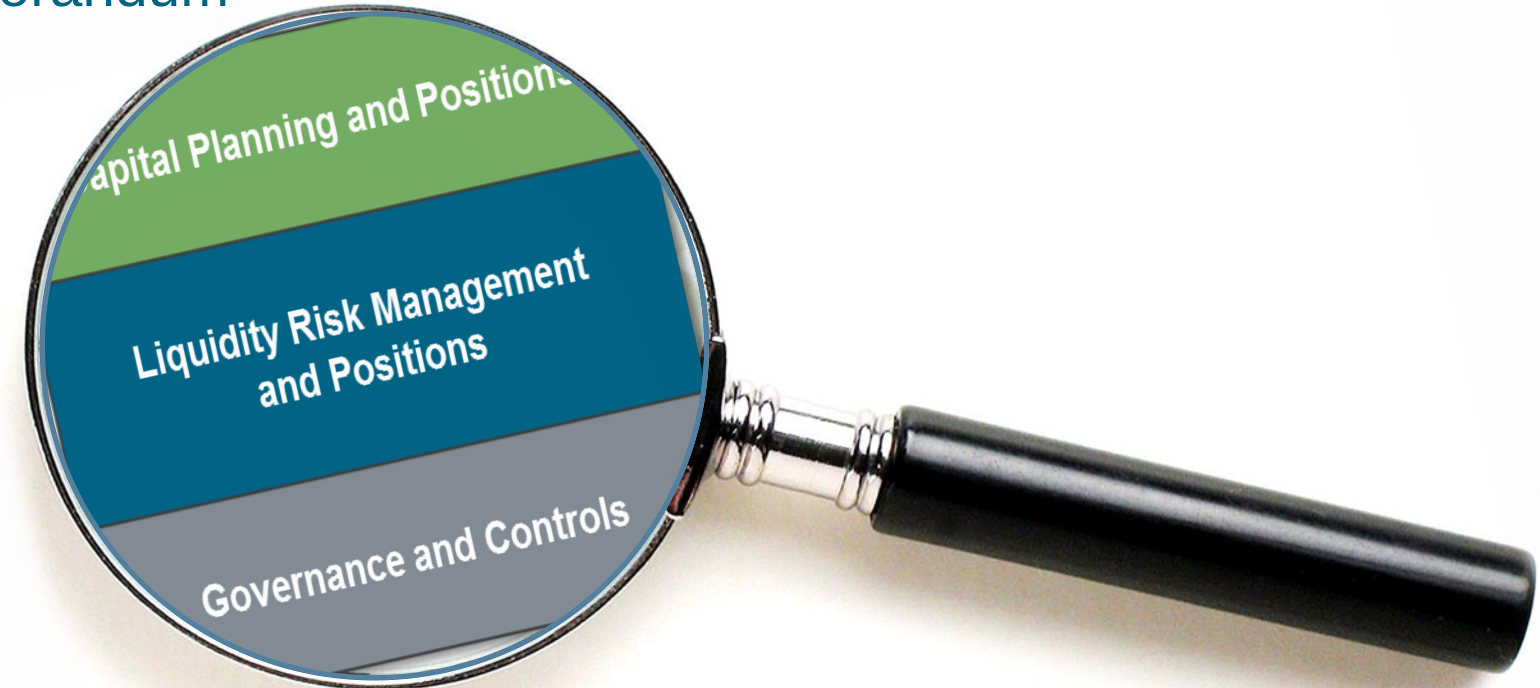
The Federal Reserve's Proposed Large Financial Institution Rating System—Application to a Large U.S. Financial Institution

Visual Memorandum



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For our discussion of the Fed's companion Governance Proposal and an in-depth discussion of certain elements of the Governance and Controls Component of the LFI Rating System, please see our **companion visual memorandum**

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Introduction to LFI Rating System

- In August 2017, the Federal Reserve proposed a new supervisory rating system for large financial institutions (**LFI rating system**)
- Even though the composition of the Board of Governors has changed since August, and more changes are to come, we do not expect these changes to alter the Federal Reserve's direction of travel in this area
- Randal Quarles, the Vice Chair for Supervision, has said that revisions to the Fed's supervisory processes are high on his agenda
- Comments on the LFI rating system were originally due on October 10, 2017 and the due date was later extended to February 15, 2018. It seems unlikely that the proposal will, as originally intended, apply during 2018

The Current Regime

The Fed's RFI/C(D) rating system, established in 2004, is **one size fits all** and applies to all bank holding companies, regardless of size or complexity.

