:

- The securitized exposures are not reported on the bank’s balance sheet under generally accepted accounting principles. In other words, there has been a true sale of the assets.
- The bank has transferred to one or more third parties the credit risk associated with the underlying exposures. That is, there is no recourse to the bank should the value of the securitized exposures decline.
- All clean-up calls are “eligible.” A call is eligible if it is (i) solely within the discretion of the originating bank or servicer, (ii) not structured to avoid allocating losses to securitization exposures held by investors or otherwise structured to provide credit enhancements, and (iii) only exercisable when 10 percent or less of the principal amount of the underlying exposures or securitization exposures (determined as of the inception of the securitization) is outstanding.
- The pool does not contain any exposures in which a borrower is permitted to vary the drawn amount within an agreed limit under a line of credit, i.e., the exposures to credit risk cannot vary in amount other than through the borrowers’ payment of principal on the loans in the pool.
- The transaction has no early amortization provisions.
If any of these conditions are not satisfied, then the bank must hold risk-based capital against all of the exposures as if they had not been securitized. As previously noted, any gain-on-sale associated with the securitization must be deducted from common equity Tier 1 capital.

Substantively comparable conditions apply to synthetic securitizations. Capital is required based solely on the risk weight of the credit risk mitigant if the following conditions are met:

- The credit risk mitigant either is financial collateral (defined above in connection with the discussion of collateral), an eligible credit derivative, or an eligible guarantee. An eligible guarantee must satisfy several conditions designed to ensure that the bank cannot lose the value of the guarantee through acts outside its control. An eligible credit derivative must satisfy the requirements for an eligible guarantee, as well as other conditions to make certain the protective features of the derivative.
- The bank transfers the credit risk associated with the underlying exposures to one or more third parties.
- The credit risk mitigant does not include any provisions that would, in the event of a deterioration in the credit quality of the underlying exposures, allow for the termination of the credit protection, require the bank to alter or replace the underlying exposures, increase the bank’s cost of credit protection, or increase the yield payable to parties other than the bank.
- The bank obtains a “well-reasoned” legal opinion that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions.
- Any clean-up calls are eligible clean-up calls. Eligibility depends on the same criteria of eligibility as in a traditional securitization except that the 10 percent ceiling standard relates to the principal amount of the reference portfolio of underlying exposures (determined as of inception) that is outstanding.

These requirements do not prevent a bank from later taking a position in one of the tranches in a securitization; the risk-weighting of such positions is discussed below.

Due Diligence. Out of a concern that, during the financial crisis, many banks lacked the ability to manage the risks of securitization exposures, the Standardized Approach Proposal directs banks to demonstrate that ability at the outset. This proposed approach would not require regulatory approval, however, and appears to be a risk management requirement that would be reviewed during the examination process.

The specific requirement is that a bank demonstrate to its regulator that it has a “comprehensive understanding” of the features of a securitization exposure that would materially affect the performance of the exposure. If a bank cannot do so, a punitive risk weight of 1,250 percent will apply to the full securitization exposures held by the bank. A demonstration of such an understanding involves two steps. First, before acquiring an interest in MBS or ABS, the bank must conduct an analysis of the risk characteristics of its interest, including structural features that could affect the performance of the exposure, the performance of the assets or other exposures in the securitized pool, relevant market data on the securitization, and for resecuritization exposures,
performance information on the underlying securitization exposures. Second, on an ongoing basis and no less frequently than quarterly, the bank must review and update the foregoing analysis for each securitization exposure.

Methodologies. The Standardized Approach Proposal recognizes two different methods of determining the risk weight of securitization exposure—the Gross-Up Approach and the Simplified Supervisory Formula Approach (“SSFA”). The former already is substantively part of the existing capital rules; the SSFA is new. The SSFA is available to any bank, but the Gross-up Approach is available to banks that are not subject to the market risk capital rules. The Gross-up Approach is all or nothing; a bank that chooses to use it must use it for all of its exposures. In many instances, the SSFA will be the only realistic alternative, thus itself taking on an all-or-nothing quality. Under either approach, the minimum risk weight is 20 percent, even if an approach suggests a lower risk weight. In addition, credit-enhancing interest-only strips must be weighted at 1,250 percent, or dollar-for-dollar.

- **Gross-Up.** This approach reflects the current method for calculating risk weights and corresponding amounts of capital. In general terms, a bank today must hold capital against the dollar amount of its position in a particular tranche plus the dollar amount of all more senior tranches. The proposal explains this approach a little more specifically. The bank’s exposure will be its pro rata portion of the par value of the tranche in which its exposure is located plus the appropriate value of all senior tranches. The exposure then would be multiplied by the weighted-average risk weights of the underlying exposures to arrive at the capital charge for the position.

- **SSFA.** This approach measures the credit risk associated with a securitization exposure, that is, the credit risk of the exposures in the securitized pool, in a way that replaces the analysis that a credit rating agency would have performed. The approach requires a bank to begin with the weighted average risk weight of the underlying exposures. This number then is adjusted by several sophisticated algorithms designed to various indicators of credit risk, including delinquencies in the underlying exposures, and the allocation of credit losses to various positions.

Separate rules apply in determining the appropriate risk-based capital amounts for exposures to asset-backed commercial paper facilities.

**Equity Exposures**

Equity exposures to unconsolidated counterparties will be risk-weighted in one of two ways, depending on whether the exposure is to an entity other than an investment fund, or an investment fund. Equity exposures would include not only securities and other direct ownership (or equivalent) interests, but interests mandatorily convertible into such interests, options or warrants for such interests, or other instruments to the extent the return on such instrument is based on the performance of a direct equity exposure. Equity exposures deducted from Tier 1 or Tier 2 capital, securitization exposures, and ownership interests that provide for periodic payments or similar obligations on the part of the issuer. Equity exposures would be computed according to their adjusted carrying values, which generally would be an exposure’s simple carrying value for on-balance-sheet assets, and a formulaic carrying value for off-balance-sheet exposures (or
exposure components) that generally would be the exposure’s notional value times a specified conversion factor.

**Simple Risk-Weight Approach.** The current capital rules provide for a simple 100 percent risk-weighting for financial equity exposures, or a deduction from capital for nonfinancial equity exposures (e.g., merchant banking investments under the Bank Holding Company Act). The Standardized Approach Proposal would replace this formula with a tiered risk-weighting formula. Several of the tiers would carry a “penalty” risk-weighting.

- Equity exposures to a sovereign, certain supranational entities, or a MDB multilateral development banks ("MDB) whose debt exposures are eligible for 0 percent risk weight, would be assigned a 0 percent risk weight (see discussion below).
- Equity exposures to a PSE, a FHLB, or Farmer Mac would be risk-weighted at 20 percent.
- Equity exposures to (i) community development investments and small business investment companies, (ii) the effective portion of a hedged pair, and (iii) nonsignificant equity investments where the aggregate adjusted carrying values of such investments does not exceed 10 percent of total regulatory capital, would be risk-weighted at 100 percent.
- Significant investments in the capital of unconsolidated financial institutions that are not deducted from capital under the Basel III Proposal would be risk-weighted at 300 percent.
- Most publicly traded equity exposures would be risk-weighted at 300 percent.
- Non-publicly traded equity exposures would be risk-weighted at 400 percent (other than those risk-weighted at 600 percent).
- Equity exposures to certain investment funds (generally, managed securitization pools with greater than "immaterial leverage") would be risk-weighted at 600 percent.

**Exposures to Investment Funds.** The current capital rules provide for a 20 percent risk-weighting for mutual funds, and for other investment funds either a risk-weighting that is the same as the highest risk-weighted asset the fund is allowed to hold, or a risk-weighting that is the function of the pro rata risk weights of assets that are permitted to be held by the fund under the fund's prospectus or governing documents. Under the Standardized Approach Proposal, three alternative approaches are proposed:

- A full look-through approach, which would risk-weight the assets of the fund as if they were owned directly by the bank, multiplied by the bank’s proportional ownership in the fund.
- A modified look-through approach, which would be the product of the highest risk weight asset permitted to be held by the fund under its prospectus or governing documents, times the adjusted carrying value of the bank’s ownership interest (excluding immaterial derivatives hedges).
- An alternative modified approach, which generally would compute a risk-weight asset amount equal to the sum of each portion of the adjusted
carrying value assigned to each exposure type allowed under the fund’s prospectus or governing documents, times the applicable risk weight (excluding immaterial derivatives hedges).

Under this methodology, a “hedged pair” would mean two qualifying equity exposures that form an “effective hedge”. The bank, in turn, would risk-weight the effective and ineffective portions of a hedge pair according to a formula, rather than weighting the adjusted carrying values of each constituent exposure.

**Sovereign Debt and Foreign Bank Exposures**

The Standardized Approach Proposal refines the risk-weighting of sovereign debt and exposures to foreign banks both to better reflect the risks of particular sovereigns and to bring U.S. practices closer to international methods for determining the capital adequacy of these exposures. In very rough terms, the existing U.S. approach relies largely on whether a foreign sovereign is or is not an OECD member and on whether an exposure is unconditionally or conditionally guaranteed by the sovereign. Many foreign regulators have relied on “country risk classifications” (“CRCs”) developed by OECD; the Standardized Approach Proposal largely adopts this approach.

The OECD rates country risk on a scale from 0 to 7, with 0 representing the least risk and the 7 the greatest risk. The sovereign debt risk weights in the proposal would increase as the CRC rating declines. The debt of a 0- or 1-rated country will have a zero risk weight, while the sovereign debt of a 7-rated country must be risk-weighted at 150 percent. These risk weights are superseded if a country has defaulted on its debt within the past five years; in such a case, the debt must be risk-weighted at 150 percent.

Exposures to certain supranational entities and multilateral development banks (“MDBs”) are currently risk-weighted at 20 percent. The proposal lowers this risk weight to zero and expands the number of MDBs whose debt will be subject to the new risk weight.

The risk weight on the debt of a foreign bank is currently and will continue to be a function of the sovereign debt rating of the country in which the bank is domiciled. Under the existing rules, the foreign bank risk weights are tied to OECD membership. Under the new proposal, the risk weights will be a function of the CRC rating. Bank debt in the least risky countries will be risk-weighted at 20 percent, while the debt of a bank domiciled in a country assigned to one of the four riskiest classifications will be weighted at 150 percent.

The Standardized Approach Proposal also adjusts the risk weights for the debt of political subdivisions within a foreign sovereign. General obligations backed by the full faith and credit of a public sector entity (“PSE”) have the same risk weight as a bank obligation in the same country. PSE obligations based on a particular source of revenue are subject to slightly higher risk weights.

**C. The Advanced Approaches Proposal**

In the third of its three Proposals, the Advanced Approaches Proposal, the Agencies have proposed changes to the Basel II and Basel III regulatory capital framework that applies only to the relatively small number of U.S. banking organizations that are subject to the advanced approaches framework or the market risk rule under Basel II, including
qualifying Federal and state savings associations and their holding companies. There is no specified effective date for these changes, if they are adopted.

The Advanced Approaches Proposal would incorporate certain changes to the advanced approaches reflected in the Basel III framework, as well as changes to the Basel II advanced approaches framework made by the Basel Committee between 2006 and 2009. In addition, it would revise the current advanced approaches risk-based capital rules to remove references to credit rating agency ratings, as required by section 939A of the Dodd-Frank Act. More specifically, the Advanced Approaches Proposal would (i) make changes to the calculation of counterparty credit risk, including a more risk-sensitive approach for certain transactions with central counterparties and adjustments to the methodologies used to calculate counterparty credit risk requirements, (ii) remove the references to credit ratings as required by the Dodd-Frank Act, and (iii) strengthen the risk-based capital requirements for certain securitization exposures by requiring affected banking organizations to conduct more rigorous credit analysis of securitization exposures and enhance the disclosure requirements related to these exposures. In conjunction with the adoption of final changes to the market risk capital rule, the Advanced Approaches Proposal proposes to extend the applicability of the market risk capital rule to qualifying Federal and state savings banks and their holding companies.

**Counterparty Credit Risk**

In general, the Advanced Approaches Proposal would seek to cure areas of weakness in Basel II identified during the recent financial crisis by ensuring that all material on- and off-balance sheet counterparty risks, including those associated with derivative-related exposures, are appropriately incorporated into banking organizations’ risk-based capital ratios. In addition, the Advanced Approaches Proposal would incorporate new risk management requirements in Basel III that are designed to strengthen the oversight of counterparty credit risk exposures. The areas of change that are proposed are as follows:

- Revisions to the recognition of eligible financial collateral by excluding resecuritizations and conforming residential mortgages from the definition of eligible collateral, and revising the supervisory haircuts for securitization exposures consistent with changes to Basel III.
- Lengthen the assumed holding periods and the calculation of certain collateralized OTC exposures under the collateral haircut and simple VaR approaches, and the margin period of risk under the internal models methodology, consistent with changes to Basel II and Basel III.
- Increase the capital requirements associated with the internal models methodology, and require better identification and management of wrong-way risk associated with certain counterparty exposures.
- Incorporate an additional capital requirement for credit value adjustments relating to OTC derivatives exposures, and specify the methods of exposure calculation, as directed by Basel III and the changes to Basel II.
- As proposed by Basel III, adjust the capital requirements for qualifying and other CCP exposures of advanced approaches banking organizations that are CCP clearing members, including capital calculations for CCP default fund contributions.
• Require advanced approaches banking organizations to assume a continuous 12-month stress period in calculating market price and foreign volatility exposures under the collateral haircut method, based on internal estimates.

Removal of Credit Rating References

Consistent with section 939A of the Dodd-Frank Act, the Advanced Approaches Proposal would remove references to credit ratings that currently exist in the advanced approaches capital rules and replace these references with alternative standards of creditworthiness. In general, the Agencies would redefine the term “investment grade” that currently is found in the advanced approaches rule to mean that an entity to which the banking organization is exposed through a loan or security, or the reference entity with respect to a credit derivative, has “adequate capacity to meet financial commitments” for the projected life of the asset or exposure. In turn, an entity or reference entity has “adequate capacity to meet financial commitments” if the risk of its default is low and the full and timely repayment of principal and interest is expected. These changes would be comparable to alternative standards proposed in the Standardized Approach Proposal, as well as alternative standards that have been adopted in the Agencies’ final market risk capital rule (see discussion below).

In the advanced approaches rule, these definitional changes would particularly affect the definitions of “eligible guarantor” (previously “eligible securitization guarantor”) and “eligible double default guarantor.” The Agencies would remove the ratings-based and internal assessment approaches for securitization exposures and require banking organizations to use the SFA or, where permitted, the SSFA, in calculating their capital requirements for these exposures. In addition, the definitional changes would modify the calculation of potential future exposures for derivative contracts. The Agencies also propose to replace the ratings-based calculations of exposures to money market mutual funds, equity exposures to investment funds, and operational risk exposures with alternative, non-ratings-based risk-weighting exposure calculations for such exposures.

Securitization Exposures

In accordance with changes to Basel II in 2009, the Agencies propose to create a new definition of resecuritization exposures and broaden the definition of securitization exposures, while excluding certain traditional investment firms from that definition. These changes also are consistent with changes proposed in the Standardized Approach Proposal. The resecuritization definition would capture exposures to securitizations that are comprised of asset-backed securities (e.g., CDOs and some ABCP conduits) and that are now subject to higher risk-weightings under the 2009 changes to Basel II.

The proposed changes to securitization exposure capital calculations also would (i) clarify the GAAP-based operational criteria for recognition of risk transfer in traditional securitizations, (ii) revise the existing ratings-based and internal assessment approaches for securitization exposures, (iii) clarify the revised risk-based capital requirements for guarantees or certain credit derivatives referencing a securitization exposure, (iv) enhance due diligence requirements for securitization exposures, and (v) require banking organizations providing credit protection through nth-to-default credit derivatives
to assign a risk weight in accordance with the supervisory formula approach or the simplified supervisory formula approach.

Further, in accordance with Basel III, the Agencies propose that certain high-risk securitization exposures previously required to be deducted from capital now generally be assigned a risk-weighting of 1,250 percent instead of being deducted. This change would not apply to securitization exposures (e.g., gain-on-sale exposures) that are required to be deducted from common equity Tier 1 capital under Basel III.

**Other Changes**

The Advanced Approaches Proposal would make other technical (and not so technical) changes to the advanced approaches rules. These changes would include (i) changes to the treatment of certain contingent obligations of the U.S. government as eligible guarantees, (ii) excluding foreign exposures of insurance underwriting subsidiaries of banking organizations from the $10 billion foreign exposure threshold for treatment as an advanced approaches banking organization, (iii) changes to conform the advanced approaches rules to the Foreign Country Exposure Report (FFIEC 009) used by advanced approaches banking organizations, (iv) for banking organizations that become subject to the advanced approaches rules, preventing their being able to avoid the rule’s applicability based on changes in asset size without supervisory approval, (v) changing the effects of seasoning on the probability of default (“PD”) for certain retail exposures by subjecting this process to supervisory oversight (Pillar 2) rather than quantitative capital requirements (Pillar 1), (vi) risk-weighting cash items in the process of collection at 20 percent, (vii) clarifying the definition of Qualifying Revolving Exposure to allow certain charge and credit card exposures to qualify under that definition, and (viii) clarifying the maturity floors for trade finance instruments to specify an effective maturity of no less than one year and no greater than five years, except for trade-related letters of credit and certain exposures of under one year’s maturity, where the effective maturity must be not less than 1 day.

Finally, the Advanced Approaches Proposal will increase certain “Pillar 3” disclosures required to be made by advanced approaches banking organizations to harmonize the timing and frequency of disclosures with SEC periodic reporting requirements, enhance reporting and disclosure requirements for securitization exposures, and clarify the reporting of equity exposures that are not covered positions.

**Expansion of Market Risk Rule Applicability**

At the same time as the publication of the Proposals, the Agencies have adopted in final form, effective January 1, 2013, changes to the market risk capital rule that previously were proposed in January 2011 and December 2011 for certain banking organizations that have specified levels of trading assets on their books. With one exception, these final changes track the Basel Committee methodologies for the calculation of market risk capital that were incorporated into Basel II after its initial adoption. As required by section 939A of the Dodd-Frank Act, the market risk capital rule changes have replaced references to credit ratings in the Basel II rules with alternative standards of creditworthiness.

In conjunction with the adoption of these changes to the market risk capital rule, the Advanced Approaches Proposal would extend the reach of the market risk capital rule to
federal and state savings banks and their holding companies that meet the rule’s qualification thresholds. As noted above, the market risk capital rule presently applies to any bank with aggregate trading assets and trading liabilities equal to 10 percent or more of total assets of at least $1 billion.

**Some Initial Observations**

Given the breadth, complexity and potential impact of the Proposals, the comment period allows U.S. banking organizations and other interested persons relatively little time to understand their requirements and assess their potential impact on their activities and operations. We expect that the U.S. banking industry will be concerned about the impact of these Proposals on core matters such as the availability and costs of equity capital, the economic costs of the capital requirements as they apply to commercial and residential mortgage lending activities and other classes of assets on the banking book, the competitive impact (both domestically and internationally) of the Proposals, and the associated compliance burdens and costs, among other issues.

Smaller banking organizations in particular may view the two Proposals that apply to them (the Basel III Proposal and the Standardized Approach Proposal) as an unnecessary and unwelcome burden that goes well beyond the intended scope of Basel II and Basel III, and that is not required by the Dodd-Frank Act or any other U.S. law. While these banking organizations may be correct on the substantive merits of this point, the current U.S. regulatory and political climate creates formidable obstacles for those parts of the banking industry that might want to argue that they should be excluded from these general capital requirements.

By the same token, the advanced approaches and market risk banking organizations that would be subject to the changes proposed by the Advanced Approaches Proposal should be less surprised by the general tenor and scope of that Proposal, inasmuch as they are designed to be consistent with more recent Basel Committee changes to Basel II, as well as Basel III. At the same time, there may be plenty in the specifics of the Advanced Approaches Proposal that the advanced approaches banking organizations may want to see modified.

Of course, there will be much discussion and debate over the impact of the Proposals on the capital-raising activities of banking organizations, and the extent to which the Agencies will be receptive to innovations in capital instruments that are structured to comply with the new Basel III-based requirements, in particular additional Tier 1 and Tier 2 capital. In this regard, there does not appear to be much space for flexibility in what qualifies as common equity Tier 1 capital, but there may be more room for innovation for new Tier 1 and Tier 2 instruments. At the same time, it is not clear how much flexibility the Agencies will exercise in making these capital determinations, although we fairly can expect the capital markets to use their usual creativity in going about the task of designing new regulation-compliant instruments.

The Standardized Approach Proposal will materially complicate the risk-weighting calculation processes of those banking organizations that have not had to be concerned with Basel II up until now. Even those non-complex smaller banks that are not subject to the full range of these new requirements, or do not have OTC derivatives or other complex exposures, will be faced with the task of applying more complicated methodologies and formulas to the risk-weighting of their assets.
A more interesting question may be the impact of the new rules on banking organizations' lending and other asset-related activities. For instance, the risk weights for residential and commercial real estate exposures are being reformulated to discourage the holding of riskier loan assets of this nature, and sovereign exposures will be subjected to more granular risk-weighting treatment. These types of financial behavior incentives in the past have influenced – some may say distorted – the balance sheets of banking organizations, and it will be interesting to see how much of a behavior modification impact the Standardized Approach Proposal may have. This is one area in which the "law of unintended consequences" may loom large, and it will bear close watching if these Proposals are adopted.

Does it matter, from an international competitive standpoint, that there are some differences, albeit not very large, between the U.S. Proposals on the one hand, and the Basel III and proposed European capital requirements on the other hand? For international U.S. banks, and even for U.S. banks that do not have international operations, there always is the possibility that EU and other international banks doing business in the U.S. under their home jurisdictions’ – and not U.S. – regulatory capital requirements may gain some competitive advantages by reason of not being subject to U.S. rules. However, at this point in time, the nature and scope of the apparent differences between the proposed U.S. and non-U.S. capital frameworks generally would not appear to create substantial competitive equality issues, although ultimately time will tell whether this continues to be the case.

One possible exception to this last point, however, may be the greater flexibility under the Basel III and EU capital regimes to treat certain types of hybrid capital or "bail-in" instruments with debt characteristics as additional Tier 1 capital, whereas such an outcome is precluded under the Agencies' Basel III Proposal. On the reverse side of the competitive equality ledger, however, the EU’s proposed CRD4 would apply the countercyclical capital buffer to all EU banking organizations, and Basel III would apply the same buffer to all banking organizations (whether subject to the standardized, foundation IRB or advanced approaches) that are subject to Basel II, whereas under the U.S. Proposals, only the advanced approaches banking organizations would be subject to the countercyclical capital buffer.

How amenable will the Agencies be to making changes to the Proposals? The three proposing releases collectively ask approximately 80 questions (primarily with respect to the Basel III Proposal) on the various aspects of the Proposals, but the nature and tenor of these does not reveal substantial hesitation or uncertainty on the Agencies’ part with respect to the Proposals.

All this being said, it will take additional time and substantial additional work to sort out more fully the more specific impact and implications of the Proposals for U.S. banking organizations and the U.S. banking industry. As the discussion progresses, we look forward to reporting further on these far-reaching Proposals and their ramifications for U.S. banks and the U.S. financial system.

Capital Rule ("Advanced Approaches Proposal"). All three of these Proposals were first approved and published by the Federal Reserve Board on June 7, 2012, but the three Agencies jointly announced their publication on June 12.


6 European Commission – legislative proposal for a new capital requirements directive (CRD4) (July 20, 2011).

7 Dodd-Frank Act section 171 [codified to 12 U.S.C. 5371].

8 This is not a surprising outcome, inasmuch as the Dodd-Frank Act “Collins Amendment” (section 171) effectively disqualified the TruPS of most banking organizations from Tier 1 capital treatment.

9 In addition, to align the requirements under the Home Owners Loan Act (“HOLA”) that Federal savings associations maintain a minimum ratio of 1.5% “tangible equity” to total assets with other changes to the regulatory capital rules, the OCC for Federal savings banks, and the FDIC for state savings banks, propose to adopt a uniform definition of “tangible equity” for HOLA and PCA purposes.

10 Banks and bank holding companies with less than $500 million in consolidated assets would be exempt from the requirements in the Standardized Approach Proposal. The Proposal would apply to all savings associations and savings and loan holding companies, regardless of size. For convenience, we simply refer to institutions covered by the Standardized Approach Proposal collectively as “banks.”

11 The proposal does not change the risk weights for the debt of the U.S. government and its agencies, government-sponsored enterprises, depository institutions and credit unions, and PSEs.

12 At some banks, these category 2 risk weights theoretically could be a reduction from current requirements. Over the past several years, the U.S. bank regulators have required some banks to risk-weight subprime loans at 300 percent. The Proposal would not affect the regulators’ discretion to set higher requirements for specific institutions, and it is unlikely that the regulators would reduce any existing requirements solely on the basis of the Proposal.

13 The bank must “conduct sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that the protective arrangements would survive any legal challenge.

14 Although the Proposal does not discuss a Title VIII designation in any further detail, a “designation” under Title VIII entails a determination by the Financial Stability Oversight Council that the failure or disruption of the utility could ultimately threaten the stability of the U.S. financial system.

15 Collateral securing repo-style transactions must also be included in a bank’s Value-at-Risk ("VaR") measurements.

The Banking Agencies’ New Regulatory Capital Proposals

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We also make available two customized services for our clients. Our Plus service provides for xml data feeds from FrankNDodd. The PlusPlus service provides a full range of concrete Dodd-Frank compliance services tailored to the particular needs of individual financial institutions.
Appendix A

1. Common Equity Tier 1 Capital

Common equity Tier 1 capital would be the sum of: outstanding common equity Tier 1 capital instruments and related surplus (net of treasury stock), retained earnings, accumulated other comprehensive income (“AOCI”), and qualifying common equity Tier 1 minority interest, minus any required regulatory adjustments and deductions.

Criteria

Common equity Tier 1 capital instruments issued by a banking organization must satisfy the following criteria:

1. The instrument is paid in, issued directly by the banking organization, and represents the most subordinated claim in a receivership, insolvency, liquidation, or similar proceeding of the banking organization.

2. The holder of the instrument is entitled to a claim on the residual assets of the banking organization that is proportional with the holder's share of the banking organization’s issued capital after all senior claims have been satisfied in a receivership, insolvency, liquidation, or similar proceeding.

3. The instrument has no maturity date, can only be redeemed via discretionary repurchases with the prior approval of the agency, and does not contain any term or feature that creates an incentive to redeem.

4. The banking organization did not create at issuance of the instrument through any action or communication an expectation that it will buy back, cancel, or redeem the instrument, and the instrument does not include any term or feature that might give rise to such an expectation.

5. Any cash dividend payments on the instrument are paid out of the banking organization’s net income and retained earnings, and are not subject to a limit imposed by the contractual terms governing the instrument.

6. The banking organization has full discretion at all times to refrain from paying any dividends and making any other capital distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of any other restrictions on the banking organization.

7. Dividend payments and any other capital distributions on the instrument may be paid only after all legal and contractual obligations of the banking organization have been satisfied, including payments due on more senior claims.

8. The holders of the instrument bear losses as they occur equally, proportionately, and simultaneously with the holders of all other common stock instruments before any losses are borne by holders of claims on the banking organization with greater priority in a receivership, insolvency, liquidation, or similar proceeding.
9. The paid-in amount is classified as equity under GAAP.

10. The banking organization, or an entity that the banking organization controls, did not purchase or directly or indirectly fund the purchase of the instrument.

11. The instrument is not secured, not covered by a guarantee of the banking organization or of an affiliate of the banking organization, and is not subject to any other arrangement that legally or economically enhances the seniority of the instrument.

12. The instrument has been issued in accordance with applicable laws and regulations.

13. The instrument is reported on the banking organization’s regulatory financial statements separately from other capital instruments.
2. **Additional Tier 1 Capital**

Additional tier 1 capital would be the sum of: additional Tier 1 capital instruments that satisfy certain criteria, related surplus, and qualifying Tier 1 minority interest that is not included in a banking organization’s common equity Tier 1 capital, minus any required regulatory adjustments and deductions.

**Criteria**

Additional Tier 1 capital instruments issued by a banking organization must satisfy the following criteria:

1. The instrument is issued and paid in.

2. The instrument is subordinated to depositors, general creditors, and subordinated debtholders of the banking organization in a receivership, insolvency, liquidation, or similar proceeding.

3. The instrument is not secured, not covered by a guarantee of the banking organization or of an affiliate of the banking organization, and not subject to any other arrangement that legally or economically enhances the seniority of the instrument.

4. The instrument has no maturity date and does not contain a dividend step-up or any other term or feature that creates an incentive to redeem.

5. If callable by its terms, the instrument may be called by the banking organization only after a minimum of five years following issuance, except that the terms of the instrument may allow it to be called earlier than five years upon the occurrence of a regulatory event (as defined in the agreement governing the instrument) that precludes the instrument from being included in additional Tier 1 capital or a tax event. In addition:

   (i) The banking organization must receive prior approval from its supervisory agency to exercise a call option on the instrument.

   (ii) The banking organization does not create at issuance of the instrument, through any action or communication, an expectation that the call option will be exercised.

