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FFIEC Issues Proposed Guidance on Social Media Risk Management

By David A. Luigs and Liz Alspector

On January 23, 2013, the Federal Financial Institutions Examination Council ("FFIEC" or "Council") published in the Federal Register a Notice and Request for Comment on proposed guidance describing the risks that arise out of social media activities of financial institutions and how existing risk management programs should address such risks (the "guidance").[1] The guidance represents the first time the federal bank regulatory agencies, through the FFIEC, have published official guidance on social media.[2]

The guidance expressly states that it does not impose any additional obligations beyond existing law on financial institutions. Nonetheless, the guidance may require significant revisions to financial institutions' risk management programs to ensure that social media activities and their related risks are addressed by risk management policies and procedures and subject to appropriate internal controls and oversight.

After consideration of public comments, the agencies will issue final guidance to their supervised institutions[3] – banks, savings associations, credit unions and nonbank consumer financial service entities supervised by the Consumer Financial Protection Bureau (the "CFPB"). Comments on the guidance must be received by March 25, 2013.

Background

The FFIEC issued the proposed guidance in response to inquiries on the applicability of existing federal consumer protection laws, regulations and policies to the social media activities of financial institutions.

For purposes of the proposed guidance, the FFIEC broadly defines social media as "a form of interactive online communication in which users can generate and share content through text, images, audio and/or video," and distinguishes social media from other forms of

1 Social Media: Consumer Compliance Risk Management Guidance, 78 Fed. Reg. 4,848 (Jan. 23, 2013). The FFIEC is an interagency body tasked with coordinating federal financial institution examination principles and standards. Its member agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation ("FDIC"), the National Credit Union Administration ("NCUA") and the Consumer Financial Protection Bureau ("CFPB").

2 In addition to the federal bank regulatory agencies, the Financial Industry Regulatory Authority ("FINRA") issued two regulatory notices to its governed firms regarding social media activities and the Securities and Exchange Commission ("SEC") issued a risk alert relating to investment adviser use of social media. *See* FINRA Regulatory Notice 11-39, Social Media Websites and the Use of Personal Devices for Business Communications: Guidance on Social Networking Websites and Business Communications (Aug. 2011), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p124186.pdf; FINRA Regulatory Notice 10-06, Social Media Web Sites: Guidance on Blogs and Social Networking Web Sites (Jan. 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120779.pdf; Office of Compliance Inspections & Examinations, SEC, National Examination Risk Alert, Investment Adviser Use of Social Media (Jan. 4, 2012), *available at* http://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf.

3 The FFIEC's State Liaison Committee, which is composed of representatives of five state financial regulatory agencies, will encourage state regulators to adopt the guidelines.

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online media by its high level of interactivity.[4] This definition could be read to be exceedingly broad, including email, instant messaging and communications over private networks, such as Chatter. We expect comments to suggest narrowing this definition. The FFIEC notes that financial institutions use social media in a variety of ways, including advertising and marketing, providing incentives, facilitating applications for new accounts, inviting public feedback and engaging with customers, for example, by collecting complaints.

Risk Areas

While acknowledging that social media may "improve market activity" and "more broadly distribute information to users of financial services," the FFIEC warns that the informal and dynamic nature of social media and their less secure environments can affect a financial institution's risk profile. In particular, the guidance highlights compliance and legal risk, reputation risk and operational risk as three risk areas that could be impacted by social media activities.

Compliance and Legal Risk

The guidance explains that compliance and legal risk arises from the potential for social media activities to not comply with laws, regulations, prescribed practices, internal policies or practices and ethical standards. Compliance and legal risk can arise from various social media activities, such as the marketing of deposit and credit products, origination of new accounts, facilitation of a customer's use of payment systems and communication with customers through social media. The guidance specifically points

4 The guidance notes that there are many forms of social media, such as "micro-blogging sites (*e.g.*, Facebook, Google Plus, MySpace, and Twitter); forums, blogs, customer review web sites and bulletin boards (*e.g.*, Yelp); photo and video sites (*e.g.*, Flickr and YouTube); sites that enable professional networking (*e.g.*, LinkedIn); virtual worlds (*e.g.*, Second Life); and social games (*e.g.*, FarmVille and CityVille)."

