

U.S. Bank Holding Companies: Overview of Dodd-Frank Enhanced Prudential Standards Final Rule

February 24, 2014

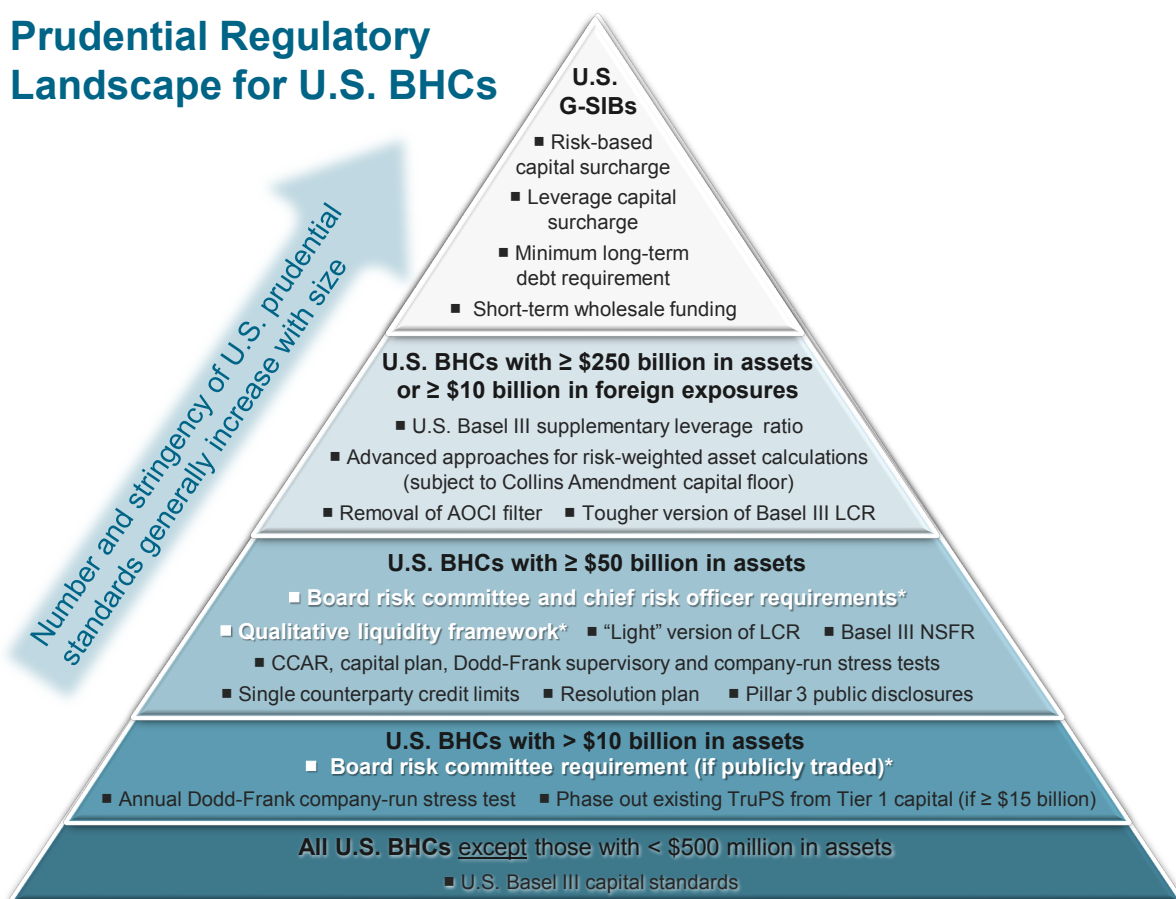
This visual summary provides an overview of key aspects of the Federal Reserve’s Dodd-Frank enhanced prudential standards (EPS) final rule applicable to:

- U.S. bank holding companies with ≥ \$50 billion in total consolidated assets (**Large U.S. BHCs**), which are required by the final rule to comply with risk management and qualitative liquidity standards.
- Publicly traded U.S. BHCs with > \$10 billion in total consolidated assets (**Public Mid-size BHCs**), which are required by the final rule to establish a risk committee of the board of directors to oversee its risk management framework.

Table of Contents

1. Key Takeaways	2
2. Risk Committee Requirement for Public Mid-size BHCs	5
3. Risk Management Standards for Large U.S. BHCs	7
4. Qualitative Liquidity Standards for Large U.S. BHCs	11
5. Next Steps for Single Counterparty Credit Limits.....	16
6. Tailoring of EPS for Nonbank SIFIs	17