   (iii) Prior to exercising the call option, or immediately thereafter, the banking organization must either:

   (A) Replace the instrument to be called with an equal amount of instruments that meet the criteria for common equity or additional Tier 1 capital; or

   (B) Demonstrate to the satisfaction of the banking organization’s supervisory agency that following redemption, the banking organization will continue to hold capital commensurate with its risk.
6. Redemption or repurchase of the instrument requires prior approval from the banking organization’s supervisory agency.

7. The banking organization has full discretion at all times to cancel dividends or other capital distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of other restrictions on the banking organization except in relation to any capital distributions to holders of common stock.

8. Any capital distributions on the instrument are paid out of the banking organization’s net income and retained earnings.

9. The instrument does not have a credit-sensitive feature, such as a dividend rate that is reset periodically based in whole or in part on the banking organization’s credit quality, but may have a dividend rate that is adjusted periodically independent of the banking organization’s credit quality, in relation to general market interest rates or similar adjustments.

10. The paid-in amount is classified as equity under GAAP.

11. The banking organization, or an entity that the banking organization controls, did not purchase or directly or indirectly fund the purchase of the instrument.

12. The instrument does not have any features that would limit or discourage additional issuance of capital by the banking organization, such as provisions that require the banking organization to compensate holders of the instrument if a new instrument is issued at a lower price during a specified time frame.

13. If the instrument is not issued directly by the banking organization or by a subsidiary of the banking organization that is an operating entity, the only asset of the issuing entity is its investment in the capital of the banking organization, and proceeds must be immediately available without limitation to the banking organization or to the banking organization’s top-tier holding company in a form which meets or exceeds all of the other criteria for additional Tier 1 capital instruments. *De minimis* assets related to the operation of the issuing entity can be disregarded for purposes of this criterion.

14. For an *advanced approaches banking organization*, the governing agreement, offering circular, or prospectus of an instrument issued after January 1, 2013 must disclose that the holders of the instrument may be fully subordinated to interests held by the U.S. government in the event that the banking organization enters into a receivership, insolvency, liquidation, or similar proceeding.
3. Tier 2 Capital

Tier 2 capital would be the sum of: Tier 2 capital instruments that satisfy certain criteria, related surplus, total qualifying capital minority interests not included in a banking organization’s Tier 1 capital, and limited amounts of the allowance for loan and lease losses, minus any required regulatory adjustments and deductions.

Criteria

Tier 2 capital instruments issued by a banking organization must satisfy the following criteria:

1. The instrument is issued and paid in.

2. The instrument is subordinated to depositors and general creditors of the banking organization.

3. The instrument is not secured, not covered by a guarantee of the banking organization or of an affiliate of the banking organization, and not subject to any other arrangement that legally or economically enhances the seniority of the instrument in relation to more senior claims.

4. The instrument has a minimum original maturity of at least five years. At the beginning of each of the last five years of the life of the instrument, the amount that is eligible to be included in Tier 2 capital is reduced by 20 percent of the original amount of the instrument (net of redemptions) and is excluded from regulatory capital when remaining maturity is less than one year. In addition, the instrument must not have any terms or features that require, or create significant incentives for, the banking organization to redeem the instrument prior to maturity.

5. The instrument, by its terms, may be called by the banking organization only after a minimum of five years following issuance, except that the terms of the instrument may allow it to be called sooner upon the occurrence of an event that would preclude the instrument from being included in Tier 2 capital, or a tax event. In addition:

   (i) The banking organization must receive the prior approval of its supervisory agency to exercise a call option on the instrument.

   (ii) The banking organization does not create at issuance, through action or communication, an expectation that the call option will be exercised.

   (iii) Prior to exercising the call option, or immediately thereafter, the banking organization must either:

       (A) Replace any amount called with an equivalent amount of an instrument that meets the criteria for Tier 1 or Tier 2 regulatory capital, or
(B) Demonstrate to the satisfaction of its supervisory agency that following redemption, the banking organization would continue to hold an amount of capital that is commensurate with its risk.

6. The holder of the instrument must have no contractual right to accelerate payment of principal or interest on the instrument, except in the event of a receivership, insolvency, liquidation, or similar proceeding of the banking organization.

7. The instrument has no credit-sensitive feature, such as a dividend or interest rate that is reset periodically based in whole or in part on the banking organization’s credit standing, but may have a dividend rate that is adjusted periodically independent of the banking organization’s credit standing, in relation to general market interest rates or similar adjustments.

8. The banking organization, or an entity that the banking organization controls, has not purchased and has not directly or indirectly funded the purchase of the instrument.

9. If the instrument is not issued directly by the banking organization or by a subsidiary of the banking organization that is an operating entity, the only asset of the issuing entity is its investment in the capital of the banking organization, and proceeds must be immediately available without limitation to the banking organization or the banking organization’s top-tier holding company in a form that meets or exceeds all the other criteria for Tier 2 capital instruments under this section.

10. Redemption of the instrument prior to maturity or repurchase requires the prior approval of the banking organization’s supervisory agency.

11. For an advanced approaches banking organization, the governing agreement, offering circular, or prospectus of an instrument issued after January 1, 2013 must disclose that the holders of the instrument may be fully subordinated to interests held by the U.S. government in the event that the banking organization enters into a receivership, insolvency, liquidation, or similar proceeding.
On June 12, 2012, the Federal banking agencies (the OCC, Federal Reserve Board and FDIC) (the “Agencies”) formally proposed for comment, in three separate but related proposals, significant changes to the U.S. regulatory capital framework: the Basel III Proposal, which applies the Basel III capital framework to almost all U.S. banking organizations; the Standardized Approach Proposal, which applies certain elements of the Basel II standardized approach for credit risk weightings to almost all U.S. banking organizations, and the Advanced Approaches Proposal, which applies changes made to Basel II and Basel III in the past few years to large U.S. banking organizations subject to the advanced Basel II capital framework.

Comments on the three proposals are due by September 7, 2012.

Clients and other interested persons are invited to read our more detailed discussion of these proposals in our memorandum on the subject here. We expect to report separately in further detail on specific elements of the regulatory capital proposals, including their effects on financial products, derivatives activities, and securitizations.

**Basel III Proposal**

**Applicability.** This proposal is applicable to all U.S. banks that are subject to minimum capital requirements, including Federal and state savings banks, as well as to bank and savings and loan holding companies other than “small bank holding companies” (generally bank holding companies with consolidated assets of less than $500 million).

**Proposed Effective Dates/Transitional Periods.** There will be separate phase-in/phase-out periods for minimum capital ratios; regulatory capital adjustments and deductions; non-qualifying capital instruments; capital conservation and countercyclical capital buffers; supplemental leverage ratio for advanced approaches banks; and changes to the Agencies Prompt Corrective Actions (“PCA”) rules. Almost all these changes would be effective by January 1, 2019.

**Revised Definitions and Calculations of Capital.** Tier 1 Capital would consist of common equity Tier 1 capital and additional Tier 1 capital. Total Tier 1 capital, plus Tier 2 capital, would constitute total risk-based capital. The proposed criteria for common equity and additional tier 1 capital instruments, and Tier 2 capital instruments, are broadly consistent with the Basel III criteria.

**Common Equity Tier 1 Capital** would be the sum of outstanding common equity tier 1 capital instruments and related surplus (net of treasury stock), retained earnings, accumulated other comprehensive income, and common
equity Tier 1 minority interest, minus certain adjustments and deductions. Unrealized gains and losses on all available-for-sale securities held by the banking organization would flow through to common equity Tier 1 capital. Qualifying common equity Tier 1 capital would have to satisfy 13 criteria that are generally designed to assure that the capital is perpetual and is unconditionally available to absorb first losses on a going-concern basis, especially in times of financial stress.

Additional Tier 1 Capital would be the sum of non-common equity capital instruments that satisfy 13 separate criteria (14 for advanced approaches banking organizations), related surplus, and Tier 1 minority interests that are not included in a banking organization’s common equity Tier 1 capital, minus applicable regulatory adjustments and deductions. The 14 criteria in question generally are designed to assure that the capital instrument is available to absorb going-concern losses and does not possess credit sensitive or other terms that would impair its availability in times of financial stress. Non-cumulative perpetual preferred stock, which now qualifies as simple Tier 1 capital, would not qualify as common equity Tier 1 capital, but would qualify as additional Tier 1 capital. Cumulative preferred stock would no longer qualify as Tier 1 capital of any kind. Certain hybrid capital instruments, including trust preferred securities, no longer will qualify as Tier 1 capital of any kind.

Tier 2 Capital of a banking organization must satisfy 10 separate criteria (11 for advanced approaches banking organizations), all of which are designed to assure adequate subordination and stability of availability. An advanced approaches banking organization may include the excess of eligible credit reserves over its total expected credit losses (“ECL”) to the extent that such amount does not exceed 0.6 percent of its total credit risk weighted-assets.

Compliance with Basel III Non-Viability Standards. The Agencies believe that the Basel III Proposal and U.S. law are consistent with the Basel III non-viability standard.

Leverage Requirement. A separate Tier 1 leverage capital requirement, measured as a ratio of Tier 1 capital (minus required deductions) to average on-balance sheet assets, is proposed for U.S. banking organizations. The practical impact of this requirement should be relatively modest, inasmuch as U.S. banking organizations already are subject to leverage capital requirements, although the minimum leverage ratio requirement for all banks will now be 4 percent. Advanced approaches banking organizations would be subject to a new and separate supplementary leverage ratio, where they would maintain capital not only against their on-balance sheet assets (less amounts deducted from Tier 1 capital), but also certain off-balance sheet assets and exposures. Covered off-balance sheet exposures would include future exposure amounts arising under certain derivatives contracts, 10 percent of the notional amount of unconditionally cancellable commitments, and the notional amount of most other off-balance sheet exposures (excluding securities lending and borrowing, reverse repurchase agreement transactions, and unconditionally cancellable commitments).

Exclusions and Deductions from Capital. A number of required capital adjustments, exclusions and deductions (primarily from Tier 1 capital) would be required, including items such as deductions of goodwill and other intangibles, most deferred tax assets, capital investments in financial firms, and reciprocal cross-holdings. These adjustments and deductions are broadly consistent with Basel III.

Treatment of Minority Interests. The Basel III Proposal limits the type and amount of qualifying minority interests that can be included in Tier 1 capital. Minority interests would be classified as a common equity Tier 1, Tier 1, or total capital minority interest depending on the underlying capital instrument and on the type of subsidiary issuing such instrument. Qualifying common equity Tier 1 minority interests would be limited to a depository institution or foreign bank that is a consolidated subsidiary of a banking organization. Limits on the amount of minority interest that may be included in the consolidated capital of a banking organization would be based on a formula generally based on the amount and distribution of capital of the consolidated subsidiary.

Minimum Capital Requirements. Required minimum capital ratios would be: (i) a common equity Tier 1 capital ratio of 4.5 percent; (ii) a Tier 1 capital ratio of 6 percent; (iii) a total capital ratio of 8 percent; and (iv) a Tier 1
leverage ratio to average consolidated assets of 4 percent and, for advanced approaches banking organizations only, an additional leverage ratio of Tier 1 capital to total leverage exposure of 3 percent. The common equity Tier 1 capital ratio would be a new minimum requirement.

*Capital Conservation Buffer*. A new phased-in capital conservation buffer for all covered banking organizations equal to 2.5% of total risk-weighted assets (“TRWA”) is being proposed.

*Countercyclical Capital Buffer*. A macro-economic countercyclical capital buffer of up to 2.5% of TRWA applicable only to advanced approaches banking organizations is proposed. The countercyclical capital buffer, applied upon a joint determination by the Agencies, would augment the capital conservation buffer.

*Changes to Prompt Corrective Action Rules*. The Agencies propose to amend the Agencies’ PCA regulations to assure consistency with the new regulatory capital requirements.

**Standardized Approach Proposal**

*Applicability*. This proposal would be generally applicable to the same banks that would be subject to the Basel III Proposal.

*Proposed Effective Date*. January 1, 2015. Banks have the option to adopt the rules earlier.

*General Elements*. The proposal revises a large number, although not quite all, of the risk weights (or their methodologies) for bank assets. For nearly every class, the proposal requires a more complex, detailed and calibrated assessment of credit risk and calculation of risk weightings.

*General Coverage/Highlights*

- Two categories of residential mortgage lending would be created: traditional lending would be category 1, where the risk weights range from 35 to 100 percent. Nontraditional loans would fall within category 2, where the risk weights would range from 50 to 150 percent.

- Most commercial loans would continue to be risk-weighted at 100 percent; “high volatility” commercial real estate loans would be risk-weighted at 150 percent.

- Over-the-counter derivative contracts (“OTC derivatives”) would no longer be subject to the existing 50 percent risk weight cap.

- Transactions cleared through central counterparties (“CCPs”) would receive more favorable treatment than transactions conducted and cleared over the counter, although the extent of the advantage would depend on the nature of the CCP.

- Guarantees and collateral would be subject to mixed treatment. A greater variety of these credit enhancements are permitted, but the conditions for their qualification would be tightened.

- Securitization exposures would be weighted according to either the current gross-up method or a new formula to replace the existing method that is based on credit ratings. The proposal also imposes new qualitative/due diligence requirements.
• Equity exposures to unconsolidated counterparties would be risk weighted under one of two broad methods, depending on whether the exposure is to an entity other than an investment fund, or an investment fund. Risk-weighting formulas for these exposures would be significantly more granular.

• Risk-weightings of sovereign debt and exposures to foreign banks would vary primarily according to OECD “country risk” classifications.

• Regulatory capital disclosure requirements would apply to banks with total consolidated assets of $50 billion or more and that are not subject to the disclosure requirements under the advanced approaches rule.

Advanced Approaches Proposal

Applicability. This proposal applies to banking organizations that are subject to the “advanced approaches” rule under Basel II, including qualifying Federal and state savings associations and their holding companies. It addresses counterparty credit risk, removal of credit rating references, securitization exposures, and conforming technical changes. It also proposes the expansion of those banking organizations that are subject to the market risk capital rule.

Proposed Effective Date: None specified.

Counterparty Credit Risk. Changes proposed include:

• Revisions to the recognition of eligible financial collateral.

• Lengthening the assumed holding periods and the calculation of certain collateralized OTC exposures under the collateral haircut and simple Value-at-Risk (VaR) approaches.

• Increasing capital requirements associated with the internal models methodology; better identification and management of wrong-way risk associated with certain counterparty exposures.

• Additional capital requirement for credit value adjustments relating to OTC derivatives exposures.

• Changing the capital requirements for qualifying and other central counterparty (CCP) exposures, including capital calculations for CCP default fund contributions.

• Requiring application of a continuous 12-month stress period in calculating market price and foreign volatility exposures under the collateral haircut method, based on internal estimates.

Removal of Credit Rating References. Consistent with section 939A of the Dodd-Frank Act, the Advanced Approaches Proposal would remove references to credit ratings that currently exist in the advanced approaches capital rules and replace these references with alternative standards of creditworthiness. In this regard, the Agencies would remove the ratings-based and internal assessment approaches for securitization exposures and require banking organizations to use the supervisory formula approach (SFA) or its simplified version in calculating their capital requirements for these exposures.

Securitization Exposures. The Agencies also propose to create a new definition of resecuritization exposures and broaden the definition of securitization exposures, while excluding certain traditional investment firms from that definition. These changes also are consistent with changes proposed in the Standardized Approach Proposal. The resecuritization definition would capture exposures to securitizations that are comprised of asset-backed
securities (e.g., CDOs and some ABCP conduits) and which are now subject to higher risk-weightings under the 2009 changes to Basel II.

**Market Risk Capital Rule Applicability.** Federal and state savings banks and their holding companies that meet the market risk capital rule threshold criteria would become subject to the rule.

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Systemically Important Nonbank Financial Institutions: FSOC Approves Final Rule

May 2012
On April 11, 2012, the Financial Stability Oversight Council (the “Council”) gave more shape to the framework of systemic risk regulation by publishing a final rule (the “Rule”) that sets forth the process for the designation of nonbank financial institutions as systemically important.1 Once designated, these systemically important financial institutions (“SIFIs”) will be supervised by the Federal Reserve Board (the “Board”) in much the same way that it supervises bank holding companies with $50 billion or more in consolidated assets. This supervision will involve the use of more rigorous “enhanced prudential standards” than apply to bank holding companies below the $50 billion floor. The Board proposed such standards earlier this year. Large nonbank financial companies should review the Rule with care, given the onerous consequences of designation and the intricacies of the designation process.

The designation of nonbank financial firms as SIFIs is one tool, but perhaps not the most efficient tool, for addressing systemic risk in the financial services industry. The Dodd-Frank Act Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or the “Act”) provides two other tools: the identification and regulation of systemically risky activities across all financial institutions and authority to resolve distressed SIFIs in an organized manner outside the bankruptcy and bank receivership processes.

Because many firms are likely to engage in any given line of business that presents a high level of risk, the identification and regulation of these activities across the financial services industry is the most effective way to address systemic risk. The regulators will be able to collect information on how several firms operate the business and manage the attendant risks, which will enable the regulators to establish a sophisticated industry-wide approach. By contrast, the designation of particular firms will focus on idiosyncrasies and unique risks to financial stability that can only be handled on an institution-specific basis. This approach will create at best a materially smaller body of knowledge that can be applied to the regulation of other large firms. Nevertheless, the Council has chosen to concentrate on the designation of nonbank financial firms as presenting threats to U.S. financial stability. The review of activities that may lead to systemic risk seems to be a lower priority.

Important consequences will flow from designation as a SIFI. Designation would adversely affect the ability of these institutions to compete with their undesignated competitors due to increased costs and supervisory impact on their decision making process. Under the Rule, a significant number of large financial firms could be pulled into the Council’s designation process. The Rule establishes quantitative thresholds to identify firms subject to the process, which appear to be at least in part "reverse engineered" based on experiences from the financial crisis. However, the metrics would also sweep up firms that would pose widely divergent levels and types of risk to financial stability, including many firms that do not warrant designation. Moreover, the Council has made clear that the universe of covered firms may go beyond those firms that meet the quantitative thresholds.

The Council has declined to provide any kind of exemption or safe harbor for sectors of the financial services industry that would seem to present no real threat to financial stability, either because regulation of particular activities would more effectively and more equitably address any risks posed, or because the bank holding company model would not effectively address any risks posed.

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The uncertainties in the process and the consequences strongly suggest that firms that would exceed any of the specified metrics, as well as other financial firms that could be viewed as presenting risks to financial stability, develop a strategy to take the initiative in addressing the Council’s likely concerns based on the information in the Rule, and as discussed more fully below.

This paper explains the basis for and the elements of such a strategy. Attached are two annexes, one a detailed analysis of the Rule and the other a description of a related rulemaking by the Board on the definition of “predominantly engaged in financial activities.”

**Overview of the Rule**

The Rule contemplates that the Board supervise those financial firms that may disrupt the U.S. financial system as a result of either their threatened failure or the nature and scope of their activities. The Council sees primarily three types of threats that could create such disruption: (i) exposures of third parties to the firm such that an adverse event at the firm could “materially impair” those third parties; (ii) reliance on short-term funding or other actions that would require the firm, if troubled, to liquidate its assets quickly in a volume and at prices that would disrupt trading or funding across the markets; and (iii) the disappearance of or diminution in critical financial functions that other market participants could not replace when the firm withdraws from the market.

The process that the Council will use to designate the nonbank financial firms that could pose one or more of these threats involves the identification of a potentially large group of institutions—that part of the process known as Stage 1—followed by a winnowing-out process—referred to as Stages 2 and 3.

The universe of firms that will be subject to the Council’s designation process includes—but is not limited to—firms with more than $50 billion in total worldwide consolidated assets that cross at least one of the five quantitative thresholds in the table below.

| Gross notional credit default swaps outstanding for which the firm is the reference entity | $30 billion |
| Derivative liabilities | $3.5 billion |
| Total debt outstanding | $20 billion |
| Leverage ratio—total consolidated assets to total equity | 15:1 |
| Short-term debt ratio—total debt outstanding with a maturity of less than 12 months to total consolidated assets | 10 percent |

These thresholds appear to be designed to identify firms with more than $50 billion in consolidated worldwide assets with a higher risk of failure or, to a lesser extent, a higher risk to counterparties if they should fail.

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2 The Council may designate as systemically important only those firms “predominantly engaged in financial activities.” The Board is responsible for defining “predominantly” and determining the precise meaning of “financial activities” and is now developing a rule. A final rule on this issue is, in our view, a pre-condition to any final designation by the Council, and we discuss it further below.
Nonbank financial firms that do not meet either the $50 billion threshold or any of the other thresholds are not necessarily home free. The Council has reserved its authority to place other nonbank financial firms in Stage 2 and has said that the fact that a nonbank financial firm does not meet the thresholds does not mean that it will not be designated as systemically important. In the supplementary information to the Rule, the Council observes that it may wish to assess the systemic risks associated with certain firms that do not currently disclose information that is sufficient to take the necessary measurements.

The thresholds do not necessarily reflect real risks to financial stability. For example, as to risks, an institution with $50 billion in total worldwide assets and only $20 billion in debt outstanding could have a tier 1 leverage ratio of 60 percent and conservative investments as assets. Further, the holders of the debt could be so many and so diverse that the remote possibility of failure of the firm would pose virtually no risk of domino failures of financial firms that could threaten paralysis of the financial system. Although such a firm should be eliminated from the designation process fairly readily, other firms that may be viewed as presenting higher levels of risk will want to be in a position to address the potential designation process.

Moreover, the thresholds already are in a state of flux. In the supplementary information to the Rule, the Council said that it anticipated revising the threshold for derivative liabilities once the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”) have finalized the definitions of “major swap participant” and “major security-based swap participant” to address potential future exposures. Since then, the two agencies have released a joint final rule on these definitions. An element of the definitions is whether the participants hold “substantial positions” in different kinds of swaps. Whether these position thresholds will constitute another quantitative threshold for Stage 1 remains to be seen. The Council also expects to rely on the new Forms PF that hedge funds and private equity funds will be required to file with the SEC. For asset management firms, the Council is still considering whether these firms in general could pose a threat to financial stability and, if so, what the appropriate metrics would be. Firms will want to consider how the resolution of these issues will affect their relationships to the stated thresholds.

A firm that meets the stated thresholds in Stage 1 automatically enters Stage 2. The Council may place other firms in Stage 2 as well. The nature of Stage 2 would suggest that the Council will or should notify a firm at least informally that it has entered Stage 2, but the Rule offers no assurance that it will do so. In this stage, the Council will begin to undertake a company-specific review of the risks posed by the firm. The Council will apply six categories of factors: interconnectedness, substitutability, size, leverage, liquidity and maturity mismatch, and existing regulatory scrutiny. Each factor has several qualitative and quantitative elements. As we discuss further below, firms should keep in mind the relationship between these six factors and the threats of credit risk to counterparties, disruption of markets due to liquidation of assets and loss of critical functions.

Among these factors, interconnectedness clearly relates to counterparty credit risk while substitutability appears to relate to loss of critical functions. Size relates to interconnectedness as well as potential for market disruption. Size also affects loss of critical functions although perhaps less directly. Leverage, liquidity, maturity mismatch and existing regulatory scrutiny relate to the likelihood of a problem at a firm more than to the consequences of the problem.

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3 As of the date of this paper, the final rule had not been officially published. It may be accessed at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister041812b.pdf.
The distinction between likelihood and effect is important. Likelihood of a problem is an issue that may be common to markets or business lines and logically should be dealt with through more general regulatory and supervisory regimes. If these issues are addressed appropriately under existing regulatory and supervisory regimes or Section 120, the need to designate individual institutions on the basis of such factors should be greatly reduced.

The Stage 2 and Stage 3 reviews are a continuum but differ in the sources of the information that the Council considers. In Stage 2, the Council will rely on public information and material available from the firm’s regulators that has been analyzed by the Treasury Department’s Office of Financial Research (“OFR”). If the Council believes that this information is insufficient to make a determination of a firm’s possible threat to financial stability, it will move the firm to Stage 3, where it will request, through OFR, and take into account, information from the firm.

A firm’s participation in Stage 2 is not entirely clear. In the supplementary information to the Rule, the Council describes Stage 3 as the time for a firm’s active participation in the designation process. Yet the Rule provides that the Council may review material provided by a firm in Stage 2.4

The Council may choose not to place a large nonbank firm into Stage 3, evidently satisfied on the basis of public and supervisory information that the firm does not present systemic risk. Nevertheless, the Council regards a decision not to move a firm into Stage 3 as “preliminary” and does not plan initially to notify firms that they have not been moved to Stage 3. Such firms will be left in limbo, apparently in perpetuity.

Stage 3 is the formal part of the process and includes specific deadlines. Once the Council decides that it needs information from a firm directly, it will issue a Notice of Consideration, which will include a request for information. The request may be wide ranging, and the Council has not indicated what a request is likely to cover. Once the Council believes it has a full record on which to make a designation, it will issue a Notice of Proposed Determination. Upon receipt of this notice, a firm will have 30 days in which to request a hearing. The Council will then set a time for a hearing within 30 days of the firm’s request, and this date will serve as a deadline for the submission of relevant information. If the firm does not request a hearing, the Council will render a decision within 40 days of the firm’s receipt of the Notice of Proposed Determination—meaning that the firm will have substantially less time to prepare and submit information if it does not request a hearing. If the Council determines that it will designate a firm as systemically important, it will give the firm one day’s advance notice before releasing a final determination so that the firm can prepare appropriate disclosures, releases, or other communications. The firm has a right to judicial review, whether or not it has requested a hearing and one has taken place.

Public statements by Treasury Department officials indicate that the Council is likely to designate its first SIFIs before the end of 2012. In order to do so, given the time periods in Stage 3, the Council will need to issue Notices of Consideration early in the summer.

The Rule describes Stages 2 and 3 as seriatim events, but the Council’s evaluation of a particular firm could result in a slightly different process. For example, the Council may decide at the outset that its decision will be governed by information held by the firm and issue a Notice of Consideration at an earlier point than with respect to other firms. Alternatively, the Council could decide, solely on the basis of Stage 2 information, that it intends to designate a firm as

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4 See 12 C.F.R. § 1310.20(b)(4). However, as noted above, not all firms may be aware that they are in Stage 2.
systemically important and that an information request is unnecessary. In this event, the Council could issue a Notice of Proposed Determination without a prior Notice of Consideration.

The only public disclosure that the Council will make is the publication of the final designation.

**The “Predominantly Engaged” Rulemaking**

Implementation of the Rule is linked to a separate and ongoing rulemaking by the Board on the meaning of “predominantly engaged.” Section 113 limits the designation process to “nonbank financial companies,” a term that, under section 102(a)(4), includes only those companies that are “predominantly engaged in financial activities.” The Board is charged with implementing this term through rulemaking. Section 102(a)(6) requires that the Board’s regulation include two tests—that a firm is predominantly engaged when 85% of its assets or revenues are derived from activities permitted to financial holding companies.

Currently pending is a proposed rule from the Board that remains open for comment.\(^5\) Annex 2 describes the rulemaking in detail. In light of the complexity both of accounting rules and of the structure of many large nonbank firms, firms with material non-financial business should carefully review how the proposed rule attributes assets and revenues to financial and non-financial operations. This mapping process may require significant time and resources, particularly for firms that are not required to use U.S. generally accepted accounting principles.

Finalization of a rule interpreting “predominantly engaged” is not, in the Council’s view, essential to the designation process.\(^6\) The Council apparently will begin its process before the Board has issued its final rule. This procedure may not matter for firms that are clearly predominantly engaged but firms near to the line could be put to substantial expense addressing a potential designation for no reason. Moreover, as we explain in Annex 2, we believe that the Council does not, as a matter of law, have the authority to designate a nonbank firm as systemically important without the Board’s final rule that describes which firms may be subject to the designation process. Notwithstanding this principle, it is likely that the Council has already begun to review certain nonbank financial firms for designation.

**Preparation**

Every nonbank financial firm with consolidated assets of more than $50 billion or that does not meet that threshold but that either meets one of the other thresholds or that has reason to believe that the Council could designate it on a qualitative basis, should develop a strategy for addressing the designation process. Three considerations drive the need for a strategy.

First, the Council has not limited itself to those firms that exceed the quantitative thresholds. Firms that approach or exceed the thresholds are, of course, at the greatest risk of designation and have an attendant greater need for a strategy to address designation. The Council has identified private equity funds, and hedge funds as firms that may be subject to designation, even if they do not meet any of the quantitative thresholds. A firm that provides a specialized

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\(^5\) 77 Fed. Reg. 21494 (Apr. 10, 2012). This notice is a supplement to an earlier proposal that remains pending, 76 Fed. Reg. 7731 (Feb. 11, 2011). The two releases should be read together.

\(^6\) Finalization of the proposed rule and completion of other rulemakings “are not essential to the Council’s consideration of whether a nonbank financial company could pose a threat to U.S. financial stability, and the Council has the statutory authority to proceed with determinations under section 113 of the Dodd-Frank Act prior to the adoption of such rules.” 77 Fed. Reg. 21637, 21639 (Apr. 11, 2012).
but critical product or that dominates a particular product or service market where there are relatively high barriers to entry may be subject to the process as well.

Second, once a large firm meets one of the thresholds, the process may begin to gain momentum towards a designation of systemic importance. Entry into Stage 2 is automatic, and the Council appears loathe to remove a firm from consideration solely on the basis of the Stage 2 review. Further, the amount and quality of the regulatory information on different types of financial firms may vary, reinforcing the Council’s inclination to undertake Stage 3 reviews. Nevertheless, it is not clear that a concentrated effort to educate the Council’s staff on why a firm should not be designated would receive appropriate attention.

