SUMMARY

On December 17, 2012, the staff of the Federal Reserve issued a Supervision and Regulation ("SR") letter describing the Federal Reserve’s new framework for consolidated supervision of large financial institutions. SR letters address significant policy and procedural matters related to the Federal Reserve’s supervisory responsibilities.

Under the new framework, the Federal Reserve’s primary supervisory objectives for large financial institutions will be (1) to enhance resiliency of an institution to lower the probability of its failure or its becoming unable to serve as a financial intermediary, and (2) to reduce the impact on the financial system and the broader economy of an institution’s failure or material weakness. These objectives are meant to conform to key provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, such as enhanced prudential standards for large financial institutions. Although the Federal Reserve has not previously stated these objectives as its primary supervisory objectives, and the new framework formally integrates areas such as corporate governance and compensation that Federal Reserve staff has been focused on since the financial crisis, changes in specific supervisory expectations are limited. Changes include greater emphasis on recovery planning in the case of financial or operational weakness, and on orderly resolution planning, as required by the Dodd-Frank Act. The Federal Reserve will also engage in greater “macroprudential” supervision to detect systemic risks.

The new framework applies to the largest and most complex financial institutions subject to consolidated Federal Reserve supervision, including nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve; other domestic bank and savings and loan
holding companies with consolidated assets of $50 billion or more; and other foreign banking organizations with combined assets of U.S. operations of $50 billion or more.

BACKGROUND

The Federal Reserve’s previous supervision framework for large financial institutions was issued in 1999 and applied to “large complex banking organizations,” which were selected based on qualitative factors and not strictly by size. The 1999 framework was procedure-oriented, and its approach was designed by the Federal Reserve to achieve a flexible supervisory framework as a result of market and technological changes. Particular requirements included development of systems and procedures for continuous identification and monitoring of risks and provision of a continuous flow of meaningful information to supervisory staff, as well as regular communication with supervisory staff. Federal Reserve supervisory staff was directed to maintain a comprehensive supervisory plan tailored to the organization and updated frequently, and to share information within the Federal Reserve and with other supervisory authorities.

In October 2008, during the financial crisis, the Federal Reserve enhanced the 1999 framework with additional guidance on specific areas of focus for its consolidated supervision program. The enhanced framework emphasized several specific elements intended to make the financial system more resilient, such as consideration of corporate governance, capital adequacy, funding and liquidity management, and supervision of material nonbank subsidiaries. The Federal Reserve stated that it would pay particular attention to risk management systems and internal controls used by large complex banking organizations that provide core clearing and settlement functions or that have a significant presence in critical or key financial markets.

The framework established by the new SR letter applies to three types of institutions:

- **Large Institution Supervision Coordinating Committee (“LISCC”) Firms.** The largest and most complex U.S. and foreign financial organizations subject to consolidated supervision by the Federal Reserve (including nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve). Supervision of these organizations will be overseen by the LISCC, which is a multidisciplinary body of Federal Reserve staff that also develops cross-firm perspectives and monitors interconnectedness and common practices that could lead to greater systemic risk. The institutions in its portfolio are considered to pose the greatest systemic risk to the U.S. economy.

---

1. The previous framework was published in Federal Reserve SR Letter 99-15, “Risk-Focused Supervision of Large Complex Banking Organizations” (superseded).
3. No such institutions have yet been designated by the Financial Stability Oversight Council.
4. The LISCC was established in 2010 as the successor to the Large Financial Institutions section of the Banking Supervision and Regulation division of the Federal Reserve. The LISCC includes not only supervisory staff but also staff from research, legal and other divisions at the Federal Reserve and the markets and payments systems groups at the Federal Reserve Bank of New York.
DISCUSSION
The new framework has two primary objectives:

- Enhancing the resiliency of a firm to lower the probability of its failure or its becoming unable to serve as a financial intermediary; and
- Reducing the impact on the financial system and the broader economy of a firm’s failure or material weakness.

According to the SR letter, these objectives are consistent with key provisions of the Dodd-Frank Act, including the enhanced prudential standards of Section 165. The supervisory framework is designed for institutions in at least satisfactory condition with no material weaknesses or risks in core areas of supervisory focus. Weaker institutions will be subject to additional supervisory expectations.