The similar CAMELS rating system for banks has also been criticized as an unduly blunt instrument:

> *"The CAMELS rating system was adopted to evaluate an institution's … safety and soundness. Over time, however, CAMELS ratings have become progressively more* ***arbitrary, subjective and compliance focused.*** *Perhaps because capital, liquidity and other factors are now regulated directly and specifically, the CAMELS rating has come to focus myopically on the one highly subjective factor: Management."*
>
> \- Greg Baer, President, The Clearing House Association

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Introduction to LFI Rating System

- The LFI rating system is intended to:
  - Fully align with the LFI supervision framework that the Federal Reserve established in 2012 and its heightened supervisory expectations for LFIs;
  - Enhance the clarity and consistency of supervisory assessments and communications of supervisory findings and implications; and
  - Provide appropriate incentives for LFIs to maintain financial and operational strength and resilience, including compliance with laws and regulations, by more clearly defining the consequences of a given rating
- As discussed in our companion visual memorandum, the Federal Reserve in August also proposed new supervisory guidance on corporate governance for LFIs (**Governance Proposal**), and in January proposed new supervisory guidance for senior management, business line management, independent risk management and internal controls for LFIs (the **Management Guidance**)
- Although there were certain variations among the proposals, each generally set applicability thresholds at asset sizes of $50 billion or greater. We expect that, in light of the passage of the Bipartisan Banking Act, the final versions of the proposals will adjust those thresholds upwards. Our visual memorandum on the Bipartisan Banking Act is available here

Introduction to LFI Rating System

LFI Supervision Framework

- The LFI supervision framework, which is described in SR Letter 12-17, has two core objectives:
  - Reducing the probability of an LFI failing or experiencing material distress, and
  - Reducing the risk to U.S. financial stability if an LFI were to fail
- Like the LFI supervision framework and the Federal Reserve's expectations for LFIs, the LFI rating system would put **greater emphasis** than under the current rating system on **capital and liquidity**, evaluating not only an LFI's quantitative levels of capital and liquidity but also its related planning and risk management practices

Key Features of LFI Rating System

Three Components

- Under the LFI rating system, an LFI would be evaluated and rated on three components to assess whether it has **sufficient financial and operational strength and resilience** to maintain safe and sound operations **through a range of conditions**

Capital Planning and Positions	Liquidity Risk Management and Positions	Governance and Controls

Financial strength and resilience means maintaining effective capital and liquidity governance and planning processes, and sufficiency of related positions, to provide for continuity of the consolidated organization and its core business lines, critical operations, and banking offices through a range of conditions

Operational strength and resilience means maintaining effective governance and controls to provide for continuity of the consolidated organization and its core business lines, critical operations, and banking offices, and promote compliance with laws and regulations, including those related to consumer protection, through a range of conditions

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Key Features of LFI Rating System

Three Components

Capital Planning and Positions	Liquidity Risk Management and Positions	Governance and Controls
Evaluation of: ▪ 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 ▪ 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 See page 18 for more details.	Evaluation of: ▪ 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 ▪ 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 See page 19 for more details.	Evaluation of the effectiveness of a firm's: ▪ board of directors; ▪ management of business lines and independent risk management (**IRM**) and controls; and ▪ recovery planning See page 20 and our companion visual memorandum for more details.

