INVESTMENT COMPANY INSTITUTE

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Regulators Propose Enhanced Prudential Standards for "SIFIs" and Large Bank Holding Companies, Assessments to Cover Office of Financial Research Expenses

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 5-12
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 6-12
SEC RULES COMMITTEE No. 8-12 RE: REGULATORS PROPOSE ENHANCED PRUDENTIAL STANDARDS FOR “SIFIs” AND LARGE BANK HOLDING COMPANIES, ASSESSMENTS TO COVER OFFICE OF FINANCIAL RESEARCH EXPENSES

Regulators recently issued two proposals to implement certain provisions in Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) that apply to
(1) bank holding companies with at least $50 billion in total consolidated assets (“large BHCs”) and (2) nonbank financial companies designated as systemically important financial institutions (“SIFIs”) by the Financial Stability Oversight Council (“FSOC”). First, the Federal Reserve Board (“FRB”) issued proposed rules to implement various portions of Section 165, under which the FRB is required to establish enhanced prudential standards for large BHCs and SIFIs, and Section 166, concerning early remediation requirements for such entities. [1] Notably, the FRB release poses a question about how the proposed counterparty credit limits should apply to a SIFI or large BHC that advises money market funds. Second, the Treasury Department (“Treasury”) issued a proposed rule to implement Section 155, which directs the Treasury to establish an assessment schedule to collect from large bank holding companies and SIFIs assessments equal to the total expenses of the Office of Financial Research (“OFR”). [2] The proposals are briefly summarized below.

ICI currently expects to submit comments on both proposals. [3] If there are any issues you would like us to consider addressing in our comment letters, please contact Rachel Graham at rgraham@ici.org or Frances Stadler at frances@ici.org by February 15 (for the OFR

Assessment Proposal) or February 22 (for the Section 165/166 Proposal).

I. Section 165/166 Proposal: Enhanced Prudential Standards and Early Remediation Requirements

To implement Section 165 of the Dodd-Frank Act, the FRB proposes to impose on SIFIs and large BHCs (collectively, "covered companies") a set of enhanced prudential standards. Under the proposal, these standards would consist of enhanced risk-based capital and leverage requirements, enhanced liquidity requirements, enhanced risk management and risk committee requirements, single-counterparty exposure limits, required stress tests (by the FRB and by the covered company), and a debt-to-equity limit for any covered company that FSOC determines poses a grave threat to financial stability. [4] In addition, to implement Section 166 of the Dodd-Frank Act, the proposal sets forth a framework for the early remediation of financial weaknesses of covered companies, which is intended to minimize the possibility of a covered company becoming insolvent and posing harm to U.S. financial stability.

The FRB release states that the "same set" of enhanced prudential standards would be applied to both SIFIs and BHCs that are covered companies. It then acknowledges that:

> . . . in applying the enhanced prudential standards to covered companies, the [FRB] may determine, on its own or in response to a recommendation by the [FSOC], to tailor the application of the enhanced standards to different companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the [FRB] deems appropriate.

The FRB release further indicates that "this authority will be particularly important in applying the enhanced standards to [SIFIs] that are organized and operated differently from banking organizations" and notes that no SIFIs have been designated for FRB supervision yet. The FRB release seeks comment on what characteristics of a nonbank covered company—in addition to its business model, capital structure, and risk profile—the FRB should consider when determining how to apply the enhanced standards and early remediation requirements. It also asks about the potential unintended consequences and burdens associated with subjecting a nonbank covered company to these standards and requirements. [5]

A. Risk-Based Capital and Leverage Limits

The FRB release indicates that the FRB intends to establish risk-based capital and leverage limits through a "two-part effort." First, the proposal would subject all covered companies to the FRB's "capital plan rule," which currently requires all large BHCs to submit an annual capital plan to the FRB for review. Under the capital plan rule, covered companies would be required to demonstrate their ability to maintain capital above existing minimum regulatory capital ratios and above a tier 1 common ratio of 5 percent under both expected and stressed conditions over a minimum nine-quarter planning horizon. [6] Second, the FRB intends to propose a quantitative risk-based capital surcharge for covered companies or a subset of covered companies based on the approach proposed by the Basel Committee on Banking Supervision ("BCBS") for global systemically important banks ("G-SIBs") [7] and consistent with the BCBS's implementation timeline. [8]

B. Liquidity Requirements

Building on existing FRB guidance, the proposal would require covered companies to conduct internal stress tests at least monthly to measure liquidity needs at 30-day, 90-day, and one year intervals during times of financial market instability and to hold liquid assets that would be sufficient to cover 30-day stressed net cash outflows under their internal stress scenarios. The proposal also specifies corporate governance requirements related to liquidity risk management and would require covered companies to project cash flow needs over various time horizons, establish internal limits on certain liquidity metrics, and maintain a contingency funding plan that identifies potential sources of liquidity strain and alternative sources of funding when usual sources of liquidity are unavailable.

