The Federal Reserve’s Large Financial Institution Rating System – Final Rule

Visual Memorandum

November 6, 2018

Davis Polk
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The Federal Reserve has finalized a new supervisory rating system for large financial institutions (LFI rating system), which replaces the RFI/C(D) rating system (RFI rating system) for LFIs.

According to the Federal Reserve, the LFI rating system is designed to:

- Fully align with the Federal Reserve’s current supervisory programs and practices;
- 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.
Introduction to LFI Rating System

THREE CORE AREAS OF FOCUS

- The LFI rating system reflects the three core areas of focus in the current LFI supervisory framework: **capital**, **liquidity** and **governance and controls**

<table>
<thead>
<tr>
<th>Capital Planning and Positions</th>
<th>Liquidity Risk Management and Positions</th>
<th>Governance and Controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>Evaluation of:</td>
<td>Evaluation of:</td>
<td>Evaluation of the effectiveness of a firm’s:</td>
</tr>
<tr>
<td>- 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</td>
<td>- 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</td>
<td>- board of directors;</td>
</tr>
<tr>
<td>- 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</td>
<td>- 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</td>
<td>- management of business lines and independent risk management (IRM) and controls; and</td>
</tr>
<tr>
<td>See pages 24-25 for more details</td>
<td>See pages 26-27 for more details</td>
<td>- recovery planning (for domestic LISCC firms only)</td>
</tr>
</tbody>
</table>

The LFI rating system puts greater emphasis than the RFI rating system on capital and liquidity, evaluating not only an LFI’s quantitative capital and liquidity levels but also its related planning and risk management practices.
Introduction to LFI Rating System

RELATED PROPOSALS

- The Federal Reserve has also proposed new supervisory guidance on expectations for the boards of directors of LFIs (board effectiveness guidance) and new supervisory guidance for senior management, business line management, IRM and internal controls for LFIs (management guidance)

- These governance proposals have not yet been finalized, and until finalized the Federal Reserve intends to evaluate an LFI’s governance and controls based on existing supervisory guidance (see pages 28-31)

- See our visual memorandum describing these proposals here

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The supplementary information states that the Federal Reserve is in the process of implementing examination and supervisory staff training and will undertake a multi-level review and vetting before ratings are assigned, to ensure that the new LFI ratings are assigned in a consistent and fair manner.
<table>
<thead>
<tr>
<th>Topic</th>
<th>Key Changes to the LFI Rating System Final Rule from the Proposal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applicability</td>
<td>▪ Consistent with recent tailoring approaches, U.S. bank holding companies (BHCs) and non-insurance, non-commercial savings and loan holding companies (SLHCs) with total consolidated assets of less than $100 billion (instead of $50 billion as proposed) will continue to be subject to the existing RFI rating system (see pages 7-8)</td>
</tr>
<tr>
<td>Timing</td>
<td>▪ The first ratings under the LFI rating system will be assigned in either early 2019 or early 2020, depending on the type of institution (see page 9)</td>
</tr>
<tr>
<td>Rating Categories</td>
<td>▪ The highest ratings are called “Broadly Meets Expectations” and “Conditionally Meets Expectations” instead of “Satisfactory” and “Satisfactory Watch” as proposed (see page 17)</td>
</tr>
<tr>
<td>Remediation Timeline</td>
<td>▪ There is no longer a general fixed maximum timeframe of 18 months for remediation of supervisory issues under a Conditionally Meets Expectations rating as proposed; timeframes instead will be based on the specific facts and circumstances of the firm (see page 20)</td>
</tr>
<tr>
<td>Changes in Terminology</td>
<td>▪ The final rule uses the term “effective” instead of “strong” to describe the required governance, oversight and risk management practices that satisfy the Broadly Meets Expectations standard</td>
</tr>
<tr>
<td></td>
<td>▪ References to risk tolerance have been changed to risk appetite</td>
</tr>
</tbody>
</table>
Which Organizations Are Affected?

- The LFI rating system applies to three categories of banking organizations:
  - BHCs with total consolidated assets of $100 billion or more;
  - Non-insurance and non-commercial SLHCs with total consolidated assets of $100 billion or more; and
  - The U.S. intermediate holding companies (IHCs) of foreign banking organizations (FBOs) with total consolidated assets of $50 billion or more.