Changes to supervisory expectations in the new framework as a result of these new objectives are described below.

Enhanced Resiliency. The purpose of this objective is to “ensure that the consolidated organization (or the combined U.S. operations in the case of foreign banking organizations) and its core business lines can survive under a broad range of internal or external stresses.” The core areas of supervisory focus for this objective include capital and liquidity planning and positions and management of core business lines, which are not new areas of focus, and specific supervisory expectations in these areas are similar to those under the previous framework. Effective corporate governance established by an institution’s board of directors, including compensation arrangements, has been a prominent area of supervisory focus since the financial crisis and is integrated into the new framework as a core area, although the specific supervisory expectations are consistent with the 2008 enhancements and previous supervisory pronouncements. The new framework more strongly emphasizes recovery planning. According to the SR letter, robust recovery planning is central to ensuring the ongoing resiliency of an institution’s consolidated operations, and each institution should plan for potential financial or operational weaknesses and identify actions to correct those weaknesses. Supervisory expectations include:

- Clearly documented quantitative and qualitative criteria, reflecting a sufficiently broad range of market- and firm-specific stresses across various risk areas, that would trigger timely implementation of specific elements of the firm’s recovery plan;
- Recovery planning that reflects a holistic view of sustainability and resiliency, is closely integrated with resolution, capital and liquidity planning and other aspects of financial contingency, crisis management and business continuity planning, and involves testing and training exercises; and
A recovery plan that is updated as needed, integrated into corporate governance, independently validated, and effectively supported by management information systems reporting to the board.

*Reduced Impact of Failure or Material Weakness.* The purpose of this objective is to “ensure the sustainability of [a firm’s] critical operations and banking offices under a broad range of internal or external stresses.” The core areas of supervisory focus for this objective include management and resiliency of critical operations and support by the consolidated institution for banking offices. These are also not new areas of focus, and specific supervisory expectations in these areas are similar to those under the previous framework. The new framework adds orderly resolution planning as a core area of focus. The Dodd-Frank Act requires bank holding companies with consolidated assets of $50 billion or more and nonbank financial companies supervised by the Federal Reserve to develop and maintain plans for rapid and orderly resolution in the event of material financial distress or failure (often called “living wills”). According to the SR letter, these resolution plans should be utilized as an element of the firm’s strategic planning and address the complexity and interconnectivity of the firm’s operations. Supervisory review of the resolution plan is expected to consider the following:

- Whether the firm’s resolution strategy inappropriately poses systemic risk or relies on extraordinary government support to prevent failure;
- The firm’s strategy for maintaining and funding operations in the event of material financial distress, analysis of potential impediments to resolution, and whether the failure of a major counterparty would likely result in the material financial distress or failure of the firm;
- Whether an insured depository subsidiary is adequately protected from risks arising from non-depository subsidiaries, and, for U.S. firms with foreign operations, the firm’s strategy for addressing the risks arising from these foreign operations to its U.S. operations, as well as the firm’s ability to maintain operations in foreign jurisdictions; and
- Whether resolution planning is sufficiently integrated into corporate governance, subject to independent validation, and effectively supported by management information systems.

In addition, according to the SR letter, the Federal Reserve will also go beyond focusing on safety and soundness of individual firms (“microprudential” supervision) and, as required by the Dodd-Frank Act, consider the broader risks to financial stability posed by individual companies and the interconnectedness among these companies. The Federal Reserve will use its supervisory expertise on individual institutions and inter-agency data from other domestic and foreign supervisors to engage in “macroprudential” supervision and better detect and address emerging threats to financial stability that arise across many firms. This does not create additional supervisory expectations for supervised institutions.

The SR letter also implies that the Federal Reserve’s increasing use of horizontal reviews will continue, as it specifically notes that the Federal Reserve will conduct coordinated horizontal reviews of several

---

5 “Banking offices” are defined as U.S. depository institution subsidiaries, as well as the U.S. branches and agencies of foreign banking organizations.
institutions simultaneously. Examples include the Comprehensive Capital Analysis and Review of capital adequacy and planning, and horizontal evaluations of resolution plans and compensation practices.

