

November 5, 2018

New Supervisory Rating System for Large Banking Organizations

Federal Reserve Establishes a New Rating System for the Supervision of Large Financial Institutions

SUMMARY

On November 2, the Board of Governors of the Federal Reserve System (the “FRB”) issued a final rule (the “Final Rule”) that establishes a new rating system for the supervision of large financial institutions (“LFIs”). The LFI rating system applies to all bank holding companies with total consolidated assets of \$100 billion or more; all non-insurance, non-commercial savings and loan holding companies with total consolidated assets of \$100 billion or more; and all U.S. intermediate holding companies of foreign banking organizations with total consolidated assets of \$50 billion or more.¹ The LFI rating system is designed to align with the FRB’s existing supervisory program for LFIs,² enhance the clarity and consistency of supervisory assessments, and provide greater transparency regarding the consequences of a given rating. For LFIs, the new rating system replaces the RFI/C(D) rating system currently used by the FRB for holding companies of all sizes.³

The LFI rating system includes a new four-level rating scale and three component ratings. The four levels are: Broadly Meets Expectations; Conditionally Meets Expectations; Deficient-1; and Deficient-2. The component ratings are assigned for: Capital Planning and Positions; Liquidity Risk Management and Positions; and Governance and Controls.

These four levels and three components of the LFI rating system are generally the same as those described in the proposed rule (the “Proposed Rule”).⁴ Unlike the RFI/C(D) system, the LFI rating system does not include a stand-alone composite rating.

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The Final Rule will become effective on February 1, 2019. The FRB will assign initial ratings under the new rating system in 2019 for those bank holding companies and U.S. intermediate holding companies that are subject to the Large Institution Supervision Coordinating Committee (“LISCC”) framework⁵ and in 2020 for all other LFIs.

BACKGROUND

As described in the preamble accompanying the Final Rule, in the years following the 2007–2009 financial crisis, the FRB developed a supervisory program specifically designed to address the risks to U.S. financial stability posed by LFIs. This program focuses supervisory attention on the core areas that are deemed most likely to threaten a firm’s financial and operational strength and resilience (namely, capital, liquidity, and governance and controls).

The FRB coordinates its supervision of firms deemed to pose the greatest risk to U.S. financial stability through the LISCC. For large financial institutions that are not LISCC firms, the FRB performs horizontal reviews and firm-specific supervisory work focused on capital, liquidity, and governance and control practices, which are tailored to reflect the risk characteristics of these institutions.

Prior to the issuance of the Final Rule, the FRB had not modified its supervisory rating system for bank holding companies to reflect the substantial changes to the statutory and regulatory framework relating to LFIs or the FRB’s implementation of the supervisory program for LFIs in recent years. Since 2004, the FRB has used the RFI/C(D) rating system to communicate its supervisory assessment of every covered firm regardless of its asset size, complexity, or systemic importance.⁶ The RFI/C(D) rating system would continue to be used in the supervision of other organizations, including community and regional bank holding companies.⁷

DISCUSSION

The LFI rating system is intended to provide a supervisory evaluation of whether a firm possesses sufficient financial and operational strength and resilience⁸ to maintain safe and sound operations through a range of conditions, including stressful ones. The LFI rating system is designed to:

- Fully align with the FRB’s current supervisory programs and practices, which are based upon the LFI supervision framework’s core objectives of reducing the probability that an LFI will fail or experience material distress, thereby mitigating the risk to U.S. financial stability;
- Enhance the clarity and consistency of supervisory assessments and communications of supervisory findings and implications; and
- Provide transparency related to the supervisory consequences of a given rating.

The preamble accompanying the Final Rule notes that the final LFI rating system adopts the core elements of the proposed LFI rating system, with certain modifications to address commenter concerns. Consistent with the Proposed Rule, a banking organization will be assigned three component ratings:

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Capital Planning and Positions; Liquidity Risk Management and Positions; and Governance and Controls. Although the final LFI rating system retains a four-category, non-numeric rating scale, it identifies the top two categories as “Broadly Meets Expectations” and “Conditionally Meets Expectations” (rather than “Satisfactory” and “Satisfactory Watch,” as proposed) to align with the definitions of those categories.