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out that consumer finance laws and regulations may apply to social media activities because they, to quote the guidance, "do not have social media exceptions."[5] The guidance specifically cites the following laws and regulations as relevant to social media activities:

- Truth in Savings Act ("TISA")/ Regulation DD and Part 707;[6]
- Fair Lending Laws: Equal Credit Opportunity Act/Regulation B[7] and Fair Housing Act;[8]
- Truth in Lending Act ("TILA")/ Regulation Z;[9]
- Real Estate Settlement Procedures Act;[10]
- Fair Debt Collection Practices Act;[11]
- Legal requirements regarding unfair, deceptive or abusive acts or practices, including the Federal Trade Commission (FTC) Act[12] and the Dodd-Frank Wall Street Reform and Consumer Protection Act;[13]
- Legal requirements regarding deposit or share insurance;[14]
- Payment systems, including the Electronic Fund Transfer Act ("EFTA")/Regulation E[15] and Rules Applicable to Check Transactions;
- Bank Secrecy Act/Anti-Money Laundering Programs;[16]
- Community Reinvestment Act ("CRA");[17]
- Privacy legal requirements, including Gramm-Leach-Bliley Act privacy rules and data security guidelines,[18] CAN-SPAM Act,[19] Telephone Consumer Protection Act,[20] Children's Online Privacy Protection Act[21] and implementing regulation;[22] and
- Fair Credit Reporting Act.[23]

In particular, the guidance clarifies the following points with respect to the application of the above laws and regulations:

- Institutions must provide all relevant disclosures (*e.g.* those required under TILA or TISA for products advertisements or the EFTA for transfers of funds) when conducting activities via social media.[24] For example, electronic advertisements for deposit and credit products must include direct links to the required information. Presumably, this means that an

5 Aside from these concerns specific to consumer financial laws and regulations, the guidance notes that broad communication can also expose an institution to litigation risk related to libel claims.

6 12 U.S.C. §§ 3201 *et seq.*, 12 C.F.R. pts. 230 and 1030 and 12 C.F.R. pt. 707 (NCUA).

7 15 U.S.C. §§ 1601 *et seq.*, 12 C.F.R. pts. 202 and 1002 and 12 C.F.R. 701.31 (NCUA).

8 42 U.S.C. §§ 3601 *et seq.*, 24 C.F.R. pt. 100 (HUD), 12 C.F.R. pt. 128 (OCC), 12 C.F.R. pt. 390 subpart G (FDIC), 12 C.F.R. 701.31 (NCUA).

9 15 U.S.C. §§ 1601 *et seq.*; 12 C.F.R. pts. 226 and 1026.

10 12 U.S.C. § 2607.

11 15 U.S.C. §§ 1692-1692p.

12 15 U.S.C. § 45.

13 Dodd-Frank Act §§ 1031, 1036; 15 U.S.C. §§ 5531, 5536.

14 12 C.F.R. pt. 328 (FDIC Membership); 12 C.F.R. pt. 740 (NCUA Membership.

15 15 U.S.C. §§ 1693 *et seq.*, 12 C.F.R. pts 205 and 1005.

16 12 U.S.C. §§ 1829b, 1951-1959; 31 U.S.C. §§ 5311-5314, 5316-5332; 31 C.F.R. Chapter X.

17 12 U.S.C. §§ 2901 *et seq.*, 12 C.F.R. pts. 25, 195, 228, 345.

18 15 U.S.C. §§ 6801 *et seq.*, 12 C.F.R. pt. 1016 (CFPB) and 16 C.F.R. pt. 313 (FTC) ; *Interagency Guidelines Establishing Information Security Standards*, 12 C.F.R. pt. 30, app B (OCC); 12 C.F.R. pt. 208, app. D-2 and pt. 225, app. F (Board) ; 12 C.F.R. pt. 364, app. B (FDIC); *Safeguards Rules*, 16 C.F.R. pt. 314 (FTC).

19 15 U.S.C. §§ 7701 *et seq.*

20 47 U.S.C. § 227.

