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A more risk-based approach to prudential standards, liquidity management and resolution planning

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On Nov. 1, 2019, the US federal banking regulators published three final rules for both US banks and non-US banks with banking operations in the United States. In this edition of her International Banking column, Kathleen A. Scott discusses highlights of all three final rules, which all are applicable in some way to non-US banks with banking operations in the United States.

On Nov. 1, 2019, the US federal banking regulators (the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC)) published three final rules for both US banks and non-US banks with banking operations in the United States: final regulations issued by the FRB revising the current prudential standards regulatory framework; final regulations issued by all three banking regulators adopting revised liquidity management requirements and final regulations issued by the FRB and FDIC revising the schedule for submission of plans for an orderly resolution by certain financial companies in the event of material financial distress or failure.

This month's column will discuss highlights of all three final rules, which all are applicable in some way to non-US banks with banking operations in the United States.

A little background

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), banking organizations (both US banking organizations, and non-US banking organizations with US banking operations) with total consolidated assets of $50 billion or more, became subject to a series of regulatory requirements imposed by the FRB, including stress testing, liquidity risk management, capital buffers, enhanced risk management, and single counterparty credit limits.

In 2018, the $50 billion threshold was raised to $250 billion in the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) for various regulatory requirements.

On Nov. 29, 2018, the Board of Governors of the Federal Reserve System (FRB) published proposed regulations to revise the current prudential standards regulatory framework for US banking organizations according to their risk profiles. On May 24, 2019, the FRB published proposed revisions to the prudential standards regulatory framework for non-US banks that operate in the United States, also to align the standards more closely to the risk profiles of the particular banks.

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In the May 24, 2019 notice, the FRB also proposed specific liquidity management requirements for the US operations of non-US banks, which the three banking agencies had proposed for US banking operations in December 2018. In May 2019, the FRB and FDIC published a proposed rule to revise the resolution planning requirements for both US and non-US banking organizations with US banking operations.

The tailored approach

The general theme of the regulatory proposals and all three final rules as adopted is to set out a more risk-based approach to regulatory compliance described as the "tailoring framework." The designated US global systemically important banking organizations (GSIBs) would continue to be subject to the current stringent prudential standards, liquidity management and resolution planning requirements. Those banking organizations considered less of a financial risk to the global or US financial system still would be subject to compliance requirements, but more attuned to the banking organization's particular risk profile. Some provisions of the final regulations also reflect changes to Dodd-Frank made by EGRRCPA.

The FRB prudential standards final rule establishes four categories of banking organizations applicable to both US and non-US banking organizations, reflecting their risk profiles. The risk for non-US banking organizations is calculated as the total assets of the non-US bank's US intermediate holding company (IHC), which is required to be established by a non-US bank with "Combined US Assets" of $100 billion or more and $50 billion or more in US non-branch assets. If there is no IHC, it is calculated as the amount of the Combined US Assets. Combined US Assets is defined as the sum of the consolidated assets of each US top-tier subsidiary, subject to limited exclusions, and the total assets of any US branch or agency of the non-US bank.

For *US banking organizations*, "total assets" as used below means average total consolidated assets. For *non-US banking organizations*, "total assets" means either average total consolidated assets of the IHC or average Combined US Assets, as applicable.

Category I: banking organizations designated as GSIBs.

Category II: banking organizations with (1) $700 billion or more in total assets or (2) $100 billion or more in total assets and $75 billion or more in average cross-jurisdictional activity that do not meet the criteria for Category I banking organizations.

Category III: banking organizations with (1) $250 billion or more in total assets or (2) $100 billion or more in total assets and at least $75 billion in average total weighted short-term wholesale funding, nonbank assets or off-balance sheet exposure that do not meet the criteria for Category I or II banking organizations.

Category IV: banking organizations with total assets of $100 billion or more that do not meet the criteria for any of the other categories of banking organizations.

The tailoring framework was adopted essentially as proposed.

The prudential standards final rule

As the risk profile of the banking organization decreases, so do some of the prudential requirements. The final rule did not make any major changes to the proposed revised prudential standards.

No change is being made to the current requirement that some non-US banks with banking operations in the United States establish IHCs to hold most of the non-US bank's US assets, except for its direct branches and agencies, except to increase the threshold as required by EGRRCPA.

Category I GSIBs remain subject to the current prudential standards with no changes.

Similar to Category I for US banking organizations, Category II banking organizations also are systemically important banks and will remain subject to the current prudential standards.

Category III banking organizations will have their annual company-run stress test requirement extended to every two years, and they will have the option to opt out of certain capital analyses.