The proposed LFI rating system would have applied to bank holding companies, non-insurance, non-commercial savings and loan holding companies, and U.S. intermediate holding companies of foreign banking organizations with \$50 billion or more in total consolidated assets. According to the FRB, the increase in the asset threshold to \$100 billion is “consistent with the minimum threshold for enhanced prudential standards established by [section 401 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (“EGRRCPA”)] as well as the [FRB’s] proposal to tailor certain of its regulations for domestic firms to implement EGRRCPA.”⁹ The FRB has retained the asset threshold of \$50 billion for U.S. intermediate holding companies as it continues to consider appropriate tailoring of its regulations for foreign banking organizations in light of EGRRCPA, but the FRB notes that it “may adjust this asset threshold in the future if necessary.”

A. LFI RATING SYSTEM COMPONENTS

Under the LFI rating system, the FRB will evaluate and assign ratings to LFIs for the following three components: Capital Planning and Positions, Liquidity Risk Management and Positions and Governance and Controls.

1. Capital Planning and Positions

The Capital Planning and Positions component encompasses an evaluation of (i) the effectiveness of a firm’s governance and planning processes used to determine the amount of capital necessary to cover risks and exposures and to support activities through a range of conditions; and (ii) the sufficiency of a firm’s capital positions to comply with applicable regulatory requirements and to support the firm’s ability to continue to serve as a financial intermediary through a range of conditions.

The Capital Planning and Positions component rating will reflect a broad assessment of the firm’s capital planning and positions, based on horizontal reviews and firm-specific supervisory work focused on capital planning and positions. According to the preamble, a firm’s compliance with minimum regulatory capital requirements will be considered in assigning the firm’s Capital Planning and Positions component rating; however, the FRB may determine that a firm does not meet expectations regarding its capital position in light of its idiosyncratic activities and risks, even if the firm meets minimum regulatory capital requirements. Findings from the Comprehensive Capital Analysis and Review (“CCAR”) process for LISCC firms and certain other large and complex LFIs, and from similar supervisory activities for other LFIs,¹⁰ will be used to help determine the Capital Planning and Positions component rating.¹¹ Consistent with requests from commenters, the FRB confirms in the preamble that the final LFI rating system does not create any new capital planning expectations applicable to LFIs.

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2. Liquidity Risk Management and Positions

The Liquidity Risk Management and Positions component encompasses an evaluation of (i) the effectiveness of a firm's governance and risk management processes used to determine the amount of liquidity necessary to cover risks and exposures and to support activities through a range of conditions; and (ii) the sufficiency of a firm's liquidity positions to comply with applicable regulatory requirements and to support the firm's ongoing obligations through a range of conditions.

The Liquidity Risk Management and Positions component rating will be based on findings of coordinated examinations of liquidity positions and risk management practices conducted across several firms (horizontal examinations), as well as ongoing assessments of an individual firm's liquidity positions and risk management practices conducted through the supervisory process.

3. Governance and Controls

The Governance and Controls component encompasses an evaluation of the effectiveness of a firm's (i) board of directors,¹² (ii) management of core business lines and independent risk management and controls, and (iii) recovery planning (for domestic LISCC firms only). This rating assesses a firm's effectiveness in aligning strategic business objectives with its risk appetite¹³ and risk management capabilities; maintaining effective and independent risk management and control functions, including internal audit; promoting compliance with laws and regulations, including those related to consumer protection; and otherwise planning for the ongoing resiliency of the firm.