**Implementation.** The new framework is being implemented in a multi-stage approach, and the Federal Reserve will develop additional supervisory and operational guidance to support implementation of the new framework and assess the progress of firms in meeting supervisory expectations.
ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Jay Plum (+1-212-558-4049; plumj@sullcrom.com) in our New York office.

CONTACTS

New York

Whitney A. Chatterjee   +1-212-558-4883  chatterjeew@sullcrom.com
H. Rodgin Cohen         +1-212-558-3534  cohenhr@sullcrom.com
Elizabeth T. Davy       +1-212-558-7257  davye@sullcrom.com
Mitchell S. Eitel       +1-212-558-4960  eitelm@sullcrom.com
Michael T. Escue        +1-212-558-3721  escuem@sullcrom.com
C. Andrew Gerlach       +1-212-558-4789  gerlacha@sullcrom.com
Andrew R. Gladin        +1-212-558-4080  gladina@sullcrom.com
Wendy M. Goldberg       +1-212-558-7915  goldbergw@sullcrom.com
Janine C. Guido         +1-212-558-3154  guidoj@sullcrom.com
Erik D. Lindauer        +1-212-558-3548  lindauere@sullcrom.com
Jiang Liu               +1-212-558-3093  liujia@sullcrom.com
Mark J. Menting         +1-212-558-4859  mentingm@sullcrom.com
Camille L. Orme         +1-212-558-3373  ormec@sullcrom.com
Rebecca J. Simmons      +1-212-558-3175  simmonsr@sullcrom.com
Donald J. Toumey        +1-212-558-4077  toumeyd@sullcrom.com
Marc Trevino            +1-212-558-4239  trevinom@sullcrom.com
Mark J. Welshimer       +1-212-558-3669  welshimerm@sullcrom.com
Michael M. Wiseman      +1-212-558-3846  wisemanim@sullcrom.com
## Federal Reserve Supervision

Decided

SC1:3351832.2

**Washington, D.C.**

<table>
<thead>
<tr>
<th>Name</th>
<th>Phone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eric J. Kadel, Jr.</td>
<td>+1-202-956-7640</td>
<td><a href="mailto:kadelej@sullcrom.com">kadelej@sullcrom.com</a></td>
</tr>
<tr>
<td>William F. Kroener III</td>
<td>+1-202-956-7095</td>
<td><a href="mailto:kroenerw@sullcrom.com">kroenerw@sullcrom.com</a></td>
</tr>
<tr>
<td>J. Virgil Mattingly</td>
<td>+1-202-956-7028</td>
<td><a href="mailto:mattinglyv@sullcrom.com">mattinglyv@sullcrom.com</a></td>
</tr>
<tr>
<td>Stephen H. Meyer</td>
<td>+1-202-956-7605</td>
<td><a href="mailto:meyerst@sullcrom.com">meyerst@sullcrom.com</a></td>
</tr>
<tr>
<td>Andrea R. Tokheim</td>
<td>+1-202-956-7015</td>
<td><a href="mailto:tokheima@sullcrom.com">tokheima@sullcrom.com</a></td>
</tr>
<tr>
<td>Samuel R. Woodall III</td>
<td>+1-202-956-7584</td>
<td><a href="mailto:woodalls@sullcrom.com">woodalls@sullcrom.com</a></td>
</tr>
</tbody>
</table>

**Los Angeles**

<table>
<thead>
<tr>
<th>Name</th>
<th>Phone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Patrick S. Brown</td>
<td>+1-310-712-6603</td>
<td><a href="mailto:brownp@sullcrom.com">brownp@sullcrom.com</a></td>
</tr>
<tr>
<td>Stanley F. Farrar</td>
<td>+1-310-712-6610</td>
<td><a href="mailto:farrars@sullcrom.com">farrars@sullcrom.com</a></td>
</tr>
</tbody>
</table>

**Tokyo**

<table>
<thead>
<tr>
<th>Name</th>
<th>Phone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Keiji Hatano</td>
<td>+81-3-3213-6171</td>
<td><a href="mailto:hatanok@sullcrom.com">hatanok@sullcrom.com</a></td>
</tr>
</tbody>
</table>