Asset Quality and Earnings: In contrast to the RFI rating system, asset quality and earnings are not identified as specific elements of a particular component in the LFI rating system. The Federal Reserve did state, however, that although these two areas are not rated separately, they continue to be important elements in assessing a firm's safety and soundness and resiliency, and are important considerations within each of the LFI component ratings.

Key Features of LFI Rating System

Horizontal Evaluations

- The Federal Reserve would use **horizontal evaluations** as well as firm-specific evaluations to help determine the rating for each of the three LFI rating system components
- The express mention of horizontal evaluations as part of the LFI rating system suggests that, in determining a firm's ratings, the Federal Reserve will consider the relative strengths and weaknesses of the firm as determined in comparison to other similar firms
- The Federal Reserve did not specify, however, whether and to what degree it may apply a best practices standard and/or penalize firms that apply different practices and standards

Key Features of LFI Rating System

NO COMPOSITE RATING

- The Federal Reserve's current RFI/C(D) system assigns ratings to BHCs on a 1 (highest) to 5 (lowest) rating scale across five elements:
  - **R**isk management (divided into subcomponents including board and senior management oversight; policies, procedures and limits)
  - **F**inancial condition (divided into subcomponents of capital, liquidity, asset quality and earnings)
  - **I**mpact (of nondepository affiliates on bank subsidiaries)
  - **C**omposite
  - **D**epository institutions (generally reflects the CAMELS rating by the bank regulator)
- The CAMELS rating system likewise assigns a composite rating
- The Federal Reserve would **not assign a standalone composite rating** under the LFI rating system
  - According to the Federal Reserve, it is unlikely that a standalone composite rating would convey new or additional information regarding supervisory assessments, and a composite rating could dilute the clarity and impact of the component ratings

Key Features of LFI Rating System

No Subcomponent Ratings and No Management rating

No Subcomponent Ratings

- Unlike the RFI rating system, no ratings would be assigned for particular elements of the three components of the LFI rating system

No Management Rating

- No single component in the LFI rating system would be designated as a management rating for purposes of determining whether a firm is considered "well managed" for purposes of the Bank Holding Company Act of 1956 and related regulations because each component evaluates different areas of the firm's management
  - A holding company **must satisfy** the requirements of **all three** components of the LFI rating system in order to be considered "**well managed**"

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Key Features of LFI Rating System

Weighting Elements in Assigning a Component Rating

- The weighting of individual elements within each LFI component rating would depend on their relative contribution to the rating definitions as outlined in the proposal
- For example, a limited number of significant deficiencies – or even just one significant deficiency – identified for management of a single CBL could be viewed as sufficiently important to warrant a "Deficient" Governance and Controls component rating, even if the firm meets supervisory expectations under the Governance and Controls component in all other respects

Key Features of LFI Rating System

Potential Resolution Planning Component

- The Federal Reserve stated that in the future it may propose to include an additional rating component to assess the sufficiency of resolution planning efforts undertaken by Large Institution Supervision Coordinating Committee (**LISCC**) firms – currently 13 firms, including all U.S. G-SIBs – and perhaps certain other LFIs
- The Federal Reserve sought public comment on whether the LFI rating system should be revised to assess the sufficiency of a firm's resolution planning efforts and, if so, what the Federal Reserve should specifically consider in conducting that assessment

LFI Rating Scale

Overview

- Each LFI component (Capital Planning and Positions, Liquidity Risk Management and Positions, and Governance and Controls) would be rated according to a four-category scale, as shown below, in contrast to the five-point numerical scale used in the current RFI system

Satisfactory	Satisfactory Watch	Deficient-1	Deficient-2
▪ The firm is considered safe and sound and broadly meets supervisory expectations	▪ The firm is generally considered safe and sound, but there are certain sufficiently material issues that, if not resolved in a timely manner in the normal course of business, would put the firm's prospects for remaining safe and sound through a range of conditions at risk ▪ See page 14 for more details about this rating	▪ 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	▪ Financial and/or operational deficiencies materially threaten the firm's safety and soundness, or have already put the firm in an unsafe and unsound condition