The FRB has previously invited comment on two proposals that relate to the Governance and Controls component rating—the first would establish principles regarding effective boards of directors focused on the performance of a board's core responsibilities (the board effectiveness proposal),¹⁴ and the second would set forth core principles of effective senior management, the management of business lines, and independent risk management and controls for LFIs (the risk management proposal).¹⁵ As noted in the preamble, the FRB continues to consider comments on both proposals and is not adopting either proposal at this time. Given that the board effectiveness proposal is not finalized, the FRB intends to rely primarily on the principles set forth in SR letter 12-17/CA letter 12-14 and safety and soundness to assess the effectiveness of a firm's board of directors. Given that the risk management proposal is not finalized, the FRB will rely on existing risk management guidance to assess the effectiveness of a firm's management of business lines and independent risk management and controls.¹⁶

The preamble notes that U.S. intermediate holding companies will not be subject to examinations solely focused on effectiveness of the U.S. intermediate holding company's board of directors in recognition of the fact that a U.S. intermediate holding company is a subsidiary of a foreign banking organization. This was an important issue for foreign banking organizations. Rather, the FRB will indirectly assess the effectiveness of a U.S. intermediate holding company's board by considering whether weaknesses or deficiencies that are identified within the organization while conducting other supervisory work may be

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evidence of, or result from, governance-related oversight deficiencies. For example, governance-related oversight deficiencies could be noted in the context of a significant risk management or control weakness that is identified during an examination of capital planning or business line management.¹⁷

The FRB notes that it has determined not to include a separate component rating for a firm's resolution planning as part of the final LFI rating system, but will continue to consider whether the LFI rating system should be modified in the future to include an assessment of the sufficiency of a firm's resolution planning efforts.

B. LFI RATING SCALE

Each component of the LFI rating system is assigned a rating using a four-level scale: Broadly Meets Expectations; Conditionally Meets Expectations; Deficient-1; and Deficient-2. A firm must be rated "Broadly Meets Expectations" or "Conditionally Meets Expectations" for each of its component ratings to be considered "well managed" in accordance with various statutes and regulations that permit additional activities, prescribe expedited procedures or provide other benefits for "well managed" firms.¹⁸ The requirement for those ratings reflects the FRB's judgment that an LFI is not in satisfactory condition overall unless it is considered sound in each of the key areas of capital, liquidity, and governance and controls. In accordance with the FRB's regulations governing confidential supervisory information, ratings assigned under the LFI rating system will be communicated to the firm by the FRB but not disclosed publicly.

1. Broadly Meets Expectations

A "Broadly Meets Expectations" rating indicates that the firm's practices and capabilities broadly meet supervisory expectations, and the firm possesses sufficient financial and operational strength and resilience to maintain safe and sound operations through a range of conditions. The firm may be subject to identified supervisory issues requiring corrective action, but these issues are unlikely to present a threat to the firm's ability to maintain safe and sound operations through a range of conditions.

2. Conditionally Meets Expectations

A "Conditionally Meets Expectations" component rating indicates that there are certain material financial or operational weaknesses in a firm's practices or capabilities that may place the firm's prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.¹⁹

The FRB notes that it does not intend for a firm to be assigned a "Conditionally Meets Expectations" rating for a prolonged period, and will work with the firm to develop an appropriate time frame to fully resolve the issues leading to the rating assignment and merit upgrade to a "Broadly Meets Expectations" rating. As noted in the preamble, the final ratings framework reflects an understanding that completion and validation of remediation activities for selected supervisory issues—such as those involving

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information technology modifications—will require an extended time horizon. Unlike the Proposed Rule, the final ratings framework does not establish a fixed timeline for how long a firm can be rated “Conditionally Meets Expectations.”²⁰ There is the clear implication, however, that the failure to resolve the issues in a timely manner would most likely result in the firm’s downgrade to a “Deficient” rating.²¹ The Proposed Rule states that the “Conditionally Meets Expectations” rating is consistent with the FRB’s existing practice of providing notice that a downgrade to a less-than-satisfactory rating is likely if identified weaknesses are not resolved in a timely manner.

3. Deficient-1

A “Deficient-1” rating indicates that, although the firm’s current condition is not considered to be materially threatened, there are financial and/or operational deficiencies that put its prospects for remaining safe and sound through a range of conditions at significant risk. There is a “strong presumption” that a firm with a Deficient-1 component rating would be subject to either an informal or formal enforcement action.

The preamble notes that, consistent with the views of commenters, there is no presumption under the final LFI rating system that a firm rated “Deficient-1” would be deemed to be in “troubled condition.”²² Whether a firm rated “Deficient-1” receives a “troubled condition” designation will be determined by the facts and circumstances at that firm, but firms rated “Deficient-1” due to financial weaknesses in either capital or liquidity would be more likely to be deemed in “troubled condition” than firms rated “Deficient-1” due solely to issues of governance or controls.