Prudential Regulatory Landscape for U.S. BHCs



Many details are omitted from this visual overview

*** Adopted in February 2014 EPS final rule**

1. Key Takeaways

- **Compliance timing**
 - Generally, a company that is a **Large U.S. BHC** as of June 30, 2014 will become subject to risk management and qualitative liquidity standards beginning on **January 1, 2015**.
 - A company that becomes a Large U.S. BHC *after* June 30, 2014 must comply beginning on the first day of the *fifth quarter* following the date on which it became a Large U.S. BHC.
 - Generally, a company that is a **Public Mid-size BHC** as of June 30, 2014 will become subject to the risk committee requirement beginning on **July 1, 2015**.
 - A company that becomes a Public Mid-size BHC *after* June 30, 2014 must comply beginning on the first day of the *ninth quarter* following the date on which it became a Public Mid-size U.S. BHC.
- **Risk management standards:** The minimum risk management requirements in the final rule are **broadly similar** to the proposed rule and supplement, rather than replace, existing Federal Reserve risk management guidance and supervisory expectations. The final rule and the preamble:
 - Clarify the risk committee’s **oversight** responsibilities with respect to risk management.
 - Revise the proposed “risk management expertise” requirement for a member of the risk committee and for a Large U.S. BHC’s chief risk officer (CRO) to focus on an individual’s experience in identifying, assessing and managing exposures of large, complex firms (or large, complex financial firms in the case of a Large U.S. BHC).
 - Retain the stand-alone risk committee requirement in the proposed rule for Large U.S. BHCs and clarify that the risk committee may not be part of a joint committee.
- **Qualitative liquidity standards for Large U.S. BHCs:** Broadly consistent with the proposed rule, the final rule requires Large U.S. BHCs to **(1)** comply with various liquidity risk management standards and **(2)** maintain a liquidity buffer of unencumbered highly liquid assets based on the results of **internal** liquidity stress testing. The final rule and the preamble:
 - Reassign certain liquidity risk management responsibilities among the board of directors, risk committee and senior management, as compared to proposed rule.
 - State that for the most complex U.S. BHCs, the Federal Reserve intends to use the supervisory process to supplement the final rule through horizontal reviews of internal stress testing methods, liquidity risk management and liquidity adequacy.
 - State that high-quality liquid assets (HQLAs) as defined in the U.S. Basel III liquidity coverage ratio (LCR) proposal “would be liquid under most scenarios” for purposes of satisfying the liquidity buffer requirement.
 - However, a Large U.S. BHC must still **(1)** make the liquidity profile demonstration to the Federal Reserve as required by the final rule; **(2)** meet a diversification requirement (if applicable); and **(3)** assign appropriate haircuts, which may be different from the haircuts prescribed for HQLAs in the U.S. LCR proposal.
 - Allow assets that are used as hedges to be considered “unencumbered” if they otherwise meet the definition of “unencumbered.” In contrast, the *proposed* rule’s definition of unencumbered required that an asset not be designated as a hedge on a trading position.
 - Clarify that the qualitative liquidity standards in the final rule are designed to complement the quantitative Basel III liquidity standards, *i.e.*, the LCR and net stable funding ratio (NSFR).

- State that BHCs **not** subject to the qualitative liquidity standards (e.g., BHCs with < \$50 billion in total consolidated assets) are also expected to have adequate liquidity resources and engage in sound liquidity risk management consistent with the March 2010 [Interagency Policy Statement on Funding and Liquidity Risk Management](#).
- **Single counterparty credit limits (SCCLs) not part of final rule:** The Federal Reserve is conducting a quantitative impact study and will take into account the Basel Committee's large exposures regime before finalizing SCCLs. Davis Polk's overview of the Basel Committee's proposed large exposures regime is available [here](#).
- **Early remediation framework not part of final rule:** The Federal Reserve will finalize the early remediation framework later this year.
- **U.S. BHC subsidiary of a large foreign banking organization:** The EPS final rule requires foreign banking organizations (FBOs) with ≥ \$50 billion in U.S. assets (excluding U.S. branch/agency assets) to establish a top-tier U.S. intermediate holding company (IHC), which will be subject to EPS.
 - U.S. BHC subsidiaries of FBOs subject to the IHC requirement must comply with EPS applicable to Large U.S. BHCs or Public Mid-size BHCs, as applicable, until an IHC is formed or designated and the IHC becomes subject to corresponding EPS.
- **Nonbank SIFIs not covered by the final rule:** The Federal Reserve intends to assess the business model, capital structure and risk profile of any nonbank financial company designated as systemically important by the Financial Stability Oversight Council (Nonbank SIFI) to determine how EPS should apply, and if appropriate, would tailor application of the standards **by order or regulation** to that Nonbank SIFI or to a category of Nonbank SIFIs.
 - The degree of tailoring would depend on similarities and differences between the Nonbank SIFI and Large U.S. BHCs in terms of activities, balance sheet structure, risk profile and functional regulation.
- **More EPS to come:** There are numerous other prudential standards on the Federal Reserve's 2014 regulatory agenda that are relevant for Large U.S. BHCs, including:
 - Finalizing the G-SIB leverage capital surcharge proposal (Davis Polk memo [here](#)).
 - Implementing the Basel Committee's recent revisions to the Basel III leverage ratio (Davis Polk visual memo [here](#)).
 - Implementing the G-SIB risk-based capital surcharge (related Davis Polk materials [here](#)).
 - Implementing additional Pillar 3 public disclosure requirements (related Davis Polk materials [here](#)).
 - Finalizing the U.S. LCR proposal (Davis Polk visual memo [here](#)).
 - Proposing to implement Basel III NSFR (related Davis Polk materials [here](#)).
 - Proposing a minimum long-term debt requirement at the holding company level to facilitate orderly liquidation.
 - Finalizing SCCLs and early remediation framework.
 - Considering policy measures to address certain risks related to short-term wholesale funding (related Davis Polk materials [here](#)).