**Tailoring:** The final rule’s applicability threshold of $100 billion in total assets for BHCs and certain SLHCs is consistent with the Economic Growth, Regulatory Relief, and Consumer Protection Act’s (EGRRCPA) revisions to the thresholds at which certain enhanced prudential standards apply to BHCs and SLHCs.

Our visual memorandum on the EGRRCPA is available [here](#) and our memorandum describing recent changes proposed by the Federal Reserve to further tailor the application of enhanced prudential standards under EGRRCPA’s revised thresholds will soon be released.
Which Organizations Are Affected?

The supplementary information to the final rule also addresses a number of potential changes to the rating systems that apply to various types of banking organizations supervised by the Federal Reserve:

- **FBOs**: The Federal Reserve said that it continues to consider appropriate tailoring of its regulations for FBOs and may adjust the $50 billion threshold that applies to U.S. IHCs to reflect the EGRRCPA. In addition, the Federal Reserve is considering adjustments to the ROCA rating system for the U.S. branches and agencies of FBOs and to the ratings for the combined U.S. operations of FBOs.

- **Mid-Size Regional BHCs**: BHCs with total consolidated assets of less than $100 billion (instead of $50 billion as proposed) will remain subject to the RFI rating system, and the Federal Reserve is reviewing its existing supervisory guidance to determine whether revisions are appropriate to further distinguish supervisory expectations for such firms.

- **Nonbank SIFIs**: The Federal Reserve continues to consider the appropriate regulatory regime for systemically important nonbank financial companies subject to its supervision.
  - With the FSOC’s October 2018 de-designation of Prudential, there are currently no such firms.

- **Certain SLHCs**: SLHCs predominantly engaged in insurance or commercial activities will continue to receive indicative ratings under the RFI rating system as the Federal Reserve considers the appropriate manner in which to assign supervisory ratings to those SLHCs.
Implementation of LFI Rating System – Timing

- **LISCC LFIs**: U.S. BHCs and IHCs that are subject to the Federal Reserve’s Large Institution Supervision Coordinating Committee (LISCC) framework will receive their first ratings under the LFI rating system in **early 2019**

- **Non-LISCC LFIs**: In light of the Federal Reserve’s ongoing work to tailor the regulatory and supervisory framework applicable to non-LISCC BHCs and IHCs, these firms will continue to be evaluated under the RFI rating system in 2019 and will have their first LFI ratings assigned in **early 2020**

**LISCC Firms**
- Bank of America, BNY Mellon, Barclays, Citigroup
- Credit Suisse, Deutsche Bank, Goldman Sachs, JP Morgan Chase, Morgan Stanley, State Street, UBS, Wells Fargo

**Timeline**
- **February 1, 2019**: LFI rating system becomes effective
- **2019**
  - **Early 2019**: LISCC BHCs and IHCs receive their first LFI ratings for all three components concurrently
  - **Going forward**: LFIs receive subsequent component ratings on a rolling basis and no less often than annually
- **2020**
  - **Early 2020**: Remaining LFIs receive their first LFI ratings for all three components concurrently
- **2021**
Implementation of LFI Rating System

Confidential Supervisory Information

- Ratings assigned under the LFI rating system will, like those assigned under the RFI rating system, be confidential supervisory information, communicated by the Federal Reserve to the firm but not disclosed publicly.

- The Federal Reserve noted in the supplementary information to the final rule that it “will continue to think broadly in considering ways to enhance transparency across its processes and communications in support of improved supervisory approaches and outcomes”

Appellate Process

- The Federal Reserve stated that it is committed to maintaining an effective independent appellate process for the review of material supervisory determinations, noting that it continues to consider comments on its February 2018 proposal to revise the framework for such appeals.

Reliance on Other Regulators

- The Federal Reserve stated that, in assigning LFI component ratings, it will continue to rely to the fullest extent possible on applicable information and assessments developed by other relevant supervisors and functional regulators.
Key Features of LFI Rating System

THREE COMPONENTS

- An LFI will 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**

<table>
<thead>
<tr>
<th>Capital Planning and Positions</th>
<th>Liquidity Risk Management and Positions</th>
<th>Governance and Controls</th>
</tr>
</thead>
</table>

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

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

**Asset Quality and Earnings**: In contrast to the RFI rating system, asset quality and earnings are not identified as specific elements of any particular component in the LFI rating system. The Federal Reserve states, however, that these two areas 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.