Third, designation, or even the perception that designation is likely, may have a material effect on a nonbank financial firm’s earnings and operations. Section 113 requires that the Board subject these firms to “enhanced prudential standards” that are the same as or substantially similar to the new and more stringent standards that the Board will apply to bank holding companies with total consolidated assets of more than $50 billion. The Board recently proposed such standards, and they have been strongly opposed by banking institutions that are potentially subject to them.\(^7\) Among other things, the standards could require designated nonbank financial firms to comply with bank holding company regulatory capital requirements, to operate with higher levels of capital and to maintain higher levels of liquidity. Although a nonbank financial firm should have the ability to establish an intermediate holding company that would be subject to the proposed requirements instead, the requirements for such a company are unclear. If the capital standards in the proposed rule apply to the entire firm, the impact of these requirements should not be underestimated. Firms also would be subject to greater oversight and additional limits if their capital were to dip below certain levels or other weaknesses became apparent.

Accordingly, any firm that may be swept into Stage 2 should begin to analyze how it may be reviewed by the Council and what material would be pertinent to that review. The Guidance indicates that the Council will evaluate a firm from the perspective of whether distress at a nonbank financial firm might cause others to become distressed and whether distress at these other companies might cause distress at still other otherwise healthy nonbank financial firms. The central question then is whether either development could contribute to a credit exposure crisis, a liquidity crisis, or the loss of critical products or services that are not readily available. We discuss approaches to these factors below, as well as ways to analyze how those factors might contribute to any of the three crises that the Council has identified. The specific components of each of the factors are described in Annex 1.\(^8\)

Anticipating how the Council actually will analyze each nonbank financial firm is complex because of the web of factors and potential sources of disruption, as well as the lack of

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\(^7\) 77 Fed. Reg. 594 (Jan. 5, 2012).

\(^8\) While section 113 and the interpretive guidance (in its description of the Second Determination) raise the possibility that a firm will be designated solely on the basis of its complexity, apparently in the absence of financial distress, the substance of the interpretive guidance deals with scenarios of distress. Given the discussion in the guidance, we would hope that the Council would understand that complexity in the absence of distress is not a meaningful indicator of systemic importance and will not devote inordinate attention to the issue. A firm’s activities alone could be problematic only if the firm is so large that a business decision that will not materially affect its financial position could have a ripple effect on smaller counterparties. A healthy firm also might decide to terminate a line of business that would affect smaller participants. In either case, the harm necessarily would be limited to smaller counterparties, and the ripple effect would not be systemically important.
precedents. At the same time, these uncertainties suggest that there may be room to educate
the Council on why designation of particular firms is inappropriate, including why other
approaches to any risks that the firm may present would be more effective. Indeed, a firm may
wish to consider proposing other prudential standards.

Three general points are worth keeping in mind as a firm approaches the analysis of systemic
risk. First, while each of these factors should be analyzed with care, communications with the
Council should address a broader theme. The designation process ultimately is intended to
protect against a future financial crisis. A firm therefore should explain how it fared during the
crisis and how it was able to avoid material financial distress. Certain financial firms, among
them mutual funds and other asset managers and life insurance companies, have long histories
of financial stability in volatile markets, and should make that point to the Council.

Second, some of the Council’s concerns have been addressed in the enhanced prudential
standards that the Board recently proposed. Since the purpose of the enhanced prudential
standards is to reduce systemic risk, a firm that meets these standards should not pose risk with
respect to the factor that such standards address. For example, a firm that would comply with
the counterparty credit risk exposure limits in the proposed standards should present little or no
risk that distress at the firm would create systemically important exposures for those
counterparties. Additionally, while the proposed standards call for institution-specific liquidity
requirements (rather than stating quantitative standards across the board), a firm that would
meet the liquidity requirements that currently are part of Basel III should not present material
risk of a liquidity event that would force asset sales that would disrupt the market.9

Third, a nonbank financial firm that has been designated as systemically important must prepare
and submit two related plans: a capital plan (or recovery plan) to the Board and a plan for its
orderly liquidation in the event of failure to the Board and the Federal Deposit Insurance
Corporation. A firm should consider whether it could develop plans of this nature before a
designation in order to demonstrate the ease of a recapitalization and an orderly liquidation and
the corresponding absence of systemic risk.

**Material financial distress**

The designation of a nonbank financial firm as systemically important is a complex process.
The Council must make two determinations: whether material financial distress, or a
combination of factors at the firm, could pose a threat to the financial stability of the United
States. Such a threat likely would come through one (or more) of three channels, which are
evaluated on the basis of six categories of factors.

The Council will measure the potential effects of financial distress primarily by three factors—
size, interconnectedness, and substitutability. In addition to undertaking the appropriate
measurements of these factors, we suggest that a firm discuss the precondition to the Council’s
material financial distress—the likelihood that distress would occur.

**Size.** The possibility that material financial distress would disrupt the financial markets will be
measured initially by size. Total consolidated assets do not necessarily correlate with any of the

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9 Basel III includes two liquidity requirements, a liquidity coverage ratio that addresses liquidity over the next 30 days
and a net stable funding ratio that measures liquidity over the coming twelve months. See Basel Comm. On Bkg.
Supervision, Basel III: International framework for liquidity risk measurement, standards and monitoring (Dec. 2010),
accessible at [http://www.bis.org/publ/bcbs188.pdf](http://www.bis.org/publ/bcbs188.pdf). The Basel Committee, however, is still reviewing both ratios.
threats of disruptive credit risk to counterparties, disruption of markets due to liquidation of assets or loss of critical functions. A firm should explain the elements and diversity of its balance sheet, the distinct risks to counterparties, potential effects of the liquidation of assets, and the availability of substitutes for the services that the firm provides. The firm’s balance sheet relative to that of its competitors and counterparties should be described as well.

**Interconnectedness.** The analysis of size should overlap with that of interconnectedness, that is, significant concentrated liabilities are most likely to present concerns about interconnectedness. A firm should be prepared to identify the third parties that have substantial exposure to it. A rule of thumb should be that a firm presents possible systemic exposure risk to a third party where that party’s exposure to the firm exceeds 25 percent of that party’s capital. This standard is the converse of the rule in section 165(e) and the Board’s enhanced prudential standards that a nonbank financial firm’s exposure to another party should not exceed 25% of the firm’s total capital. Exposures below that level should present limited systemic concerns.

**Substitutability.** This factor presents interesting issues because it should be the principal if not the sole determinant of the “crucial products and services” decision that the Council must make. Regarding experience, in the history of bank regulation, substitutability is an antitrust concept that the federal banking agencies have applied in the competition analyses that are a necessary part of the review of merger and acquisition applications. Specifically, substitutability is considered where a market must be defined in order to calculate market share. This analysis does not create a solid precedent for a systemic risk assessment, because the possibility of reduced competition is different from a potential risk to financial stability. Moreover, the banking agencies’ analysis of substitutability has been somewhat crude—the markets that have been defined using substitutability have been those for deposits and commercial loans. The products and services offered by large financial institutions are more complex and determining substitutes may be a difficult process.

As a result, a firm should be prepared to educate the Council about substitutability and the importance of distinguishing substitutability as a systemic issue for its more traditional place in competition assessments. In particular, a firm should explain how nominally different products serve similar economic functions and are ready substitutes for one another in the credit and capital markets, as well as how any barriers to entry into the market can be overcome.

**Vulnerability to financial distress**

Vulnerability to financial distress is a function of three factors, which are somewhat more limited in scope than those that relate to material financial distress: leverage, liquidity risk and maturity mismatch, and the degree of regulatory scrutiny. In addressing the quantitative elements of these factors, a firm should demonstrate how its measurements compare to industry standards and those of its peers to the extent such information is available. In addition, this area in particular should be influenced by how a firm’s business model faired in past financial crises.

**Leverage.** The potential risks inherent in leverage is that lower levels of equity may hasten undercapitalization in a time of stress and generally will make it more difficult for a nonbank

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10 For firms with $500 billion or more in worldwide consolidated assets, the rule of thumb should be 10 percent of capital for exposures to any other firms with $500 billion or more in worldwide consolidated assets.

11 The services most likely to present substitutability concerns are those where there is a high concentration—exchanges and clearinghouses. Title VIII of the Act addresses the potential systemic risk of the providers of these services—“financial market utilities”—and the Council already has addressed the potential systemic risk of these services in a final rule. 76 Fed. Reg. 44763 (July 27, 2011).
financial firm to find necessary financing when financial markets are disrupted. However, leverage involves more than just levels of equity. Short-term liabilities are more likely to trigger assets sales that will, in turn, put pressure on capital than will longer term liabilities. The character of the holders of the liabilities and their potential for flight will also be important. Holders of insurance policies may be much less susceptible to panics that create liquidity pressures than risk-averse holders of unsecured demand obligations. Since different forms of debt and the cost of funds will have different effects on counterparties and future access to liquidity, communications with the Council should analyze a firm’s debt structure. A firm should also, of course, explain how it plans to obtain liquidity when under stress and, if applicable, how it has done so in the past. Generally, access to liquidity through assets sales is probably the least favorable approach under the Council’s analysis.

Arguably, a protected anchorage, if not a complete safe harbor exists: a ratio of total liabilities to total equity of 15:1. (The bank capital rules present the leverage ratio in converse form, here 6.67 percent.) This ratio is a ceiling imposed by section 165(j) of the Act and the Board’s proposed enhanced prudential standards on those nonbank financial firms and bank holding companies with assets greater than $50 billion that present a “grave threat” to U.S. financial stability.

Liquidity risk and maturity mismatch. Liquidity risk for the Council’s purpose is the degree to which a nonbank financial firm relies on short-term funding and the firm’s ability to find replacement funding. The issue is whether the firm maintains a sufficient amount of readily liquid assets to cover any liabilities over 30-day and one-year time horizons. As noted above, liquidity risk is closely related to, if not a component of leverage. Any submission should identify with precision the nature of any reliance on short-term funding—i.e., which business lines do and do not rely on short-term funding—the diversity of its funding sources and the response of the firm if its different lines are affected by the loss in such funding.

Maturity mismatch relates to the differences in the maturities of a nonbank financial firm’s assets and of its liabilities. A firm should be prepared not only to identify the different maturities but also to show any links between particular assets and particular liabilities, which would show the real impact of maturity mismatches. In this regard, the liquidity of assets and the volatility of the markets for these assets will be important components in analyzing their maturity. In addition, interest rate risk is a function partly of maturity mismatches and should be part of the firm’s analysis.

Regulatory oversight. Much of the information on the quality of regulatory oversight should already be available to the Council through its member agencies. For example, the insurance regulators’ representative can speak to state insurance regulation. The Board has significant relationships with foreign regulators, a number of whom regulate nonbank financial companies as well as banking institutions. The Board already has determined that several foreign regulators provide comprehensive consolidated supervision in the banking sector, and these determinations may inform the Council’s analysis. Nevertheless, communication, and more significantly, understanding between and among regulators is notoriously incomplete. In any case, the Council is unlikely to have a full understanding of the specific experience of a firm with its regulators, and a firm should be prepared to provide that information.
Annex 1 – The Final Rule

Statutory Requirements

Section 113 of Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or the “Act”)\(^1\) authorizes the Financial Stability Oversight Council (the “Council”) to determine that a nonbank financial institution be supervised by the Board and be subject to enhanced prudential standards if the Council determines that either (i) material financial distress at the company, or (ii) the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities, “could pose a threat to the financial stability of the United States.” Such a determination requires a two-thirds vote by the voting members of the Council. The provision identifies ten factors for the Council to consider when reviewing a U.S. nonbank financial company:

i. The extent of the leverage of the company;

ii. The extent and nature of its off-balance-sheet exposures;

iii. The extent and nature of its transactions and relationships with other significant nonbank financial companies and significant bank holding companies;

iv. The company’s importance as a source of credit for households, businesses, and state and local governments, and as a source of liquidity for the U.S. financial system;

v. The company’s importance as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of the company would have on the availability of credit in such communities;

vi. The extent to which assets are managed rather than owned, and the extent to which the ownership of such assets is diffuse;

vii. The nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;

viii. The degree to which the company is already regulated by 1 or more primary financial regulatory agencies;

ix. The amount and nature of the company’s financial assets; and

x. The amount and types of the company’s liabilities, including the degree to which it relies on short-term funding.

The factors are nearly the same for foreign nonbank financial firms. The one difference is that the eighth factor is replaced by consideration of the nature of the home-country supervision of a firm. The Council is required, as part of the determination process, to consult with the firm’s primary financial regulator and any foreign regulatory authorities as appropriate.

Section 113 also outlines the procedures for the Council to follow in making a determination. The Council must provide a company with advance notice that the Council plans to designate the firm as systemically important. The firm may request a hearing within 30 days. If it does so, the Council must schedule a hearing within 30 days, and the firm may submit additional information within those 30 days. The Council must render a final determination within 60 days after hearing. If the firm does not request a hearing, the Council must notify the firm of its final determination within 40 days of the firm’s receipt of the advance notice. The Council may waive any of the procedural requirements if necessary or appropriate to prevent or mitigate threats to financial stability. The Council must review the determination of each nonbanking firm annually.

Judicial review of a final determination is available, whether or not a hearing has been held. A firm has 30 days in which to file suit in U.S. District Court for either the district in which the firm’s headquarters are located or the District of Columbia. The court’s standard of review is whether the Council’s determination was “arbitrary and capricious.”

The Rule

The Rule is the result of a lengthy process. In October 2010, the Council published an advance notice of proposed rulemaking that posed several questions about the nature of systemic importance. In January 2011, the Council proposed a set of criteria that reflected the section 113 factors without significant further detail. Following comments that complained about the lack of guidance in the January proposal, the Council released a second proposal in October 2011, with a formal rule and interpretive guidance. The Rule adopts substantially all of the second proposal. The formal regulation itself is procedural in nature. The substantive discussion of the Council’s analysis of systemic importance lies in the interpretive guidance, with some gloss provided in the Council’s explanation of the Rule in the supplementary information.

Analytic Framework

The designation of a nonbank financial firm as systemically important is a complex process. The Council must make two determinations, whether material financial distress (the “First Determination Standard”) or a combination of factors at the firm (the “Second Determination Standard”) could pose a threat to the financial stability of the United States. Such a threat likely would come through one (or more) of three channels, which are evaluated on the basis of six categories of factors.

Determination Standards

The ultimate decision of a threat to financial stability will be based on either or both of two different standards, depending on which set of facts exists. The Council recognizes that in many cases both determinations will be justified.

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2 Presumably a firm can submit additional information without requesting a hearing. If it does so, however, it would have substantially less than 40 days in which to do so. The firm will have a total of 60 days, however, if it requests a hearing.
• “Material distress,” which the Council refers to as the “First Determination Standard,” exists when a firm is in “imminent danger of insolvency or defaulting on its obligations.” The Council explains that it will assess material distress in the context of a period of overall stress in the financial services industry and in a weak macroeconomic environment.

• The combination of factors—the nature, scope, size, scale, concentration, interconnectedness, or mix of activities—constitutes the “Second Determination Standard.” This determination does not include an assessment of a nonbank financial firm’s distress and appears to rest solely on the current characteristics of the firm.

Both standards require a finding that a nonbank financial firm presents threat to financial stability. The Council explains that a threat exists “if there would be an impairment of financial intermediation or of financial market functions that would be sufficiently severe to inflict significant damage on the broader economy.”

Channels of Threats to Financial Stability

In the interpretive guidance, the Council identifies three channels that would facilitate transmission of the negative effects of a firm’s material distress or characteristics to other firms and markets. These channels are not the only mechanisms for systemic risk to arise. It may be fair to assume, however, that many systemic risk designations will be based on findings that one or more of the channels is the source of the transmission of risk. In analyzing each of the channels, the Council will apply different factors, including combinations of six sets of factors, which we explain in greater detail below. With respect to the three channels, they are as follows:

• Exposures by the firm’s creditors, counterparties, investors or other market participants that would materially impair those participants. The Council’s analysis of this channel likely would be based on five sets of factors: total consolidated assets, credit default swaps outstanding, derivative liabilities, total debt outstanding, and leverage ratio.

• Assets that, if liquidated quickly, would cause a fall in asset prices and thereby significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings. This channel would come into play when a firm relies heavily on short-term funding. The sets of factors relevant to this analysis are total consolidated assets and the short-term debt ratio.

• Critical functions or services on which market participants rely and for which there are no ready substitutes. In large part, this analysis is a review of the competitiveness of the markets in which a firm participates and the services it provides. These services include those identified in section 113: the provision of (i) liquidity to the U.S. financial system, (ii) credit to low-income, minority, or underserved communities, or (iii) credit to households, businesses and state and local governments. The focal points of the review are the firm’s market share of particular services and the ability of other firms to replace those services. The analysis of this channel does not appear to involve any of quantitative factors applied in the other two channels.
The Council advises that in all cases it will examine a firm’s complexity and opaqueness, as well as whether resolution of the firm in bankruptcy would disrupt key markets or have a material adverse impact on other financial firms or markets.

**Factors**

In order to evaluate whether a nonbank financial firm presents consequences that could flow through any of the three channels and thus support a systemic designation under either of the two determination standards, the Council will apply six categories of factors. These factors are a re-formulation of the ten factors enumerated in section 113 and the formal regulation. Taken together, the factors largely follow those approved by the G-20 for the designation of globally systemically important banks, although the Rule’s criteria have a U.S., rather than global, focus.

- **Interconnectedness.** This factor relates to the number and quality of a firm’s relationships with counterparties and those counterparties’ other relationships. The Council’s assessment of this factor may involve several measurements:
  - Counterparties’ exposures to a nonbank financial firm, including derivatives, reinsurance, loans, securities borrowing and lending, and lines of credit that facilitate settlement and clearing activities.
  - Number, size, and financial strength of a nonbank financial firm’s counterparties, including the proportion of its counterparties’ exposure to the nonbank financial company relative to the counterparties’ capital.
  - Identity of a nonbank financial company’s principal contractual counterparties, which reflects the concentration of the nonbank financial firm’s assets financed by particular firms and the importance of the nonbank financial firm’s counterparties to the market.
  - Aggregate amounts of a nonbank financial firm’s gross or net derivatives exposures and the number of its derivatives counterparties.
  - The amount of gross notional credit default swaps outstanding for which a nonbank financial firm or its parent is the reference entity.
  - Total debt outstanding, which captures a nonbank financial firm’s sources of funding.

- **Substitutability.** This factor resembles the competitive analysis that commonly occurs in connection with merger or acquisition applications. The systemic risk concern is that other firms may not be able to provide the products and services of a distressed or complex firm readily and at a comparable price if that firm withdraws from the market, particularly if the company is the dominant provider. The Council may use several metrics, as follows:
  - Market shares of the company and its competitors in particular markets.
  - The stability of market share across firms in the market over time.
  - Market shares for products and services that provide a substantially similar economic function as the primary market under consideration.
• **Size.** The size factors are intended to capture the amount of financial services or financial intermediation that a nonbank financial firm provides. Size may also signal the extent to which distress at a firm may transmit risk to other firms and markets. Size metrics include:
  - Total consolidated assets or liabilities
  - Total risk-weighted assets
  - Off-balance sheet exposures where the company has a risk of loss, such as lines of credit.
  - Assets under management and the extent to which ownership is diffuse.
  - For insurance companies, direct written premiums.
  - Risk in force—the aggregate risk exposure from risk underwritten in insurance related to certain financial risks, such as mortgage insurance.
  - Total loan originations, by loan type, in number and dollar amount.

• **Leverage.** This set of factors covers exposure or risk in relation to equity capital and is one indication of the risk of financial distress to a firm. According to the Council, greater leverage raises the likelihood that the firm may suffer losses exceeding its capital and makes the firm more dependent on creditors’ willingness and ability to fund the balance sheet. Greater leverage also will increase the exposure of other financial institutions to the firm and increase the size of possible asset liquidations.
  - Total assets and total debt measured relative to total equity
  - Gross notional exposure of derivatives and off-balance sheet obligations relative to total equity or to net assets under management
  - Ratio of risk to statutory capital
  - Changes in leverage ratios

• **Liquidity and maturity mismatch.** As described in the interpretive guidance, liquidity refers to the risk that a company may not have sufficient funding to satisfy its short-term needs, either through its cash flows, maturing assets, or assets saleable at prices equivalent to book value, or through its ability to access funding markets. The specific concern is whether a firm holds assets that will have a liquid market in times of distress; such assets generally are cash instruments or Treasury securities. Maturity mismatch refers to the difference between the maturities of a firm’s assets and liabilities. Mismatches, particularly where a firm must fund long-term assets with short-term liabilities, affect a firm’s ability to survive a period of stress that may limit access to funding and to withstand shocks in the yield curve. The relevant metrics include:
- Fraction of assets that are classified as level 2 and level 3 under applicable accounting standards
- Liquid asset ratios
- Ratio of unencumbered and highly liquid assets to the net cash outflows that a nonbank financial company could encounter in a short-term stress scenario.
- Callable debt as a fraction of total debt
- Asset-backed funding versus other funding
- Asset-liability duration and gap analysis
- Short-term debt as a percentage of total debt and as a percentage of total assets.

- **Existing regulatory scrutiny.** The Council will look to the consistency of regulation across nonbank financial firms within a sector, across different sectors, and providing similar services, and the statutory authority of the regulators.
  - The extent of state or federal regulatory scrutiny, including processes or systems for peer review; inter-regulatory coordination and cooperation; and whether existing regulators have the ability to impose detailed and timely reporting obligations, capital and liquidity requirements, and enforcement actions, and to resolve the company.
  - The existence and effectiveness of consolidated supervision, and a determination of whether and how non-regulated entities and groups within a nonbank financial company are supervised on a group-wide basis.
  - For entities based outside the United States, the extent to which a nonbank financial company is subject to prudential standards on a consolidated basis in its home country that are administered and enforced by a comparable foreign supervisory authority.

### Three-Stage Determination Process

The Rule sets forth a three-stage process for determining which nonbank financial companies will be supervised by the Board or will be exempt from such supervision. The difference between the stages does not appear to reflect different standards of review but rather the level of confidence that the Council has in the information available for each firm. Each stage is based on different data points.

#### Stage 1

This stage identifies nonbank financial companies for further review based primarily on six quantitative thresholds. The necessary threshold is size: the Council will review only those

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6 In applying these thresholds, the Council may—and, in all likelihood, will—aggregate legally separate funds that are managed by the same adviser, particularly if the funds’ investments are identical or highly similar. The application of
companies with total consolidated assets of $50 billion or more. Size will be measured on the most recently available data on a quarterly basis. A nonbank financial firm over the $50 billion mark then will be measured against five additional thresholds, and if it passes any one of them, it will move on to Stage 2. The five thresholds are as follows:

- Gross notional credit default swaps outstanding for which the company is the reference entity: $30 billion. The Council will calculate this threshold using data available from the Trade Information Warehouse although it may later use data from other sources.

- Derivative liabilities: $3.5 billion. Derivative liabilities consist of the fair value of derivative contracts in a negative position. In making the calculation, the Council will take account of netting arrangements and cash collateral with the same counterparty. This calculation will include derivatives embedded in insurance products and accounted for separately under generally accepted accounting principles, even though statutory accounting principles that apply to insurance companies do not provide for separate accounting. The risks associated with embedded derivatives will be part of the Council’s review in Stages 2 and 3.

- Total debt outstanding: $20 billion. Total debt is defined broadly to include secured and unsecured loans, bonds, repurchase agreements, commercial paper, securities lending arrangements, surplus notes (for insurance companies), and other forms of indebtedness.

- Leverage ratio—total consolidated assets to total equity: 15:1. Assets in separate accounts will not be included in this calculation.

- Short-term debt ratio—total debt outstanding with a maturity of less than 12 months to total consolidated assets: 10%.

The Council will calculate these measurements using global assets, liabilities, and operations of a U.S. nonbank financial company. For foreign companies, the Council will consider only U.S. assets, liabilities, and operations. GAAP will govern the application of the thresholds, unless statutory or insurance accounting principles apply.

These thresholds are not conclusive. The fact that a large nonbank financial firm does not trigger any of the thresholds is no guarantee that the firm will not be reviewed for potential systemic risk. The Council reserves the right to place such firms into Stage 2 if “further analysis … is warranted.” The Council explains that the State 1 thresholds “do not reflect a determination … that nonbank financial companies that do not meet the thresholds will not be designated” as systemically important. Rather, the thresholds “are designed to identify nonbank financial companies for further evaluation based on the statutory standards and considerations.”

More specifically, the Council contemplates revising one threshold and adding two more. The threshold to be revised is that for derivative liabilities. In its present form, the metric captures only current exposures. Recently finalized definitions of “major swap participant” and “major securities-based swap participant” by the Commodity Futures Trading Commission (“CFTC”) will, however, “appropriately reflect” the distinction between assets under management and an asset manager’s own assets. The Council notes that data reported on Form PF will be useful in this review.
and the Securities and Exchange Commission (“SEC”) include a methodology for measuring the potential future exposure created by an entity’s outstanding derivatives, with respect to certain institutions.\(^7\) The rule then sets forth its own quantitative standards of swap and security-based swap positions that would cause the holder to be deemed “major.” The Council has indicated that this methodology could lead to refinements in the derivative liabilities threshold; whether the Council will adopt the same thresholds as the CFTC and SEC remains to be seen.

As to one of the new thresholds, the Council in the supplementary information singles out financial guarantors, asset management companies, private equity firms, and hedge funds as the types of firms that “may pose risks that are not well-measured by the quantitative thresholds approach.” With respect specifically to hedge funds and private equity funds, “less data are generally available about these companies” than about others. The Council observes that the Forms PF that these funds will be required to file beginning in June 2012 may provide useful data and that it may then establish additional thresholds for these firms. Any such development is several months away at the earliest.

The other new threshold would apply to asset management companies. The Council observes in the supplementary information that it is still analyzing the extent to which asset management companies could present potential threats to U.S. financial stability and, if so, whether such threats are better addressed through enhanced prudential standards and Board supervision or through other means. As it addresses these questions, the Council may develop additional Stage 1 thresholds. However, until any additions to the Stage 1 metrics are made, nonfinancial firms that do not publicly report information that the Council can apply against the thresholds may be faced with a Stage 2 evaluation.

**Stage 2**

This stage involves a “robust” analysis of the potential threat that a nonbank financial firm may pose to U.S. financial stability, either as a result of material distress or because of the nature of the firm and its operations. The analysis largely employs the six categories of factors described above. The Stage 2 analysis will be based on information already available to the Council through existing public and regulatory sources, including information possessed by the company’s primary financial regulatory agency or home country supervisor, as appropriate, and information voluntarily submitted by the company.

Another source of information will be the Office of Financial Research (“OFR”). An ongoing duty of the OFR is to coordinate with the member agencies of the Council and any other primary financial regulatory agencies to collect and analyze data from those agencies about particular institutions. Stage 2 also will involve two qualitative assessments that may not be covered fully

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7 As of the date of this paper, the final rule had not been published officially. It may be accessed at [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister041812b.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister041812b.pdf). The agencies’ definitions of “substantial financial position” are complex and beyond the scope of this paper, but the general rule is that an institution’s position in a given category of swaps is significant if either its daily average aggregate uncollateralized exposure is $1 billion or more or if the sum of its daily average aggregate uncollateralized outward exposure plus its daily average aggregate potential outward exposure is $2 billion or more. For rate swaps, the thresholds are $3 billion and $6 billion, respectively. The definitions are to be codified at 12 C.F.R. § 1.3(jjj) (CFTC) and 12 C.F.R. § 240.3a67-3 (SEC).
by the six categories of factors: the extent to which a nonbank financial firm is regulated and whether the resolution of the firm could pose a threat to financial stability.

The resolvability issue is whether the firm’s entry into bankruptcy or an analogous insolvency proceeding will mitigate or aggravate a company’s potential threat to financial stability. This evaluation will entail an assessment of the company’s structure and any obstacles to its “rapid and orderly resolution.” Factors that the Council will consider include the ability to separate functions and spin off services or business lines; the likelihood of preserving franchise value in a recovery or resolution scenario and of maintaining continuity of critical services within the existing or a new legal entity or structure; the company’s intra-group dependency for liquidity and funding, payment operation, and risk management needs; and the size and nature of intra-group transactions. This evaluation requires much (but not all) of the quantitative and qualitative information that a nonbank financial firm must provide in a resolution plan—after it has been deemed systemically important. The evaluation also will include much of the same analysis as the review of a resolution plan by the Board and the Federal Deposit Insurance Corporation. How the Council will deal with the possible circularity of its review remains to be seen.

The extent to which a firm may voluntarily submit information to the Council or otherwise participate in Stage 2 is unclear. In the supplementary information to the Rule, the Council appears to reject suggestions that a firm be notified of Stage 2 or that it be permitted to participate in this stage: “the Council believes that Stage 3 provides a sufficient opportunity for nonbank financial companies to participate in the Determination Process.” Nevertheless, the interpretive guidance makes a fleeting reference to this possibility.

The Rule does not state a precise standard that the Council will apply in moving a firm from Stage 2 into Stage 3. It is evident, however, the Council will base its decision on the adequacy of information from sources other than the firm. That is, when the Council decides that it needs additional information from a firm itself, it will have moved the firm into Stage 3. We are not certain that the Council will deem any firms not systemically important solely on the basis of Stage 2 information. The Council states that it will not provide any firm a notice that it will not move into Stage 3 because of “the preliminary nature” of the Stage 2 evaluation, although the Council may provide such notification as it gains experience in the Determination Process. Moreover, although the Council does not address the issue, the regulatory and other information available for a nonbank financial institution is substantially less than the examination and other reports available for bank holding companies, and in many circumstances is unlikely to be deemed sufficient.