21 15 U.S.C. § 6501 *et seq.*

22 16 C.F.R. pt. 312.

23 15 U.S.C. § 1681-1681u.

24 12 U.S.C. § 1813(u). Guidance from the Agencies addressing third-party relationships is generally available on their respective Web sites. *See, e.g.*, CFPB Bulletin 2012-03, *Service Providers* (Apr. 13, 2012), available at http://files.consumerfinance.gov/f/ 201204_cfpb_bulletin_service-providers.pdf; FDIC FIL 44-2208, *Managing Third-Party Risk* (June 6, 2008), available at http://www.fdic.gov/news/news/financial/2008/fil08044a.html; NCUA Letter 07-CU-13, *Evaluation Third Party Relationships* (Dec. 2007), available at http://www.ncua.gov/Resources/Documents/LCU207-13.pdf; OCC Bulletin OCC 2001-47, *Third-Party Relationships* (Nov. 1, 2001), available at http://www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-47.html.

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institution may use abbreviated formats, such as Twitter, to advertise such products so long as the message includes a link to the full disclosures. Similarly, disclosures required when credit products are advertised may be on a different page as long as clearly and conspicuously linked.

[T]he guidance may require significant revisions to financial institutions' risk management programs to ensure that social media activities and their related risks are addressed . . . .

- Creditors must ensure that they are not using information collected through social media platforms in a way that violates fair lending or privacy laws. For example, demographic data provided by a customer on a platform such as Facebook (*e.g.*, age or gender) should not be improperly requested, collected or used. Additionally, any customer information collected must be handled in compliance with privacy laws, if applicable.
- Debt collectors may not inappropriately contact consumers, for example, by disclosing the existence of a debt on the consumer's Facebook.
- Financial institutions should not engage in any social media practices that could be deemed unfair, deceptive or abusive. Although there is significant existing guidance on what practices will be considered unfair or deceptive, there is less information on the standard for abusive practices.
- Institutions that advertise FDIC-insured products must include the official advertising statement of FDIC membership, usually "Member FDIC," even in a message that "promotes nonspecific banking products and services, if it includes the name of the insured depository institutions." Conversely, when those institutions advertise nondeposit products, they must ensure that consumers are fully informed that the products are not insured.
- Banking products and services offered through social media must be subject to anti-money laundering controls. In particular, the guidance notes that illicit actors increasingly use the virtual economies of internet games to launder money.
- Public comments should be monitored, collected and addressed as required by law. For example, institutions may be required to collect written comments under the CRA, and institutions subject to the CFPB's jurisdiction may be required to have complaint resolution processes.

Reputation Risk

The guidance also warns that financial institutions can be harmed by the risk arising from negative public opinion voiced on social media, or reputation risk. To protect against such risk, the guidance states that financial institutions should have policies and procedures in place to monitor and address attacks on brand identity, such as phishing or spooling, privacy concerns, such as the public posting of account numbers on a financial institution's social media page, and any third parties to which social media responsibilities have been delegated. Notably, the FFIEC states that policies should be in place to investigate and respond to consumer complaints in a timely manner, and that certain institutions use monitoring software to identify any discussions of the institution on the internet. Again, we expect comments will seek more clarity regarding the breadth of these monitoring requirements in a social media environment.

With respect to social media platforms, the guidance acknowledges that even when a financial institution has little control over the platform or its policies, consumers may blame the financial institution if something goes wrong on the financial institution's part of the platform, and that institutions "should thus weigh these issues against the benefits of using a third party to conduct social media activities." This statement is potentially troubling. If financial institutions are expected to monitor and respond to public comments as part of their risk management program, they must to be on the same social media platforms that are used by the public; financial institutions should not be expected to withdraw from social media simply due to the potential for customer confusion.

Financial institutions are also advised to create policies to address employee use of social media that

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involves the institution, as such use could be viewed by the public as reflecting on the institution. However, the Council notes that the guidance is not intended to address any employment law principles.