Davis Polk

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### Key Features of LFI Rating System

**DIFFERENCES ACROSS SUPERVISORY RATING SYSTEMS**

<table>
<thead>
<tr>
<th>Feature</th>
<th>RFI System</th>
<th>CAMELS*</th>
<th>LFI System</th>
<th>Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Composite Rating</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
<td>▪ The Federal Reserve states that (1) it is unlikely that a standalone LFI composite rating would convey new or additional information regarding supervisory assessments of LFIs and (2) a composite rating could dilute the clarity and impact of the component ratings</td>
</tr>
<tr>
<td>Sub-component Ratings</td>
<td>✓</td>
<td>X</td>
<td>X</td>
<td>▪ According to the Federal Reserve, communicating a single rating for each component is intended to reinforce the view that the strength of an LFI’s capital and liquidity position is integrated with the effectiveness of its capital planning and liquidity risk management, respectively, and the strength of an LFI’s risk management depends on the effectiveness of its board oversight</td>
</tr>
</tbody>
</table>
| Separate Management Rating | ✓          | ✓       | X          | ▪ Because each component of the LFI rating system evaluates different areas of the firm’s management, no single component will be designated as a management rating to determine whether an LFI is “well managed” for purposes of the Bank Holding Company Act of 1956 and related regulations  
▪ A firm must satisfy the requirements of all three components of the LFI rating system in order to be considered “well managed” |

*CAMELS Ratings:* The Uniform Financial Institutions Rating System, known as CAMELS, is used to assign ratings to insured depository institutions (IDIs), and the IDIs of LFIs will continue to receive ratings under that system. FDIC Chairman Jelena McWilliams has stated her intention to review the CAMELS framework, which was adopted in 1979 and last revised in 1996.
Key Features of LFI Rating System

Weighting Elements in Assigning a Component Rating

- The weighting of an individual element in assigning a component rating will depend on its impact on the firm’s safety, soundness and resilience as provided for in the LFI rating system definitions.

- **Example**: The Federal Reserve explained that a limited number of significant deficiencies – or even just one significant deficiency – identified for management of a single material business line could be viewed as sufficiently important to warrant a Deficient-1 rating for the Governance and Controls component, even if the firm meets supervisory expectations under the Governance and Controls component in all other respects.
Key Features of LFI Rating System

Materiality

Governance and Controls

- In response to a comment suggesting that the governance and controls component rating take into account only compliance matters that would have a material impact on a firm’s financial and operational strength and resiliency, the Federal Reserve stated that it will take into consideration the materiality of outstanding and identified supervisory issues, including the extent to which a matter would have a material impact on the firm’s financial and operational strength and resiliency.

- But the Federal Reserve stated that it expects all firms to comply fully with all applicable laws and regulations, including those related to consumer protection.

Downgrades in LFI Ratings

- In response to a comment stating that the rule should clarify the circumstances under which Matters Requiring Attention (MRAs) or Matters Requiring Immediate Attention (MRIAs) would trigger a downgrade from a Broadly Meets Expectations rating, the Federal Reserve stated that it will take into account the materiality of a firm’s outstanding and newly identified supervisory issues, presumably including MRAs and MRIAs.
Key Features of LFI Rating System

**HORIZONTAL EVALUATIONS**

- The Federal Reserve will 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 new best practices standard retroactively and/or penalize firms retroactively for failing to be in immediate compliance with the new standard, as opposed to giving firms prior notice and a fair opportunity to challenge a new standard and a reasonable period of time to comply with the new standard before failure to comply can result in any adverse supervisory action or impact, which was a key concern expressed by commenters regarding the LFI rating system proposal.
Each LFI component will 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.