Category IV banks would see both their FRB Comprehensive Capital and Analysis Review (CCAR) and their supervisory stress testing requirements reduced to a two year cycle, and no requirements for company-run stress testing or maintenance of a supplementary leverage capital ratio.

The liquidity management final rule

The final rule adopted the proposed requirement that certain IHCs of non-US banks must comply with the liquidity requirements now imposed on large US banks—the liquidity cover ratio (LCR) for which final regulations were issued in 2014, and the net stable funding ratio (NSFR), for which regulations were proposed in 2016, but have not yet been finalized.

Large US banking organizations subject to the LCR rule must maintain an amount of high-quality liquid assets (HQLA) equal to or greater than their projected total net cash outflows (a defined term which would include outflow of retail deposits) over a projected 30-calendar-day period, on an ongoing basis.

Under the NSFR proposal, which is complementary to the LCR, large US banking organizations would need to maintain on a daily basis a minimum level of stable funding relative to the liquidity of their assets, derivatives, and commitments, over a one-year period on an ongoing basis.

The liquidity standards in the final rule for non-US banks with US banking operations are based only on the risk profile of the IHC, and not the risk profile of its combined US operations; the term "banking organization" for purposes of the liquidity standards for non-US banks applies only to the IHC. Any assets held pursuant to the LCR requirement must be held in the IHC.

According to the commentary accompanying the final rule, the FRB still is considering whether to propose liquidity standards for US branches and agencies of non-US banks.

Requirements under the final liquidity standards rule include the following:

Category I liquidity standards for US GSIBs remain the same.

Category II liquidity standards for banking organizations in this category (including IHCs and any covered depository institution subsidiary of a banking organization subject to Category II liquidity standards) remain subject to the full daily LCR and NSFR requirements.

Category III liquidity standards for banking organizations in this category (including IHCs and any covered depository institution subsidiary of a banking organization subject to Category III liquidity standards) remain subject to the same LCR and NSFR requirements as Category II banking organizations. However, if the total assets include less than $75 billion in weighted short-term wholesale funding, the banking organization will be subject to daily LCR and NSFR requirements at 70-85% of the full requirements.

Category IV liquidity standards for banking organizations in this category: If the weighted short term wholesale funding assets are less than $50 billion, there would be no LCR or NSFR requirements. If the weighted short term wholesale funding assets are equal to or greater than $50 billion, the banking organization will be subject to monthly LCR and NSFR requirements at 70-85% of the full requirements.

Current internal liquidity stress testing requirements would remain monthly, except for Category IV banks, which would be subject to them quarterly.

Resolution plan final rule

The Resolution Plan rule is aimed at avoiding serious adverse effects to the US financial system by requiring that certain bank holding companies, depository institutions and non-US banks with US banking operations submit these plans to the FDIC and FRB for review. Initially, resolution plans were required to be submitted annually, but over the years, based on their experience with the regulation, the FRB and the FDIC on a case-by-case basis have extended the time periods for covered companies to submit the plans. In addition, the filing threshold has been raised to $250 billion (from $100 billion), as required by the EGRRCPA.

While the regulators reserve the right to make changes with respect to a particular bank, the regulations as revised provide as follows:

Biennial Filers: Category I banking organizations (US GSIBs) will be required to submit resolution plans every two years, alternating between a full and "targeted" resolution plan. A targeted resolution plan is a subset of the full resolution plan which must include the core elements of the full plan as set forth in the regulations and certain key areas of focus designated in advance by the FRB and FDIC.

Triennial Full filers: Category II and III banking organizations will be required to submit a resolution plan every three years, alternating between a full resolution plan and a "targeted" resolution plan.

Triennial Reduced Filers: These are banking organizations that are not GSIBs or Category II or III banking organizations. They are required to submit a “reduced” resolution plan every three years. Those plans would include a discussion of any material changes since its last filing and a description of changes to its strategic analysis described in the previous plan that comes from changes in law or regulation, guidance or feedback given by the FRB and FDIC or material changes in the resolution plan.

These triennial reduced filers are non-US banking organizations with US banking operations that have greater than $250 billion in total global assets and do not fit the criteria of Category II or III banking organizations.

There are no Category IV filers because the minimum threshold is below the EGRRCPA threshold of $250 million in assets.

Conclusion

The tailoring framework adopted in these rules was developed with a risk-based focus that is used for many aspects of bank regulation in the United States and globally. It remains to be seen whether implementation of these new regulations will on balance be of benefit to both the US bank regulators and banks operating in the United States. While all three sets of final rules have effective dates of Dec. 31, 2019, transition periods vary with each rule, so banks should be sure to review them now so they can begin to develop the relevant implementation plans.