Operational Risk

A financial institution's use of social media can raise operational risk, or the risk of loss resulting from inadequate or failed processes, people or systems. For example, a financial institution might be exposed to operational risk if customer accounts are accessed by an unauthorized party through social media. The guidance references existing supervisory guidance issued by the member agencies as sources for updates to risk management programs.[25] The guidance thus directs financial institutions to ensure that existing risk controls and practices encompass operational risks arising from social media activities.

Risk Management Program

In order to identify, measure and manage the legal, compliance, reputational and operational risks discussed above, the FFIEC expects each financial institution to maintain a risk management program appropriate to the size of that financial institution's social media presence, requiring an institution with a larger presence to have more extensive program. The FFIEC notes, however, that even institutions with limited or no official social media activities must still prepare to "address the potential for negative comments or complaints" arising from social media platforms and to provide their employees with guidance on their own use of social media that may implicate the institution.

Under the guidance, personnel from compliance, technology, information security, legal, human resources and marketing should assist in the development of the risk management program. Because, as mentioned above, the FFIEC states that the guidance does not impose any new obligations on financial institutions, the guidance is not detailed regarding the risk management program, but does state that it should include the following components:

Governance Structure

A financial institution's risk management program should designate roles and responsibilities such that senior management or the board of directors "direct how using social media contributes to the strategic goals of the institution," for example, by advertising the overall brand or specific products, and implement controls and periodic reviews of social media activities.

Policies and Procedures

A financial institution must create policies and procedures addressing the use and oversight of social media and compliance with all applicable consumer protection laws, regulations and guidance. In particular, the policies and procedures must "incorporate methodologies to address risks from online postings, edits, replies and retention." These policies and procedures may be separate from or incorporated into other institutional policies and procedures.

Third Party Due Diligence and Oversight

Third parties that provide social media services for a financial institution, including the administration of proprietary social media sites, should be subject to due diligence processes and oversight.

Training

Employees should be trained on an institution's policies with respect to official, work-related uses of social media and what activities are impermissible.

Audit and Compliance

A financial institution should implement audit and compliance functions to ensure all applicable internal policies, regulations and laws are being followed.

Periodic Reporting and Review

A financial institution 's board of directors or senior management should receive periodic reports on the effectiveness of the social media program.

The FFIEC specifically requests comments on (a) whether other types of social media, or ways in which social media is used, should be added to the guidance, (b) whether any other consumer protection laws, regulations, policies or concerns should be added to the guidance, and (c) whether there are any technological or other impediments to financial institutions' compliance with applicable laws, regulations or policies.

25 *See* FFIEC InfoBase for all information technology handbooks, *available at* http://ihandbook.ffiec.gov.

Federal Reserve Finalizes Stress Testing Requirements for Systemically Important Nonbank Financial Companies and Savings and Loan Holding Companies

Gregory J. Lyons, Paul D. Patton, Samuel E. Proctor

On October 12, 2012, the Board of Governors of the Federal Reserve System (the "Federal Reserve") published in the Federal Register two final rules (the "Final Rules") implementing the stress testing requirements of Section 165(i) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The first (the "SIFI Final Rule") requires systemically important nonbank financial companies designated by the Financial Stability Oversight Council ("SIFIs") and bank holding companies ("BHCs") with $50 billion or more in total consolidated assets ("Title I BHCs") to perform supervisory and company-run stress tests.[1] The second (the "Holding Company Final Rule") requires depository institution holding companies with total consolidated assets of $10 billion or more other than Title I BHCs to conduct company-run stress tests.[2] This Article discusses the Final Rules as applied to SIFIs and savings and loan holding co mpanies ("SLHCs") with $10 billion or more in total consolidated assets ("Covered SLHCs") (together, "Covered Companies").

Background

As part of its overall objective of mitigating systemic risk, Title I of the Dodd-Frank Act subjects SIFIs and Title I BHCs to enhanced regulation and supervision by the Federal Reserve and enhanced prudential standards, including capital, liquidity, risk management and other requirements. Among these enhanced prudential standards, Section 165(i)(1) requires the Federal Reserve to conduct supervisory stress tests of SIFIs and Title I BHCs. In addition, Section 165(i)(2) of the Dodd-Frank Act requires that SIFIs, Title I BHCs and depository institution holding companies with total consolidated assets of $10 billion or more conduct stress tests on a semi-annual (in the case of SIFIs and Title I BHCs) or annual (in the case of depository institution holding companies with $10 billion or more in assets) basis.