The examination process may provide additional information before the Council moves a firm from Stage 2 to the Stage 3 process for collecting information directly from the firm. If the Council cannot, on the basis of information available publicly and from other regulatory sources, decide whether a nonbank financial firm is systemically important, the Council may ask the Board to examine the firm. The purpose of such an examination is limited to whether the firm should be designated as systemically important. Given the extensive time often involved in even a relatively focused examination of a large and complex banking organization, the time required for this type of examination may discourage or even preclude the Council from suggesting it.
Stage 3

This stage includes both the gathering of information on a firm to create the largest record possible for the firm and the final determination of a firm's threat, if any, to financial stability. The underlying analysis and the application of the six sets of factors necessary to make this determination is essentially the same as in Stage 2, and the Council repeatedly refers to the analysis in Stages 2 and 3 as a single analysis.

Stage 3 will involve up to three notices. Stage 3 commences with the delivery to a nonbank financial firm of a “Notice of Consideration” from the Council. The notice will include a request for information that the Council deems relevant and accordingly is likely to be wide-ranging. The request may involve both quantitative and qualitative information. The supplementary information in the Rule indicates that the request will include internal assessments, internal risk management procedures, funding details, counterparty exposure or position data, strategic plans, resolvability, and potential acquisitions or dispositions. The Council explains that in reviewing this information, it may pay greater attention to issues of opacity and complexity than it had in Stage 2. Assessments of resolvability and of the nature of the current regulatory oversight of a firm will also be part of Stage 3.

Formal Determination

Once the Council believes it has all of the information necessary to make a determination, it will so notify the firm involved through a Notice of Proposed Determination. The NPD commences the formal determination process; the process set forth in the Rule adheres to the statutory requirements described above. A firm will have 30 days in which to request a hearing. If it does so, the Council must set a date within the next 30 days for the hearing; during these roughly 30 days, the firm may collect information to present at the hearing or, presumably, beforehand. After the hearing, the Council will have 60 days in which to make a final determination. If the firm does not request a hearing, then the Council must make a decision within 40 days of the firm’s receipt of the Proposed Determination. Thus a firm that does not request a hearing but that wishes to provide additional information will, in all probability, have significantly fewer than 30 days in which to provide any additional information. Judicial review is available under the terms of the Act.

Public statements from Treasury Department officials suggest that the Council may issue its first designations before the end of 2012. Given the several time periods in Stage 3, the Council would have to begin to issue Notices of Consideration by early summer in order to meet a year-end deadline.

Public Information

Throughout the designation process, the only information that the Council will release to the public will be the final determination of systemic importance. The Council will alert a firm, one business day in advance of making the designation public, so that the firm can prepare appropriate responses and disclosure materials. Of course, counterparties, investors, and other market participants will be able to determine whether a nonbank financial firm will enter Stage 1. All firms that cross one of the Stage 1 thresholds will be subject to considerable public attention. Whether a firm is required by the securities laws to make public disclosures about the designation process before the Council publishes the final determination is a matter for firms to discuss with securities counsel.
Any information submitted to the Council by a nonbank financial firm will be protected under the Freedom of Information Act in the same way that data submitted to another federal financial regulatory agency is handled.
Annex 2 -- “Predominantly Engaged in Financial Activities”

The authority of the Financial Stability Oversight Council (the “Council”) to designate a firm as systemically important is limited to those firms that meet the definition of “nonbank financial company” under section 102(a)(4) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The term is limited to any firm “predominantly engaged in financial activities.” Section 102(b) charges the Federal Reserve Board (the “Board”) with defining that term through rulemaking. Section 102(a)(6) requires that the Board’s rule contain two tests, one relating to 85 percent of assets and the other 85 percent of revenues. In our view, as discussed further below, the Council cannot begin to implement its rule until the Board has completed the regulation that will define the universe of nonbank financial firms potentially subject to the Council’s designation process. The Council, however, disagrees.

“Nonbank financial company” is a term that includes only those companies “predominantly engaged in financial activities.” The Board is required to implement this standard through regulation, but it is constrained by specific statutory requirements. Under section 102(a)(6), financial activities are those that are financial in nature under section 4(k) of the Bank Holding Company Act. Under the same provision, a company is “predominantly” engaged in financial activities if one of two conditions exists: either (i) the annual gross revenues derived by the company and all of its subsidiaries from financial activities, as well as from the ownership or control of an insured depository institution, represent 85 percent or more of the consolidated annual gross revenues of the company; or (ii) the consolidated assets of the company and all of its subsidiaries related to financial activities, as well as related to the ownership or control of an insured depository institution, represent 85 percent or more of the consolidated assets of the company.

The Board has been considering certain refinements to the statutory definitions. In February 2011, the Board proposed regulations that would apply both of the 85 percent tests to each of the past two calendar years. An institution that met either test in either of the two years would be regarded as being “predominantly” engaged in financial activities. This proposal provided no further explanation of “financial activity.” The Board received several comments the applicability of the restrictions on the conduct of certain financial activities, particularly investment activities, by bank holding companies.

In response, the Board last week revised the February 2011 proposal to address “financial activities” in greater detail. The guiding principle is that “any activity referenced in section 4(k) will be considered to be a financial activity without regard to conditions that were imposed on bank holding companies that do not define the activity itself.” Conditions not applicable to the definition of “predominantly engaged” include those “that were imposed to ensure that the activity is conducted in a safe and sound manner, to prevent a financial holding company from controlling a commercial firm, or to comply with another provision of law.”

Merchant banking may be the best single example of the Board’s approach to “predominantly engaged.” Two conditions that bank holding companies must observe—a requirement that shares be held for a reasonable period of time to enable sale or disposition on a reasonable
basis consistent with the firm’s underwriting, merchant, or investment banking activities, and the prohibition on routine management of a portfolio company other than for purposes of recognizing a reasonable return—are essential elements of merchant banking and apply when considering whether a nonbank financial firm is engaged in this activity. Other restrictions, by contrast, do not apply, including a requirement that a firm engaged in underwriting or merchant or investment banking have a securities or insurance company affiliate and restrictions on the nature of shares, assets or ownership interests.

Nonbank firms should bear in mind that bank holding company-related restrictions will not come into play when evaluating those firms’ financial activities. A firm that provides an agency transactional service, such as providing securities brokerage services, acting as a riskless principal, providing private placement services, and acting as a futures commission merchant, is engaged in a financial activity. Bank holding company restrictions, such as prohibitions on underwriting and dealing associated with brokerage services and on purchasing or repurchasing securities for the company’s own account in connection with private placement services, and rules on exchange trading and guarantees of certain liabilities with respect to futures commission merchant activities, do not apply. Derivative transactions also constitute a financial activity regardless of whether the derivative contract is bank-eligible or not and whether physical settlement is provided for. Organizing, sponsoring, and managing a mutual fund is a financial activity even if the firm also exercise managerial control over companies in which the fund invests or holds more than 25% of the equity of the fund, two characteristics prohibited for bank holding companies.

A critical legal issue for the Council is whether it may begin the designation process for nonbank financial firms before the Board has completed the rulemaking that defines this term. Neither the Council’s nor the Board’s rulemaking addresses the issue. We do not believe that the Council may do so. Section 102(b) is explicit that the Board “shall establish, by regulation, the requirements for determining if a company is predominantly engaged in financial activities, as defined in subsection (a)(6).” Thus, a determination of the level of a company’s engagement in financial activities cannot be made until the Board has issued regulations. The legislative history on the definition of “predominantly engaged” supports this result:

[Section 102] requires the Board … to establish by rulemaking the criteria for determining whether a company is substantially engaged in financial activities to qualify as a nonbank financial company…. [T]his provision is intended to provide certainty by mandating the establishment of the criteria through the public notice and comment process required for rulemaking.18

The Council’s process for designating nonbank financial firms accordingly can be understood only in relation to the Board’s rulemaking on the meaning of “predominantly engaged in financial activities.” Indeed, as a matter of law, that rulemaking must be completed before the Council can make a final designation of a nonbank firm as systemically important.

Systemically Important Nonbank Financial Institutions: FSOC Approves Final Rule

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If you are following regulatory developments, you may be interested in FrankNDodd, Morrison & Foerster’s online resource that tracks rulemaking pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act. FrankNDodd features a robust search function that allows users to quickly navigate to particular sections of the Act and to find links to related regulatory materials as well as relevant MoFo commentary. Email subscribe@frankndodd.com for your password. FrankNDodd is a registered trademark of Morrison & Foerster LLP.

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Enhanced Prudential Standards: The Federal Reserve’s Proposal

January 2012
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Shortly before year-end, the Federal Reserve Board ("FRB") proposed several rules to manage systemic risks presented by bank holding companies with consolidated assets of $50 billion or more and by nonbank financial institutions that are designated as systemically important by the Financial Stability Oversight Council ("FSOC"). The proposed regulation (the "Proposal") would implement the mandatory portions of sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act").

The Proposal includes seven sets of requirements for the bank holding companies over the $50 billion mark and the (to-be-designated) systemically important nonbanks (collectively, the "covered companies"): (i) risk-based capital requirements and leverage limits, (ii) liquidity requirements, (iii) single-counterparty credit limits, (iv) risk management, (v) stress tests, (vi) the debt-to-equity ceiling, and (vii) early remediation. Portions of the risk management and stress test provisions extend to banking organizations with less than $50 billion but more than $10 billion in consolidated assets.

**Highlights**

As a whole, Proposal reflects a fair reading of the Act and provides a level of detail that is a two-edged sword. On the one hand, the details in the Proposal are helpful for a covered company to measure its compliance with enhanced prudential standards. On the other hand, the specifics in many of the new standards, including those relating to capital planning by nonbank covered companies, liquidity, restrictions on single-counterparty exposures, mandatory stress-testing, and early remediation, will compel all but the very largest bank holding companies to revisit their risk management systems to ensure that all of the particular requirements have been covered. Areas that warrant careful attention include:

- **Capital planning by nonbank covered companies.** These companies must re-orient their financial planning to incorporate new quantitative requirements and to take account of all factors that inform capital adequacy.

- **Liquidity management.** The board of directors and senior management have explicit duties to monitor and manage liquidity, including the development of specific limits on liquidity risk. Certainly covered companies already oversee and address liquidity issues at a high level, but the existing governance structures may not satisfy all of the proposed new requirements.

- **Liquidity buffer and the underlying liquidity stress test.** The Proposal requires a liquidity buffer that anticipates the proposed liquidity coverage ratio under Basel III. The buffer will be composed of a limited number of highly liquid assets. The size of the buffer is to be determined by complex and virtually continuous stress tests. Covered companies typically have robust models for analyzing liquidity, but the Proposal places some critical parameters around the process that may require significant changes to those models.

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2 Pub. L. No. 111-203, 124 Stat. 1376 (July 10, 2010). The Proposal does not purport to be exhaustive, and further rulemaking is likely since the Proposal does not address all of the FRB’s authority under section 165. New capital and leverage requirements are not required for all systemically important financial institutions. Two other requirements in section 165 already have been the subject of rulemaking. Section 165(d) requires the submission of resolution plans and credit exposure reports by covered companies. In October 2011, the FRB finalized a new Regulation QQ that addresses resolution plans (12 C.F.R. part 243), 76 Fed. Reg. 67323 (Nov. 1, 2011). A proposed rule dealing with credit exposure reports, 76 Fed. Reg. 22648 (Apr. 22, 2011), remains pending.
Credit enhancements for single-counterparty exposures. The Proposal has one set of explicit requirements and one implicit set of provisions. Explicitly, the Proposal identifies how a covered company at risk of exceeding exposure limits may avoid compliance issues through the use of credit mitigants. Implicitly, because not all forms of credit enhancement under the risk-based capital rules would qualify as mitigants for the credit risk presented by counterparties, the Proposal suggests that the FRB could begin to take a narrower view of credit enhancements.

Double stress-testing. As directed by Dodd-Frank, the Proposal requires that both covered companies and the FRB conduct stress tests of the covered companies. Two aspects of the double-testing are important. First, because the tests use essentially the same inputs, the FRB test functions as a test of the validity of a covered company’s testing process. Second, the Proposal requires that detailed stress test results be made public on a company-specific basis, which could lead to a variety of adverse market responses to the point that the responses to stress test results could create their own stress conditions for a company. The Proposal’s public disclosure requirement, however, is not required by Dodd-Frank.

Early remediation. Although the substance of the early remediation regime may not differ in material respects from how the FRB currently supervises large bank holding companies under stress, the Proposal identifies several cause-and-effect scenarios that may result in harsher FRB responses to troubled institutions than has previously been the case.

In addition to these core issues, the Proposal discusses a few specific points that could have important operational consequences.

Capital. Capital adequacy is one of the highest priorities in bank supervision. For bank holding companies, however, the Proposal does not break new ground in this area. The Proposal does signal that the FRB will adopt the Basel III standards. The Proposal does not address the suggestion of at least one FRB governor that, in the course of reviewing proposed capital distributions and capital plans, the FRB will apply these standards. At the same time, the FRB proposes to require covered nonbank companies to comply with the regulatory capital standards that currently apply to bank holding companies, a requirement that may pose significant operational and compliance challenges for some, if not all, covered nonbank companies.

Companies that are not large U.S. bank holding companies. The Proposal treats these institutions in different ways. Foreign bank organizations (“FBOs”) are excluded, as are, for most purposes, savings and loan holding companies. In addition to the covered companies, other institutions—bank and thrift holding companies with more than $10 billion in consolidated assets—are by statute subject to stress-test and risk committee requirements. The FRB observes that it

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5 The FRB notes that it will propose an enhanced framework for FBOs shortly. In applying enhanced standards, the FRB is required by section 165(b)(2) to give due regard to the principle of national treatment and equality of competitive opportunity and to take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to U.S. standards. The FRB has exempted FBOs from the Proposal because of international agreements that do not contemplate all of the requirements in the Proposal, different home country approaches to bank supervision, diverse structures in the U.S., and wide variance in risk to U.S. financial stability.

6 Before issuing new capital and stress testing standards, the FRB must develop consolidated capital requirements for SLHCs.
has authority to apply enhanced standards to bank holding companies with less than
$50 billion in consolidated assets, but the Proposal does not attempt to do so, apart
from the statutory requirements.

- **Foreign sovereign debt.** These instruments cannot be included in the “liquidity
  buffer”—the pool of assets each covered company must maintain for short-term
  liquidity. The limits on credit exposure to a single counterparty apply to investments
  in sovereign debt.

- **Fannie Mae and Freddie Mac securities.** For “policy” reasons, this debt may be
  included in the liquidity buffer, although it must be discounted to reflect credit risk and
  volatility. The single-counterparty credit exposure limits do not apply to mortgage-
  backed securities issued by either of these two entities while they are operating
  under conservatorship.
Overview

A core system regulation requirement of Dodd-Frank is that the FRB establish prudential standards for the largest banking institutions that are more stringent than those that apply to smaller banks. The stated purpose of these enhanced requirements is to prevent or mitigate risks to U.S. financial stability that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions. Another purpose of these standards is, in the FRB’s words, “to provide incentives for covered companies to reduce their systemic footprint.”

The Proposal marks the formal beginning of the standard-setting process. More will follow, including standards for FBOs and SLHCs. Section 165 authorizes the FRB to tailor standards, taking into consideration the capital structure, riskiness, complexity, financial activities (including activities), size, and any other risk factors that the FRB deems appropriate. Throughout the Proposal, the FRB notes that it will apply particular standards according to these factors, referred to by the FRB as the “systemic footprint” of a covered company. With respect to nonbank financial companies subject to enhanced standards, the FRB will assess the business model, capital structure, and risk profile of the company. Dodd-Frank does not provide for tailoring in all cases: the capital requirements in the Collins Amendment, section 171 of Dodd-Frank, apply equally to nonbank financial companies deemed systemically important as they do to bank holding companies over the $50 billion threshold.

The dates for compliance with the enhanced standards are not uniform. Although section 165 does not set a uniform compliance date, the Proposal provides two dates for compliance with most requirements in the Proposal. For companies that are covered companies on the effective date of the final rule, the deadline is the first day of the fifth full calendar quarter following the effective date. The deadline for companies that become covered after the effective date—either because they have been designated as systemically important by the FSOC or because as bank holding companies they have grown to more than $50 billion in consolidated assets—is the first day of the fifth full calendar quarter following the date on which they become covered. The compliance dates are different, however, for the enhanced risk-based capital and leverage requirements, the limits on single counterparty credit exposures, and stress testing.

The Proposal places the enhanced prudential standards in a new Regulation YY (12 C.F.R. part 252). We review each of the substantive subparts below in the order of their appearance in Regulation YY.
Risk-based Capital and Leverage (Subpart B)

The Proposal extends the existing capital requirements for covered bank holding companies to nonbank covered companies. A nonbank covered company must calculate total and Tier 1 risk-based capital and leverage ratios in the same way that bank holding companies do now. The nonbank covered company also must meet the same minimum capital requirements: four percent Tier 1 risk-based capital, eight percent total risk-based capital, and four percent leverage. Whether the balance sheet of every nonbank covered company can accommodate these requirements is an open question; the FRB requests comment on whether nonbank covered companies should be held to the same minimum capital requirements as bank holding companies.

The Proposal does not otherwise set forth new, quantitative capital requirements for all covered companies. The FRB’s discussion in the Proposal\(^7\) describes a two-part process for implementing enhanced risk-based capital and leverage standards for covered companies.

First, nonbank covered companies will be subject to certain regulatory capital requirements and to the same new rules that require bank holding companies with assets of more than $50 billion to file capital plans and to conduct stress tests.\(^8\) With respect to capital standards, these companies must calculate their minimum risk-based and leverage capital requirements in accordance with the rules for bank holding companies. The companies also must hold capital sufficient to meet tier 1 and total risk-based capital ratios of four percent and eight percent, respectively, as well as a tier 1 leverage ratio of four percent. These requirements take effect on the later of the effective date of the final rule or 180 days after the date on which the FSOC determined the company to be systemically important and therefore subject to supervision by the FRB.

With respect to capital planning, the core requirement is that a plan demonstrate that the covered company is able to maintain a Tier 1 common equity ratio of at least five percent, as well as meeting all other minimum capital requirements, under both expected and stressed conditions over a nine-month planning horizon. The plan also must explain how the company will be able to continue operations during times of economic and financial stress. Much of the plan will depend on and incorporate the results of the covered company’s internal stress tests. The stress tests will rely on financial data as of September 30 and on three sets of economic assumptions provided by the FRB in mid-November. A covered company must then complete its stress test and finalize the capital plan in time for submission to the FRB on January 5. The FRB will evaluate the plan, using the results of the company’s own stress tests and the results of the FRB’s own stress tests. The FRB will provide comments to the company by the end of March. The company then may be required to make changes to the capital plan; these changes must be completed within 30 calendar days.

In addition, the capital plan regulation requires, in some cases, advance FRB approval of capital distributions.

The date on which a covered company must begin to comply with the capital planning and stress testing requirements depends on the time period between the date on which the FSOC subjected the company to FRB supervision and September 30. September 30 is the reference date because both the capital plan and the stress tests use financial data as of that date. If a company has been designated as systemically important no less than 180 days

\(^7\) The FRB’s discussions or explanations of the enhanced prudential standards are located in the Supplementary Information portion of the Proposal.

before September 30 in a calendar year, then the company must comply with the capital planning and stress testing requirements from September 30 of that year and thereafter. By inference, if the designation is made less than 180 days before September 30, then the compliance date is September 30 of the following year.

Second, the FRB will, probably in 2014, introduce a quantitative risk-based capital surcharge for “some or all” covered companies, based on the Basel III capital surcharge framework for globally systemically important banks (“G-SIBs”). The Basel III framework would impose surcharges in five tiers ranging from 100 to 350 basis points on approximately 30 G-SIBs. A particular G-SIB would be assigned to one of the four lower tiers (the fifth would be left empty for the time being) based on an assessment of twelve factors. The surcharge would phase in between 2016 and 2019. The G-SIBs and their assignments, however, have not been finally determined. The G-20 recently identified 29 G-SIBs, of which eight are covered companies. 26 other U.S. bank holding companies are not G-SIBs but are covered companies, and the FRB will have to make a decision on whether to impose a surcharge on them.

In its discussion of the Proposal, the FRB observes that other Basel III requirements other than the surcharge on G-SIBs and including generally higher capital requirements, a common equity requirement, conservation and countercyclical buffers, and a leverage standard (at least for internationally active banking entities), are under discussion and will be the subject of future FRB rulemakings. Given the length of the Basel III process and the emergence of some requirements already, most of the bank covered companies already will have begun to take these requirements into account in their capital planning. These requirements will present a greater challenge to nonbank covered companies as they are designated systemically important.

The FRB appears to be planning a tiered approach to higher capital requirements—indeed, section 165(a)(2) encourages doing so—but the Proposal does not provide any substantive guidance on how the FRB might draw the lines in this area.

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10 The Proposal contains a 180-day grace period for nonbank covered companies that are designated as systemically important after the effective date of Regulation YY. There is no such period for any institution so designated before the effective date.
Liquidity (Subpart C)

The Proposal requires a far-reaching liquidity management program; several provisions are intended to increase in stringency as the systemic footprint of a covered company widens.\textsuperscript{11} The program has at least seven elements. The timing of compliance with all of these elements is subject to the presumptive first-day-of-the-fifth-quarter rule.

Corporate governance (12 CFR 252.52 - .54)

The Proposal places extensive and specific obligations on the board of directors in overseeing liquidity. Each covered company will need to take care that the board addresses these duties and documents its decision-making. Certain of the duties, but not necessarily all, may be carried out by a risk committee. We discuss the formation of the risk committee below, in connection with subpart E of the proposed Regulation YY.

The board is required to make the following decisions or take the following actions:

- Review and approve the liquidity risk management strategies, policies, and procedures established by senior management.

- On at least an annual basis, establish the company’s liquidity risk tolerance. In doing so, the board must consider the company’s capital structure, risk profile, complexity, activities, size, and any other appropriate risk-related factors.

- On at least a semi-annual basis, review information provided by senior management to determine whether the company is managed in accordance with the established liquidity risk tolerance.

- On at least an annual basis, review and approve the contingency funding plan. Review and approval is required as well whenever material revisions are made to the plan.

This risk committee (or a designated subcommittee) must undertake the following:

- Review and approve the liquidity costs, benefits, and risks of each significant new business line and each significant new product. The review and approval must take place before the company implements the new line or offers the new product. The analysis must include consideration of the liquidity risk of the new business line under current conditions and under liquidity stress. This risk must be within the liquidity risk tolerance established by the board.

- At least annually, review significant business lines and products to determine whether any has created unanticipated liquidity risk and whether the liquidity risk of each remains within the company’s liquidity risk tolerance.

- On at least a quarterly basis, conduct the following oversight tasks:
  - Review the cash flow projections (discussed below) for time periods beyond 30 days to ensure that liquidity risk is within the established tolerance.

\textsuperscript{11} Provisions to be tailored based on systemic footprint include the liquidity risk tolerance, the amount of detail provided in cash flow projections, liquidity stress testing, the size of the liquidity buffer, the contingency funding plan, and specific limits on potential sources of liquidity risk.
Review and approve liquidity stress testing, including practices, methodologies, and assumptions. Review and approval also must take place whenever material revisions are made to the tests.

Review the liquidity stress testing results.

Approve the size and composition of the liquidity buffer.

Review and approve the specific limits on liquidity risk (described below).

Review liquidity risk management information necessary to identify, measure, monitor, and control liquidity risk and otherwise to comply with subpart C.

- On a periodic basis, review the independent validation of the liquidity stress tests.

- Establish procedures governing the content of senior management reports on the company’s liquidity risk profile.

The FRB expects the periodic liquidity reviews and approvals to occur more frequently as market and idiosyncratic conditions warrant.

Senior management has inherent responsibility, of course, to manage the company in accordance with the decisions and recommendations of the board and the risk committee and with regulatory requirements. The Proposal identifies two aspects of these obligations; management should in turn ensure that its actions are appropriately documented. Senior management must:

- Establish and implement strategies, policies, and procedures for managing liquidity risk. This responsibility includes oversight of all of the substantive elements of subpart C—liquidity risk management and reporting systems, cash flow projections, liquidity stress testing, the liquidity buffer, the contingency funding plan, specific limits on liquidity risk, and monitoring these procedures.

- Regularly report to the risk committee (or its designated subcommittee) on the company’s liquidity risk profile, as well as providing other necessary information to the board or the risk committee.

In addition to specifying duties of the board, risk committee, and senior management, the Proposal requires a covered company to establish an independent review function of liquidity risk management. This unit will have three responsibilities: on at least an annual basis, to review and evaluate the adequacy and effectiveness of such management; to assess compliance with both regulatory and internal requirements; and to report any noncompliance or material risk management issues to the board or the risk committee. The function must be independent of the management functions that execute funding, but otherwise the precise placement of the unit is within the company’s discretion.

**Liquidity buffer (12 CFR 252.57)**

The one quantifiable element of the liquidity risk management process outlined in the Proposal is the liquidity buffer. The size of the buffer is based predominantly on two underlying analyses—cash flow projections and liquidity stress-testing—as well as on the company’s systemic footprint. Before turning to these processes, it is helpful to consider the instruments includable (and not includable) in the buffer.
The asset pool that constitutes the buffer is limited to highly liquid and unencumbered assets that are sufficient to meet projected net cash outflows and the projected loss or impairment of existing funding sources for 30 days over a range of liquidity stress scenarios. The pool must be diversified by instrument type, counterparty, geographic market, and other liquidity risk identifiers. Discounts will be applied to reflect market volatility and credit risk.

While the language of the proposed regulation is general, the FRB’s discussion of the buffer is specific. Eligible highly liquid assets are limited to cash, U.S. Treasuries, and other securities issued or guaranteed by the U.S. government, a U.S. government agency, or a U.S. government-sponsored entity. Notably, this portfolio would include debt issued by Fannie Mae and Freddie Mac. Non-U.S. sovereign debt and any debt issued by state or local governments in the U.S., however, are excluded. The FRB may approve other “flight-to-quality” assets for inclusion in the buffer (e.g., “plain vanilla” senior corporate debt) but only if they have low credit risk and low market risk, are traded in an active secondary two-way market with certain features, and historically have been purchased by investors in periods of financial distress during which market liquidity has been impaired.

A highly liquid asset also must be unencumbered: it cannot be pledged, be used to secure, collateralize, or provide credit enhancement to any transaction, be subject to any lien or be subject to any legal or contractual restrictions on the company’s ability to promptly liquidate, sell, transfer, or assign the asset. An asset designated as a hedge on a trading position is ineligible. An asset will be so designated if it is held in order to directly offset the market risk of another trading asset or group of trading assets, e.g., a corporate bond held in order to hedge a position in a corporate bond index.

**Cash flow projections (12 CFR 252.55)**

A detailed set of cash flow projections, both short- and long-term, is required. The Proposal calls for a robust methodology and reasonable assumptions, all of which must be documented. The projections should be dynamic rather than static and must take account of the flows resulting from assets, liabilities, and off-balance sheet exposures, as well as from contractual maturities and from new business, funding renewals, customer options, and other potential events that could affect liquidity. The projections must identify cash flow mismatches as well. The projections also must reflect the company’s systemic footprint, which could entail projections at business line, legal entity or jurisdiction levels and the use of additional time horizons. The short-term projections must be updated daily and the long-term projections monthly.

**Liquidity stress testing (12 CFR 252.56)**

On a monthly basis, a covered company must stress-test its cash flow projections. Given the complexity of these tests, a covered company effectively will be testing liquidity continuously. The testing is expected to follow the principles set forth in proposed guidance on stress.

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12 The buffer requirement is comparable to the liquidity coverage ratio (“LCR”) now under review in the Basel III process. The FRB indicates that it will adopt the final Basel III LCR, as well as its companion, the net stable funding ratio.

13 A qualifying market must have observable market prices, committed market makers, a large number of market participants, and a high trading volume.

14 Compelling the largest participants in the capital markets to re-focus their investment strategies on a limited number of instruments will, for better or worse, drive up the price of those instruments and may well exacerbate the liquidity issues surrounding other instruments.

testing that was released in June 2011.\textsuperscript{16} The company must use the results of the stress tests to determine the size of its liquidity buffer and must incorporate the results in the quantitative assessment component of its contingency funding plan. The Proposal does not specify the methodology for the tests, but it imposes four sets of requirements. A company must:

- Incorporate a range of stress scenarios that in turn take into consideration at least the company’s balance sheet exposures, off-balance sheet exposures, business lines, and organizational structure. The scenarios are required to:
  - Account for market stress, idiosyncratic stress, and combined market and idiosyncratic stresses.
  - Address the potential impact of market disruptions on the company.
  - Address the potential actions of other market participants experiencing liquidity stresses under the same market disruptions.
  - Be forward-looking and incorporate a range of potential changes in the company’s activities, exposures, and risks, as well as changes to the broader economic and financial environment.
  - At a minimum, include four time horizons: overnight, 30 days, 90 days, and one year. The FRB could require additional horizons.
- Address in a comprehensive manner, the company’s activities, exposures, and risks, including off-balance sheet exposures.
- Be tailored to, and provide sufficient detail to reflect the company’s systemic footprint. Accordingly, analyses by business line, legal entity, or jurisdiction may be necessary.
- Incorporate four conditions:
  - Only assets in the liquidity buffer—i.e., unencumbered, highly liquid assets—are available to meet funding needs in the first 30 days.
  - After 30 days, other “appropriate” funding sources may be added to the buffer assets for use as cash flow.
  - Any asset treated as a funding source must be discounted to reflect market risk and volatility.
  - Liquid assets (other than cash and securities issued by the U.S. government, a U.S. government agency, or a U.S. government sponsored entity) must be diversified by collateral, counterparty, borrowing capacity, or other liquidity risk identifiers.