Current Status of U.S. Prudential Regulatory Rulemaking

Already Finalized	To Be Finalized	To Be Proposed
<ul style="list-style-type: none"> ▪ U.S. Basel III capital rules ▪ Capital planning and CCAR ▪ Dodd-Frank supervisory and company-run stress tests ▪ Qualitative liquidity standards ▪ Risk management standards 	<ul style="list-style-type: none"> ▪ Leverage capital surcharge for U.S. G-SIBs ▪ Single counterparty credit limits ▪ U.S. Basel III liquidity coverage ratio ▪ Early remediation framework ▪ Risk governance standards for large depository institutions 	<ul style="list-style-type: none"> ▪ Risk-based capital surcharge for U.S. G-SIBs ▪ Minimum long-term debt requirement ▪ U.S. Basel III net stable funding ratio ▪ Measures to address certain risks related to short-term wholesale funding ▪ Additional Pillar 3 disclosure requirements ▪ Rules to implement Basel Committee's ongoing revisions to the Basel capital framework, including: <ul style="list-style-type: none"> ▪ Revisions to Basel III leverage ratio ▪ Fundamental review of trading book capital rules ▪ Non-internal model method for calculating derivatives exposures ▪ Exposures to central counterparties ▪ Equity exposures to investment funds ▪ Securitization exposures ▪ Review of standardized approach for credit risk and operational risk

Bottom line: More prudential standards to come in 2014 and beyond

- **EPS for savings and loan holding companies (SLHCs):** The Federal Reserve reaffirmed in the preamble to the EPS final rule (consistent with the preamble to the EPS proposed rule) that it may apply prudential requirements to certain SLHCs that are similar to EPS for U.S. BHCs if the Federal Reserve determines that such standards are consistent with the safety and soundness of such SLHCs.
 - Through the U.S. Basel III final rule, the Federal Reserve has already established risk-based and leverage capital requirements for certain savings and loan holding companies (SLHCs), which will become effective on January 1, 2015. Davis Polk's visual memo on the U.S. Basel III final rule is available [here](#).
 - The Federal Reserve has also set forth supervisory expectations for SLHCs regarding, among other things, liquidity risk management and enterprise-wide risk management.

2. Risk Committee Requirement for Public Mid-size BHCs

A Public Mid-size BHC must maintain an enterprise-wide risk committee of the board of directors that approves and periodically reviews the BHC's risk management policies and oversees the operation of its risk management framework.

A. Composition of the Risk Committee

A Public Mid-size BHC's risk committee must:

- **(1) Include at least one member who has experience identifying, assessing, and managing risk exposures of large, complex firms.**
 - For Public Mid-size BHCs, an individual's risk management experience may be acquired through experience in a nonbanking or nonfinancial field, such as executive-level service at a large nonfinancial company with a high risk profile and above average complexity.
 - The Federal Reserve expects that the risk committee member's experience in risk management would be commensurate with the Public Mid-size BHC's structure, risk profile, complexity, activities and size, and the BHC should be able to demonstrate that an individual's experience is relevant to the particular risks facing the BHC.
 - While the final rule requires only one member of the risk committee to have experience in identifying, assessing and managing risk exposures of large, complex firms, the Federal Reserve expects all risk committee members generally to have an understanding of risk management principles and practices relevant to the Public Mid-size BHC.
 - However, the Federal Reserve does not expect board members of Public Mid-size BHCs to have risk management expertise comparable to that of board members of larger BHCs.
- **(2) Be chaired by a director who meets the following independence requirements:**
 - The director is not an officer or employee of the BHC and has not been an officer or employee of the BHC during the previous three years.
 - The director is not a member of the immediate family, as defined in Section 225.41(b)(3) of the Federal Reserve's Regulation Y (12 C.F.R. § 225.41(b)(3)), or a person who is, or has been within the last three years, an executive officer of the BHC, as defined in Section 215.2(e)(1) of the Federal Reserve's Regulation O (12 C.F.R. § 215.2(e)(1)).
 - The director is an independent director under Item 407 of the SEC's Regulation S-K (17 C.F.R. § 229.407(a)).
- **Additional independent directors optional:** The Federal Reserve stated that:
 - A BHC should determine the appropriate proportion of independent directors on the risk committee based on its size, scope, and complexity, provided that it meets the minimum requirement of one independent director.
 - BHCs are encouraged to consider including additional independent directors as members of their risk committees because active involvement of independent directors can be vital to robust oversight of risk management.
 - At the same time, involvement of directors affiliated with the BHC on the risk committee may complement the involvement of independent directors.

B. Governance of the Risk Committee

A Public Mid-size BHC's risk committee must:

- Have a formal written charter approved by the board of directors.

- Meet at least quarterly, and otherwise as needed.
- Fully document and maintain records of its proceedings, including risk management decisions (which the Federal Reserve clarified refers to decisions relating to risk management policies).

C. Responsibilities of the Risk Committee

The final rule imposes responsibilities on a Public Mid-size BHC's risk committee that are broadly similar to those in the proposed rule. However, the final rule clarifies the risk committee's **oversight** responsibilities with respect to risk management.

- A risk committee must “approve and periodically review” the risk management policies of the BHC's operations and “oversee” the operation of the BHC's risk management framework.
- The proposed rule would have made the risk committee responsible for documenting, reviewing, and approving the BHC's enterprise-wide risk management practices. In response to comments that this would have blurred the distinction between management and board responsibilities, the final rule does not assign this responsibility to the risk committee.
- The Federal Reserve clarified that the risk committee, acting in its oversight role, should fully understand the enterprise-wide risk management policies and framework and have a general understanding of the risk management practices of the BHC.

D. Risk Management Framework

Public Mid-size BHCs are required to establish a risk management framework.

- The mandatory components of the risk management framework in the final rule are broadly similar to those in the proposed rule, except that the final rule does not include specific risk limitations for each business line of the BHC.
- As a Public Mid-size BHC grows or increases in complexity, its risk committee should ensure that its risk management practices and framework adapt to changes in the BHC's operations and risk profile.
- A Public Mid-size BHC's risk management framework must be commensurate with its structure, risk profile, complexity, activities and size, and must include:
 - Policies and procedures establishing risk management governance, risk management procedures, and risk control infrastructure for its operations.
 - Processes and systems for implementing and monitoring compliance with such policies and procedures, including:
 - Processes and systems for identifying and reporting risks and risk management deficiencies, including regarding emerging risks, and ensuring effective and timely implementation of actions to address emerging risks and risk management deficiencies for the BHC's operations.
 - Processes and systems for establishing managerial and employee responsibility for risk management.
 - Processes and systems for ensuring the independence of the risk management function.
 - Processes and systems to integrate risk management and associated controls with management goals and the BHC's compensation structure.