A Deficient-1 component rating could also be a barrier for a firm seeking FRB approval to engage in new or expansionary activities, unless the firm can demonstrate that (i) it is making meaningful, sustained progress in resolving identified deficiencies and issues; (ii) the proposed new or expansionary activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and (iii) the proposed activities would not distract the board or senior management from remediating current deficiencies or issues. It remains to be seen whether, as a practical matter, a banking organization with a Deficient-1 component rating would ever meet these conditions.

Under the Final Rule, a firm previously rated “Deficient-1” may be upgraded to “Conditionally Meets Expectations” if the firm’s remediation and mitigation activities are sufficiently advanced so that its prospects for remaining safe and sound are no longer at significant risk, even if the firm has outstanding supervisory issues or is subject to an active enforcement action.

4. Deficient-2

A “Deficient-2” rating indicates financial or operational deficiencies in a firm’s practices or capabilities present a threat to the firm’s safety and soundness, or have already put the firm in an unsafe and unsound condition. There is a “strong presumption” that a firm with a Deficient-2 component rating would be subject to a formal enforcement action. The FRB states that it would be extremely unlikely to approve

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any proposal seeking to engage in new or expansionary activities from a firm with a Deficient-2 component rating. A firm with a “Deficient-2” rating should expect to be deemed to be in “troubled condition.”

The proposal provides the definitions of Broadly Meets Expectations, Conditionally Meets Expectations, Deficient-1 and Deficient-2 for each of the three components in the LFI rating system.

C. CHANGES TO EXISTING REGULATIONS

References to holding company ratings are included in a number of the FRB’s existing regulations. In certain cases, the regulations contemplate only the assignment of a stand-alone composite rating using a numerical rating scale, which is consistent with the current RFI/C(D) rating system but is not compatible with the LFI rating system. The FRB identifies three provisions in its existing regulations that are written in this manner, including two in Regulation K²³ and one in Regulation LL.²⁴ As noted in the preamble accompanying the Final Rule, the FRB is amending these provisions so they would apply to firms that receive numerical composite ratings as well as to firms that do not receive numerical composite ratings. To satisfy the requirements of these provisions, a firm subject to the LFI rating system will have to be rated “Broadly Meets Expectations” or “Conditionally Meets Expectations” for each component of the LFI rating system.

D. IMPLICATIONS

Perhaps the most important implication of the new rating system is that banking organizations are explicitly provided with a period of time to remedy even “material” weaknesses in a firm’s practices or capabilities before there is a downgrade to an “unsatisfactory”-type rating. There is a widely held view that banking organizations have been immediately downgraded to a “3,” or “unsatisfactory”-type rating, under the current rating system upon a determination of such weakness.

Another key implication relates to those institutions that are currently rated as a “3.” Under the new rating system, will they be rated as “Conditionally Meets Expectations,” which would presumably free them from the substantial restraints that a “3” rating imposes, or as “Deficient-1,” which would presumably continue those restraints.

Another important implication is that the new rating system still involves substantial subjectivity in the rating process.²⁵ Both the capital and liquidity components emphasize planning and risk management, as well as actual financial positions. The governance and control component is inherently subjective. The element of subjectivity may be intensified because an institution will not be considered well managed unless it is rated at least “Conditionally Meets Expectations” for each of the three rating components.

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¹ Under the Final Rule, total consolidated assets will be calculated based on the average of the firm's total consolidated assets in the four most recent quarters as reported in the firm's quarterly financial reports filed with the FRB. A firm will continue to be rated under the LFI rating system until it has less than \$95 billion in total consolidated assets, based on the average total consolidated assets as reported in the firm's four most recent quarterly financial reports filed with the FRB.

² See SR letter 12-17/CA letter 12-14, "Consolidated Supervisory Framework for Large Financial Institutions," available at <http://www.federalreserve.gov/bankinforeg/srletters/sr1217.htm>.