Because of the frequency of the testing and the volume of data to be tested, a covered company must have in place an extensive risk management framework. A covered company must:

\textsuperscript{16} See 77 Fed. Reg. 599 n.32. The proposal in June goes beyond liquidity stress-testing and covers testing for all risk management purposes.
must maintain management information systems and data processes sufficient to enable a company to effectively and reliably collect, sort, and aggregate data and other information relating to stress testing. Policies and procedures must outline the testing practices, methodologies, and assumptions, detail the use of each stress test, and provide for the enhancement of stress testing practices as risks change and techniques evolve. Oversight of the testing process must be sufficient to ensure that each test is designed in accordance with section 252.56 and that the stress process and assumptions are validated. Validation may be conducted internally but must be independent of the liquidity stress-testing functions and of the functions that execute funding.

Contingency funding plan (12 CFR 252.58)

A contingency funding plan is described by the FRB as a compilation of policies, procedures, and action plans for managing liquidity stress events. The plan is required to set out a covered company’s strategies for addressing liquidity needs during liquidity stress events. A plan must be updated at least annually and more frequently as market and idiosyncratic events warrant. The plan must have four components:

- Identification of stress events. This part incorporates information from liquidity stress testing. This part will consist of quantitative assessments of the impact of identified stress events on liquidity and of available funding sources (including alternative sources) during these events. Four specific types of information are necessary for this component of the contingency plan.
  - A company must identify stress events with significant effects on liquidity. These events could include deterioration in asset quality, rating downgrades, widening of credit default swap spreads, operating losses, declining financial institution equity prices, and negative press coverage.
  - The plan must assess the level and nature of the impact of various levels of stress severity, various stages for each type of event. There is no time period for disruptions; the plan should cover temporary, intermediate term and long-term events. This assessment should be used to design early warning indicators, assess potential funding needs, and to specify action plans.
  - The plan also must assess available funding sources and needs. This assessment requires an analysis of the potential loss of funding at various points in the stress event and the identification of cash flow mismatches. The FRB expects a realistic analysis of the company’s cash inflows, outflows, and funds availability at different time intervals, which will enable the company measure its ability to fund operations.
  - The company must identify alternative funding sources. Discount window borrowing is acceptable, but the FRB implies that only primary credit (which is limited to healthy institutions and must be collateralized) will qualify. If a company does rely on the discount window, it must include a plan to replace this borrowing with permanent funding. The FRB expects procedures and agreements with alternative lenders to be in place before there is a need to access this funding.

- Event management process. This process involves an action plan for responding to liquidity shortfalls during stress events (including accessing alternative funding sources), an identified “liquidity stress event management team,” an explanation of
how the company will invoke the plan, and a mechanism for communications internally and with the FRB, other regulators, counterparties, and other stakeholders.

- **Monitoring.** A covered company must be able to identify early warning indicators and other means of monitoring stress events. Indicators may include negative publicity concerning an asset class owned by the company, potential deterioration in the company’s financial condition, widening debt or credit default swap spreads, and increased concerns of the funding of off-balance sheet items.

- **Testing.** The plan must provide for the periodic testing. Trial runs are necessary, with simulations to evaluate communications, coordination, and decision-making by the relevant managers. Additionally, a covered company is required to test the availability of alternative funding and its ability to access collateral to secure additional borrowing.

**Specific limits (12 CFR 252.59)**

The board is required to set several limits on the sources of liquidity risk. Even for large bank holding companies, the extent of the specific limits may go beyond those that an institution historically has set. The mandated limits must cover:

- Concentrations of funding by instrument type, single counterparty, counterparty type, secured and unsecured funding, and any other liquidity risk identifiers.

- The amount of specified liabilities that mature within various time horizons.

- Off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events.

**Monitoring (12 CFR 252.60)**

The Proposal requires a covered company to establish and maintain procedures for monitoring four different items:

- The assets already pledged and unencumbered assets available to be pledged as collateral. The company must be able to calculate “in a timely manner” the value of its existing collateral positions relative to contractual requirements. Collateral monitoring also must cover levels of available collateral by legal entity, jurisdiction, and currency exposure; shifts between intraday, overnight, and term pledging of collateral; the operational and timing requirements associated with accessing collateral at its physical location.

- Liquidity risk exposures and funding needs within and across business lines, legal entities, and jurisdictions, and intraday positions. A covered company must maintain sufficient liquidity for each significant legal entity in light of any restrictions on the transfer of liquidity between legal entities.

- Intraday liquidity positions. These procedures must cover the monitoring of daily gross liquidity inflows and outflows, the use of collateral when necessary to obtain intraday credit, the prioritization of time-sensitive obligations, the ability to settle “less critical” obligations, controls on the issuance of credit where necessary, and the amounts of collateral and liquidity necessary to meet payment systems obligations. The FRB observes that the monitoring of these positions is generally an operational
risk function, and a covered company accordingly will need to develop an integrated procedure for both operational and liquidity risk.

- Compliance with the liquidity limits set by the company.

The FRB expects that, in order to conduct this monitoring, a covered company will need processes that aggregate data across multiple systems to develop an enterprise-wide view of liquidity risk management and to identify constraints on transferring liquidity within the organization.

Documentation (12 CFR 252.61)

A covered company has broad obligations to document all material aspects of its liquidity risk management process and its compliance with subpart C and to submit all of this documentation to the risk committee. In addition, a company must provide to the committee, the methodologies and material assumptions included in cash flow projections and liquidity stress tests, and all elements of the contingency funding plan. This material will be available to the FRB on request.
Single-counterparty Credit Exposure Limits (Subpart D)

Section 165(e) caps the credit exposure of a covered company to any unaffiliated company at 25% of the covered company’s capital and surplus and authorizes the FRB to impose stricter limits. This rule forms the basis for a more detailed set of restrictions in the Proposal.

**Two limits (12 CFR 252.93)**

The Proposal contains two limitations. First, it largely re-states the provision in section 165(e):

No covered company shall, together with its subsidiaries, have an aggregate net credit exposure to any affiliated counterparty that exceeds 25 percent of the consolidated capital stock and surplus of the covered company.\(^{18}\)

In addition, credit exposures between “major” covered companies are capped at 10% of capital and surplus. This stricter rule applies only when both companies to the transaction are covered companies that are “major” in size. The limit is as follows:

No major covered company shall, together with its subsidiaries, have aggregate net credit exposure to any unaffiliated counterparty that is a major counterparty that exceeds 10 percent of the consolidated capital stock and surplus of the major covered company.\(^{19}\)

Each word or phrase is critical in understanding the scope of the rule. We discuss most of the terms immediately below but thereafter discuss the meaning of “net credit exposure.” Determining a net credit exposure is a two-step process involving determination of “gross credit exposure” and then making various deductions or other modifications. Additionally, bear in mind is that section 165(e) has its own effective date that differs from the dates for all other provisions in section 165, and it may be difficult to determine exactly what date applies to some covered companies. The dates are discussed below in connection with compliance.

**Definitions (12 CFR 252.92)**

Important definitions, other than credit exposure, are as follows, in order of their appearance in the Proposal.

- Aggregate net credit exposure. This term means the sum of all net credit exposures of a covered company to a single counterparty.

- Credit transaction. This term underlies the definition of credit exposure and broadly encompasses virtually any agreement that exposes a covered company to credit risk. In full, the term includes: any extension of credit to a counterparty, including loans, deposits, and lines of credit, but excluding advised or other uncommitted lines of

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\(^{17}\) § 165(e)(2); 12 U.S.C. § 5365(e)(2). This limit differs from the restrictions placed on insured depository institutions for loans to one borrower under 12 U.S.C. § 84 and related statutory provisions. The bank-level limits are stricter: there is a 25% limit (measured against the same capital that covered companies must use) on certain credit exposures, but 10% of these exposures must be fully secured. Over time, various exceptions have been grafted onto the bank-level rules; these interpretations overlap with but do not match up against the exceptions in the Proposal.

\(^{18}\) 12 C.F.R. § 252.93(a).

\(^{19}\) 12 C.F.R. § 252.93(b). A sovereign government (including the U.S.) is a counterparty for the purpose of this rule.
credit; any repurchase or reverse repurchase agreement with the counterparty; any securities lending or securities borrowing transaction with the counterparty; any guarantee, acceptance, or letter of credit (including any confirmed letter of credit or standby letter of credit) issued on behalf of the counterparty; any purchase of, or investment in, securities issued by the counterparty; any credit exposure to the counterparty in connection with a derivative transaction between the covered company and counterparty; any credit exposure to the counterparty in connection with a credit derivative or equity derivative transaction between the covered company and a third party, the reference asset of which is an obligation or equity security of the counterparty; and any transaction that is the functional equivalent of the above, and any similar transaction that the FRB determines to be a credit transaction for purposes of the credit exposure rule.

- **Counterparty.** A counterparty includes the typical parties with which a covered company might enter into a credit transaction: a natural person and members of the person’s immediate family and a company and all of its subsidiaries. The treatment of government entities warrants particular attention. The term also encompasses sovereign entities: the U.S. government, State governments, foreign sovereign entities, and all of their agencies, instrumentalities, and subdivisions. Additionally, as noted in the discussion of exemptions below, exposures to the U.S. government and its agencies or to Fannie Mae and Freddie Mac are not subject to the single-counterparty credit exposure limits, notwithstanding the inclusion of these entities in the definition of counterparty.

- **Covered company.** This term has the same definition used for other provisions in the Proposal, but a single credit exposure limit applies to the net credit exposures of a covered company “together with” its subsidiaries. The Federal Home Loan Banks are not covered companies.

- **Major covered company.** This term encompasses any bank holding company with total consolidated assets equal to or greater than $500 billion and any nonbank covered company (regardless of asset size).

- **Subsidiaries.** A covered company’s subsidiaries include any company controlled directly or indirectly by the covered company. “Control” is defined more narrowly than in the Bank Holding Company Act. One company controls another for the purposes of the single counterparty credit exposure limits when the company owns, controls, or holds with the power to vote 25 percent or more of a class of voting securities or owns or controls 25 percent of the total equity of the other company, or when the company consolidates the other for financial reporting purposes. Other arrangements that in other contexts would constitute control—e.g., ability to elect a majority of the board or to control a general partner—do not create control under the credit exposure limits.

- **Unaffiliated counterparty.** This term is not specifically defined, but reasoning from the definition of affiliate, it is a counterparty that does not control, is not controlled by, and is not under company control with the covered company.

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20 The asset amount is determined on the basis of the average of the company’s total consolidated assets in the four most recent quarters as reported quarterly on the company’s FR Y-9C.
Gross credit exposure (12 CFR 252.94)

“Net credit exposure” is determined through a two-step process. First, a covered company must determine its “gross credit exposure” to a counterparty.\(^\text{21}\) The Proposal recognizes several different types of credit transactions to be included in this calculation. Different valuation methods apply. The types of credit transactions, together with the appropriate valuation method, are as follows:

- Extensions of credit to the counterparty, including loans, deposits, lines of credit, and leases, are valued at the amount owed by the counterparty to the covered company. Committed credit lines are valued at their face amount. Advised or other uncommitted lines of credit are excluded.

- Debt securities issued by the counterparty are valued in different ways. For securities traded and available for sale, the value is the greater of the amortized purchase price or market value; for securities held to maturity, the amortized purchase price.

- Equity securities issued by the counterparty are valued at the greater of the purchase price or market value.

- Repurchase agreements are equal to the market value of the securities transferred by the company to the counterparty plus the product of multiplying the market value by the same “haircut” required for collateral. The Proposal includes a table of haircuts. For example, a bond traded on the Standard & Poor’s 500 index with a current market value of $100 would be haircut by 15% when provided as collateral. Conversely, when part of a repurchase agreement, the credit exposure is an additional 15%, and the total exposure would be $115. The FRB requires the add-on to capture market volatility.

- Reverse repurchase agreements are equal to the amount of cash transferred by the covered company to the counterparty.

- Securities borrowing transactions are valued at the amount of cash collateral plus the market value of securities collateral transferred by the covered company to the counterparty.

- Securities lending transactions are equal to the market value of the securities lent to the counterparty, plus the product of multiplying the market value amount by the appropriate haircut (the same calculation used for repurchase agreements).

- Guarantees, acceptances, or letters of credit (including any confirmed letter of credit or standby letter of credit) issued by the company on behalf of a counterparty are valued at the lesser of the face amount or the maximum potential loss to the company on the transaction.

- Derivative transactions that are subject to a qualifying master netting agreement are valued at the exposure-at-default amount calculated under the advanced risk-based capital guidelines. The amount of any initial margin and excess variation margin posted to a counterparty also is included. If a derivative is cleared through a central

\[^{21}\text{12 C.F.R. 252.94(a).}\]
counterparty ("CCP"), then any contribution to the CCP’s guaranty fund is an exposure and is valued at the notional amount.

- Derivative transactions between a company and a counterparty that are not subject to a qualifying master netting agreement are valued at an amount equal to the sum of (i) the current exposure of the derivatives contract equal to the greater of the mark-to-market value of the contract or zero and (ii) the potential future exposure of the derivatives contract, calculated by multiplying the notional principal amount of the contract by the appropriate conversion factor (the Proposal includes a matrix of conversion factors).

- Credit or equity derivative transactions between the covered company and a third party where the company is the protection provider and the reference asset is an obligation or equity security of the counterparty are equal to the lesser of the face amount of the transaction or the maximum potential loss to the company on the transaction.

Two important provisions apply when summing up exposures for the purpose of applying the limits. First, a single limit applies to the sum of the exposures of a covered company and its subsidiaries. Even if a covered company itself—e.g., a shell holding company—does not extend credit, all of the exposures of all of its subsidiaries will be added together in order to determine whether the covered company is in compliance with the limits. An attribution rule also applies: a transaction with any person is a credit exposure to a counterparty to the extent the proceeds of the transaction are used for the benefit of or transferred to the person. Such a person need not be a party to the credit agreement between the covered company and the initial counterparty.

**Net credit exposure (12 CFR 252.95)**

Once a covered company determines its gross credit exposure, it must take the second step, making adjustments to account for credit risk mitigants. In general, as the FRB explains, these mitigants consist of eligible collateral, eligible guarantees, eligible credit and equity derivatives, other eligible hedges, and, for securities financing transactions, bilateral netting agreements. Whether the Proposal has captured the universe of effective mitigants may be an issue for discussion during the comment period. One apparent omission concerns simple credits held by both a covered company and a counterparty that could be set off against each other for state law purposes. Legal set-offs do not appear to constitute an adjustment under the Proposal. The adjustments in the Proposal are as follows:

- **Netting arrangements in securities financing transactions.** For repurchase and reverse repurchase exposures subject to a bilateral netting agreement, a covered company may use the associated net credit exposure. The same rule applies to securities lending and borrowing transactions.

- **Eligible collateral.** An exposure may be reduced by the adjusted market value of “eligible collateral,” after application of the appropriate haircut, subject to three conditions to insure that the collateral reduces the exposure only to the counterparty providing the collateral.

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22 Note that this rule is narrower than the attribution rules in Regulations O and W.

23 The conditions are (i) that the company use the adjusted market value of the collateral in calculating its gross credit exposure to the issuer of the collateral; (ii) that the collateral cannot be used to adjust the covered company’s gross credit exposure to any other counterparty; and (iii) that the covered company’s
“Eligible collateral” includes cash on deposit with a covered company, debt securities (other than mortgage- or other asset-backed securities) that are bank-eligible, and publicly traded equity securities and convertible bonds. All forms of collateral other than cash are subject to a haircut; the largest haircuts are on equity securities and convertible bonds. Collateral is eligible only if the covered company has a perfected, first-priority security interest (or the equivalent for collateral outside the U.S.) in the collateral.

- **Unused portions of credit commitment.** These portions may be deducted from a gross credit exposure—but only if the covered company has no legal obligation to advance additional funds until the borrower provides the amount of adjusted market value of collateral required with respect to the entire used portion of the extension of credit. The credit contract must limit such collateral to cash, obligations of the U.S. or its agencies, and securities backed by Fannie Mae or Freddie Mac (for as long as a conservator or receiver is in place). The FRB also may allow other obligations of U.S. government-sponsored enterprises to be used as collateral. Note that if a commitment could become legally enforceable for reasons other than the provision of collateral, then this commitment cannot be used to reduce gross credit exposure.

- **Eligible guarantee.** A guarantee from an “eligible protection provider” may be used to reduce gross credit exposure. Eligible providers include sovereign entities, certain international financial groups, certain government-sponsored entities (but not Fannie Mae or Freddie Mac), and financial institutions, including foreign banking organizations. A covered company must, however, treat the guarantee as an exposure to the provider. The FRB has imposed this requirement in order to limit the ability of a covered company to extend credit to a large number of high risk borrowers that are guaranteed by a single guarantor. The value of this exposure cannot exceed the value of the exposure to the original counterparty.

- **Eligible credit or equity derivative.** A covered company also must reduce its gross credit exposure by the notional amount of any eligible credit or equity derivative that has been written by an eligible protection provider that references the counterparty (subject to certain conditions). In order to be eligible, a credit derivative must be in simple form, including single-name or standard, non-tranched index credit derivatives. An equity derivative includes only an equity-linked total return swap and not other more complex equity derivatives, such as purchased equity-linked options. A covered company must treat the amount by which a derivative has reduced exposure to a counterparty as an exposure to the protection provider.

- **Short sales.** A short sale of a counterparty’s debt or equity security may be used as a hedge to reduce the amount of the exposure.

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24 The term includes any sovereign entity; the Bank for International Settlements, the International Monetary Fund, the European Commission, or a multilateral development bank; a Federal Home Loan Bank; the Federal Agricultural Mortgage Corporation; a depository institution; a bank holding company; a savings and loan holding company; a registered securities broker or dealer; an insurance company to supervision by a state insurance regulator; a foreign banking organization; a non-U.S.-based securities firm or insurance company that is subject to consolidated comparable supervision; and a qualifying central counterparty.
Compliance and timing (12 CFR 252.91, .96)

The Proposal requires that a covered company track compliance as of the end of each business day and submit a monthly compliance report to the FRB.

If a covered company falls out of compliance either because its capital has declined (thus reducing the denominator and increasing the percentage of capital represented by the credit transactions with a counterparty or because of mergers of the covered company with another covered company or of two counterparties, the company will have a 90-day period in which it must make reasonable efforts to return to compliance. During the 90 days, a covered company may not enter into similar transactions with the same counterparty, unless the FRB finds that the transactions are necessary to preserve safety and soundness of the company or U.S. financial stability. In making this determination, the FRB will consider any decrease in the covered company’s capital stock and surplus, and mergers involving either the covered company and another such company or two unaffiliated counterparties. During the 90-day compliance period, the company must comply with all applicable restrictions on a daily basis and must submit a monthly report that demonstrates daily compliance.

The dates for compliance with the single-counterparty exposure rules are difficult to determine, and the language in the proposed rule may not reflect the intent of the FRB. Section 165(e)(7)(A) clearly provides that these rules take effect on July 21, 2013. As written, the proposed regulation recognizes three categories of covered companies: (i) companies that are covered companies on the effective date, July 21, 2013; (ii) companies that become covered after the effective date but before September 12, 2012; and (iii) companies that become covered companies after July 21, 2013. Since the effective date is after September 12, 2012, category (ii) is a null set. A category (i) company must begin complying on October 1, 2013. A category (iii) company must comply beginning on the first day of the fifth full calendar quarter following the date on which the company became covered.25

Exemptions (12 CFR 252.97)

The limits on single counterparty credit exposures in subpart D do not apply to:

- Direct claims on, and the portions of claims that are directly and fully guaranteed as to principal and interest by, the United States and its agencies.

- Direct claims on and the portions of claims that are directly and fully guaranteed as to principal and interest by, Fannie Mae and Freddie Mac, only while operating under the conservatorship or receivership of the Federal Housing Finance Agency. The FRB may determine that additional obligations issued by a U.S. GSE are exempt.

- Intraday credit exposure to a counterparty.

- Any other transaction that the FRB exempts, based on findings that the exemption is in the public interest and consistent with the purpose of the other exemptions.

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25 The existence of a null set category and the fact that a category (i) company could have far less time to prepare for compliance than a category (iii) company cast some doubt on the intent behind the timing of compliance. A better approach would be to allow every covered company at least four quarters in which to prepare.
Risk Management (Subpart E)

Section 165(h) requires every covered company and every publicly traded bank holding company with assets of $10 billion or more to establish a risk committee. The statute prescribes three elements for this committee: (i) responsibility for enterprise-wide risk management, (ii) inclusion of a number of independent members as the FRB deems appropriate, and (iii) inclusion of at least one risk management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms. The Proposal imposes certain obligations on the committee and requires the appointment of a chief risk officer. The timing of compliance with the risk management requirements is governed by the general first-day-of-the-fifth-quarter principle.

Risk committee (12 CFR 252.126(a)-(c))

A company must adhere to several requirements in setting up a risk committee. The committee must be enterprise-wide, with a formal, written charter approved by the full board. The committee’s membership is restricted to directors. Two requirements do not apply to bank holding companies below the $50 billion threshold. The committee must report directly to the full board and may not be housed in another board committee or be part of a joint committee.

An independent director must chair the committee. For public companies, independence is governed by the SEC’s Regulation S-K. That is, the company must indicate in its securities filings that the director satisfies the applicable independence requirements of the exchange on which the company’s securities are traded. These requirements typically include limitations on compensation paid to the director or his or her family members and prohibitions on material business relationships between the director and the company. A director who is or recently was employed by the company or whose immediate family member is or recently was an executive officer of the company is not independent. For companies that are not publicly traded, the company must demonstrate to the FRB that the director would satisfy the public company requirements if the company were public.

The Proposal requires that at least one member of the committee must have risk management expertise commensurate with the company’s systemic footprint. The FRB’s expectations are considerably greater, however, and could shrink the pool of qualifying members. All members of the committee generally should have an understanding of the risk management principles and practices relevant to the company. Moreover, the members should have experience developing and applying risk management practices and procedures, measuring and identifying risks, and monitoring and testing risk controls—all specifically with respect to banking organizations (or, if applicable, nonbank financial companies). The level of necessary experience increases with the systemic footprint of the company.

The risk committee has responsibility for management of the company’s risk on an enterprise-wide basis. The Proposal identifies specific committee tasks that should be reflected in committee records. As the systemic footprint of a company grows, the risk management framework overseen by the committee should become increasingly robust.

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26 Section 165(h) authorizes the FRB to push the risk committee requirement down to publicly traded bank holding companies with less than $10 billion in assets, but the Proposal does not do so.

27 The publicly traded bank holding companies with assets between $10 billion and $50 billion, which are subject to the statutory and related regulatory requirements regarding a risk committee are not required to appoint a chief risk officer.
• The committee must document the enterprise-wide policies and procedures of the company—and oversee them.

• The committee must review and approve an appropriate risk management framework, commensurate with the company’s systemic footprint. This framework must include:
  - risk limitations for each business line;
  - appropriate policies and procedures relating to risk management governance, risk management practices, and risk control infrastructure;
  - processes and systems for identifying and reporting risks, including emerging risks;
  - monitoring compliance with the company’s risk limit structure and policies and procedures relating to risk management governance, practices, and risk controls;
  - effective and timely implementation of corrective actions;
  - specification of management’s authority and independence to carry out risk management responsibilities; and
  - integration of risk management and control objectives in management goals and the company’s compensation structure.

• Review regular reports from the CRO.

Chief risk officer (12 CFR 252.126(d))

Every covered company must designate a chief risk officer (the “CRO”) whose basic responsibility is to implement and maintain appropriate enterprise-wide risk management practices. The CRO must have direct oversight for:

• allocating delegated risk limits and monitoring compliance with such limits;
• establishing appropriate policies and procedures relating to risk management governance, practices, and risk controls;
• developing appropriate processes and systems for identifying and reporting risks, including emerging risks;
• managing risk exposures and risk controls;
• monitoring and testing risk controls;
• reporting risk management issues and emerging risks;
• ensuring that risk management issues are effectively resolved in a timely manner; and
• make regular reports to the risk committee.
The CRO must have a level of expertise commensurate with the systemic footprint of the company, an experience level not much different from that of at least one member of the risk committee. The FRB takes a rigorous position on the necessary degree of experience: an executive whose qualifications and experience are highly focused in a specific area, such as credit risk, would be unlikely to have the required level of expertise to serve as CRO for a company engaged in more diverse businesses.

The CRO must report directly to both the risk committee and the CEO of the company. The compensation structure of the CRO must enable the CRO to provide an objective assessment of the risks taken by the company.
Stress Tests (Subparts F and G)

Section 165(i) of the Act requires two sets of stress tests, one by the FRB and the other by the covered company. In addition to covered companies, all publicly traded bank holding companies with assets in excess of $10 billion must conduct annual stress tests.28

The tests could have interesting and not entirely foreseen consequences. Both tests likely would have the same inputs—the same assumptions, since the FRB provides all of them, and presumably identical data. The FRB would have the authority to request the same data that the covered company uses. The methodologies will be somewhat different, however. The FRB’s stress tests will be standardized across all covered companies, while company tests will necessarily be tailored to each company. Differences in test results, particularly where results may seem skewed, will result in heightened scrutiny by the FRB.

Different test results might have other important consequences. The company-specific results of both the FRB and the covered company tests must be made public in mid-April of each year.29 Despite differences in methodologies (or perhaps because of them), any differences could be important to investors, counterparties, and other regulators as an apparent reflection on management and its ability to handle risk in distress conditions. Adverse conclusions could affect access to the capital markets. Further, the results of the annual tests for all companies will become public at approximately the same time, initiating a variety of cross-company comparisons by a range of third parties. Finally, because the FRB may require changes to a company’s resolution plan that will be based at least in part on the published stress test results, a company may be compelled to make parts of the resolution plan public that the resolution plan regulation does not require be made public.

The year in which a covered company must begin submitting information to the FRB and conducting its own stress tests is complicated. September 30 is the critical date because it is financial data as of that date that are the quantitative inputs to the stress tests. Companies that are covered as of the effective date must begin compliance that year; the first duties begin each year shortly after September 30. There is no transition period; if the effective date is shortly before September 30, a covered company still must begin compliance then. A bank holding company that passes the $50 billion floor after the rule takes effect must begin compliance as of the September 30 that is at least 90 days after the time at which it passes the floor. If this transition occurs as of the end of the second calendar quarter (June 30), compliance would be necessary in the same year. Nonbank financial companies that are deemed systemically important by the FSOC after the effective date of the rule must begin their compliance as of the first September 30 that is at least 180 days after the designation.

FRB tests (12 CFR 252.133 - .136)

The FRB must conduct annual stress tests of covered companies under section 165(i)(1) of Dodd-Frank. The statutory purpose of the tests is to evaluate whether covered companies have the capital necessary to absorb losses as a result of adverse conditions. Accordingly, the tests must assess capital adequacy under baseline, adverse, and severely adverse conditions. The tests build on the Supervisory Capital Assessment Program from 2009 and the Comprehensive Capital Analysis and Review in late 2010. The FRB tests outlined in the Proposal are designed to work in tandem with the capital plan rule.

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28 Section 165(i) does not require the FRB to conduct its own stress tests of these bank holding companies, referred to hereafter as the "$10 billion companies." The FRB has discretion to do so but has not included any such provision in the Proposal.

29 Section 165(i) does not require that the FRB release summary information on a company-specific basis.
The FRB has developed an annual cycle for its stress tests, and it may be most helpful to review the duties of covered companies and the testing by the FRB in chronological order.

- After September 30, each covered company will begin compiling data for several quarter-end reports. This process will include gathering information necessary for the FRB’s tests. The specifics on the necessary data beyond that provided for existing reports are unknown and will be the subject of a future rulemaking on information collection. The FRB may require virtually any data from a covered company.

  It seems clear that the FRB will ask for data regarding on- and off-balance sheet exposures, including exposures in the company’s trading portfolio, other trading-related exposures (i.e., counterparty credit risk exposures), and positions in the trading portfolio that are sensitive to changes in market prices and interest rates. The FRB also will request information that would enable it to estimate the sensitivity of the company’s revenues and expenses to changes in economic and financial conditions.

- In mid-November of each year, covered companies must submit to the FRB regulatory reports and any other necessary stress-test data as of September 30. The FRB may later request supplemental information, presumably on a company-specific basis. Information submitted to the FRB for use in the stress test will be subject to the same level of protection that applies to the submission of other data under the Freedom of Information Act. The Proposal does not, however, specifically protect the data submitted as information provided for examination or supervisory reasons.