On January 5, 2012, the Federal Reserve issued a notice of proposed rulemaking (the "Proposed Rule") to implement certain of the enhanced prudential standards, including the stress testing requirements of Section 165(i).[3] While the Proposed Rule implements several of the enhanced prudential standards contemplated by Title I, including capital, liquidity and risk management requirements, the Final Rules address only the stress testing requirements of Section 165(i); the Federal Reserve has yet to finalize the remaining enhanced prudential standards implemented by the Proposed Rule.

Stress Testing Requirements for SIFIs and Covered SLHCs

Implementation Timeline

Section 171 of the Dodd-Frank Act, commonly known as the "Collins Amendment," requires that the Federal Reserve impose consolidated capital requirements on SIFIs and all SLHCs, including Covered SLHCs. In recognition of the fact that the Federal Reserve has yet to impose such requirements, the Final Rules establish staggered implementation timeframes for the stress testing requirements for Covered Companies. Under the Final Rules, Covered Companies must commence stress testing beginning with the cycle commencing the calendar year <u>after</u> the year they first become subject to minimum regulatory

1 Supervisory and Company-Run Stress Test Requirements for Covered Companies, 77 Fed. Reg. 62,378 (Oct. 12, 2012).

2 Annual Company-Run Stress Test Requirements for Banking Organizations With Total Consolidated Assets Over $10 Billion Other Than Covered Companies, 77 Fed. Reg. 62,396 (Oct. 12, 2012).

3 Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012).

capital requirements imposed by the Federal Reserve. As noted above, the Proposed Rule, which would impose capital requirements on SIFIs, is not yet final. In addition, the Federal banking agencies have separately issued three notices of proposed rulemaking that would substantially revise the regulatory capital framework for U.S. banking organizations, and would impose consolidated regulatory capital requirements on all SLHCs, including Covered SLHCs, for the first time.[4]

Stress Testing Methodologies and Practices

In addition to an annual supervisory stress test conducted by the Federal Reserve, the SIFI Final Rule requires SIFIs to perform annual stress tests by January 5 and "mid-cycle" stress tests by July 5 of each calendar year, using September 30 data in the case of annual stress tests and March 31 data in the case of mid-cycle stress tests. For annual stress tests, SIFIs must use baseline, adverse and severely adverse economic scenarios provided by the Federal Reserve. For mid-cycle stress tests, SIFIs must develop and employ baseline, adverse and severely adverse scenarios that are "appropriate" to the SIFI's risk profile and operations.[5]

The Holding Company Final Rule requires Covered SLHCs with more than $10 billion but less than $50 billion in total consolidated assets to perform stress tests by March 31 of each calendar year using data as of September 30 of the previous calendar year. Covered SLHCs with $50 billion or more in total consolidated assets must perform stress tests by January 5 of each calendar year using data as of September 30 of the previous calendar year. In each case, Covered SLHCs must use baseline, adverse and severely adverse scenarios provided by the Board.

Stress tests performed pursuant to the Final Rules must estimate the potential impact of stressed conditions on Covered Companies' capital positions. The Covered Company's board of directors or a committee thereof must approve and review the Company's stress testing policies, procedures and processes as frequently as economic conditions or the condition of the company may warrant, but no less than annually. The Covered Company's board and senior management must consider the stress test results as part of normal-course business activities, including with respect to capital planning, assessment of capital adequacy, and risk management processes.

Disclosure of Stress Test Results

Section 165(i) requires that stress test results be publicly disclosed. The Final Rules implement these disclosure requirements, but with certain modifications as compared to the Proposed Rule. First, the Federal Reserve has adjusted the timeframes during which disclosure of stress test results must take place, so as to avoid overlap with "quiet periods" under the Federal securities laws. Second, to account for the concern that disclosure of supervisory stress results under the baseline and adverse scenarios could potentially amount to the provision of earnings guidance, Covered Companies will only be required to disclose stress test results under the severely adverse scenario, and will not be required to disclose results under the baseline or adverse scenarios.