<table>
<thead>
<tr>
<th>Broadly Meets Expectations</th>
<th>Conditionally Meets Expectations</th>
<th>Deficient-1</th>
<th>Deficient-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>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</td>
<td>Certain material financial or operational weaknesses in a firm’s practices or capabilities 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</td>
<td>Financial or operational deficiencies in a firm’s practices or capabilities put the firm’s prospects for remaining safe and sound through a range of conditions at significant risk</td>
<td>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</td>
</tr>
<tr>
<td>The firm may be subject to identified supervisory issues requiring corrective action. However, these issues are unlikely to present a threat to the firm’s ability to maintain safe-and-sound operations through a range of conditions</td>
<td>Enables the Federal Reserve to identify certain material issues at a firm and provide the firm with notice and the ability to fix those issues before the firm experiences regulatory consequences as a result of the rating downgrade</td>
<td>The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require the firm to make a material change to its business model or financial profile, or its practices or capabilities</td>
<td></td>
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<tr>
<td></td>
<td></td>
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</tbody>
</table>
The supplementary information states that the final rule uses different names for the two highest proposed rating categories to improve the descriptiveness of those rating categories. It states that the definitions of each category are also clarified to provide additional guidance to examiners and provide transparency to firms about the calibration of each category. The table below summarizes the changes in names and definitions.

<table>
<thead>
<tr>
<th></th>
<th>Category 1</th>
<th>Category 2</th>
<th>Category 3</th>
<th>Category 4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Proposed Name</strong></td>
<td>Satisfactory</td>
<td>Satisfactory Watch</td>
<td>Deficient-1</td>
<td>Deficient-2</td>
</tr>
<tr>
<td><strong>Proposed Definition</strong></td>
<td>This rating would have indicated that the firm is generally considered safe and sound and broadly meets supervisory expectations</td>
<td>This rating would have indicated that the firm is generally considered safe and sound; however, certain issues are sufficiently material 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</td>
<td>Same as final</td>
<td>Same as final</td>
</tr>
<tr>
<td><strong>Final Name</strong></td>
<td>Broadly Meets Expectations</td>
<td>Conditionally Meets Expectations</td>
<td>Same as proposed</td>
<td>Same as proposed</td>
</tr>
<tr>
<td><strong>Final Definition</strong></td>
<td>See page 16</td>
<td>See page 16</td>
<td>See page 16</td>
<td>See page 16</td>
</tr>
</tbody>
</table>
LFI Rating Scale
CRITERIA TO BE CONSIDERED WELL MANAGED

<table>
<thead>
<tr>
<th>Broadly Meets Expectations</th>
<th>Conditionally Meets Expectations</th>
<th>Deficient-1</th>
<th>Deficient-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well managed</td>
<td>Well managed</td>
<td>Not well managed</td>
<td>Not well managed</td>
</tr>
</tbody>
</table>

- A firm’s 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 system, a firm must be rated ** Broadly Meets Expectations** or **Conditionally Meets Expectations** for each component rating in order to be considered well managed
- A firm with a **Deficient-1** or **Deficient-2** rating on any component will not be considered well managed
LFI Rating Scale

BROADLY MEETS EXPECTATIONS

Perfection Not Required

- A firm may receive a Broadly Meets Expectations rating even though the Federal Reserve has identified supervisory issues requiring corrective action, provided that such issues are unlikely to present a threat to the firm’s ability to maintain safe-and-sound operations through a range of conditions.

Rejection of a “Strong” Rating Category

- The Federal Reserve rejected a suggestion by two commenters that the LFI rating scale should include a rating higher than Broadly Meets Expectations, similar to the Strong rating used with the RFI, CAMELS and other supervisory rating systems, noting that such a higher rating “may suggest that the Federal Reserve expects firms to exceed, not simply meet, supervisory expectations.”
  - The Federal Reserve also stated that a higher rating would not enhance or clarify supervisory communications, as it would have no supervisory consequences.

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Timely Remediation in the Normal Course of Business

- A firm will be assigned a Conditionally Meets Expectations rating, rather than a Deficient rating, when it has the ability to resolve identified material weaknesses during the normal course of business.
  - Normal course of business means 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.

- The Federal Reserve does not intend for a firm to be rated Conditionally Meets Expectations for a prolonged period and will work with the firm to develop an appropriate timeframe during which the firm will be required to fully resolve the issues leading to the rating.
  - But the final rule clarifies that the timeline for remediation will be based on the facts and circumstances of the firm, and not be subject to a fixed maximum timeline of 18 months as proposed.

- The final rule recognizes that completing and validating certain remediations, such as those involving information technology modifications, may require an extended time horizon.
  - In all instances, appropriate and effective risk mitigation techniques must be used in the interim to maintain safe and sound operations under a range of conditions until remediation activities are completed, validated and fully operational.

