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Regulatory Alert

Financial Services Regulatory Insight Center

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New supervisory ratings system

Key points

- The Federal Reserve adopted a new supervisory ratings system for large financial institutions that will evaluate capital, liquidity, and governance and controls; the final rule becomes effective February 1, 2019.
- The final rule is substantially similar to the proposal released in August 2017, with modifications to the assets threshold for domestic BHCs and non-insurance, non-commercial SLHCs.
- BHCs and U.S. IHCs subject to the LISCC framework will receive ratings under the new ratings system in 2019; all other large financial institutions will receive ratings in 2020.

Applicability

The large financial institutions ratings system (LFI Ratings System) applies to:

- BHCs and non-insurance, non-commercial SLHCs with $100 billion or more in total consolidated assets (higher than the originally proposed $50 billion threshold).
- U.S. intermediate holding companies (IHCs) of foreign banking organizations (FBOs) with $50 billion or more in total consolidated assets established under Regulation YY (Enhanced Prudential Standards) (same as proposed).

BHCs with total consolidated assets of less than $100 billion will continue to be evaluated under the current RFI rating system; non-insurance, non-commercial SLHCs with less than $100 billion in total consolidated assets will also be subject to the RFI rating system beginning February 1, 2019. (The Federal Reserve published a separate notice outlining the application of the ratings systems to SLHCs.)

Ratings categories and criteria

The LFI Ratings System uses a new four-category scale with descriptive terminology that ranks firms as Broadly Meets Expectations, Conditionally Meets Expectations, Deficient-1, and Deficient-2.

- **Broadly Meets Expectations:** In this rating, a firm may have supervisory issues, but the issues are unlikely to present a threat to the firm's ability to maintain safe-and-sound operations through a range of conditions.
- **Conditionally Meets Expectations:** This rating indicates some supervisory issues, and the Federal Reserve will work with the firm to develop an appropriate timeframe during which the firm would resolve them. The proposed 18-month timeframe to resolve issues has been removed.
- **Deficient-1:** This rating indicates that the firm has financial or operational deficiencies that place its safety and soundness at significant risk. A Deficient-1 rating could be a barrier for a firm seeking Federal Reserve approval to engage in new or expansionary activities.

— **Deficient-2:** This rating indicates that the firm's financial and/or operational deficiencies materially threaten its safety and soundness or have put the firm in an unsafe and unsound condition. There is a strong presumption a firm with a Deficient-2 rating will be subject to a formal enforcement action and would be unlikely to receive approval to engage in new or expansionary activities.

A firm must be rated "Broadly Meets Expectations" or "Conditionally Meets Expectations" in each of the three component ratings to be considered "well managed."

The ratings system will assess these three components:

— **Capital planning and positions:** Firms will be evaluated on two broad areas: (1) the effectiveness of the governance and planning processes used to determine the capital necessary to cover risks and exposures, and to support activities through a range of conditions; and (2) the sufficiency of capital to comply with regulations and to support the firm's ability to continue as a financial intermediary through a range of conditions. Findings from supervisory stress testing, such as the Comprehensive Capital Analysis and Review (CCAR) or similar activities, will be inputs into this component rating.

— **Liquidity risk management:** Firms will be evaluated on two broad areas (consistent with the capital planning component): (1) 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 (2) sufficiency of liquidity to comply with applicable regulatory requirements and to support the firm's ongoing obligations through a range of conditions. A firm's performance on the Comprehensive Liquidity Assessment Review (CLAR) and horizontal and firm-specific examination work conducted under the Large Institution Supervision Coordinating Committee (LISCC) liquidity program will be a "material input into a firm's liquidity rating."

— **Governance and controls:** Firms will be evaluated on the effectiveness of its: (1) board of directors, (2) management of business lines and independent risk management and controls, and (3) recovery planning (for domestic firms subject to the LISCC framework).

Related guidance and rulemakings

The Federal Reserve is still considering two Governance and Controls proposals: (1) the proposed guidance on supervisory expectations for boards of directors and (2) a proposal on management of business lines and independent risk management and controls. It is not adopting either proposal at this time. For purposes of evaluating the Governance and Control component under the LFI Ratings System, the Federal Reserve states that it intends to rely primarily on "SR Letter 12-17/CA Letter 12-14 and safety and soundness" to assess the effectiveness of a firm's board of directors. Similarly, the agency 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. Separately, the Federal Reserve is also revising provisions in Regulations K (International Banking Operations) and LL (Savings and Loan Holding Companies) for consistency with the new LFI Ratings System.

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