³ Under the current RFI/C(D) rating system, each bank holding company is assigned a composite rating (C) based on an evaluation and rating of its managerial and financial condition and an assessment of future potential risk to its subsidiary depository institution(s). The three main components of the rating system are: Risk Management (R); Financial Condition (F); and potential Impact (I) of the parent company and nondepository subsidiaries on the subsidiary depository institution(s). The fourth component rating, Depository Institution (D), generally mirrors the primary regulator's assessment of the subsidiary depository institution(s). The R and F components each have four subcomponents. For the R component, the subcomponents are board and senior management oversight; policies, procedures, and limits; risk monitoring and management information systems; and internal controls. For the F component, the subcomponents are capital, asset quality, earnings, and liquidity. The composite, component, and subcomponent ratings are assigned based on a 1 to 5 numerical score with 1 being the highest rating. See SR letter 04-18, "Bank Holding Company Rating System," 69 Fed. Reg. 70444 (December 6, 2004), available at <https://www.federalreserve.gov/boarddocs/srletters/2004/sr0418.htm>.

⁴ The Proposed Rule was published by the FRB in the Federal Register in August 2017. The Federal Reserve, *Large Financial Institution Rating System; Regulations K and LL*, 82 Fed. Reg. 39049 (August 17, 2017). For additional information regarding the Proposed Rule, see our memorandum to clients, *Federal Reserve Proposes New Rating System: Federal Reserve Proposes to Establish a New Rating System for the Supervision of Large Financial Institutions Designed to Align with the Supervisory Program for Those Institutions and to Enhance the Clarity and Consistency of Supervisory Assessments* (August 7, 2017), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Federal_Reserve_Proposes_New_Rating_System.pdf.

⁵ The LISCC framework is designed to materially increase the financial and operational resiliency of systemically important financial institutions to reduce the probability of, and cost associated with, their material financial distress or failure. Firms subject to the LISCC framework include certain large bank holding companies, the U.S. operations of certain foreign banking organizations, and systemically important nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the FRB. See <https://www.federalreserve.gov/bankinforeg/large-institution-supervision.htm>.

⁶ See SR letter 04-18, "Bank Holding Company Rating System," 69 Fed. Reg. 70444 (December 6, 2004), available at <https://www.federalreserve.gov/boarddocs/srletters/2004/sr0418.htm>.

⁷ The preamble notes that bank holding companies with total consolidated assets of at least \$50 billion but less than \$100 billion will continue to be evaluated subject to the RFI rating system. The FRB states that it is currently reviewing existing supervisory guidance with respect to these firms to determine whether it is appropriate to make revisions to further distinguish supervisory expectations for firms with total consolidated assets of less than \$100 billion.

Concurrently with the Final Rule, the FRB adopted a final rule to apply the RFI rating system on a fully implemented basis to all savings and loan holding companies with total consolidated assets of less than \$100 billion, excluding savings and loan holding companies engaged in significant insurance or commercial activities. As noted in the preamble, the FRB had applied the RFI rating

ENDNOTES (CONTINUED)

system to savings and loan holding companies on an indicative basis since assuming supervisory responsibility for those firms from the Office of Thrift Supervision in 2011. The FRB continues to consider the appropriate regulatory regime for savings and loan holding companies that are predominantly engaged in insurance or commercial activities. Accordingly, the FRB will continue to rate these savings and loan holding companies on an indicative basis under the RFI rating system as it considers further the appropriate manner to assign supervisory ratings to such firms on a permanent basis.

As noted in the preamble, the FRB continues to consider the appropriate regulatory regime for systemically important nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the FRB.

⁸ “Financial strength and resilience” is defined as maintaining effective capital and liquidity governance and planning processes, and sufficiency of related positions, to provide for continuity of the consolidated organization (including its critical operations and banking offices) through a range of conditions.

“Operational strength and resilience” is defined as maintaining effective governance and controls to provide for the continuity of the consolidated organization (including its critical operations and banking offices) and to promote compliance with laws and regulations, including those related to consumer protection, through a range of conditions.

“Critical operations” are a firm’s operations, including associated services, functions and support, the failure or discontinuance of which, in the view of the firm or the FRB, would pose a threat to the financial stability of the United States.