- Under the final rule, 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 are identified that, taken alone, would be consistent with a Conditionally Meets Expectations rating.
LFI Rating Scale
CONDITIONALLY MEETS EXPECTATIONS

Downgrades
- A firm’s failure to resolve issues in a timely manner would most likely result in a downgrade to a Deficient rating
  - The inability to resolve the issues would indicate that the firm does not have sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions

Upgrades
- A firm 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 and even if a validation process for the remediation and mitigation activities has not yet been completed
Remediation Timeframes

- A firm with a Deficient-1 rating is required to take **timely corrective action** to correct financial or operational deficiencies and to restore and maintain its safety and soundness and compliance with laws and regulations, including those related to consumer protection.

- A firm with a Deficient-2 rating is required to immediately implement **comprehensive corrective measures** and demonstrate the **sufficiency of contingency planning** in the event of further deterioration.

Supervisory Consequences

- In addition to the loss of well-managed status, a Deficient-1 or Deficient-2 rating is likely to result in other supervisory consequences, as summarized on the following page.
LFI Rating Scale

**SUPERVISORY CONSEQUENCES OF DEFICIENT-1 AND DEFICIENT-2**

The chart below summarizes the supervisory consequences of a Deficient rating in addition to the loss of well-managed status.

<table>
<thead>
<tr>
<th>Limitations on New or Expansionary Activities</th>
<th>Deficient-1</th>
<th>Deficient-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ A Deficient-1 rating <strong>could be a barrier</strong> for a firm seeking approval to engage in new or expansionary activities, unless the firm can demonstrate that:</td>
<td></td>
<td>▪ The Federal Reserve will be <strong>unlikely to approve</strong> any proposal to engage in new or expansionary activities</td>
</tr>
<tr>
<td>▪ it is making meaningful, sustained progress in resolving identified deficiencies and issues;</td>
<td></td>
<td></td>
</tr>
<tr>
<td>▪ the proposed activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and</td>
<td></td>
<td></td>
</tr>
<tr>
<td>▪ the proposed activities would not distract the firm from remediating current deficiencies or issues</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Enforcement Action</th>
<th>Deficient-1</th>
<th>Deficient-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ There is a <strong>strong presumption</strong> that a firm will be subject to an <strong>informal or formal</strong> enforcement action</td>
<td></td>
<td>▪ There is a <strong>strong presumption</strong> that a firm will be subject to a <strong>formal</strong> enforcement action</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Troubled Condition</th>
<th>Deficient-1</th>
<th>Deficient-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ A Deficient-1 rating will <strong>not</strong> carry a presumption that the firm is in troubled condition; such a determination will be based on the facts and circumstances of that firm</td>
<td></td>
<td>▪ An LFI should expect to be deemed to be in troubled condition</td>
</tr>
<tr>
<td>▪ The supplementary information notes that a firm rated Deficient-1 due to financial weaknesses in capital or liquidity would be more likely to be deemed in troubled condition than a firm rated Deficient-1 due solely to governance or controls issues</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Capital Planning and Positions Component

The final LFI rating system rule adopts the Capital Planning and Positions component described in the proposal with few changes.

**Capital Planning**

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

- maintains sound capital planning practices though effective governance and oversight;
- maintains effective 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 will 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 “through a range of conditions” language indicates that the applicable regulatory requirements are post-stress requirements, even for firms that, under the Federal Reserve’s tailoring proposal, would be subject to CCAR only every other year.
In response to comments on the proposal, the Federal Reserve provided the following clarifications in the supplementary information with respect to the Capital Planning and Positions component:

- **Interaction with regulatory minimums**: Despite meeting regulatory capital minimums, a firm may receive a rating lower than Broadly Meets Expectations in light of its “idiosyncratic activities and risks”

- **Interaction with CCAR**: Findings from CCAR and other supervisory stress testing will represent inputs into the component rating, but a firm's receipt of a non-objection in the CCAR process will not automatically result in a Broadly Meets Expectations rating

- **No new capital planning expectations**: The Federal Reserve confirmed that the final LFI rating system does not create any new capital planning expectations applicable to LFIs
The final LFI rating system rule adopts the Liquidity Risk Management and Positions component described in the proposal with few changes.