3. Risk Management Standards for Large U.S. BHCs

A. Risk Committee Requirement

A Large U.S. BHC must maintain an enterprise-wide risk committee of the board of directors that approves and periodically reviews the BHC's risk management policies and oversees the operation of its global risk management framework. The risk committee also has responsibilities under the qualitative liquidity framework for Large U.S. BHCs.

Similar to the proposed rule, the final rule imposes additional risk committee requirements on Large U.S. BHCs as compared to Public Mid-size BHCs.

- **Composition:** A Large U.S. BHC's risk committee must:
 - **(1) Include at least one member who has experience identifying, assessing, and managing risk exposures of large, complex financial firms.**
 - The term "financial firm" includes a bank, a securities broker-dealer or an insurance company, provided that the risk management experience is relevant to the particular risks facing the Large U.S. BHC.
 - The Federal Reserve expects that the risk committee member's experience in risk management would be commensurate with the BHC's structure, risk profile, complexity, activities, and size, and the BHC should be able to demonstrate that an individual's experience is relevant to the particular risks facing the company.
 - While the final rule requires only one member of the risk committee to have experience in identifying, assessing and managing risk exposures of large, complex financial firms, the Federal Reserve expects all risk committee members generally to have an understanding of risk management principles and practices relevant to the Large U.S. BHC.
 - The appropriate level of risk management expertise for a Large U.S. BHC's risk committee varies depending on the risks posed by the BHC to the stability of the U.S. financial system. The risk committee of a Large U.S. BHC that poses more systemic risk should have more risk committee members with commensurately greater understandings of risk management principles and practices.
 - **(2) Be chaired by a director who meets the following independence requirements:**
 - The director is not an officer or employee of the BHC and has not been an officer or employee of the BHC during the previous three years.
 - The director is not a member of the immediate family, as defined in Section 225.41(b)(3) of the Federal Reserve's Regulation Y (12 C.F.R. § 225.41(b)(3)), or a person who is, or has been within the last three years, an executive officer of the BHC, as defined in Section 215.2(e)(1) of the Federal Reserve's Regulation O (12 C.F.R. § 215.2(e)(1)).
 - If the BHC has an outstanding class of securities traded on a national securities exchange, the director is an independent director under Item 407 of the SEC's Regulation S-K (17 C.F.R. § 229.407(a)).
 - If the BHC does **not** have an outstanding class of securities traded on a national securities exchange, the director would qualify as an independent director under the listing standards of a national securities exchange, as demonstrated to the satisfaction of the Federal Reserve.

- **Additional independent directors optional:** The Federal Reserve stated that:
 - A BHC should determine the appropriate proportion of independent directors on the risk committee based on its size, scope, and complexity, provided that it meets the minimum requirement of one independent director.
 - BHCs are encouraged to consider including additional independent directors as members of their risk committees because active involvement of independent directors can be vital to robust oversight of risk management.
 - At the same time, involvement of directors affiliated with the BHC on the risk committee may complement the involvement of independent directors.
- **Corporate governance:** A Large U.S. BHC's risk committee must:
 - Have a formal, written charter that is approved by the board of directors.
 - Be a stand-alone committee of the board of directors that has, as its **sole and exclusive function**, responsibility for the risk management policies of the BHC's global operations and oversight of the operation of the BHC's global risk management framework.
 - Report directly to the board of directors.
 - Receive and review regular reports on at least a quarterly basis from the CRO.
 - Meet at least quarterly, or more frequently as needed.
 - Fully document and maintain records of its proceedings, including risk management decisions.
- **Stand-alone risk committee requirement:**
 - The final rule retains the proposed requirement for a separate risk committee and clarifies that the risk committee may not be part of a joint committee.
 - This requirement would prevent the risk committee from having other substantive responsibilities at the Large U.S. BHC.
 - However, it would not prevent a BHC's risk committee from serving as the risk committee for one or more of its subsidiaries as long as the requirements of the final rule are otherwise satisfied.
 - The Federal Reserve explained that the risk committee may have members that are on other board committees, and other board committees, such as audit or finance, may have some involvement in establishing the Large U.S. BHC's risk management framework. However, the Federal Reserve believes that a stand-alone risk committee, rather than a joint risk/audit or risk/finance committee, enables appropriate board-level attention to risk management.
- **Responsibilities:**
 - A risk committee must "approve and periodically review" the risk management policies of the BHC's global operations and "oversee" the operation of the BHC's global risk management framework.
 - In addition, the risk committee, or a designated sub-committee of the risk committee, must approve a Large U.S. BHC's contingency funding plan (see [Qualitative Liquidity Standards for Large U.S. BHCs](#) below) at least annually and must give its prior approval to any material revisions to the plan.
- **Global risk management framework:** Large U.S. BHCs are required to establish a global risk management framework. The mandatory components of the risk management framework in the

final rule are broadly similar to the proposed rule, except that the final rule does not include specific risk limitations for each business line of the BHC.