⁹ Section 401 of EGRRCPA amended section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act to modify the \$50 billion minimum asset threshold for general application of enhanced prudential standards. Public Law 115–174, section 401, 132 Stat. 1296 (2018). Effective immediately on the date of EGRRCPA’s enactment on May 24, 2018, bank holding companies with total consolidated assets equal to or greater than \$50 billion and less than \$100 billion were no longer subject to these standards.

Section 401(f) of EGRRCPA also provides that any bank holding company, regardless of asset size, that has been identified as a Global Systemically Important Bank (GSIB) under the FRB’s GSIB capital surcharge rule shall be considered a bank holding company with \$250 billion or more in total consolidated assets for purposes of applying the standards under section 165 and certain other provisions.

¹⁰ In 2017, the FRB amended its capital plan rule, Section 225.8 of Regulation Y, to eliminate the qualitative assessment in CCAR for “large and noncomplex” firms, *i.e.*, those that are not U.S. G-SIBs and have less than \$250 billion of total consolidated assets and less than \$75 billion of total nonbank assets. For additional information on the elimination of the qualitative assessment for large and noncomplex firms, see our memorandum to clients, *Banking Organization Capital Plans and Stress Tests: Federal Reserve Finalizes Elimination of the Qualitative CCAR Assessment for Smaller Firms, Reduction in the De Minimis Exception for Additional Capital Distributions, and Other Notable Revisions to its Capital Plan and Stress Testing Rules* (February 1, 2017), available at <https://sullcrom.com/banking-organization-capital-plans-and-stress-tests-02-01-2017>. The FRB assesses the capital planning processes of large and noncomplex firms through horizontal reviews, separate from the CCAR process. For additional information on the 2017 horizontal capital review for those firms, see our memorandum to clients, *Banking Organization Capital Plans and Stress Tests: Federal Reserve Issues Instructions, Guidance and Supervisory Scenarios for the 2017 Comprehensive Capital Analysis and Review Program* (February 6, 2017), available at <https://www.sullcrom.com/banking-organization-capital-plans-and-stress-tests-02-06-17>.

¹¹ The FRB’s supervisory expectations for capital planning at large bank and intermediate holding companies are set forth in SR letter 15-18 (for LISCC firms and certain other large and complex

ENDNOTES (CONTINUED)