**Liquidity Risk Management**
For the risk management element of the liquidity component, the Federal Reserve will evaluate the extent to which a firm:
- maintains sound liquidity risk management practices through effective governance and oversight;
- maintains effective 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 will 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 and the liquidity risk management and stress testing requirements that are part of the enhanced prudential standards. For some LFIs, these regulatory requirements are subject to revision by the tailoring proposal.
Liquidity Risk Management and Positions Component

- In response to comments on the proposal, the Federal Reserve provided the following clarifications in the supplementary information with respect to the Liquidity Risk Management and Positions component:
  - **Interaction with minimum liquidity requirements**: The Federal Reserve states that a firm’s rating for this component will “reflect the materiality of issues identified through the supervisory process.”
    - It will involve an evaluation of the firm’s liquidity positions against applicable regulatory requirements and an assessment of the firm’s ability “to support its obligations through other means, such as its funding concentrations”
  - **Interaction with CLAR for LISCC Firms**: Horizontal and firm-specific examinations under LISCC’s liquidity program, including horizontal evaluations under CLAR, will represent a “material input” into a firm’s liquidity rating but will not be determinative of a firm’s rating for this component.
As discussed in additional detail on the following slides, the Governance and Controls component will evaluate the effectiveness of an LFI’s

- board of directors;
- management of business lines and IRM and controls; and
- recovery planning (for domestic LISCC firms only)
Governance and Controls Component

Board Effectiveness Subcomponent

- As illustrated in the sidebar, the LFI rating system describes five key attributes of an effective board.

- The Federal Reserve’s board effectiveness guidance has not yet been finalized.

- Until that guidance is finalized, the Federal Reserve intends to rely primarily on SR Letter 12-17/CA Letter 12-14 and safety and soundness to evaluate the effectiveness of an LFI’s board of directors.

- Though the effectiveness of the board of directors of a U.S. IHC would not be evaluated under this component, the Federal Reserve notes that it may consider the effectiveness of a U.S. IHC’s board in connection with other examinations.
  - For example, a review of a U.S. IHC’s capital planning may reveal governance or control weaknesses.

<table>
<thead>
<tr>
<th>Five Key Attributes of an Effective Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Set clear, aligned and consistent direction regarding firm’s strategy and risk appetite</td>
</tr>
<tr>
<td>2. Direct senior management regarding the board’s information</td>
</tr>
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<td>3. Oversee and hold senior management accountable</td>
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<td>4. Support the independence and stature of the firm’s independent risk management and internal audit functions</td>
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<td>5. Maintain a capable board composition and governance structure</td>
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The Federal Reserve will evaluate the extent to which:

- Senior management effectively and prudently manages the day-to-day operations of the firm and provides for ongoing resiliency; implements the firm’s strategy and risk appetite; maintains an effective risk management framework and system of internal controls; and promotes prudent risk taking behaviors and business practices, including compliance with laws and regulations, including those related to consumer protection.

- Business line management executes business line activities consistent with the firm’s strategy and risk appetite; identifies and manages risks; and ensures an effective system of internal controls for its operations.

- Independent risk management effectively evaluates whether the firm’s risk appetite appropriately captures material risks and is consistent with the firm’s risk management capacity; establishes and monitors risk limits that are consistent with the firm’s risk appetite; identifies and measures the firm’s risks; and aggregates, assesses and reports on the firm’s risk profile and positions. Additionally, the firm demonstrates that its internal controls are appropriate and tested for effectiveness. Finally, internal audit effectively and independently assesses the firm’s risk management framework and internal control systems, and reports findings to senior management and the firm’s audit committee.

- The Federal Reserve’s management guidance has not yet been finalized and, until it is, the Federal Reserve intends to rely on existing risk management guidance to evaluate an LFI’s management of business lines and IRM and controls.
The recovery planning practices of the eight domestic LISCC firms (i.e., the U.S. GSIBs) will be evaluated under the Governance and Controls component in light of the “heightened risks” that these firms present to financial stability.

- The Federal Reserve stated that effective recovery planning practices are central to ensuring that a LISCC firm has sufficient financial and operational strength to continue operations through a range of conditions.

No resolution planning component: The final LFI rating system does not include a separate component rating for resolution planning.

- The Federal Reserve, however, says it will continue to consider whether the LFI rating system should be modified to include an assessment of a firm’s resolution planning efforts.
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.

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