The FRB release further notes that the FRB intends, in conjunction with other federal banking agencies, to implement through one or more separate rulemakings the standards contained in the liquidity rules approved by the BCBS as part of the Basel III reforms in December 2010. [9]; The FRB release states that the FRB anticipates that the Basel III liquidity rules would then become a central component of the enhanced liquidity requirements for covered companies, or a subset of covered companies.

C. Single-Counterparty Credit Limits

The proposal would implement requirements under Section 165(e) of the Dodd-Frank Act directing the FRB to: (1) establish single-counterparty credit limits for covered companies to limit the risks that the failure of any individual company could pose to a covered company; and (2) prescribe regulations that prohibit any covered company from having credit exposure to any unaffiliated company that exceeds 25 percent of the capital stock and surplus of the covered company. [10] “Credit exposure” is defined in Section 165(e) to cover: all extensions of credit to the company; all repurchase and reverse repurchase agreements, and securities borrowing and lending transactions, with the company; all guarantees and letters of credit issued on behalf of the company; all investments in securities issued by the company; counterparty credit exposure to the company in connection with derivatives transactions; and any other similar transaction that the FRB determines to be a credit exposure for purposes of Section 165(e). [11]

The proposal defines various key terms (e.g., unaffiliated counterparty, capital stock and surplus). It sets a lower, 10 percent limit for credit exposure between a covered company and a counterparty if both entities either have more than $500 billion in total consolidated assets or are a nonbank financial company. The proposal provides rules for measuring credit exposure and would allow covered companies to reduce their credit exposure to a counterparty for purposes of the limit by obtaining eligible “credit risk mitigants” such as collateral, guarantees, and credit derivative hedges.

The single-counterparty credit exposure limits would apply to a covered company “together with its subsidiaries.” Under the proposal, a “subsidiary” of a specified company is defined as a company that is directly or indirectly controlled by the specified company. [12] The FRB release notes that, consequently, a fund or vehicle sponsored or advised by a covered company would not be considered a subsidiary of the covered company if it is not controlled by the covered company. The FRB release then queries whether this approach may be at odds with the fact that, during the financial crisis, many banking organizations supported their money market funds to allow them to meet investor redemption requests. The FRB release asks explicitly whether money market funds sponsored or advised by a covered company ought to be included as part of the covered company for purposes of the proposed rule, given that “a covered company may have strong incentives to provide support in times of distress” to such money market funds. [13]

D. Risk Management and Risk Committee Requirements

Pursuant to Section 165(h) of the Dodd-Frank Act, the proposal would require covered companies to implement enterprise-wide risk management practices overseen by a risk committee of the board of directors and a chief risk officer with specified levels of independence, expertise, and stature. In addition, any publicly traded bank holding company with $10 billion or more in total consolidated assets that is not a covered company would be required to establish a risk committee.

E. Stress Testing Requirements

The proposal would implement the requirements in Section 165(i)(2) of the Dodd-Frank Act by requiring the FRB to conduct annual supervisory stress tests of covered companies under baseline, adverse, and severely adverse scenarios and by requiring each covered company to conduct its own semi-annual capital adequacy stress tests. [14] The FRB would publish a high-level, company-specific summary of the supervisory stress test results.; Covered companies would be required to publish summaries of the results of their company-run stress tests.

F. Debt-to-Equity Limits for Certain Covered Companies

Section 165(j) of the Dodd-Frank Act provides that the FRB must require a covered company to maintain a debt-to-equity ratio of no more than 15-to-1 upon a determination by the FSOC that the company poses a grave threat to U.S. financial stability and that imposing such a requirement is necessary to mitigate the risk that the company poses to U.S. financial stability. The proposal would establish procedures for notifying a company that it must comply with the 15-to-1 debt-to-equity ratio requirement, define key terms for purposes of calculating compliance, and provide a transition period for an affected company to come into compliance.

G. Early Remediation Framework

The proposal establishes a regime for the early remediation of financial distress at covered companies, as required by Section 166 of the Dodd-Frank Act. The FRB release indicates that the proposal includes several forward-looking triggers designed to identify emerging or potential issues before they develop into larger problems. The proposed triggers are based on regulatory capital ratios, supervisory stress test results, market indicators, and weaknesses in enterprise-wide and liquidity risk management. In addition, the proposal describes the regulatory restrictions that apply to a covered company at each remedial stage.

H. Reservation of Authority

The proposal includes a reservation of authority provision that would permit the FRB to impose additional or further enhanced prudential standards on a covered company if the FRB deems such action necessary to carry out the purposes of the proposal or Section 165 of the Dodd-Frank Act. The FRB release indicates that such additional or further standards may include, but are not limited to, additional capital or liquidity requirements, corporate governance standards, concentration limits, stress testing requirements, or activity limits.