LFI Rating Scale

Criteria to be Considered Well Managed

Satisfactory	Satisfactory Watch	Deficient-1	Deficient-2
Well managed	Well managed	Not well managed	Not well managed

- Status as a financial holding company is contingent on retention of a **well managed** rating, among other criteria
- To be well managed means to have sufficient financial and operational strength and resilience to maintain safe and sound operations through a range of conditions
- Under the LFI Rating Proposal, a firm must be rated **Satisfactory** or **Satisfactory Watch** for **each** component rating in order to be considered well managed
- A firm with a **Deficient-1** or **Deficient-2** rating on **any** component would not be considered well managed

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LFI Rating Scale

Satisfactory Watch Rating

Remediation in Normal Course of Business

- In considering whether supervisory issues are likely to be resolved in the normal course of business, as required with a Satisfactory Watch rating, the Federal Reserve will assess the firm's ability to timely remediate or mitigate the issues, through **compensating controls and/or a reduced risk profile**, without material changes to, or investments in, the firm's governance, risk management or internal control structures, practices, or capabilities
  - This focus on timely remediating issues in the normal course of business suggests that the assignment of a Satisfactory Watch vs. a Deficient-1 rating could turn on not only the nature of the identified issue(s) but also the firm's capabilities to address them through business-as-usual processes and structures

Supervisory Focus

- For a firm with a Satisfactory Watch rating, supervisors would focus on determining whether the relevant issues are related to each other, are similar in nature or root cause, or constitute a pattern reflecting **deeper governance or risk management weaknesses**, warranting a downgrade to a Deficient rating

LFI Rating Scale

SATISFACTORY WATCH RATING

Timeframe

- A Satisfactory Watch rating is not intended to be used for a prolonged period, and the Federal Reserve would specify a timeframe, generally no more than **18 months**, for the firm to fully resolve the issues
  - The timeframe for resolving issues will become more precise over time and may be extended by the Federal Reserve as circumstances warrant
  - If the firm successfully resolved the issues, it would typically be upgraded to Satisfactory
  - If the firm failed to timely remediate or mitigate the issues, the Federal Reserve would generally view that failure as evidence that the firm lacked sufficient financial and/or operational capabilities to remain safe and sound through a range of conditions, and would typically downgrade the firm to a Deficient rating

Request for Comment

The Federal Reserve requested comment on whether the proposal clearly describes how and under what circumstances a Satisfactory Watch rating would or would not be assigned and whether the rating provides appropriate messaging and incentives to firms to correct identified deficiencies

Consequences of Deficient Ratings

- A firm with a Deficient-1 or Deficient-2 rating for **any** component would not be considered “well managed,” reflecting the Federal Reserve’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
- The chart below sets out consequences of a Deficient rating on **any** component of the LFI rating system

	Deficient-1	Deficient-2
Limitations on New or Expansionary Activities	▪ A Deficient-1 rating could be a barrier for a firm seeking approval to engage in new or expansionary activities, unless the firm can demonstrate that: ▪ it is making meaningful, sustained progress in resolving identified deficiencies and issues; ▪ the proposed activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and ▪ the proposed activities would not distract the board or senior management from remediating current deficiencies or issues	▪ The Federal Reserve would be extremely unlikely to approve any proposal seeking to engage in new or expansionary activities from a firm with a Deficient-2 rating
Enforcement Action	▪ The firm may be subject to an informal or formal enforcement action ▪ The firm may be designated as being in “troubled condition”	▪ The firm should expect to be subject to a formal enforcement action and deemed to be in “troubled condition”
Other	▪ A firm with less than satisfactory ratings may face restrictions or higher charges in accessing the Federal Reserve’s discount window or obtaining intraday credit	

SR Letter 14-2 identifies other factors that must or may be considered in evaluating proposals from firms with less-than-satisfactory ratings. It is not clear how that guidance and this proposal may be aligned