- At the same time (the order is not clear), the FRB will provide to the covered companies the conditions for each of the three scenarios that it will use in conducting its stress tests. (The companies will use the same assumptions in their own tests.) This information will include a range of macroeconomic and financial indicators, such as real gross domestic product, the unemployment rate, and equity and property prices. To address trading positions that may have large short-term volatility with respect to adverse market events, the FRB also will provide market price and interest “shocks” that are consistent with historical or other adverse market events. The level or quality of the assumptions will apply to the three scenarios in the following ways, as described by the FRB:

  - Baseline. The FRB will consider the most recently available views of the macroeconomic outlook expressed by government agencies, other public-sector organizations, and private-sector forecasters as of the beginning of the annual stress-test cycle. Note that if these views are positive, the results of this scenario might show increased capital without any action on the part of a covered company. Of course, a positive outlook likely would lead to greater growth or expansion, in which case additional capital also would be necessary.

  - Adverse. This scenario could include economic and financial conditions consistent with a recession of at least moderate intensity, including a shortfall of

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30 Note that all of the banking organizations to be tested by the FRB will soon be subject to prohibitions and restrictions on proprietary trading. Among other things, the recent Volcker Rule proposal suggests that assets in the trading book with high volatility—i.e., high sensitivity—are likely to reflect prohibited trading.

31 In its discussion of the Proposal, the FRB suggests that submissions of data as of calendar quarter ends in addition to September 30 may be required, but the proposed regulation does not include such a provision.
economic activity and increase in unemployment relative to the baseline scenario, weakness in household incomes, declines in asset prices (including equities, corporate bonds, and property prices) and changes in short- and long-term yields on government bonds.

- **Severely adverse.** The assumptions here would consist of economic and financial conditions that are more unfavorable than those of the adverse scenario and that also include, in some instances, salient factors that are likely to place notable strains on at least some lines of business. For example, these conditions could include precipitous declines in property or other asset prices; shifts in the shape of the yield curve; marked changes in the propensity of households or firms to enter bankruptcy; or strains on households, businesses, or real property markets in particular regions of the United States.

- By January 5, the companies will have submitted to the FRB both the results of its own stress tests and their capital plans.

- By early March, the FRB will have completed its stress tests and will communicate the results to the covered companies. As part of these tests, the FRB will calculate pro forma, post-stress capital levels and ratios over at least nine calendar quarters under the three scenarios. The tests also will produce projections of losses, pre-provision net revenue, and allowance for loan losses. The FRB plans to publish the conditions included in each of the scenarios in advance of the annual tests and will publish an overview of its methodologies.

  The FRB expects that some (and possibly all) covered companies will need to take one or more actions after taking the results of the FRB tests into account. Such actions would include appropriate changes to the company’s (i) capital structure, (ii) exposures, concentrations, and risk positions, (iii) recovery plans, and (iv) risk management.

- By March 31, the FRB will provide comments to the covered companies on their capital plans, using the results of its own stress tests, as well as reviews of the companies’ own tests. (The companies will evaluate these comments and make any appropriate amendments to their plans within 30 calendar days.)

- In mid-April, the FRB will publish the summary results of the stress tests. These summaries will be company-specific and will have some detail, notwithstanding the FRB’s characterization of the summaries as “high level” and its cautionary statements about the use of these summaries by the public. For each tested company, the FRB proposes to publish estimated losses, including overall losses on loans by subportfolio, available-for-sale and held-to-maturity securities trading portfolios, and counterparty exposures; estimated pre-provision net revenue; estimated allowance for loan losses; and estimated pro forma regulatory and other capital ratios. These results will be published for each quarter-end within the FRB’s planning horizon in the tests, presumably at least nine quarters. In its discussion, the FRB recognizes that its published results may differ from the published results of a covered company’s own stress tests but offers no mechanism for explaining the differences to the public.

  The FRB may require changes to resolution plans based on test results; any such changes must be made within 90 days of the FRB’s publication of its stress test results. In the worst case, the FRB’s tests could trigger early remediation.
Section 165(i)(2) requires all covered companies to conduct internal stress tests semi-annually and, in addition, all financial companies with total consolidated assets of more than $10 billion and that are regulated by a federal banking agency, the Securities and Exchange Commission or the Commodity Futures Trading Commission to conduct annual stress tests. Given the FRB’s jurisdiction with respect to the non-covered companies, the Proposal covers only bank holding companies and state member banks that are over the $10 billion threshold. Other financial companies with more than $10 billion in assets and that are regulated by federal agencies other than the FRB must await direction from those agencies, although the requirements of those agencies should not differ materially from those of the FRB. With respect to all of these organizations, multiple stress tests may be required, one for the top-tier holding company and one for each insured depository institution or other financial company with consolidated assets of more than $10 billion. These additional tests will be submitted to the primary federal regulator. The FRB will coordinate with the other agencies in providing scenarios and for other purposes.

The company tests are intended to produce quantitative estimates of essentially the same items as the FRB tests: (i) pro forma capital levels and capital ratios, including regulatory ratios or other ratios specified by the FRB; (ii) losses by exposure category; (iii) pre-provision net revenue; (iv) allowance for loan losses; (v) total assets and risk-weighted assets, (vi) aggregate loan balances; and (vii) potential capital distributions over the planning horizon. The planning horizon is a minimum of nine calendar quarters. The tests will analyze capital adequacy under the same three scenarios used for the FRB tests: baseline, adverse, and severely adverse. The conditions within each scenario will be the same in both the FRB and the company tests and will be provided to each company for the annual test. For the second, semi-annual test, a covered company will develop its own conditions for each scenario. The annual test uses company data as of September 30; the second test required for covered companies will be as of March 31.

As with the FRB tests, the Proposal contains an annual cycle for the company tests, which is intended to dovetail with the FRB cycle. Soon after September 30, each company should begin compiling the data necessary for FRB’s and its own stress tests. In mid-November, the FRB will provide the conditions for each scenario, and at that point, the companies can begin their tests. They will have slightly over a month to do so. They must submit reports of the tests to the FRB by January 5 of each year, together with the annual capital plans.

Covered companies conducting a second test must file a second report by July 5. The FRB will not provide scenarios for these second tests; each company must develop its own set of conditions for each of the baseline, adverse, and severely adverse scenarios.

The content of the report to be filed by January 5 will be set forth in detail in a separate rulemaking. In addition to the quantitative outputs enumerated above, qualitative items also will be required, including (i) a general description of the company’s use of the stress test, (ii) a description of the risks captured in the test, (iii) a general description of the methodologies...
used to estimate the numerical results, (iv) assumptions about capital distributions, and (v) for covered companies, a description of the variable used for the three scenarios. The annual report may cross-reference information submitted with the capital plan. Indeed, because stress-test results will be submitted at the same time as capital plans, stress-testing and capital planning should be part of a continuous planning and testing function that also encompasses resolution planning. Based on the information provided in the stress test results, the FRB will analyze the quality of each company’s testing processes and results.

Within 90 days after submission of the required report, a covered company or an over-$10 billion banking organization must publish on its website or other reasonably accessible public place a summary of the stress-test results. Covered companies also must publish a summary within 90 days after submission of the second report in early July.35 This summary must have four substantive elements.

- A description of the types of risks being included in the stress test.
- For each covered company, a high-level description of scenarios developed for the second test, including key variables used (such as GDP, unemployment rate, and housing prices).
- A general description of the methodologies employed to estimate losses, revenues, allowance for loan losses, and changes in capital positions over the planning horizon.
- Aggregate losses, pre-provision net revenue, allowance for loan losses, net income, and pro forma capital levels and capital ratios (including regulatory and any other capital ratios specified by the FRB) over the planning horizon under each scenario.

It must describe the types of risks included in the stress test and the methodologies employed to estimate losses, revenues, allowance for loan losses, and changes in capital positions over the planning horizon. The summary also must present largely the same types of financial results that the FRB must include in its publication of results. Covered companies also must explain how they developed the scenarios for the second test, including the key variables they used.

A company’s stress tests will not pass or fail any particular metric. The FRB will review the test results as part of its supervision of each company and will provide feedback through the supervisory process.

The Proposal calls for certain controls over the stress testing process. There are two specific requirements:

- A covered company must establish policies and procedures that outline the company’s stress testing practices and methodologies, validation, use of stress test results and processes for updating the company’s stress testing practices consistent with relevant supervisory guidance. The policies and procedures also must include information describing its processes for scenario development for the additional stress tests.

35 In other words, the second set of test results are likely to be published in early October, just as a company is gearing up for the annual report. Public or supervisory reaction may inform the annual test.
• The board of directors and senior management must, on an annual basis, approve and review the controls, oversight, and documentation (including policies and procedures) of the company.
Debt-to-Equity Ratio Limit (Subpart H)

Section 165(j) directs the FRB to limit a covered company’s debt-to-equity ratio to no more than (and conceivably less than) 15-to-1, if the FSOC has made two findings: (i) that the company poses a “grave threat” to U.S. financial stability and (ii) that the imposition of the requirement is necessary to mitigate the risk that the company poses to financial stability.36 “Grave,” which is undefined in Dodd-Frank, may be superfluous since section 165(j) does not instructs the FSOC to consider the same factors it uses when determining whether a U.S. or foreign nonbank financial company should be supervised by the FRB. The touchstone for such a determination is a “threat” to U.S. financial stability.

The Proposal does little more than define the debt-to-equity ratio and to establish a time frame for imposing and lifting the ceiling. Debt consists of total liabilities. Equity means total equity capital less goodwill. This information will be as reported by a bank holding company on the FR Y-9C or by a nonbank financial company in the new report of financial condition that it will be required to file with the FRB.

A covered company will receive written notice of the FSOC’s determination that it must conform to the debt-to-equity limit. The company has 180 days in which to comply. Two extensions of 90 days each are available, if the Board determines that the company has made good faith efforts to comply and that an extension would be in the public interest. The cap will be removed as soon as the FSOC determines that no grave threat exists.

The debt-to-equity ceiling functions largely as an incentive to maintain or increase the capital of a covered company. If a company fails to do so and the ceiling is put in place, the FRB expects the company to increase equity capital through limits on distributions, share offerings, and other capital raising efforts. The FRB would look more skeptically at efforts to improve the ratio through asset sales or presumably other actions that would shrink the company.

36 “Grave threat” is not defined, and the debt-to-equity ratio is the only provision in the Act triggered by the finding of a grave threat.
Early Remediation (Subpart I)

Section 166 requires the FRB (after consultation with the FSOC and FDIC) to prescribe regulations for the early remediation of financial distress at a covered company. The regulations are to be designed to minimize the possibility of insolvency and the consequent effects on U.S. financial stability. The section directs the FRB to define regulatory capital, liquidity, and other forward-looking measurements of financial condition that would trigger early remediation. Remediation is to increase in stringency as the financial condition of a company declines. Less rigorous requirements are to include limits on capital distributions, acquisitions, and asset growth. For companies in later stages of decline, remedies are to include preparation of a capital restoration plan and capital-raising requirements, limits on transactions with affiliates, management changes, and asset sales.37

Within the context of enhanced prudential standards, the early remediation procedures represent the FRB’s response to many forms of non-compliance with the standards set forth elsewhere in the Proposal. Compliance problems in the areas of capital, liquidity, risk management, or stress-testing will lead to some kind of early remediation. (Violations of the single counterparty exposure rules will not, however.) The range of possible actions is wide. Most are discretionary, but a few actions are required when a particular trigger is pulled.

For bank holding companies, section 166 and the Proposal formalize much of the FRB’s supervisory approach to large and complex banking organizations. The mechanics of compliance are new, but much of the substance is not. For nonbank covered companies, however, the requirements are new, and the authority to enforce them is new to the FRB. The early remediation provisions in the Proposal will take effect immediately upon finalization of the regulation; there is no conformance period.

The Proposal creates four levels for regulatory response to a distressed covered company: “heightened supervisory review,” “initial remediation,” “recovery,” and “resolution assessment,” which are discussed immediately below. The level appropriate for a distressed covered company is determined by several different triggering events, which are described thereafter.

Remedial actions (12 CFR 252.162)

The four levels of remedial actions are intended to produce a calibrated response to the particular circumstances surrounding a distressed covered company.

- Level 1—heightened supervisory review. By itself, Level 1 is a modest response and serves largely as a gateway to greater responses. Heightened review will occur when a covered company first shows signs of financial distress or material risk management weaknesses such that further decline is probable. Upon the discovery of these signs, the FRB will have 30 days in which to consider and to report on whether the company should be subject to a Level 2 response. Further supervision thus will take one of two courses. First, the FRB may begin to apply Level 2 responses (meaning that Level 1 served simply as a justification for Level 2). Second, the company technically would leave Level 1 because the FRB had taken its Level 1 action—producing a report within 30 days—and determined not to bring...

37 The remediation framework is roughly modeled on the prompt corrective action regime for insured depository institutions that was put in place 20 years ago, see 12 U.S.C. § 1831o. This regime, which is based almost exclusively on regulatory capital levels, remains in place at the bank level but has been perceived as inadequate during the financial crisis. The early remediation framework has been deliberately designed to look beyond regulatory capital levels for leading signs of distress that warrant intervention.
Level 2 into play. As a practical matter, however, if a company is not subjected to Level 2 intervention, the FRB will continue to monitor the condition of the company more closely than if it had not triggered Level 1 responses to begin with. Of course, the FRB would be free to take supervisory action as it deems appropriate regardless of how the Proposal might cover a company just at Level 1.

- Level 2—initial remediation. The company may not make capital distributions in a calendar quarter that would exceed 50 percent of its average net income over the two preceding calendar quarters. The company also is subject to several growth restrictions that generally preclude the company from growing at more than 5 percent annually. Both the capital distribution and growth limits are mandatory and effective immediately. Any acquisitions by a company in Level 2 require the prior approval of the FRB. The FRB also must take enforcement action, at a minimum in the form of a memorandum of understanding on the specific steps necessary to improve the company’s condition. The FRB has additional authority to restrict the company’s business as it sees fit.

- Level 3—recovery. Capital distributions, growth, investments in another company (whether controlling or not), and salary increases or bonuses for senior executive officers or directors are prohibited. Affiliate transactions may be restricted. Changes in management or the board may be required. The company also must enter into a written agreement or other formal enforcement action that requires specific actions to improve capital adequacy. If the company does not comply with the agreement—e.g., it cannot raise sufficient capital—then the FRB may require divestitures of assets identified by the FRB as contributing to the company’s decline or that pose substantial risk of contributing to the company’s further decline.

- Level 4—resolution assessment. The FRB considers whether the covered company poses a risk to the stability of the U.S. financial system. If the FRB determines that the company should be placed in receivership under the orderly liquidation authority, then it must make the necessary recommendation that begins that process. Unlike the other three levels of early remediation, however, Level 4 remediation is a function exclusively of a covered company’s low regulatory capital levels.

**Triggers (12 CFR 252.163)**

Six separate sets of triggering events—capital and leverage, the results of stress tests, risk management, liquidity, and market indicators—dictate the level of response appropriate for a covered company that seems to be distressed. Five of the six relate to compliance with enhanced prudential standards elsewhere in the Proposal. Each of the triggers involves qualitative judgments by the FRB. If these factors would lead to different levels, the SIFI will be subject to the most stringent response available. Note, however, that resolution assessment must occur when a covered company falls below certain capital levels, regardless of what other triggers might indicate.

- **Capital and leverage.** This trigger is premised on a determination by the FRB that a covered company’s capital structure, capital planning processes, or the amount of capital it holds is not commensurate with the level and nature of the risks to which it is exposed. This qualitative judgment may be made even with respect to a well-capitalized company, and accordingly such a company could be subjected to Level 1
Otherwise, the specific capital ratios in the table below indicate the level of response.

<table>
<thead>
<tr>
<th>Level</th>
<th>Total risk-based capital</th>
<th>Tier 1 risk-based capital</th>
<th>Tier 1 leverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level 1</td>
<td>10% or more</td>
<td>6% or more</td>
<td>5% or more</td>
</tr>
<tr>
<td>Level 2</td>
<td>Between 8 and 10%</td>
<td>Between 4 and 6%</td>
<td>Between 4 and 5%</td>
</tr>
<tr>
<td>Level 3</td>
<td>Below 10% for two complete consecutive quarters or between 6 and 8%</td>
<td>Below 6% for two complete consecutive quarters or between 3 and 4%</td>
<td>Below 5% for two complete consecutive quarters or between 3 and 4%</td>
</tr>
<tr>
<td>Level 4</td>
<td>Less than 6%</td>
<td>Less than 3%</td>
<td>Less than 3%</td>
</tr>
</tbody>
</table>

An important consideration reflected in the table is that a Level 2 company that cannot restore its capital within only two quarters becomes a Level 3 institution. The FRB also observes that it will modify this framework to take account of any changes to regulatory capital requirements as the result of further Basel II or III developments.

Capital will be deemed to have been calculated as of the most recent of either (i) the FR Y-9C report, (ii) any capital calculations submitted to the FRB at the FRB’s request, or (iii) a final inspection report delivered to the company by the FRB that shows capital ratios calculated more recently than in the most recent FR Y-9C.

- **Stress tests.** A company will be subject to a Level 1 response if it has not complied with the capital plan or stress-test regulations—even if it continues to meet minimum regulatory capital requirements in the severely adverse scenario. If the results of a test under the severely adverse scenario for any quarter of the planning horizon reflect a Tier 1 common risk-based capital ratio of less than five percent but more than three percent, then a Level 2 response is indicated. If this ratio is less than 3 percent, then Level 3 is called for. A stress test is deemed to have produced the Tier 1 common ratio as of the date the FRB transmits its stress test report to the company.

- **Risk management.** In general, for a covered company that fails to comply with the enhanced risk management provisions in Subpart E, a Level 2, 3, or 4 response is necessary. If a company has “manifested signs of weakness” in the enhanced risk management and risk committee requirements, then it is subject to a Level 1 response. Level 2 comes into play if the company has demonstrated “multiple deficiencies” in complying with these requirements. “Substantial noncompliance” warrants a Level 3 intervention. The Proposal does not identify any concrete factors to differentiate these judgments.

- **Liquidity.** The triggers here are similar to the risk management triggers. If a company’s measurement or management of liquidity risks does not comply with Subpart C, remediation in Level 1, 2, or 3 is appropriate. Signs of weakness in meeting liquidity risk management standards would lead to a Level 1 intervention. Level 2 applies where there are multiple deficiencies and Level 3 where there is substantial noncompliance. The FRB considered but did not propose quantitative liquidity triggers on the view that such measurements could exacerbate funding pressures at a distressed company.

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38 Capital levels are deemed to have been calculated as of the most recent of the FR Y-9C report, calculations submitted in response to an FRB request, or a final inspection report with capital ratios.
Market indicators. Recognizing that market-based data can provide early signals of financial deterioration, the FRB proposes the use of publicly available market information essentially as a warning sign that the agency should supervise a covered company more carefully. The indicators thus would trigger only a Level 1 response; they would not have a role in the FRB’s decision as to whether higher levels of response are called for.

In the regulatory language in the Proposal, a company will be subject to a heightened supervision if, over a given number of days, its own “market indicator” exceeds a “market indicator threshold.” The proposed regulation does not describe the specific indicators; the FRB will develop a list annually, through notice-and-comment rulemaking.

However, in its discussion of the Proposal, the FRB requests comment on four equity-based indicators—expected default frequency, marginal expected shortfall, market equity ratio, and option-implied volatility—and two debt-based indicators—credit default swaps and subordinated debt spreads. None of these indicators is easily measured. They are based on historical and peer activity, and the indicator or trigger is a point at which a company’s own performance is outside the range of common industry performance.
Conclusion

The requirements in the Proposal are not revolutionary and overall are consistent both with sections 165 and 166 of the Act and with the FRB’s efforts to supervise large and complex bank holding companies both before and during the financial crisis. Further, the publication of the Proposal may help put to rest some uncertainties as to how the FRB would attempt to apply these core system regulations provisions of Dodd-Frank. In implementing these two sections of the Act, however, the FRB has opted for a detailed set of rules, rather than a set of general principles. As a result, every covered company will have to review its risk management structure and its compliance regime to ensure that it will meet the many specific and detailed requirements. We believe covered companies should focus on the following sets of duties that may present especially complex obligations:

- **Liquidity management.** Even though every covered company already manages liquidity intensively, the Proposal requires a specific management structure and specific sets of decisions and analyses that may not match up with current practices.

- **Liquidity buffer and the underlying liquidity stress test.** The buffer requirement anticipates the Basel III liquidity coverage ratio, even though this ratio still is under discussion in the Basel III process.

- **Credit enhancements for single-counterparty exposures.** The Proposal’s use of credit risk mitigants in dealing with this aspect of credit risk is not identical to the use of credit enhancements under the risk-based capital rules and will require a company to review its enhancement techniques.

- **Double stress-testing.** In effect, the FRB will re-test each covered company’s internal stress tests, and the results of both will be made public. In order to minimize differences and the adverse consequences that could occur, each company should be prepared to work closely with the FRB on testing issues.

- **Early remediation.** The new regulatory structure for increasing regulatory intervention as a covered company becomes increasingly troubled will require careful monitoring of all compliance efforts (and not just of capital levels).

- **Capital planning by nonbank covered companies.** Specific minimum capital requirements will apply, and each company must prepare the same kind of capital plan as a bank holding company covered by the Proposal. The critical threshold question is whether a nonbank covered company can accommodate the new requirements. The capital planning process will be a substantially new event for companies unaccustomed to dealing with the FRB.
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Every banking organization will have compliance obligations under the Volcker Rule\(^1\) published in November (the “Proposed Rule”) by four of the federal financial regulatory agencies and, in January, by the Commodity Futures Trading Commission (collectively, the “Agencies”).\(^2\) The Volcker Rule broadly prohibits a banking entity from engaging in proprietary trading and from acquiring or retaining any kind of ownership interest in or sponsoring a hedge fund or private equity fund. The Rule permits certain kinds of trading or fund activity, however, and the Proposed Rule addresses the parameters of and possible conditions on these activities. Compliance with the requirements in the Proposed Rule and some suggestions for a more streamlined approach are the focus of this paper.\(^3\)

This paper focuses on the compliance duties that the Proposed Rule creates for all banking organizations, even those not engaged in Volcker Rule activities. While the Proposed Rule is, of course, only a proposal, the time for compliance is running short. Volcker takes effect on July 21, 2012, for all banking entities, whether or not there is a final regulation. The Agencies specifically would require that, by July 21, 2012, the largest organizations begin keeping daily records and making monthly reports of their trading activities and have full compliance programs in place. There is a nominal two-year conformance period, but the Agencies plan to use that time to fine-tune many of the requirements—underscoring the obligation of banking organizations to have compliance programs up and running in short order. Given this timeframe, the Proposed Rule is the only blueprint for compliance.

The deadline for comments on the Proposed Rule is February 13, 2012. The Agencies have faced a daunting task in developing a regulation that implements the complex Volcker provisions in Dodd-Frank without imposing unnecessary burdens. The Proposed Rule nevertheless would impose some significant burdens not required by Dodd-Frank. As we explain below, various requirements could be streamlined without undermining the statutory purpose.

**Highlights**

The source of the compliance burdens is that, while the Proposed Rule appropriately attempts to calibrate obligations according to an institution’s level of involvement in proprietary trading or fund-related activities, the Proposed Rule as written likely will force even those organizations that present few or no Volcker risks to adhere

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to many, if not all, of the requirements applicable to riskier institutions. Additionally, for the largest banking organizations with businesses covered by Volcker, the Proposal sets forth a highly detailed compliance regime that may be less effective than a principles-based regime to be applied on an institution-specific basis. The principal requirements in the Proposed Rule that present these issues include the following:

- Every banking organization will be compelled to develop a six-point compliance program, even if the organization engages in no trading or fund work covered by Volcker. The Proposed Rule also requires that these organizations have specific compliance programs covering trading for liquidity management and avoidance of high risk in trading not covered by Volcker.
  - For an organization with no trading or fund-related businesses, a set of policies and procedures that bar the organization from trading or fund-related activities, together with the identification of an officer—in all likelihood, the chief compliance officer or chief risk officer—with oversight responsibility, should be sufficient.

- Smaller institutions that engage in trading or fund-related activities are expected to at least use the elaborate compliance program requirements for the largest institutions as a “model.”
  - Because the volume of trading and fund-related work is concentrated in a relatively small number of large banking organizations in the United States, the smaller organizations should not be compelled to model their compliance programs on those of the largest organizations.

- A banking organization engaged in market making must collect large amounts of data and make several complex quantitative measurements without knowing whether the measurements will meet with regulatory approval. Additionally, every such organization, regardless of size, is required to make several calculations.
  - If the Agencies require detailed measurements, rather than relying on general principles, then the banking organization should identify the specific thresholds at which trading would be either permissible or impermissible.
  - As above, given the concentration of market making and proprietary trading in the largest U.S. banking organizations, smaller banks that undertake market making should be required only to demonstrate that their market-making revenues derive primarily from fees and other sources unrelated to short-term increases in the value of the instruments in which they make markets.
Covered Banking Entities

The Proposed Rule applies to every “covered banking entity” (“CBE”). A “banking entity” is essentially any organization that includes an insured depository institution or a foreign bank with U.S. banking operations. The Proposed Rule creates three tiers of CBEs, for which compliance obligations are supposed to vary.

- The first tier (Tier 1) consists of CBEs not engaged in either of the businesses covered by Volcker—proprietary trading in securities or ownership or sponsorship of hedge funds or private equity funds. Notwithstanding what the Agencies say in the Proposed Rule, as a practical matter, even those banking entities within this group will need to create and maintain a compliance program.

- The second tier (Tier 2) is comprised of CBEs that engage in trading or fund activities and investments on a relatively small scale. Generally, if the value of the trading assets and liabilities of a CBE or of the assets of covered funds that a CBE sponsors or in which it invests are less than $1 billion, then the CBE is in the second group.

- The third tier (Tier 3) is made up of CBEs that either
  - hold trading assets and liabilities (including those of all affiliates and subsidiaries on a worldwide basis), the average gross sum of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than either $1 billion or ten percent of the CBE’s total assets;
  - hold, together with their affiliates and subsidiaries, aggregate investments in one or more covered funds, the average value of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion; or
  - sponsor or advise, together with their affiliates and subsidiaries, one or more covered funds, the average total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion.

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4 If the only insured depository institution within an organization operates solely in a trust or fiduciary capacity, then the organization is not a banking entity.
5 A “covered fund” under the Proposed Rule includes a hedge fund or a private equity fund as defined in Volcker, a commodity pool, and any issuer as defined in section 2(a)(22) of the Investment Company Act (“ICA”) that is organized or offered outside of the United States and that would be a covered fund if it were organized or offered under the laws, or offered to one or more residents, of the United States.
6 The Proposed Rule appears to say that the denominator in calculating the percentage consists of assets only of the CBE and not those of any affiliate or subsidiary, even though their trading assets and liabilities are included in the numerator. This approach does not seem internally consistent and would be one item to clarify in the final rule. Throughout this paper, we refer broadly to the minimum dollar amount as the “$1 billion threshold.”
Within the third group, CBEs that exceed a threshold of $5 billion for any of the activities above (Tier 3.5) are subject to certain data gathering and reporting requirements in addition to those applicable to CBEs over the $1 billion threshold. These additional requirements are best understood within the context of the obligations of all CBEs over the $1 billion threshold.

The understandable foundation of the Proposed Rule is that the more substantial the trading or fund activities of a CBE, the more extensive and rigorous the compliance regime should be. However, the obligations of one group in practice may drift into those of another. Tier 1 CBEs must develop policies and procedures to ensure that they do not enter into the restricted proprietary trading and fund businesses and that, if they do expand into these businesses, they will satisfy new compliance requirements, including the prudential risk management requirements (i.e., the prohibitions on “high-risk” trading and funds activities) which apply to every CBE that engages to any extent in the buying and selling of covered financial instruments or in any private funds investment or management activities. These obligations appear to mean that these Tier 1 CBEs will have to address some of the conditions in Volcker, even though the conditions do not technically apply under the terms of the Proposed Rule. In turn, Tier 2 CBEs will find themselves creating a variation on the detailed compliance program that is required for a Tier 3 CBE because the broader compliance program requirements apply to any CBE that engages to any extent in covered trading and funds activities.

Two additional cautionary notes are in order as to which group a CBE may belong. First, the $1 billion and the 10%-of-assets thresholds for Tier 2 CBEs are stated in the disjunctive and, as a result, smaller banking entities need to pay close attention to the impact of the Proposed Rule’s percentage threshold on their investment and activities. The calculation of these dollar and percentage thresholds must include any trading or investment in securities exempt from Volcker restrictions, such as U.S. Treasury and agency securities and related covered financial positions (“CFPs”). For example, a smaller community bank that is actively engaged in Government securities trading activities could inadvertently become a Tier 2 CBE.

Compliance Programs

The compliance framework in the Proposed Rule consists of three sections and three appendices. Section __.20 requires the compliance program, with different requirements for the three different groups of CBEs. Section __.20(b) sets forth the basic elements of the six-point program. Reporting and record-keeping requirements for trading activities are set forth in section __.7. Section __.15 directs a CBE that owns or sponsors a permissible fund to comply with section __.20 and Appendix C “as applicable.”