- A Large U.S. BHC's global risk management framework must be commensurate with its structure, risk profile, complexity, activities, and size and must include:
 - Policies and procedures establishing risk management governance, risk management procedures, and risk control infrastructure for its global operations.
 - Processes and systems for implementing and monitoring compliance with such policies and procedures, including:
 - Processes and systems for identifying and reporting risks and risk management deficiencies, including regarding emerging risks, and ensuring effective and timely implementation of actions to address emerging risks and risk management deficiencies for the BHC's operations.
 - Processes and systems for establishing managerial and employee responsibility for risk management.
 - Processes and systems for ensuring the independence of the risk management function.
 - Processes and systems to integrate risk management and associated controls with management goals and the BHC's compensation structure.

B. Chief Risk Officer Requirement

A Large U.S. BHC must employ a CRO with specified risk management responsibilities.

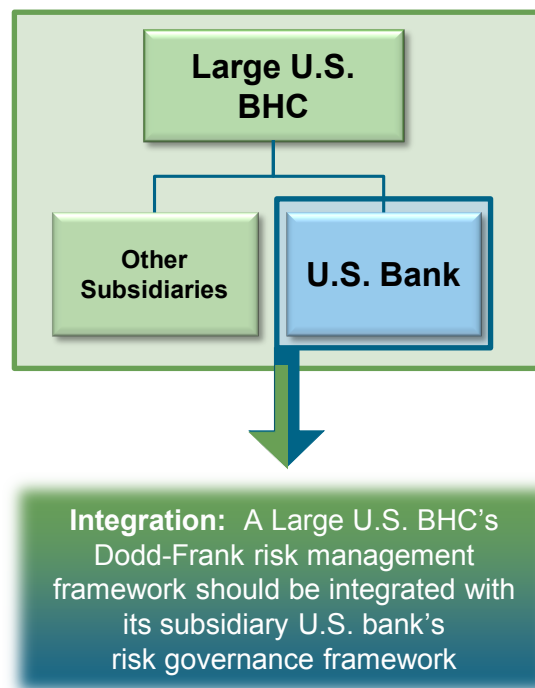
- **Risk management experience:** A CRO must have experience identifying, assessing and managing risk exposures of large, complex **financial firms**.
 - The Federal Reserve expects a Large U.S. BHC to be able to demonstrate that its CRO's experience is relevant to the particular risks facing the BHC and commensurate with the BHC's structure, risk profile, complexity, activities, and size.
- **Dual reporting:** The CRO must report directly to the risk committee and the CEO. The CRO must provide quarterly reports to the risk committee.
- **Compensation and Incentives:** The compensation and other incentives provided to the CRO must be consistent with providing an objective assessment of the risks taken by the Large U.S. BHC. According to the Federal Reserve:
 - This requirement would not prevent a Large U.S. BHC from using discretion in adopting a compensation structure for its CRO, whether through its compensation committee or otherwise, as long as the structure of the CRO's compensation provides for an objective assessment of risks.
 - This requirement supplements existing Federal Reserve guidance on incentive compensation, which provides, among other things, that compensation for employees in risk management and control functions should avoid conflicts of interest and that incentive compensation received by these employees should not be based substantially on the financial performance of the business units that they review.
- **Responsibilities:** CRO responsibilities in the final rule are broadly similar to those in the proposed rule, although the final rule does not include the proposed requirement that the CRO have "direct" oversight over the enumerated responsibilities or perform the functions that carry out those responsibilities.
 - The CRO is responsible for overseeing:

- The establishment of risk limits on an enterprise-wide basis and the monitoring of compliance with such limits.
 - The implementation of and ongoing compliance with risk management policies and procedures.
 - The development and implementation of the processes and systems to monitor compliance with risk management policies and procedures.
 - The management of risks and risk controls within the parameters of the Large U.S. BHC's risk control framework.
 - The monitoring and testing of the Large U.S. BHC's risk controls.
- The CRO is responsible for reporting risk management deficiencies and emerging risks to the risk committee and resolving risk management deficiencies in a timely manner.

C. Interaction Between Large U.S. BHC's Risk Management Framework and Subsidiary U.S. Bank's Risk Governance Framework

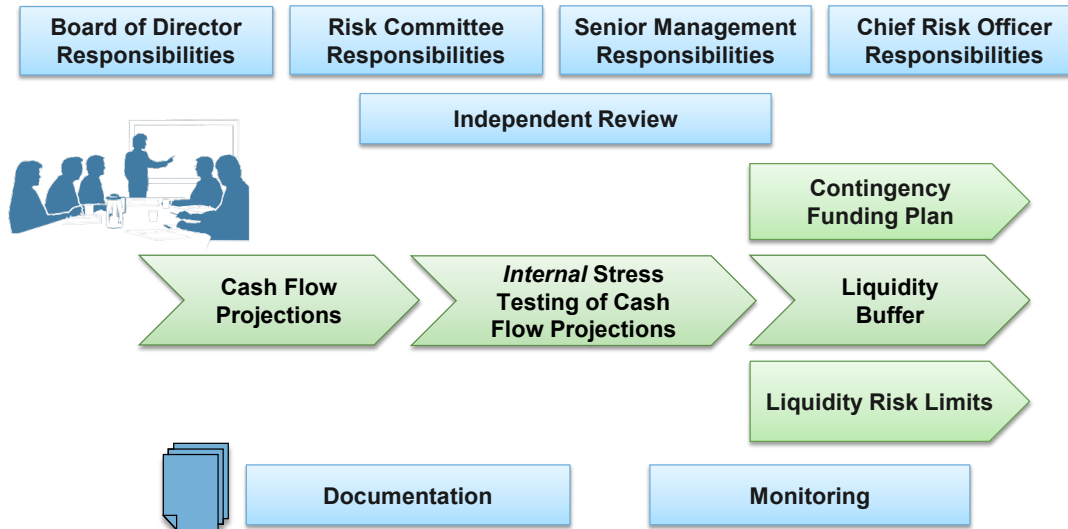
Large U.S. BHCs will need to consider the interaction between **(1)** the risk management framework required by the EPS final rule and **(2)** risk governance expectations or guidelines applicable to their U.S. depository institution subsidiaries (e.g., the OCC's proposed risk governance guidelines).