- firms) and SR letter 15-19 (for large and noncomplex firms). For a discussion of SR letters 15-18 and 15-19, see our memorandum to clients, *Bank Capital Plans and Stress Tests: Federal Reserve Board Issues Consolidated Guidance on Supervisory Expectations for Capital Planning at Large Bank Holding Companies* (December 30, 2015), available at <https://www.sullcrom.com/bank-capital-plans-and-stress-tests-12-30-15>.
- ¹² The Final Rule notes that references to “board” or “board of directors” in the rating system framework include the equivalent to a board of directors, as appropriate, as well as committees of the board of directors or the equivalent thereof, as appropriate.
- ¹³ Under the Final Rule, “risk appetite” is defined as the aggregate level and types of risk the board and senior management are willing to assume to achieve the firm’s strategic business objectives, consistent with applicable capital, liquidity, and other requirements and constraints.
- ¹⁴ The Federal Reserve, *Proposed Guidance on Supervisory Expectations for Boards of Directors*, 82 FR 37219 (August 9, 2017). For additional information, see our memorandum to clients, *Federal Reserve Proposes to Refocus Expectations for Banking Organization Directors on Core Responsibilities: Proposal Recognizes the Distinct Role of the Board as Compared to Management and the Adverse Impact of Unduly Extensive Requirements on the Board’s Attention and Effectiveness* (August 7, 2017), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Federal_Reserve_Proposes_to_Refocus_Expectations_for_Banking_Organization_Directors_on_Core_Responsibilities.pdf.
- ¹⁵ The Federal Reserve, *Proposed Supervisory Guidance*, 83 FR 1351 (January 11, 2018). For additional information, see our memorandum to clients, *Federal Reserve Proposes Guidance to Clarify Supervisory Expectations Related to Risk Management for Large Financial Institutions: Proposed Guidance Presents Core Principles for Effective Senior Management, Management of Business Lines, and Independent Risk Management and Controls* (January 8, 2018), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Federal_Reserve_Proposes_Guidance_to_Clarify_Supervisory_Expectations_Related_to_Risk_Management_for_Large_Financial_Institutions.pdf.
- ¹⁶ Existing risk management guidance includes SR letter 95-51, “Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies”; SR letter 03-5, “Amended Interagency Guidance on the Internal Audit Function and its Outsourcing”; SR letter 12-17/CA letter 12-14, “Consolidated Supervision Framework for Large Financial Institutions”; SR letter 10-6, “Interagency Policy Statement on Funding and Liquidity Risk Management”; SR letter 13-1/CA letter 13-1, “Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing”; SR letter 13-19/CA letter 13-21, “Guidance on Managing Outsourcing Risk”; SR letter 15-18, “Supervisory Assessment of Capital Planning and Positions for LISC Firm and Large and Complex Firms”; and SR letter 15-19, “Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms.” In addition, Regulation YY sets forth risk management requirements, including liquidity risk management requirements.
- ¹⁷ The preamble accompanying the Final Rule notes that the FRB will continue to evaluate the U.S. branches of foreign banks under the ROCA system, and assign a single component rating to the foreign banking organization’s U.S. operations. The FRB is considering adjustments to the ratings for U.S. branches and the U.S. operations of foreign banking organizations to better align with the LFI framework.
- ¹⁸ For example, under the Bank Holding Company Act and the Home Owners’ Loan Act, companies that have elected to be treated as financial holding companies and that do not remain “well managed” face restrictions on commencement or expansion of certain activities.
- ¹⁹ In response to requests for clarification by commenters, the FRB provides that, under the final LFI rating system, “normal course of business” means that a firm has the ability to resolve these issues through measures that do not require a material change to the firm’s business model or financial profile, or its governance, risk management, or internal control structures or practices.

ENDNOTES (CONTINUED)

- ²⁰ The Proposed Rule indicated that the FRB would provide firms that receive a “Satisfactory Watch” rating with a specified time frame (generally no longer than 18 months) to fully resolve the issues leading to that rating.
- ²¹ As noted in the preamble, the FRB acknowledges that there are circumstances when a firm may be rated “Conditionally Meets Expectations” for a longer period of time if, for instance, the firm is close to completing resolution of the supervisory issues leading to the “Conditionally Meets Expectations” rating, but new issues may be identified that, taken alone, would be consistent with a “Conditionally Meets Expectations” rating. In this event, the firm may continue to be rated “Conditionally Meets Expectations,” provided the new issues do not reflect a pattern of deeper or prolonged capital planning or position weaknesses consistent with a “Deficient” rating.
- ²² The ramifications of a “troubled condition” designation (as defined in 12 C.F.R. § 225.71(d)) include the application of the “golden parachute” regulations (12 C.F.R. Part 359). In addition, under Subpart H of Regulation Y, a firm in “troubled condition” must give the FRB 30 days’ written notice before adding or replacing any member of its board of directors, employing any person as a senior executive officer, or changing the responsibilities of any senior executive officer so that the person would assume a different senior executive officer position. See 12 C.F.R. § 225.72(a).
- ²³ Section 211.2(z) of Regulation K includes a definition of “well managed” which in part requires a bank holding company to have received a composite rating of 1 or 2 at its most recent examination or review; and Section 211.9(a)(2) of Regulation K requires an investor (which by definition can be a bank holding company) to have received a composite rating of at least 2 at its most recent examination in order to make investments under the general consent or limited general consent procedures contained in Sections 211.9(b) and (c).
- ²⁴ Section 238.54(a)(1) of Regulation LL restricts savings and loan holding companies from commencing certain activities without the FRB’s prior approval unless the company received a composite rating of 1 or 2 at its most recent examination.
- ²⁵ The preamble states that the FRB is implementing staff training and will undertake a multilevel review and vetting before ratings are assigned in order to ensure that ratings are assigned in a consistent and fair manner.

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