The three appendices provide greater detail on the required compliance program. The broadest of the three, Appendix C, describes a full compliance program for Tier 3 CBEs, covering both trading and fund-related activities. Appendix A nominally applies only to Tier 3 CBEs and requires certain quantitative measures to ensure (i) that market-
making activities are not a cover for proprietary trading and (ii) that other permissible trading activities are not high risk. Appendix B discusses in a more comprehensive manner than Appendix A the compliance program specifically for market making and applies to Tier 2 CBEs as well as those in Tier 3. The interplay between the two appendices presents complicated compliance issues. Appendix B incorporates by reference several of the quantitative measurements required by Appendix A. The result of that incorporation by reference is that substantial parts of Appendix A apply to the smaller Tier 3 CBEs and to Tier 2 CBEs, even though Appendix A does not impose such requirements. Indeed, in some cases, even Tier 1 CBEs may be compelled to fashion compliance programs based on portions of Appendices A and C.

The six-point program set forth in section __.20(b) for Tier 2 and 3 CBEs includes the following:

- Internal written policies and procedures reasonably designed to document, describe, and monitor permissible trading activities and activities and investments with respect to covered funds.

- A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with the Volcker Rule in trading activities and investments in covered funds—and to prevent the occurrence of activities or investments that are prohibited by Volcker.

- A management framework that delineates responsibility and accountability for compliance with Volcker.

- Independent testing for the effectiveness of the compliance program. The testing may be conducted by “qualified” personnel of either the CBE or an outside party.

- Training for trading personnel and managers, as well as other “appropriate” personnel.

- The making and keeping of appropriate records and other written compliance documentation.

We consider each of the compliance tiers below.

**Tier 1**

A banking organization’s confirmation that it is not covered by Volcker and therefore subject only to comparatively light compliance duties requires a detailed understanding of what constitutes impermissible proprietary trading and a prohibited relationship with or ownership interest in a hedge fund or private equity fund. Moreover, because of the need to develop and implement this understanding, many Tier 1 CBEs will find that the necessary elements of a Volcker Rule “compliance lite” program may not be
as “light” as first meets the eye. This determination requires a careful legal analysis and, as a starting point, the following table may be helpful.

<table>
<thead>
<tr>
<th>Proprietary trading</th>
<th>Hedge funds and private equity funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>A CBE is engaged in proprietary trading if its activities reflect any of the following:</td>
<td>A CBE is engaged in restricted fund activities if the following three conditions are present:</td>
</tr>
<tr>
<td>• The CBE reports trading assets and liabilities on</td>
<td>• The fund in question is either:</td>
</tr>
<tr>
<td>- Call report: RC, item 5; RI, items 1.e, 5.c</td>
<td>- An investment company as defined in section 2 of the ICA, but is exempt from registration under 3(c)(1) or (c)(7) of the ICA.</td>
</tr>
<tr>
<td>- FR Y-9C: HC, item 5; HI, items 1.e, 5.c</td>
<td>- A commodity pool, as defined in section 1a(10) of the Commodity Exchange Act.</td>
</tr>
<tr>
<td>• The CBE trades in a capacity other than or in addition to that of agent, broker, or custodian for a third party.</td>
<td>• With respect to the fund, the CBE:</td>
</tr>
<tr>
<td>• The CBE trades securities and other instruments—not only loans, commodities, or foreign exchange or currency.</td>
<td>- Holds an ownership interest in the fund;</td>
</tr>
<tr>
<td>• The CBE holds securities for less than 60 days. Note that the 60-day cutoff is not absolute. An Agency would look to several factors relating to positions held for more than 60 days to determine whether to honor the presumption.</td>
<td>- Manages the fund;</td>
</tr>
<tr>
<td>• All positions taken in securities are not limited to the following:</td>
<td>- Controls the fund; or</td>
</tr>
<tr>
<td>- Repos and reverse repos</td>
<td>- Sponsors the fund.</td>
</tr>
<tr>
<td>- Securities borrowing and lending</td>
<td>Note that a CBE may serve as an independent adviser to such a vehicle without triggering Volcker limits, other than the “Super 23A” restrictions discussed below.</td>
</tr>
<tr>
<td>- <em>Bona fide</em> liquidity management</td>
<td>• Every insured depository institution within the CBE is not trust only and either:</td>
</tr>
<tr>
<td>• The CBE and its insured depository institution affiliate are organized under U.S. federal or state law or conduct trading inside the United States.</td>
<td>- Takes deposits other than in a fiduciary capacity;</td>
</tr>
<tr>
<td></td>
<td>- Markets insured deposits through an affiliate;</td>
</tr>
<tr>
<td></td>
<td>- Accepts demand deposits or deposits that may be withdrawn by check or similar means;</td>
</tr>
<tr>
<td></td>
<td>- Makes commercial loans;</td>
</tr>
<tr>
<td></td>
<td>- Obtains Federal Reserve Bank payment services; or</td>
</tr>
<tr>
<td></td>
<td>- Exercises discount or borrowing privileges.</td>
</tr>
</tbody>
</table>
With respect to proprietary trading, two interlocking definitions are critical. Proprietary trading is defined as “engaging as principal for the trading account of the covered banking entity in any purchase or sale of one or more CFPs.” If there is no trading account or CFP, then there is no proprietary trading.

- A “trading account” is an account used by a banking entity either to (i) take short-term “CFPs” (or otherwise benefit from short-term price movements) or (ii) acquire CFPs that are covered by the market-risk capital rule, if the entity is required to use that rule in risk-weighting its assets for capital calculations.

Accounts limited to certain CFPs, however, are not trading accounts; namely, accounts for repurchase and reverse repurchase agreements, accounts for temporary securities borrowing or lending transactions, and accounts for the *bona fide* purpose of liquidity management. Certain prerequisites apply to each of these carve-outs, as do the general prudential limitations on high-risk trading activities.

An account for the *bona fide* purpose of liquidity management is one that is used to manage liquidity in light of the CBE’s risk profile, that limits its trades to highly liquid financial instruments that are not expected to give rise to appreciable profits or losses as a result of short-term price movements, that trades in amounts limited to near-term funding needs, and is consistent with the Agencies’ supervisory guidance on liquidity management.

- A CFP is any position in a security, a derivative, a commodity future contract, or any option on one of these instruments. Security, derivative, and commodity future have the standard definitions under the pertinent statutes; the term “derivative” encompasses several kinds of instruments. Loans, commodities, and foreign exchange or currency are not CFPs.

As to fund activity, the specific prohibition is that a banking entity may not, as principal, acquire any ownership interest in or sponsor certain types of hedge funds or private equity funds. Funds covered by Volcker are funds that are able to avoid regulation as investment companies under the ICA, by virtue of the exemptions in sections 3(c)(1) or 3(c)(7) of the ICA. These exemptions apply, respectively, to (in general terms) funds with fewer than 100 investors or with investors who all are qualified purchasers. Accordingly, Volcker does not reach three categories of funds: (i) those that are registered investment companies and are regulated as such by the SEC, (ii) those that

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7 12 C.F.R. § __.3(b)(1) (emphasis added).
8 Certain banking entities are deemed to hold trading accounts solely on the basis of taking a CFP of any duration, if the entity is a registered dealer, municipal securities dealer, government securities dealer, swap dealer, or security-based swap dealer or is engaged in dealing, swap dealing, or security-based swap dealing outside of the United States and if the CFP relates to activities in these capacities.
9 An account holding a position taken by a banking entity in its capacity as a derivatives clearing organization also is not a trading account.
are exempt from the definition of investment company to begin with under the definition in section 3(b) of the ICA, and (iii) those that are able to rely on a 3(c) exemption other than (3)(c)(1) or 3(c)(7).\textsuperscript{11} In our experience, however, most funds in which a banking entity likely would have or be interested in sponsoring or taking an ownership interest in rely on the 3(c)(1) and 3(c)(7) exemptions. At the same time, the Proposed Rule extends the coverage of the Volcker Rule to commodity pools subject to the Commodity Exchange Act, as well as “but for” offshore private investment funds that, were they offered in the U.S. or to a United States resident, would have to rely on the 3(c)(1) and 3(c)(7) exemptions.

Turning to the compliance obligations in Tier 1, the Proposed Rule requires that the existing compliance policies and procedures include measures that are designed to prevent the [CBE] from becoming engaged in such activities or making such investments and which require the [CBE] to develop and provide for the compliance program required under paragraph (a) of this section prior to engaging in such activities or making such investments.

That is, a Tier 1 CBE must implement measures with two separate functions: (i) preventing the entity from becoming engaged in activities or investments covered by Volcker and (ii) requiring the necessary compliance plan for CBEs if the entity should enter any of these businesses. These measures unavoidably will include internal policies and procedures, internal controls to ensure that the policies are followed, and designation of responsible and accountable officers. Documentation of these measures also will be required. These Tier 1 measures match at least four of the elements of the required six-point compliance program. An Agency also could require a particular CBE to gather data in a way that will resemble testing, and training may be appropriate. Accordingly, even a CBE that is not engaged and not planning to engage in Volcker-covered activities may have to implement a version of the six-point program.

Specific compliance programs are necessary for two activities of Tier 1 CBEs, which by definition are not otherwise subject to the Volcker Rule or the Proposed Rule. First, a Tier 1 CBE that is engaged in exempt trading activities must ensure that these activities are not high risk. This standard is the same as the requirement for Tier 2 and 3 CBEs in their permissible trading activities, which are covered by Appendices A and C (discussed further below in connection with Tier 3 CBEs). Among other things, Appendix C describes elements of a compliance program to manage trading risk, and Appendix A includes certain quantitative measurements to assess whether trading may be high risk. Accordingly, some Tier 1 CBEs may find it necessary to review Appendices A and C, even though they are otherwise outside the Volcker Rule.

Second, trading for liquidity management purposes is not subject to the Volcker Rule. However, a Tier 1 CBE may continue such trading only if it has a “documented liquidity management plan.” This plan must contain five elements. First, it must

\textsuperscript{11} In addition, vehicles established for the securitization of loans are fully exempt from the Volcker Rule. The exemption may not, however, apply to entities that securitize certain non-loan assets.
authorize the specific instruments that may be used for liquidity purposes (in light of the CBE’s risk profile) and the circumstances under which it may or must be used. Second, the plan must require that any authorized transaction be principally for the purpose of managing liquidity. The plan must be clear that the transaction is not for the purpose of short-term resale, benefitting from short-term price movements, or hedging a short-term position. Third, the plan must limit the instruments used to those that are highly liquid and with credit and market risks that are not expected to give rise to appreciable short-term profits or losses. Fourth, the plan must set forth limits on liquidity positions to amounts consistent with near-term funding needs. Fifth, the plan must reflect supervisory guidance on liquidity.

This regime that the Proposed Rule appears to contemplate, and that perhaps inadvertently may apply to Tier 1 CBEs, could be streamlined in many cases. A CBE can identify the bases on which it is not covered by Volcker and then create (if they do not already exist) safeguards to prevent entry into the covered business. For example, it should be sufficient for a Tier 1 CBE that takes financial positions over the long term to establish a policy against short-term trading and to designate an officer to enforce the policy and review possible trades.

At the same time, the requirement that a Tier 1 policy include some degree of anticipation that a CBE will enter Tier 2 is open-ended and is likely to force unnecessary compliance management work by many CBEs. If a Tier 1 CBE plans to engage in permissible trading or fund activity of any kind, it should be aware of the Tier 2 requirements and can put in place a compliance program at that point.

**Tier 2**

Tier 2 CBEs will have a different compliance focus from that of the Tier 1 CBEs. The Tier 2 institutions have made the decision to engage in certain trading or fund activities. The Volcker Rule enumerates these activities, the prerequisites for which are contained in Annex I to this paper. Briefly, six different types of trading are allowed: (i) trading as part of underwriting a security, (ii) trading in connection with market making-related activities, (iii) trading as part of hedging program, (iv) trading in certain government securities, (v) trading through a regulated insurance company, and (vi) trading on behalf of customers. On the fund side, a CBE may sponsor and hold *de minimis* positions in customer funds.\textsuperscript{12}

The formal requirement for a CBE in the second group is the six-point compliance program, the substance of which will depend on the particular activity or investment. We review the compliance obligations in Tier 2 immediately below and then turn to the specific requirements in Appendix B for Tier 2 CBEs that undertake market-making-related activities.

\textsuperscript{12} Securitizations that are not fully exempt from the Volcker Rule may constitute customer funds and would be subject to the same requirements.
Compliance obligations generally

The Proposed Rule differentiates between Tiers 2 and 3 and appears to impose fairly general requirements on the Tier 2 institutions and more stringent and detailed requirements on the Tier 3 CBEs. Section __.20(c)(1) states that the detailed requirements in Appendix C apply only to CBEs that are in Tier 3. Appendix A applies only to Tier 3 CBEs, according to section __.7(a).

On the other hand, Tier 2 CBEs are urged to consider the Tier 3 requirements as a model. “Banking entities engaged in a relatively small amount of covered fund activities are encouraged to look to the minimum standards of Appendix C for guidance.”13 Moreover, a part of Appendix C—the purpose of a compliance program—applies to Tier 2 CBEs. “[A]lthough this statement of purpose appears within the text of proposed Appendix C, the Agencies note the statement equally describes the general purpose of any compliance program required under subpart D of the proposed rule, regardless of whether proposed Appendix C specifically applies.”14 The statement of purpose in Appendix C is not merely a restatement of the six-point program outlined in general in section __.20(b), but calls for a detailed description of, among other things, potential areas of noncompliance and the particular activities of the CBE. The Proposed Rule preamble also requires review of the effectiveness of the program by the board of directors or the CEO—a specific condition not included in the general description of the program in section __.20(b).

In fact, Tier 2 CBEs that are engaged in market making have nearly the same compliance requirements as the CBEs in Tier 3. Appendix B, which is devoted to the market-making exception, applies equally to both Tiers and expressly requires that all of its provisions be incorporated in a compliance program. The duty to comply with Appendix B in turn means that most of the quantitative measurements in Appendix A will apply to Tier 2 CBEs, even though Appendix A and __.7(a) state that that appendix covers only Tier 3 CBEs.

Given the uncertainty of the distinctions between the compliance programs for Tiers 2 and 3, a Tier 2 CBE should become familiar at a bare minimum with most, if not all, of the full-blown Tier 3 requirements and in fact, may have to incorporate many of the Tier 3 compliance requirements into their programs. Some obligations—for example, the corporate governance structure described in Appendix C—may readily be undertaken by a CBE of any size, and the Agencies may have some expectation that Tier 2 CBEs will do so. In this regard, the Agencies encourage Tier 2 CBEs to look to Appendix C as a compliance model.

The prerequisites for specific activities that a compliance program is intended to cover are set forth in Annexes I and II to this paper. Annex I identifies the activity-specific requirements, and Annex II describes the broader prudential standards and the limits on transactions between a CBE and a covered fund. Suffice it to say, a program by

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13 Id.
any CBE in Tier 2 must address how it will (i) satisfy all of the conditions for each of the permissible activities in which it is engaged and (ii) how it will manage the business in a way that is consistent with the prudential and other requirements in Volcker.

**Appendix B**

Appendix B applies to all Tier 2 (and Tier 3) CBEs engaged in trading as part of making a market in a particular security. The appendix identifies some relatively concrete factors that the Agencies will apply to market making. Some of the factors involve calculations that are described in Appendix A—thus applying to smaller CBEs guidance that otherwise nominally applies only to Tier 3 CBEs.\(^{15}\) On a qualitative basis, Appendix B suggests that the source of revenues is the most critical factor in distinguishing permissible market making from impermissible proprietary trading. If fees and other payments by customers comprise most of the revenue, then the function likely will be deemed market making. An operation in which the bulk of the revenues are based on gains and losses in the purchase and sale of securities, based on changes in short-term value, is likely to be forbidden. There is no bright-line rule, however, and it seems unlikely that a unit that generates 51 percent of revenue from fees and other customer payments would automatically qualify as a market-making operation.

The six factors addressed in Appendix B are as follows:

- **Risk management.** The issue here is whether a CBE retains risk in excess of the size and type required to provide intermediation services to customers. Relevant factors include the amount of risk generally required to execute a particular market-making function; available hedging options, the CBE’s prior levels of retained risk and hedging practices, and levels of retained risk and hedging for similar positions.

- **Source of revenue.** The basic question is whether the revenue from a market-making channel is derived “primarily” from short-term price movements or from customer revenues such as fees and commissions. The pertinent quantitative measures are Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income and Expense, and Spread Profit and Loss. The measurements may be compared to one another.

- **Revenue relative to risk.** The trading activity (i) generates only very small or very large amounts of revenue per unit of risk taken, (ii) does not demonstrate consistent profitability, or (iii) demonstrates high earnings volatility. A key assumption of the Agencies in examining trading is that impermissible short-term trading is characterized by significant volatility in earnings, while market making

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\(^{15}\) Annex III lists all of the quantitative measurements required by Appendix A. Those measurements that are incorporated by reference in Appendix B are noted by superscript number 2.
(depending, as it does, on fees) should be a relatively stable source of revenue. There are several quantitative measures for each of these issues.\textsuperscript{16}

- \textit{Customer-facing activity}. This element encompasses two conclusions: (i) that the CBE transactions are with customers rather than noncustomers and (ii) that the CBE retains principal positions and risks calibrated to (and not in excess of) reasonably expected near-term customer demands.

- \textit{Payment of fees, commissions, and spreads}. The CBE routinely earns, rather than pays, fees, commissions, or spreads. The underlying assumption is that the business of proprietary trading typically requires that the trading unit pay a variety of fees to third-party service providers (in addition to the fact that there are, by definition, no earnings from customers).

- \textit{Compensation incentives}. These incentives do not “primarily” reward proprietary risk taking. This issue is one where the Agencies have not adopted a defined quantitative measurement, but the basic consideration is whether the incentives are based on revenue derived from price movements in trades or from customer revenues. The Agencies are likely to engage in some peer review.

\textbf{Tier 3}

CBEs in this tier have more extensive compliance requirements that are detailed in two appendices to the Proposed Rule. All of these CBEs must have robust compliance programs with all of the elements described in Appendix C. For CBEs in this tier that are engaged in trading over the $1 billion or $5 billion thresholds, the program must include mechanisms for making several quantitative measurements described in Appendix A. We discuss first the structural requirements in Appendix C, which cover all compliance programs whether involving trading or fund activities. The Agencies encourage Tier 2 CBEs to look to Appendix C as a model. We then turn to the related measurements in Appendix A, which apply to certain forms of permissible trading.

\textit{Appendix C}

The program required under Appendix C is built around the same six-point framework that covers all Tier 2 CBEs, but is substantially more elaborate than the general six-point program. Certain Appendix C requirements, however, stand out.

\textsuperscript{16} As to the generation of either very small or very large amounts of revenue, the quantitative measures are Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss, the Comprehensive Profit and Loss to Volatility Ratio, the Portfolio Profit and Loss to Volatility Ratio, and Comprehensive Profit and Loss Attribution. Regarding consistency of profitability, the Agencies will review Unprofitable Trading Days Based on Comprehensive Profit and Loss and Unprofitable Trading Days Based on Portfolio Profit and Loss. The measurements for high-earnings volatility are Skewness of Portfolio Profit and Loss and Kurtosis of Profit and Loss.
For those banking organizations with more than one CBE, an enterprise-wide program is permissible, rather than separate programs for each CBE, if three conditions are met. First, the program must clearly apply to all Volcker-covered activities within the organization. Second, the program also must specifically address all of the requirements in Appendix C for all of the enterprise’s Volcker-covered activities. The program must take into account the structure, size, and complexity of the whole organization, as well as the particular risks of and requirements for each relevant subsidiary or affiliate. Third, the organization must periodically test the effectiveness of the program in addressing all aspects of all of its covered activities.

One ongoing regulatory issue for an organization with an enterprise-wide plan will be the scope of authority of the different Agencies with jurisdiction of at least one CBE in the structure. Appendix C attempts to limit each Agency to its own CBE(s) and to the relevant portions of the compliance program, but ultimately the jurisdictions will overlap. It is possible that an organization could be faced with competing agency requirements that are difficult to reconcile under an enterprise-wide program.

A CBE must prepare a formal statement of mission and strategy. The mission will describe the nature and scope of the trading or fund businesses conducted; the strategy is the business model and execution plan for the generation of revenues. Among other things, the statement needs to explain how customers are identified, which business units will engage in covered activities, how covered activities will be measured and reported, and outline the nature and scope of relevant compensation arrangements.

A CBE must establish specific lines of responsibility for compliance, running from the board of directors to individual traders. Important duties begin at the top.

- The board of directors must approve a compliance plan, noting the approval in the minutes. The board also must review the capabilities of management in overseeing compliance and the incentives to support compliance. The board and the CEO are responsible for setting a culture of compliance.

- Senior management is responsible for implementing and enforcing the compliance program and for communicating and reinforcing the culture of compliance. Senior management also must ensure that effective corrective action is taken when a compliance failure is found. Senior management must report to the board or an appropriate board committee on the effectiveness of the program. In connection with trading activities, senior management must review new products and strategies.
- Business-line managers that oversee one or more trading or asset management units are accountable for the effective implementation and enforcement of the compliance program as it applies to their units.

- For trading activities, each individual trader must receive trading “mandates.” The mandates must clearly inform each trader of the Volcker Rule prohibitions and requirements and must contain four parameters: (i) the conditions for relying on the Volcker exceptions; (ii) the financial contracts, products, and underlying assets that the trader is permitted to trade; (iii) the risk limits of the trading unit and the types and levels of risk that may be taken; and (iv) the unit’s hedging policy.

- Compliance testing must occur at least once every 12 months. The CBE’s internal audit department may conduct the testing, but the department otherwise must be clearly separated from the trading and asset management units it reviews.

- Training may be conducted by internal personnel, as well as by third parties. Training should occur with “appropriate” frequency, but Appendix C does not specify a time period. While that internal training will need to be calibrated with the size, scope and sophistication of the CBE’s covered trading and funds activities, all CBEs, including smaller Tier 1 CBEs, should expect to conduct at least annual Volcker Rule compliance training activities.

- Records sufficient to demonstrate compliance should be retained for five years. As discussed below in connection with Appendix B, there are far more extensive record-keeping requirements for trading activities.

- For trading activities, a CBE must establish and enforce risk limits appropriate for each trading unit, including limits based on probabilistic (VaR) and non-probabilistic (notional exposures) measures of potential loss, measured under normal and stress market conditions.

 Appendix A

Appendix A requires a Tier 3 CBE to furnish various quantitative measures to its regulator in order for the regulator to make either or both of two determinations, one dealing with market making, the other with possible high-risk assets or strategies. First, so that the regulator may assess the assertion of a Tier 3 CBE over the $5 billion threshold that it is engaged solely in market making and not in proprietary trading, 17 different measurements are required. For other Tier 3 CBEs claiming the same exemption, eight of these measurements are necessary. Second, in order to determine whether a Tier 3 CBE (regardless of size) engaged in other forms of permissible proprietary trading, including underwriting, risk-mitigating hedging, trading in government securities, trading by a regulated insurance company, and trading outside the United States, is employing a high-risk strategy or is trading high-risk assets, five of the 17 measurements are necessary. The Agencies do not claim that the specific
measurements are the optimal or the only possibilities and have asked for comment on all of them. In assessing the impact of the measurements, a CBE should consider whether other approaches would be more effective.

By the terms of Appendix A, no one measurement or even group of measurements is decisive in determining whether a CBE has complied with the Proposed Rule. Indeed, there are no specified numerical targets. In a few situations, the Agencies have observed that a particular operation should rely “primarily” on a source of revenue and accordingly the required measurements include certain ratios. The Agencies have not indicated, however, an appropriate numerical ratio.

The quantitative measurements required by Appendix A fall into the following five categories. In broad terms, the categories look to the level of risk on a stand-alone basis, revenue from customers versus revenue from the appreciation in value of CFPs, stability of the revenue stream, the volume of trading for customers relative to total trading, and the receipt versus the payment of fees, commissions, and other expenses. Annex III to this paper identifies and defines the specific measurements. (We have identified these measurements in Appendix III.)

- **Risk management.** The Agencies look at the risks associated with permissible trading in two ways. First, trading in general should adhere to the prudential requirements in Volcker relating to high-risk assets and strategies. Second, a relatively high degree of risk reflects proprietary trading. Accordingly, the five measurements in this category are designed simply to measure the level of risk in the CFPs. The measurements in this category could produce two red flags. First, any abrupt change in the measurements that are inconsistent with prior experience or with measurements at similarly situated trading units could indicate proprietary trading. Second, indicators of unanticipated or unusual levels of risk, such as a significant number of VaR or breaches of Risk and Position Limits (as defined in Appendix III) would suggest undue risk that requires further analysis.

Of the five measurements in this area that apply to Tier 3 CBEs with [trading assets in excess of $5 billion], __ nominally apply only to the other Tier 3 CBEs. However, Appendix B requires that all five will be necessary for all Tier 3 and Tier 3 CBEs.

- **Source of revenue.** The Agencies expect that a CBE engaged in permissible market making will generate profits by providing customers with intermediation and related services while maintaining (and minimizing) any inventory required to meet customer demand. Appendix C calls for five quantitative measurements in this category, which should provide information on how a CBE generates revenue. It is evident that if more than half of the revenues of a market-making unit derive from sources other than fees, commissions, and similar payments from customers, then an Agency may regard a CBE as engaging in proprietary trading. Of course, the Agencies may require that the percentage of revenues from customer payments be considerably higher than the implied 51%.
• *Revenue relative to risk.* The Agencies’ effort here is to understand whether a CBE’s trading business is producing revenues consistent with the degree of risk that is being assumed with typical market-making activities. Market-making revenues come in the form of fees, commissions, spreads and other customer revenue that, in the Agencies’ view, are relatively insensitive to market fluctuations.

• *Customer-facing activity measurements.* This group of measurements should produce information about the extent to which trading activities are servicing the demands of customers as opposed to generating profits for CBEs directly through gains on the sale of CFPs.

• *Payment of fees, commissions, and spreads measurements.* This category of measurements reflects another way of looking at whether the purchase and sale of CFPs are for the benefit of customers or for the benefit of the CBE itself. In this case, the assumption is that market making generates more revenues, in the form of fees from customers for the market maker’s intermediary services, than expenses that would have to be paid to other intermediaries to support customer transactions. In contrast, proprietary trading by definition generates no customer fees and the CBE involved is likely to pay substantial fees for the execution of trading strategies. Accordingly, the Agencies will look primarily to the Pay-to-Receive Spread Ratio, which, in lay terms, compares the revenues of a trading unit for facilitating buy and sell orders with its expenses for the execution of similar orders.

In developing or modifying the systems needed to take these measurements, each CBE should be aware that the measurements are required daily at the trading desk level. On a monthly basis, the data will be reported to the Agencies.

Compliance with the data-gathering requirements will be difficult, in part because the relevant data points that are required under the Proposed Rule most assuredly will change after the implementing regulations are adopted, and perhaps materially so, as the Agencies develop experience with the compliance management and oversight aspects of the Proposed Rule. By their own admission, the Agencies will use a “heuristic” approach, in plain English, trial-and-error, to the implementation of the quantitative measurements required by Appendix A, which means that as the Agencies learn over time which data points are useful and which are not, they will change the required quantitative measurements accordingly.

**Some Concluding Observations**

The Proposed Rule, if adopted in the form proposed, will require an elaborate compliance regime for the Volcker Rule that encompasses at least to some extent most, if not all, U.S. banking organizations. Even those institutions not involved in the trading or fund activities covered by Volcker are likely to find themselves working through the
consequences of the Rule. The other institutions that do engage in at least some Volcker-
covered activities will be required to implement fairly substantial programs. The
Proposed Rule accordingly requires close review so that institutions can identify
especially problematic elements for the Agencies and begin to prepare appropriate
programs.

Could the Proposed Rule be modified in such a way as to achieve its desired
objectives while not subjecting a large constituency of CBEs to unnecessarily costly and
burdensome compliance management requirements? Several changes that would be
helpful in this regard come to mind:

- **Establish clear compliance program parameters for CBEs.** One of the
  principal implementation issues for CBEs under the Proposed Rule is the
  potential for CBEs to become caught up in compliance program requirements
  that are disproportionate to the nature and scope of their covered activities.
  To address this issue, the Agencies should establish clear boundaries for the
  imposition of graduated compliance management requirements. For example,
  Tier 1 CBEs should be expressly excluded from any Volcker Rule compliance
  management requirements other than those that are needed to assure that they
  will not engage in covered activities. A related issue is the fact that a CBE
  may be subject to Tier 2 or even Tier 3 compliance obligations even if it
  engages solely in exempted trading or funds activity. In turn, the Agencies
  should consider excluding exempted trading and fund activities from the
  quantitative benchmarks used to identify Tier 2 and Tier 3 CBEs.

- **Create less elaborate compliance requirements for exempted activities.** Is it
  necessary for CBEs that engage in exempted trading and funds activities to be
  subject to a full panoply of Volcker Rule-specific compliance management
  requirements? In the case of many types of trading or funds activities, such
  as trading in U.S. government securities, a full Volcker Rule compliance
  infrastructure simply is not necessary to assure compliance with the Rule’s
  prohibitions, because the line between permitted and prohibited activities is
  clear and easy to draw.