- Davis Polk's visual memo on the OCC's proposed risk governance guidelines for large national banks and federal savings associations is available [here](#).



4. Qualitative Liquidity Standards for Large U.S. BHCs

The final rule, like the proposed rule, contains a qualitative liquidity framework for a Large U.S. BHC, depicted as follows:



- Horizontal reviews by Federal Reserve:** The Federal Reserve stated that for the most complex U.S. BHCs, it intends to use the supervisory process to supplement the EPS final rule through horizontal reviews of internal stress testing methods, liquidity risk management and liquidity adequacy.

A. Liquidity Risk Management Standards

Compared with the proposed rule, the final rule contains broadly similar liquidity risk management standards, including specific responsibilities for the board of directors, risk committee and senior management. The final rule makes a number of adjustments to the allocation of responsibilities among these groups.

- The **board of directors** is required to:
 - “Approve” (proposed rule used the term “establish”) a Large U.S. BHC’s liquidity risk tolerance at least annually.
 - Receive and review at least semi-annually information provided by senior management to determine whether the Large U.S. BHC is operating in accordance with its established liquidity risk tolerance.
 - Approve and periodically review the liquidity risk management strategies, policies and procedures established by senior management.
- The **risk committee or a designated subcommittee thereof** (rather than the board of directors as was the case in the proposed rule) is required to review and approve the Large U.S. BHC’s contingency funding plan at least annually, and must approve any material revisions before they are implemented.
- Senior management** (rather than the risk committee as was the case in the proposed rule) is required to:
 - Review and pre-approve new products and business lines and evaluate liquidity costs, benefits, and risks related to each new business line and product that could have a

significant effect on the Large U.S. BHC's liquidity risk profile and to annually review the liquidity risk of each significant business line and product.

- Establish liquidity risk limits and to review the Large U.S. BHC's compliance with those limits at least quarterly.
- Review cash flow projections at least quarterly and review and approve certain aspects of the liquidity stress testing framework at specified intervals.
- A Large U.S. BHC may assign senior management's liquidity risk management responsibilities to the CRO as a member of senior management.

B. Cash Flow Projections

The cash flow projection requirement in the final rule is similar to that in the proposed rule.

- A Large U.S. BHC must produce comprehensive cash flow projections that project cash flows arising from assets, liabilities and off-balance sheet exposures over, at a minimum, short- and long-term time horizons.
- **Frequency:** Short-term cash flow projections must be updated **daily** and longer-term cash flow projections must be updated at least **monthly**.
- **Methodology:** A Large U.S. BHC must establish a methodology for making cash flow projections that results in projections that:
 - Include cash flows arising from contractual maturities, intercompany transactions, new business, funding renewals, customer options and other potential events that may impact liquidity.
 - Include reasonable assumptions regarding the future behavior of assets, liabilities and off-balance sheet exposures.
 - Identify and quantify discrete and cumulative cash flow mismatches over these time periods.
 - Include sufficient detail to reflect the capital structure, risk profile, complexity, currency exposure, activities, and size of the Large U.S. BHC and include analyses by business line, currency or legal entity as appropriate.
- **Documentation:** A Large U.S. BHC must adequately document its methodology for making cash flow projections and the included assumptions and submit such documentation to the risk committee.
- While the final rule does not require cash flow projections over time horizons longer than one year, the Federal Reserve noted that, under certain circumstances, it may be appropriate for Large U.S. BHCs to produce cash flow projections for longer time periods to account for long-term debt maturities.

C. Internal Liquidity Stress Tests

The Internal liquidity stress testing requirement in the final rule is similar to that in the proposed rule.

- A Large U.S. BHC must conduct stress tests to assess the potential impact of liquidity stress scenarios on its cash flows, liquidity position, profitability and solvency, taking into account:
 - Its current liquidity condition, risks, exposures, strategies and activities.
 - Its balance sheet exposures, off-balance sheet exposures, size, risk profile, complexity, business lines, organizational structure and other characteristics that affect its liquidity risk profile.

- The potential direct adverse impact of associated market disruptions on the Large U.S. BHC and incorporate the potential actions of other market participants experiencing liquidity stresses under the market disruptions that would adversely affect the Large U.S. BHC.
- **Frequency:** The liquidity stress tests must be performed at least monthly. The Federal Reserve may require a Large U.S. BHC to perform stress testing more frequently.
- **Stress scenarios:** Each liquidity stress test must include, at a minimum:
 - A scenario reflecting adverse market conditions.
 - A scenario reflecting an idiosyncratic stress event for the Large U.S. BHC.
 - A scenario reflecting combined market and idiosyncratic stresses.
- A Large U.S. BHC must incorporate additional liquidity stress scenarios into its liquidity stress test, as appropriate, based on its financial condition, size, complexity, risk profile, scope of operations or activities.
- The Federal Reserve may require a Large U.S. BHC to vary the underlying assumptions and stress scenarios.
- **Stress test planning horizon:** Each stress test must include:
 - An overnight planning horizon.
 - A 30-day planning horizon – a Large U.S. BHC must use the results of the stress test over the 30-day planning horizon to calculate the size of its liquidity buffer.
 - A 90-day planning horizon.
 - A 1-year planning horizon.
 - Any other planning horizons that are relevant to the Large U.S. BHC's liquidity risk profile.
- **Assets used as cash flow sources in a stress test**
 - **Haircuts:** To the extent an asset is used as a cash flow source to offset projected funding needs during the planning horizon in a liquidity stress test, the fair market value of the asset must be discounted to reflect any credit risk and market volatility of the asset.
 - The final rule does not prescribe minimum haircuts.
 - **Diversification:** Assets used as cash-flow sources during a planning horizon must be diversified by collateral, counterparty, borrowing capacity and other factors associated with the liquidity risk of the assets.
 - **Lines of credit:** A line of credit does **not** qualify as a cash flow source for purposes of a stress test with a planning horizon of 30 days or less. A line of credit may qualify as a cash flow source for purposes of a stress test with a planning horizon that exceeds 30 days.
- **Policies and procedures:** A Large U.S. BHC must establish and maintain policies and procedures governing its liquidity stress testing practices, methodologies and assumptions that provide for the incorporation of the results of liquidity stress tests in future stress testing and for the enhancement of stress testing practices over time.
- **Controls and oversight:** A Large U.S. BHC must establish and maintain a system of controls and oversight that is designed to ensure that its liquidity stress testing processes are effective in meeting the requirements of the final rule.
 - The controls and oversight must ensure that each liquidity stress test appropriately incorporates conservative assumptions with respect to stress scenarios and other elements