Tailoring of Stress Testing for SIFIs

The Federal Reserve notes in the preamble to the Final SIFI Rule that the stress testing requirements may need to be tailored to SIFIs that differ in structure, risk profile and mix of activities from a Title I BHC. For example, in response to comments that the Proposed Rule's stress testing requirements were overly "bank-centric" in nature, the Federal Reserve states that it

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4 *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52,792 (Aug. 30, 2012); Regulatory Capital Rules: Standardized Approaches for Risk-Weighted Assets; Market Discipline and Disclosure Requirements; 77 Fed. Reg. 52,888 (Aug. 30, 2012); Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule; 77 Fed. Reg. 52,978 (Aug. 30, 2012).

5 The Federal Reserve has integrated implementation of the Final SIFI Rule with the capital planning process for Title I BHCs, the Consolidated Capital Assessment and Review ("CCAR"). *See* Federal Reserve, *Comprehensive Capital Analysis and Review 2013 Summary Instructions and Guidance* (Nov. 9, 2012), available at http://www.federalreserve.gov/newsevents/press/bcreg/ 20bcreg20121109b1.pdf.

"may, by order or regulation, tailor the application of the enhanced standards to [SIFIs] on an individual basis or by category" and that the Federal Reserve "expects to take into account differences among bank holding companies and [SIFIs] … when applying enhanced supervisory standards, including stress testing requirements."[6] Thus, it appears that the Federal Reserve intends to tailor application of the Final SIFI Rule to the specific SIFI.

The Final Rules have particular implications for SIFIs and Covered SLHCs that are predominantly insurance enterprises.

Additional Guidance

The Federal Reserve has provided additional guidance that will impact implementation of the Final Rules. On November 23, 2012, the Federal Reserve published for comment in the Federal Register a policy statement detailing its framework for stress testing scenario design.[7] The policy statement is open for comment until February 15, 2013, and describes the Federal Reserve's approach to scenario design that will be used in connection with implementation of the Final Rules. Separately, the Federal Reserve indicated in the preamble to the Final SIFI Rule that it plans to "issue supervisory guidance to provide more detail describing supervisory expectations for company-run stress tests" that would be "tailored based on the size and complexity" of the specific company.[8] In addition, the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (the "OCC") have separately promulgated final rules and related policy statements implementing the stress testing requirements of Section 165(i) for depository institutions with $10 billion or more in total consolidated assets subject to their jurisdiction.[9] These parallel efforts by the FDIC and OCC will presumably influence the Federal Reserve's implementation of the Final Rules.

Implications for SIFIs and Covered SLHCs

The Final Rules present several implications for both SIFIs and Covered SLHCs, which are discussed below.

Impact on SIFIs and SLHCs Engaged in Nonbanking Activities

The Final Rules have particular implications for SIFIs and Covered SLHCs that are predominantly insurance enterprises. As noted above, the Federal Reserve has explicitly indicated its intent to tailor the application of the Final SIFI Rule to SIFIs that differ from Title I BHCs, further evidence of the Federal Reserve's stated intention to tailor the enhanced prudential standards to SIFIs that differ from "traditional" banking organizations.[10] However, because no SIFIs have yet been designated, let alone made subject to enhanced prudential standards, the mechanics of this tailoring process have yet to be made clear.[11] At the very least, however, the Federal Reserve will presumably seek to take into account insurance-specific risks in stress tests for insurance-centric SIFIs, such as mortality risk in the case of a life insurer or catastrophe risk in the case of a property and casualty insurer. The failure of the Federal Reserve to so tailor the Final SIFI Rule could have negative implications for insurance-centric SIFIs, as discussed below.

6 Supervisory and Company-Run Stress Test Requirements for Covered Companies, 77 Fed. Reg. 62,380.

7 Policy Statement on Stress Testing Scenario Design, 77 Fed. Reg. 70,124 (Nov. 23, 2012).

8 Supervisory and Company-Run Stress Test Requirements for Covered Companies, 77 Fed. Reg. 62,380.

9 *See*, e.g., Annual Stress Test, 77 Fed. Reg. 62,417 (Oct. 15, 2012) (FDIC); Annual Stress Test, 77 Fed. Reg. 61,238 (Oct. 9, 2012) (OCC).