II. OFR Assessment Proposal

As required by Section 155 of the Dodd-Frank Act, the Treasury has developed proposed procedures to estimate, bill, and collect, on an ongoing basis beginning July 20, 2012, the total budgeted expenses of the OFR, including expenses of the FSOC (as estimated separately by the FSOC) and the FDIC's Title II "implementation expenses" (as defined in Section 210(n)(10)(C) of the Dodd-Frank Act). These expenses are to be paid out of the Financial Research Fund ("FRF"), a fund managed by the Treasury. Under the proposal, the aggregate of these expenses would serve as the basis for an assessment that would be allocated to individual companies through a semiannual assessment fee calculated from a schedule based on each company's total consolidated assets. "Assessed companies" would be large BHCs and SIFIs.

The Treasury release describes how the Treasury proposes to determine the pool of assessed companies, how it will determine the "assessment basis," [15] how the assessment basis will be allocated to assessed companies, and other matters such as billing and collection of assessment fees. In discussing the allocation of the assessment basis, the Treasury release indicates that the Treasury was informed by two principles: (1) the assessment structure should be simple and transparent; and (2) as required by the Dodd-Frank Act, allocation among companies should take into account differences among such companies based on the considerations for establishing the prudential standards under Section 115 of the Dodd-Frank Act. It states that in balancing these principles, the Treasury ultimately concluded that "it would be reasonable to allocate the assessment basis among assessed companies by means of an assessment fee that is based on the asset size of each assessed company." The Treasury release notes that the FSOC has not yet designated any SIFIs under Section 113 of the Dodd-Frank Act. It indicates that as the FSOC begins to make these determinations, "Treasury will review the methodology for determining the assessment fee for these companies to determine if any changes in approach are needed."

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endnotes

[1] Board of Governors of the Federal Reserve System, Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012) ("Section 165/166 Proposal"), available at http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf.

[2] Department of the Treasury, Assessment of Fees on Large Bank Holding Companies and Nonbank Financial Companies Supervised by the Federal Reserve Board To Cover the Expenses of the Financial Research Fund, 77 Fed. Reg. 35 (Jan. 3, 2012) ("OFR Assessment Proposal"), available at http://www.gpo.gov/fdsys/pkg/FR-2012-01-03/pdf/2011-33659.pdf. Under Section 155, OFR's expenses include the combined expenses of OFR and FSOC, as well as certain costs incurred by the Federal Deposit Insurance Corporation in connection with the implementation of Title II of the Dodd-Frank Act (orderly liquidation authority).

[3] Comments on the OFR Assessment Proposal are due by March 5, 2012, and comments on the Section 165/166 Proposal are due by March 31, 2012.

[4] The FRB proposes phase-in periods for initial compliance with the enhanced standards. Generally, a company that is a covered company on the effective date of the final rule would have to comply beginning on the first day of the fifth quarter following the effective

date. A company that becomes a covered company after the effective date of the final rule would have to comply beginning on the first day of the fifth quarter following the date it became a covered company. Different transition arrangements would apply for the risk-based capital and leverage requirements, single-counterparty credit limits, and stress testing requirements.

[5] See Section 165/166 Proposal, Questions 1 and 2.

[6] The FRB release indicates that under the capital plan rule, tier 1 common is defined as tier 1 capital less non-common elements in tier 1 capital, including perpetual preferred stock and related surplus, minority interest in subsidiaries, trust preferred securities and mandatory convertible preferred securities.

[7] See Basel Committee on Banking Supervision, Global systemically important banks:; Assessment methodology and the additional loss absorbency requirement (November 2011), available at http://www.bis.org/publ/bcbs207.htm.

[8] The FRB release states that the forthcoming proposal would contemplate adopting implementing rules in 2014 and requiring G-SIBs to meeting the capital surcharges on a phased-in basis from 2016-2019.

[9] These rules include: (1) a Liquidity Coverage Ratio (LCR), which would require banks to hold an amount of high-quality liquid assets sufficient to meet expected net cash outflows over a 30-day time horizon under a supervisory stress scenario; and (2) a Net Stable Funding Ratio (NSFR), which would require banks to enhance their liquidity risk resiliency out to one year.

[10] The FRB is authorized to lower the 25 percent threshold if necessary to mitigate risks to U.S. financial stability.

[11] The FRB can exempt transactions from the definition of “credit exposure” if it finds that the exemption is in the public interest and consistent with the purposes of Section 165(e).

[12] “Control” is defined in the proposal as follows: “A company controls another company if it (1) owns, controls, or holds with power to vote 25 percent or more of a class of voting securities of the company; (2) owns or controls 25 percent or more of the total equity of the company; or (3) consolidates the company for financial reporting purposes.”

[13] See Section 165/166Proposal, Question 24.

[14] In addition, any state member bank, bank holding company or savings and loan holding company with more than $10 billion in total consolidated assets (that is not a covered company) would have to conduct annual company-run stress tests.

[15] The Treasury release states that the assessment basis would be designed to replenish the FRF at the start of each assessment period to a level equivalent to six months of budgeted operating expenses and twelve months of capital expenses for the OFR and the FSOC, as well as covered FDIC expenses.