of the stress test process, taking into consideration the Large U.S. BHC's capital structure, risk profile, complexity, activities, size, business lines, legal entity or jurisdiction and other relevant factors.

- The assumptions must be approved by the CRO and be subject to independent review.
- **Management information systems:** A Large U.S. BHC must maintain management information systems and data processes sufficient to enable it to effectively and reliably collect, sort, and aggregate data and other information related to liquidity stress testing.

D. Liquidity Buffer Requirement

Broadly consistent with the proposed rule, a Large U.S. BHC must maintain a liquidity buffer of **unencumbered highly liquid assets** sufficient to meet the projected **net stressed cash flow need** over the 30-day planning horizon of a liquidity stress test under each of an adverse market condition scenario, an idiosyncratic stress event scenario and a combined market and idiosyncratic stresses scenario.

- **Net stressed cash flow need** = cash flow needs over the 30-day planning horizon **minus** cash flow sources over the 30-day planning horizon
- **Unencumbered:** An asset is unencumbered if it:
 - Is free of legal, regulatory, contractual, or other restrictions on the ability of such company promptly to liquidate, sell or transfer the asset; **and**
 - Is **either**:
 - Not pledged or used to secure or provide credit enhancement to any transaction; **or**
 - Pledged to a central bank or a U.S. government-sponsored enterprise (GSE), to the extent potential credit secured by the asset is not currently extended by such central bank or U.S. government-sponsored enterprise or any of its consolidated subsidiaries.
- The final rule allows assets that are used as hedges to be considered “unencumbered” if they otherwise meet the above definition. In contrast, the *proposed* rule’s definition of unencumbered required that an asset not be designated as a hedge on a trading position.
- The Federal Reserve clarified that unencumbered highly liquid assets should generally not include assets pledged to a counterparty for provisional needs. In particular, assets pledged to clearing counterparties and assets subject to “banker’s liens” must be considered encumbered in most scenarios, as their encumbrance is an ongoing requirement for conducting business with such counterparties.
- **Highly liquid assets:** The Federal Reserve adopted the proposed definition of highly liquid assets, which includes:
 - Cash
 - Securities issued or guaranteed by the United States, a U.S. government agency or a U.S. GSE)
 - Any other asset that the Large U.S. BHC **demonstrates** to the satisfaction of the Federal Reserve:
 - Has low credit risk and low market risk;
 - Is traded in an active secondary two-way market that has committed market makers and independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be

determined within one day and settled at that price within a reasonable time period conforming with trade custom; and

- Is a type of asset that investors historically have purchased in periods of financial market distress during which market liquidity has been impaired.
- **Treatment of LCR HQLAs:** The preamble to the final rule states that HQLAs as defined in the U.S. LCR proposal “would be liquid under most scenarios.” However, the Large U.S. BHC must still:
 - Make a liquidity profile demonstration to the Federal Reserve as required by the final rule;
 - Meet the diversification requirement (which, under the final rule, does **not** apply to cash and securities issued by the United States, a U.S. government agency or a U.S. GSE); and
 - Assign appropriate haircuts, which may be different from the haircuts prescribed for HQLAs in the U.S. LCR proposal.
- **Definition of HQLAs in U.S. LCR proposal:** The definition of HQLAs in the U.S. LCR proposal is **narrower** than in the Basel Committee’s revised LCR framework. For example, under the U.S. LCR proposal, HQLAs do **not** include securities issued or guaranteed by public sector entities (e.g., state, local authority or other governmental subdivision below the sovereign level), covered bonds or RMBS. Davis Polk’s visual memo on the U.S. LCR proposal is available [here](#).
- **Treatment of reverse repos:** The Federal Reserve clarified that if a Large U.S. BHC is able to rehypothecate collateral consisting of highly liquid assets that secures a loan (but has not done so), the Large U.S. BHC may count that collateral as a highly liquid asset, subject to appropriate haircuts.
- **Treatment of deposits at other banks:** Cash held in deposit at other banks are loans and may constitute cash inflows, rather than highly liquid assets that count towards the liquidity buffer.
- **Dipping into liquidity buffer:** The final rule clarifies that dipping into the liquidity buffer during periods of liquidity stress may, in certain circumstances, be beneficial for the safety and soundness of the institution and potentially for financial stability. The Federal Reserve anticipates that any supervisory decisions in response to a reduction of the liquidity buffer will take into consideration the particular circumstances surrounding the reduction.
 - If a firm is experiencing idiosyncratic or systemic stress and is otherwise practicing good liquidity risk management, the Federal Reserve expects that supervisors would observe the firm closely as it uses its liquid resources and work with the firm to determine how to rebuild these resources once the stress period has passed, through a plan or similar process.
 - However, a supervisory or enforcement action may be appropriate when a firm’s liquidity buffer is reduced substantially, or falls below its stressed liquidity needs as identified by the stress test, because of operational issues or inadequate liquidity risk management. Under these circumstances, a firm may be required to enter into a written agreement if it does not meet the liquidity buffer requirement within an appropriate period of time.