- **Rationalize the data collection and reporting requirements of the Proposed
  Rule.** In their collective eagerness to assure that CBEs do not surreptitiously
  engage in prohibited trading activities, the Agencies have created a highly
  elaborate and potentially expensive data collection and reporting infrastructure
  for certain types of trading activities. Compounding the compliance
  management issues here is the fact that the Agencies are unable to predict
  with any level of confidence at this time which data they will need to receive
  in order to oversee the Volcker Rule compliance process, an uncertainty
  which could materially complicate CBE and Agency compliance management
  and oversight activities going forward.
A more workable alternative for the Agencies to adopt at this time would be a principles-based compliance framework for CBEs that would allow them, subject to supervisory review and approval, to develop their own Volcker Rule compliance systems, taking into account the nature and scope of their covered activities. Failing this approach, however, at a minimum the Agencies should defer the adoption of required data collection and reporting requirements—such as those set forth in Appendix A—until they have developed a sufficient amount of hands-on experience with the administration of the Proposed Rule to understand better what data is needed for the performance of their supervisory oversight responsibilities.
Annex I – Conditions for permissible trading and fund activities

I. Trading

- **Underwriting**
  - Appropriate compliance program already in place
  - CFP is a security
  - Purchase or sale effected solely in connection with a distribution for which the CBE is acting as underwriter
  - Registration as dealer with appropriate regulator for making a market in specific CFP
  - Designed not to exceed reasonable near-term demands of investors
  - Designed to generate income through fees or other payments, not through appreciation in value of CFP
  - Compensation does not reward proprietary risk taking

The Proposed Rule describes underwriting as the purchase or sale of a security in connection with a distribution of securities for which the CBE is acting as underwriter. The Agencies explain that this definition is intended to be in line with “common usage and understanding” of the term and that the specific words “distribution” and “underwriter” are “generally identical” to the use of the words in the SEC’s Regulation M.17 Under that regulation, a “distribution” is distinguished from other sales of securities by the “magnitude” of an offering and the need for “special selling efforts and selling methods.” With respect to the definition of an “underwriter,” the Agencies will consider the extent to which an entity assists an issuer in capital raising, performs due diligence, advises the issuer on market conditions and assists in the preparation of offering documents, purchasing securities from an issuer, a selling security holder, or another underwriter; participating in or organizing a syndicate of investment banks; marketing securities; and transacting to provide a post-issuance secondary market and to facilitate price discovery. None of these factors appears to be conclusive.

An entity that seeks to rely on the underwriting exception must either be: (i) a registered dealer under section 15 of the Exchange Act; (ii) for municipal securities, a municipal securities dealer registered with the SEC under section 15B of the Exchange Act; or (iii) for government securities, a government securities dealer registered with the SEC or that has filed notice under section 15C of the Exchange Act. A non-registered entity may rely on the underwriting exemption if it is explicitly exempt from registration under the relevant statute. The underwriting of security-based swaps, commercial paper, bankers’ acceptances, and commercial bills does not require that the underwriter be registered or have a specific statutory exemption available.

17 The definition of underwriting under the Proposed Rule is more expansive than the Regulation M definition in one respect: a person who has an agreement with another underwriter to engage in a distribution of securities for or on behalf of an issuer or selling security holder is an underwriter itself for the purposes of the Proposed Rule.
• **Market-making-related activities**
  - Appropriate compliance program already in place
  - Trading unit holds itself out as a market maker for specific CFP on a regular or continuous basis
  - Designed not to exceed reasonable near term demands of investors
  - Designed to generate income through fees or other payments, not through appreciation in value of CFP
  - Registration as dealer with appropriate regulator for making a market in specific CFP
  - Consistent with Appendix B
  - Compensation does not reward proprietary risk taking
  - Record-keeping and reporting of certain quantitative measurements specified in Appendix A

How a CBE should demonstrate that its trading is in connection with market-making-related activities, rather than proprietary trading, is now the subject of intense debate. The Agencies’ effort to distinguish the two kinds of trading requires market makers to erect an elaborate compliance framework. The Agencies describe a market-making unit as one that “hold[s] itself out as being willing to buy and sell, or otherwise enter into long and short positions in, the CFP for its own account on a regular or continuous basis.”\(^\text{18}\) The Agencies also explain that the definition is similar to the definition of “market maker” in section 3(a)(38) of the Exchange Act.\(^\text{19}\) The Agencies expect to take the same approach as the SEC in assessing whether a person is engaged in market making. The Agencies recognize that market making varies, depending on the liquidity, trade size, market infrastructure, trading volumes and frequency, and geographic location.

For relatively liquid positions, a market-making activity should, according to the Agencies, reflect several factors:

- Making continuous, two-sided quotes and holding oneself out as willing to buy and sell on a continuous basis;

- A pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity;

- Making continuous quotations that are at or near the market on both sides; and

- Providing widely accessible and broadly disseminated quotes.

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\(^\text{18}\) The Agencies note that block positioning may be a form of permissible market making.

\(^\text{19}\) The Agencies also note similar criteria in the definition of “swap dealer” and “security-based swap dealer” in a recent proposed rule by the CFTC and SEC, 75 Fed. Reg. 80174, 80176 (Dec. 21, 2010).
For less liquid markets, such as over-the-counter markets for debt and equity securities or derivatives, market making would involve:

- Holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis;

- With respect to securities, regularly purchasing CFPs from, or selling the positions to, clients, customers, or counterparties in the secondary market; and

- Transaction volumes and risk proportionate to historical customer liquidity and investment needs.

There are two important limitations. The market-making exemption applies only to the specific position in which a market is made; a unit cannot otherwise rely on the exemption for trading in other positions. The exemption also is available only to the specific trading desk or other unit engaged in the trading; another desk or unit within the same legal entity may not invoke the exemption.

As with underwriting, regulatory status is important. A market maker must be (i) a registered dealer under section 15 of the Exchange Act; (ii) for swaps, a swap dealer registered with the CFTC under the Commodity Exchange Act; (iii) for security-based swaps, a registered security-based swap dealer under section 15F of the Exchange Act; (iv) for municipal securities, a municipal securities dealer registered with the SEC under section 15B of the Exchange Act; or (v) for government securities, a government securities dealer registered with the SEC or that has filed notice under section 15C of the Exchange Act. A non-registered entity may rely on the underwriting exemption if it is explicitly exempt from registration under the relevant statute. The exemption also is available to an unregistered CBE engaged in dealing securities, swaps, or security-based swaps outside of the United States, if the CBE is subject to substantive regulation in that jurisdiction.

- **Risk-mitigating hedging activities**
  - CBE has established internal compliance program, including reasonably designed written policies and procedures regarding the instruments, techniques and strategies that may be used or hedging, internal controls and monitoring procedures, and independent testing.
  - The purchase or sale:
    - Is made in accordance with the written policies, procedures and internal controls established by the CBE;
    - Hedges or otherwise mitigates one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a CBE;
- Is reasonably correlated, based upon facts and circumstances, to the risks the purchase or sale is intended to hedge or otherwise mitigate;
- Does not give rise, at the inception of the hedge, to significant exposures that were not already present in the individual or aggregated positions, contracts, or other holdings of a CBE and that are not hedged contemporaneously;
- Is subject to continuing review, monitoring and management by the CBE that (i) is consistent with the CBE’s written policies and procedures, (ii) maintains a reasonable level of correlation, based upon the facts and circumstances, to the risks the purchase or sale is intend to hedge, and (iii) mitigates any significant exposure arising out of the hedge after inception.
- The compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk taking.
- If the hedging transactions are conducted at a level of organization different from the level that acquired the positions the risk of which the hedge is designed to mitigate, the CBE must, at the time the hedging transactions are conducted, document:
  - The risk-mitigating purpose of the transactions;
  - The risks that the transactions are designed to reduce; and
  - The level of organization that is establishing the hedge.

Trading in certain U.S., state, and local government obligations
- Obligations of the United States or any agency thereof.
- Obligations, participations, or other instrument of or issued by Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, Farmer Mac, or a Farm Credit System institution.
- Obligations of any state or any political subdivision thereof.
- Obligations above include both general obligations and limited obligations, such as revenue bonds.

Trading on behalf of customers
- Purchase or sale must:
  - Be conducted by CBE acting as investment adviser, commodity trading advisor, trustee, or in a similar fiduciary capacity for the customer;
  - Be conducted for the account of the customer; and
  - Involve solely CFPs of which the customer, and not the CBE or any subsidiary or affiliate of the CBE is the beneficial owner (including as a result of having long or short exposure under the relevant CFP).
- CBE acts as riskless principal in a transaction in which the CBE, after receiving an order to purchase (or sell) a CFP from a customer, purchases (or sells) the CFP for its own account to offset a contemporaneous sale to (or purchase from) the customer.
- CBE is an insurance company that purchases or sells a CFP for a separate account if:
The insurance company is directly engaged in the business of insurance and subject to regulation by a state insurance regulator or foreign insurance regulator;

- The insurance company purchases or sells the CFP solely for a separate account established by the insurance company in connection with one or more insurance policies issued by the company;

- All profits and losses arising from the purchase or sale of a CFP are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the company; and

- The purchase or sale is conducted in compliance with, and subject to, the insurance company investment other laws, regulations, and written guidance of the state or jurisdiction in which such company is domiciled.

**Trading by a regulated insurance company (or any affiliate thereof)**

- Company is directly engaged in the business of insurance and subject to regulation by a state insurance regulator or foreign insurance regulator;

- The company or its affiliate purchases or sells the CFP solely for the company’s general account;

- Trading complies with and is subject to insurance company investment laws, regulations, and written guidance of the state or jurisdiction in which the company is domiciled; and

- The appropriate federal banking agencies, after consultation with the Financial Stability Oversight Council (“FSOC”) and the relevant insurance commissioners of the state, have not jointly determined, after notice and comment, that particular law, regulation, or written guidance in third bullet above is insufficient to protect the safety and soundness of the CBE, or of the financial stability of the United States.

**Trading outside of the U.S.**

- The CBE is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more states;

- The trade is conducted pursuant to paragraph (9) or (13) of the section 4(c) of the Bank Holding Company Act;

- If the CBE is a foreign bank organization (“FBO”), the CBE is a qualifying FBO and is trading in compliance with Regulation K, subpart B; or

- If the CBE is not an FBO, the two of three conditions must be met: (i) the CBE’s total assets held outside the United States exceed CBE’s total assets in the United States; (ii) the CBE’s total revenues derived from the CBE’s business outside the United States exceed total revenues derived from the CBE’s business in the United States; or (iii) total net income derived from the CBE’s business outside the United States exceeds total net income derived from the CBE’s business in the United States.

- The trade occurs solely outside the United States.
o The CBE is not organized under laws of the United States or of one or more states;
o No party to the trade is a U.S. resident;
o No personnel directly involved in the trade is physically located in the United States; and
o The trade is executed wholly outside the United States.
II. **Fund Organization and Offering**

- **Customer fund**
  - CBE provides *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services.
    - Fund may be organized and offered only in connection with services above; and
    - Fund may be offered only to customers of these services (but preexisting relationship not required), pursuant to a credible plan or similar documentation outlining how the CBE intends to provide these services through the organization and offering of the fund.
  - CBE acquires or obtains only a *de minimis* ownership interest in the fund.
    - Sufficient initial equity for investment to permit fund to attract unaffiliated investors. CBE must actively seek unaffiliated investors to reduce ownership interest;
    - Not later than one year after establishment of fund, CBE may not hold more than 3 percent of total amount or value of outstanding ownership interests in the fund (FRB may extend time for up to an additional 2 years); and
    - Aggregate value of ownership interests of CBE in all sponsored funds may not exceed 3 percent of CBE’s Tier 1 capital.
  - CBE complies with “Super 23A and 23B” provisions.
  - CBE does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the fund or of any fund in which the fund invests.
  - Fund does not (i) share the same name or a variation of the same name with the CBE (or any affiliate or subsidiary of the CBE) or (ii) use the word “bank” in its name.
  - No director or employee of the CBE takes or retains an ownership interest in the fund, except for any director or employee of the CBE who is directly engaged in providing investment advisory or other services to the fund.
  - Individual ownership interests allowed only for CBE employees involved with a particular fund.
  - CBE clearly and conspicuously discloses in offering documents or elsewhere that
    - “Any losses in [such fund] will be borne solely by investors in [the fund] and not by [the CBE and its affiliates or subsidiaries]; therefore, [the CBE’s and its affiliates’ or subsidiaries’] losses in [such fund] will be limited to losses attributable to the ownership interests in the covered fund held by the [CBE and its affiliates or subsidiaries] in their capacity as investors in the [fund].”
    - The investor should read the fund offering documents before investing in the fund;
    - The “ownership interests in the covered fund are not insured by the FDIC and are not deposits, obligations of or endorsed or guaranteed in any way, by any banking entity.”
- The role of the CBE and its affiliates, subsidiaries and employees in sponsoring or providing any services to the fund.

- **Small Business Investment Companies (“SBICs”) and related investments**
  - SBICs as defined in section 102 of Small Business Investment Act of 1958.
  - Investment designed primarily to promote the public welfare, including the welfare of low- and moderate-income communities or families (such as providing housing, services, or jobs).
  - Investment that is a qualified rehabilitation expenditure with respect to a qualified rehabilitation building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar state historic tax credit program.

- **Risk-mitigating hedging activities**
  - Investment made in connection with and related to individual or aggregated obligations or liabilities of the CBE that are;
    - Taken by the CBE when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the fund; or
    - Directly connected to a compensation arrangement with an employee that directly provides investment advisory or other services to the covered fund.
  - Investment designed to reduce the specific risks to the CBE in connection with and related to such obligations or liabilities.
  - Internal compliance program established.
  - Acquisition or retention of interest:
    - Is made in accordance with the written policies, procedures and internal controls established by the CBE.
    - Hedges or otherwise mitigates an exposure to a covered fund through an offsetting exposure to the same fund and in the same amount of the ownership interest in that fund that either (i) arises out of a transaction conducted solely to accommodate a specific customer request with respect to, or (ii) is directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to, the fund.
    - Does not give rise, at the inception of the hedge, to significant exposures there were not already present in individual or aggregated positions, contracts, or other holding of a CBE and that are not hedged contemporaneously; and
    - Is subject to continuing review, monitoring and management by the CBE that is consistent with its written hedging policies and procedures, maintains a substantially similar offsetting exposure to the same amount and type of ownership interest, based upon the facts and circumstances, to the risk or risks the trade is intended to hedge and mitigates any significant exposure arising out of the hedge after inception.
- Compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk taking.
- At the time the transaction is conducted, the CBE documents, with respect to the acquisition or retention of the ownership interest, (i) the risk-mitigating purpose of the interest, (ii) the risks that the interest is designed to reduce, and (iii) the level of organization that is establishing the hedge.

- **Fund activities and investments outside the United States**
  - CBE is not directly or indirectly controlled by a banking entity that is organized under U.S. law or state law.
  - Activity is conducted pursuant to paragraph (9) or (13) of section 4(c) of the Bank Holding Company Act.
    - If CBE is an FBO, CBE is a qualifying FBO and is trading in compliance with Regulation K, subpart B; or
    - If CBE is not an FBO, the two of three conditions must be met: (i) CBE’s total assets held outside the United States exceed CBE’s total assets in the United States; (ii) CBE’s total revenues derived from CBE’s business outside the United States exceed total revenues derived from CBE’s business in the United States; or (iii) total net income derived from CBE’s business outside the United States exceeds total net income derived the CBE’s business in the United States.
  - No ownership interest in such fund is offered for sale or sold to a U.S. resident.
  - Activities occur solely outside the United States.
    - CBE is not organized under U.S. or state law;
    - No subsidiary, affiliate, or employee of the CBE that is involved in the offer or sale of an ownership interest in the covered fund incorporated or physically located in the U.S. or in one or more states; and
    - No ownership interest in such covered fund is offered for sale or sold to a U.S. resident.

- **Loan securitizations**
  - “Nothing in [the Volcker Rule] shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the [FRB] to sell or securitize loans in a manner otherwise permitted by law.”
  - Ownership interest in, or acting as sponsor to, a fund that is an issuer of asset-backed securities, the assets or holdings of which are solely comprised of loans; contractual rights or assets directly arising from those loans supporting the asset-backed securities; interest rate or foreign exchange derivatives that materially relate to the terms of such loans or contractual rights or assets and are used for hedging purposes with respect to the securitization structure.
  - Comment requested on whether the exemption should cover the securitization of derivatives and re-securitizations.

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• **Bank-owned life insurance**
  - Separate account used solely for the purpose of allowing a CBE to purchase a bank-owned life insurance (“BOLI”) policy, provided that CBE:
    o Does not control investment decisions regarding assets in the account; and
    o Holds its ownership interest in compliance with agency guidance on BOLI.

• **Joint venture**
  - Operating company
  - Does not engage in any prohibited activity or make any prohibited investments.

• **Acquisition vehicle**
  - Sole purpose and effect is to effectuate a transaction involving the acquisition or merger of one entity with or into the CBE or one of its affiliates.

• **Liquidity management subsidiary**
  - Engaged principally in performing *bona fide* liquidity management activities in accordance with a documented liquidity management plan that:
    o Specifically contemplates and authorizes the particular instrument to be used for liquidity management purposes, its profile with respect to market, credit and other risks, and the liquidity circumstances in which the particular instrument may or must be used;
    o Requires that any transaction contemplated and authorized by the plan be principally for the purpose of managing the CBE’s liquidity and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes;
    o Requires that any position taken for liquidity management purposes be highly liquid and limited to financial instruments the market, credit and other risks of which the CBE does not expect to give rise to appreciable profits or losses as a result of short-term price movements;
    o Limits any positions taken for liquidity management purposes, together with any other positions taken for such purposes, to an amount that is consistent with the CBE’s near-term funding needs, including deviations from normal operations, as estimated and documented pursuant to methods specified in the plan; and
    o Is consistent with the relevant agency’s supervisory requirements, guidance and expectations regarding liquidity management.
  - Carried on the CBE’s balance sheet.

• **Debt previously contracted**
  - Ownership interest in fund is acquired or retained in the ordinary course of collecting a debt previously contracted in good faith.
  - CBE must divest interest within the time period set by its federal regulator.
Annex II – Prudential requirements

Prudential requirements

In addition to the specific conditions for particular activities, Volcker imposes four broad prudential requirements or “backstops” that should be incorporated in any compliance program. Breach of any of these requirements—a judgment involving substantial discretion on the part of the regulator—can lead to a termination or divestiture, even if the specific conditions for the activity in question have been satisfied. The backstops are that a CBE may not engage in a permissible activity that would:

- Involve or result in a material conflict of interest between a CBE and its clients, customers, or counterparties;
- Result, directly or indirectly, in a material exposure by the CBE to a high-risk asset or high-risk trading strategy;
- Pose a threat to the safety and soundness of the CBE; or
- Pose a threat to the financial stability of the United States.

These backstops apply equally to permissible trading and fund activity. The Proposed Rule includes provisions for the first two backstops. The remaining two are not further addressed.

Material conflicts of interest

No trading activity is permissible if it would result in a CBE’s interests being materially adverse to those of a client, customer, or counterparty. It is difficult to go beyond generalities. The Agencies explain a material conflict exists when CBE places its own interests ahead of its obligations to its clients or seeks to gain by treating one customer more favorably than another. A CBE that acquires confidential information about a client and then uses the information to profit from trades with the client also has engaged in a material conflict of interest. The fact that, as part of a bona fide and permissible trading activity, a CBE is on one side of a transaction an a client on the other does not by itself create a material conflict of interest, however.

A CBE accordingly will need to have a compliance framework in place to prevent material conflicts. The Agencies observe that they will have “elevated concerns” about conflicts where a transaction is complex, highly structured or opaque, involves illiquid or hard-to-value instruments or assets, requires the coordination of multiple internal groups, or involves a significant asymmetry of information or transactional data among participants. From a compliance perspective, a CBE’s program should attempt to identify transactions that might have these characteristics and ensure that they are subject to careful review.
A CBE may take preventive steps that will, under the Proposed Rule, remove the conflict. There are two alternatives. First, the CBE may make full disclosure of the conflict with enough clarity for a client to understand the situation and in a manner that gives the client the opportunity to negate or substantially mitigate the adverse effect of the conflict. The timing of the disclosure presents a difficult judgment call. The disclosures must be made early enough so that a client has a reasonable opportunity to mitigate the effects of a conflict of interest, but not so early that a client could not meaningfully apply the disclosures to a later transaction.

Second, a CBE may erect “information barriers,” such as physical separation of personnel or functions or limitations on types of activities that are designed to prevent the materially adverse effect of a conflict of interest. The purpose of the barriers is to mitigate the effect of a conflict rather than to prevent the underlying conflict. The establishment of barriers does not conclude a CBE’s duties regarding conflicts of interest. If a CBE knows or reasonably should know that the barriers will not prevent a material adverse effect as a result of a conflict in a particular transaction, then it must make the required disclosures in order to complete a transaction. Accordingly, the use of information barriers entails continuous monitoring of each trading activity.

The meaning of a material conflict of interest and the means by which it may be mitigated will be finalized in conjunction with SEC’s finalization of a rule governing material conflicts of interest in connection with asst-backed securities. Section 621 of the Act adds a new section 27B to the Securities Act of 1933 that bars an underwriter, placement agent, initial purchaser, or sponsor (or any subsidiary or affiliate thereof) of an asset-backed security from engaging in a transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of the activity. The SEC proposed a rule to implement section 27B in ___. The agency consciously has linked its proposal to the Proposed Rule, and both have the same deadline for comments.

**High-risk assets and trading strategies**

Under the Proposed Rule, a CBE that holds an asset or engages in an activity that significantly increases the likelihood that the CBE would incur a substantial financial loss or would fail is an impermissible, high-risk asset or strategy. The Agencies have not discussed the term “high-risk” in any greater detail.

**Prohibited transactions with funds**

Additionally, with respect to permitted hedge fund and private equity fund activity, Volcker prohibits certain transactions between a CBE and these funds. The prohibitions have some important details. One of the prohibitions, for example, reaches beyond ownership or sponsorship to reach wholly permissible activities, such as advising a fund.
A CBE may not extend credit to or enter into certain other transactions with a fund. The universe of prohibited transactions is nearly the same universe of transactions between a bank and an affiliate that are restricted in section 23A of the Federal Reserve Act.\textsuperscript{21} Most CBEs should be familiar with section 23A. Four points warrant emphasis here.

- The transactions between a CBE and a fund are completely barred under Volcker and not merely restricted as they would be under section 23A.

- The prohibition extends to transactions between a CBE and a fund that the CBE serves as investment manager, investment adviser, or commodity trading advisor, as well as as owner or sponsor. Volcker does not otherwise prohibit or restrict a CBE from acting in the management or advisory roles.

- The prohibition also extends to any affiliate of the CBE.

- The prohibition does not apply to a prime brokerage transaction between a CBE and a covered fund that is managed, sponsored, or advised by the CBE—or any affiliate or subsidiary of the CBE. In order to act as a prime broker under the Proposed Rule, a CBE must meet the requirements for organizing or offering a fund and the chief executive officer of the top-tier affiliate of the CBE certifies annually in writing that the CBE does not guarantee or support the performance of the fund or the assets in which it invests. (The FRB also must not have determined that the transaction is not unsafe or unsound with respect to the CBE.)

\textsuperscript{21} One difference is that section 23A would treat an investment by a bank in an affiliate as a transaction subject to various restrictions. The Proposed Rule is clear that this provision does not apply to a CBE’s permissible \textit{de minimis} investment in a fund.
# Annex III

Appendix A quantitative risk measurements for CBEs over the $5 billion threshold engaged in market making

<table>
<thead>
<tr>
<th>Risk management</th>
<th></th>
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<tbody>
<tr>
<td><strong>Value-at-Risk¹ ² ³</strong></td>
<td>Commonly used percentile measurement of the risk of future financial loss in the value of a given portfolio over a specified period of time, based on current market conditions. Appendix A requires a 1% VaR over a one-day period. That is, the VaR should reflect the loss that is likely to occur only 1% of the time.</td>
</tr>
<tr>
<td><strong>Stress Value-at-Risk² ³</strong></td>
<td>Similar measurement to VaR, except using market conditions during a period of significant financial stress. Appendix A does not identify the stress assumptions.</td>
</tr>
<tr>
<td><strong>VaR Exceedance²</strong></td>
<td>The difference between VaR and Portfolio Profit and Loss (net of Spread Profit and Loss).</td>
</tr>
<tr>
<td><strong>Risk Factor Sensitivities² ³</strong></td>
<td>Changes to Portfolio Profit and Loss (exclusive of Spread Profit and Loss) expected to occur in the event of a change in a trading unit’s risk factors. This measurement should account for a “preponderance” of the price variation in a trading unit’s holdings. The algorithm is left to a CBE to devise, but it should take account of commodity derivative positions, credit positions, credit-related derivative positions, equity positions, equity derivative positions, foreign exchange derivative positions, and interest rate positions (including interest rate derivative positions).</td>
</tr>
<tr>
<td><strong>Risk and Position Limits³</strong></td>
<td>These limits are the constraints that define the amount of risk that a trading unit is permitted to take at a point in time. Often expressed in terms of VaR or Risk Factor Sensitivities. If other criteria are used (such as net open positions), the value of the limits and of the variables used should be reported.</td>
</tr>
</tbody>
</table>

## Source of Revenue Measurements

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<tbody>
<tr>
<td><strong>Comprehensive Profit and Loss (“CPL”)¹ ² ³</strong></td>
<td>Net profit or loss of a trading unit’s material sources of revenue over a specific period of time. Generally, this measurement should be the sum of Portfolio Profit and Loss and Fee Income. The calculation does not include the expenses of operating the unit or accounting reserves.</td>
</tr>
<tr>
<td><strong>Portfolio Profit and Loss (“PPL”)¹ ²</strong></td>
<td>Net profit or loss on the market value of a trading unit’s underlying holdings over a specified period of time, whether</td>
</tr>
</tbody>
</table>
realized or unrealized. Expenses are not included unless directly related to the market value of the holdings.

<table>
<thead>
<tr>
<th>Fee Income and Expense¹ ²</th>
<th>Direct fees, commissions and other distinct income for services provided by or to a trading unit.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spread Profit and Loss¹ ²</td>
<td>The portion of PPL that generally includes revenue generated by the bid-ask spread on comparable instruments. The calculation includes spreads paid by a trading unit to initiate a transaction, typically a negative number. For many asset classes, spreads are widely disseminated; a CBE may use certain substitutes if there is not wide dissemination of the spread on a particular instrument.</td>
</tr>
<tr>
<td>Comprehensive Profit and Loss Attribution¹ ²³</td>
<td>An analysis that divides CPL into separate sources of risk and revenue that have caused any observed variation in CPL. This measurement should show CPL can be attributed to specific market and risk factors that can be measured over time.</td>
</tr>
</tbody>
</table>

### Revenue-Relative-to-Risk Measurements

<table>
<thead>
<tr>
<th>Volatility of CPL and Volatility of PPL¹ ²</th>
<th>Standard deviation of CPL and PPL estimated over a given calculation period. (PPL is exclusive of Spread Profit and Loss.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPL to Volatility and PPL¹ ²</td>
<td>The ratios of CPL and PPL to the two volatility metrics above. (Again, PPL is exclusive of Spread Profit and Loss.)</td>
</tr>
<tr>
<td>Unprofitable Trading Days based on CPL and on PPL²</td>
<td>Number or proportion of trading days on which the CPL or PPL is less than zero over a given period. The Agencies assume that it is rare for customer-facing trading to have unprofitable days, while proprietary trading is likely to include a material number of unprofitable days.</td>
</tr>
<tr>
<td>Skewness of Portfolio Profit and Loss²</td>
<td>Use of standard statistical methods.</td>
</tr>
<tr>
<td>Kurtosis of Portfolio Profit and Loss²</td>
<td>Use of standard statistical methods.</td>
</tr>
</tbody>
</table>

### Customer-Facing Activity Measurements

<p>| Inventory Risk Turnover² | Ratio of the amount of risk in a trading unit’s inventory that is turned over by the trading unit over a specific period of time. A ratio is calculated for each Risk Factor Sensitivity: the numerator is the absolute value of the Risk Factor Sensitivity associated with each transaction over the calculation period, and the denominator should be the value of each Risk Factor Sensitivity for all of the trading unit’s holdings at the beginning of the calculation period. |</p>
<table>
<thead>
<tr>
<th>Measurement</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>Inventory Aging²</td>
<td>The trading unit’s aggregate assets and liabilities and the amount of time these assets have been held for: 0 to 30 days, 30-60 days, 60-90 days, 90 to 180 days, 180 days to 360 days, and greater than 360 days. The proprietary trading limitations are geared to positions held for 60 days or less; the greater the aging the better.</td>
</tr>
<tr>
<td>Customer-Facing Trade Ratio²</td>
<td>Ratio comparing the number of transactions involving a counterparty that is a customer of the trading unit to the number of transactions involving a noncustomer counterparty. Counterparties to a transaction executed on a designated contract market or a national securities exchange or that are broker-dealers, swap dealers or security-based swap dealers and noncustomers for the purpose of this measurement. A ratio below one would be a red flag.</td>
</tr>
<tr>
<td>Payment of Fees, Commissions, and Spreads Measurement</td>
<td>Pay to Receive Spread Ratio² Ratio of the sum of Spread Profit and Loss and Fee Income earned by a trading unit to the sum of the same items paid by the unit. A ratio below one would be problematic; how far above one the ratio should be is uncertain.</td>
</tr>
</tbody>
</table>

¹ Measurements for Tier 3 CBEs below the $5 billion threshold.
² Measurements for all Tier 2 and 3 CBEs engaged in market making.
³ Measurements for all other permissible trading activities by Tier 3 CBEs.
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