Implementation of LFI Rating System

Timing

- Originally, the Federal Reserve envisioned that initial LFI ratings would be assigned to all applicable firms during 2018, but, given the delay in the comment period, that date will be pushed back
    - Firms may receive their initial LFI ratings at different times due to timing differences in the supervisory cycles across the Federal Reserve's supervisory portfolios
    - Going forward, LFI ratings would be assigned and communicated to firms on an **annual basis**, and more frequently as warranted
    - During the initial LFI rating supervisory cycle, each firm would receive all three component ratings **concurrently**
        - After the initial cycle, examiners may assign and communicate individual component ratings on a **rolling basis** to the firms

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- Ratings assigned under the LFI rating system would be confidential supervisory information, communicated by the Federal Reserve to the firm but not disclosed publicly
    - The Federal Reserve requested public comment on whether there are options that should be considered to enhance the transparency of LFI ratings in order to incent more timely and comprehensive remediation of supervisory deficiencies or issues

Capital Planning and Positions Component

- The results of a firm's CCAR process would be a material part of the capital component

Capital Planning

The Federal Reserve would evaluate the extent to which a firm:

- maintains sound capital planning practices though strong governance and oversight;
- maintains strong risk management and controls;
- maintains updated capital policies and contingency plans for addressing potential shortfalls; and
- incorporates appropriately stressful conditions and events into capital planning and projections of capital positions

Capital Positions

The Federal Reserve would evaluate the extent to which a firm's capital is sufficient to comply with **regulatory requirements** and to support its ability to meet its obligations to depositors, creditors, and other counterparties and continue to serve as a financial intermediary through **a range of conditions**

The language about supporting activities and serving as a financial intermediary through a "range of conditions" indicates that the applicable regulatory requirements are post-stress requirements – i.e., similar to the CCAR adverse and severely adverse scenarios

Liquidity Risk Management and Positions Component

- The rating for the liquidity component would be based on:
  - Ongoing assessments of an individual firm's liquidity positions and risk management practices conducted through the supervisory process; and
  - Findings of horizontal examinations conducted across several firms

Liquidity Risk Management

For the risk management element of the liquidity component, the Federal Reserve would evaluate the extent to which a firm:

- maintains sound liquidity risk management practices though strong governance and oversight;
- maintains strong risk management and controls;
- maintains updated liquidity policies and contingency plans for addressing potential shortfalls; and
- incorporates appropriately stressful conditions and events into liquidity planning and projections of liquidity positions

Liquidity Positions

The Federal Reserve would evaluate the extent to which a firm's liquidity is sufficient to comply with **regulatory requirements** and to support its ability to meet current and prospective obligations to depositors, creditors and other counterparties through a **range of conditions**

The relevant regulatory requirements are the liquidity coverage ratio rule and the liquidity risk management and stress testing requirements that are part of the enhanced prudential standards

Governance and Controls Component

- The elements of the Governance and Controls component are the effectiveness of a firm's:
  - Board of directors*;
  - Management of business lines and independent risk management (**IRM**) and controls; and
  - Recovery planning (for LISCC firms only)

Like the other components under the LFI rating system, the results of both **firm-specific evaluations** and **horizontal examinations** would inform the rating for the Governance and Controls component

* Not applicable to U.S. intermediate holding companies of foreign banking organizations established pursuant to Regulation YY

Governance and Controls Component

Proposed Supervisory Guidance

- As discussed above, the Federal Reserve released the Governance Proposal at the same time that it proposed the LFI rating system
  - This proposed guidance provides additional detail about how the Federal Reserve will evaluate board effectiveness
- Subsequently, in January 2018, the Federal Reserve released the Management Guidance, setting out core principles for senior management, business line management, IRM and internal controls
- Because the concepts of corporate governance, board effectiveness, management of business lines, and IRM and internal controls are inextricably linked, we discuss these elements of the Governance and Controls component in additional depth in our **companion visual memorandum**

Recovery Planning Element

- For LISCC firms, recovery planning processes should effectively identify options that provide a reasonable chance of the firm being able to remedy financial weakness and restore market confidence without extraordinary official sector support

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