E. Interaction with the Basel III Liquidity Framework

The internal liquidity stress testing and buffer requirements will exist alongside of, and are designed to complement, the Basel III LCR and NSFR.

A **key difference** between the LCR and the liquidity buffer requirement in the final rule is that the former is based on **prescribed** cash inflow and outflow rates and assumptions under the standardized supervisory stress scenario, whereas the latter is based on the results of a Large U.S. BHC’s **internal** liquidity stress testing.

5. Next Steps for Single Counterparty Credit Limits

The Federal Reserve is conducting a quantitative impact study and will take into account the Basel Committee's large exposures regime before finalizing SCCLs. Davis Polk's overview of the Basel Committee's March 2013 proposed large exposures regime is available [here](#).

Overview of SCCLs in December 2011 proposed rule: Under the proposed rule, a Large U.S. BHC, together with its subsidiaries, would be prohibited from having an aggregate net credit exposure to any unaffiliated counterparty, together with the counterparty's subsidiaries, in excess of 25% of the Large U.S. BHC's consolidated "capital stock and surplus."

- "Capital stock and surplus" = the Large U.S. BHC's total regulatory capital (sum of Tier 1 and Tier 2 capital) plus the excess allowance for loan and lease losses not included in its Tier 2 capital.
- "Net credit exposure" = gross credit exposure arising from "credit transactions" after applying adjustments to take into account eligible credit risk mitigants.
- A stricter SCCL of 10% of capital stock and surplus would apply between a major U.S. BHC, together with its subsidiaries, and any unaffiliated major counterparty, together with the counterparty's subsidiaries.
- Major counterparty = a U.S. BHC with \geq \$500 billion in total consolidated assets; an FBO with \geq \$500 billion in global total consolidated assets; and a Nonbank SIFI of any size.

6. Tailoring of EPS for Nonbank SIFIs

- **Differences between Nonbank SIFIs and Large U.S. BHCs:** Large U.S. BHCs and U.S. Nonbank SIFIs may have very different business models, balance sheets, capital structures and liquidity profiles and are subject to different regulatory regimes.
- **Certain EPS may not be appropriate for Nonbank SIFIs:** The Federal Reserve recognizes that EPS applicable to Large U.S. BHCs and foreign banking organizations (FBOs) may not be appropriate, in whole or in part, for all Nonbank SIFIs. Accordingly, the Federal Reserve is **not** applying EPS to Nonbank SIFIs through the EPS final rule for Large U.S. BHCs and FBOs.
- **Tailoring by company or category through order or regulation:** Following designation of a Nonbank SIFI, the Federal Reserve intends thoroughly to assess the business model, capital structure, and risk profile of the company to determine how EPS should apply, and if appropriate, would tailor application of the standards by order or regulation to that Nonbank SIFI or to a category of Nonbank SIFIs.
- **Degree of tailoring depends on differences between Nonbank SIFIs and Large U.S. BHCs:**
 - For those Nonbank SIFIs that are similar in activities and risk profile to Large U.S. BHCs, the Federal Reserve expects to apply EPS that are similar to those that apply to Large U.S. BHCs.
 - For those Nonbank SIFIs that differ from Large U.S. BHCs in their activities, balance sheet structure, risk profile and functional regulation, the Federal Reserve expects to apply more tailored standards.
- **Procedures:** The Federal Reserve will ensure that Nonbank SIFIs receive notice and opportunity to comment prior to determination of their EPS.

We plan to publish more detailed analysis, visuals and interactive tools relating to the enhanced prudential standards final rule. Our enhanced prudential standards resources are available at USBasel3.com/EPS. Our capital and prudential standards blog can be accessed at blog.usbasel3.com

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Luigi L. De Ghenghi	212 450 4296	luigi.deghenghi@davispolk.com
Randall D. Guynn	212 450 4239	randall.guynn@davispolk.com
Lena V. Kiely	212 450 4619	lena.kiely@davispolk.com
Reena Agrawal Sahni	212 450 4801	reena.sahni@davispolk.com
Margaret E. Tahyar	212 450 4379	margaret.tahyar@davispolk.com
Andrew S. Fei	212 450 4063	andrew.fei@davispolk.com
Reuben Grinberg	212 450 4967	reuben.grinberg@davispolk.com
Eric McLaughlin	212 450 4897	eric.mclaughlin@davispolk.com
Daniel E. Newman	212 450 4992	daniel.newman@davispolk.com
Michael I. Overmyer	212 450 4408	michael.overmyer@davispolk.com

© 2014 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

Notice: This publication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you have received this email in error, please notify the sender immediately and destroy the original message, any attachments thereto and all copies. Refer to the firm's [privacy policy](#) located at davispolk.com for important information on this policy. Please consider adding Davis Polk to your Safe Senders list or adding dpwmail@davispolk.com to your address book.

Unsubscribe: If you would rather not receive these publications, please respond to this email and indicate that you would like to be removed from our distribution list.