10 In testimony before the House of Representatives, Federal Reserve staff similarly indicated their intention to tailor application of the enhanced prudential standards to SIFIs. *See Systemically important financial institutions and the Dodd-Frank Act: Before the H. Subcomm. on Financial Institutions and Consumer Credit*, 112th Cong. (2012) (statement of Michael S. Gibson, Director, Division of Banking Supervision and Regulation, Federal Reserve).

11 Given the considerable complexity presented by the task of tailoring application of the enhanced prudential standards to non-bank-centric enterprises, the Federal Reserve itself may have not yet determined how it will undertake this process.

The Holding Company Final Rule is less clear as to how the stress testing requirements will be tailored to Covered SLHCs that are predominantly insurance enterprises or otherwise engage in other nonbanking activities, such as commercial or industrial activities. While the Federal Reserve states in the preamble to the Holding Company Final Rule that it expects to tailor the application of the Rule to Covered SLHCs with less than $50 billion in total consolidated assets, the Federal Reserve does not appear to address the issues presented by application of the Holding Company Final Rule to a Covered SLHC with $50 billion or more in total consolidated assets that differs in structure and mix of activities from a bank-centric SLHC, issues similar to those arising from the application of the SIFI Final Rule to an insurance enterprise. Given that there will be a substantially greater number of Covered SLHCs that engage in insurance or other nonbanking activities than SIFIs, this tailoring issue would appear to be of significant importance to Covered SLHCs, including those with $50 billion or more in total consolidated assets. In any event, as the Federal Reserve gains a deeper understanding of SLHCs through its ongoing regulation and supervision of these entities, it may further tailor application of the Holding Company Final Rule to Covered SLHCs that engage in insurance, commercial, industrial or other nonbanking activities.

Federal Reserve Disclosure of Stress Test Methodologies

An additional issue that has proven to be of significant importance to Title I BHCs is the Federal Reserve's lack of disclosure with respect to its stress test methodologies. In the CCAR context, for example, Title I BHCs have argued that the Federal Reserve's failure to provide substantive disclosure as to its stress test methodologies and assumptions essentially means that the Federal Reserve's approach to capital planning and stress testing is a "black box" that fails to provide institutions with sufficient certainty.

Insurance-centric SIFIs will presumably desire similar transparency from the Federal Reserve regarding the application of the Final SIFI Rule. Such additional transparency (or lack thereof) may be even more impactful with respect to insurance-centric SIFIs than with respect to Title I BHCs, because state insurance law currently does not provide for a stress testing regime anywhere near as comprehensive as the regime contemplated by the Final SIFI Rules, and because additional transparency with respect to stress testing methodologies may help prevent market confusion that would otherwise result from the disclosure of an insurance-centric SIFI's stress test results.

Conclusion

The Final Rules represent the first of several steps that must still take place before implementation of the enhanced prudential standards is complete. In this regard, it does not appear that the Federal Reserve intends to finalize the other enhanced prudential standards applicable to SIFIs and Title I BHCs covered in the Proposed Rule, including capital, liquidity and risk management standards, in the near future.

The impact of the Holding Company Rule on Covered SLHCs, especially those that are predominantly insurance enterprises, may be more muted than initially suspected. This is because since the passage of the Dodd-Frank Act, several SLHCs with $50 billion or more in total consolidated assets have taken steps to divest or restructure their savings associations such that they are removed from the sphere of Federal Reserve regulation and supervision and the potential applicability of enhanced prudential standards, including the stress testing requirements of Section 165(i). As of this writing, for example, several large insurers have either divested their savings association or converted it to a limited purpose entity that engages only in trust and fiduciary activities.[12] The SLHC regulatory regime established by the Dodd-Frank Act

12 *See, e.g.*, Federal Reserve Letter to Raymond J. Manista, Esq. (Sept. 26, 2012) (approving the request of Northwestern Mutual Life Insurance Company to deregister as an SLHC by converting its subsidiary savings association to a "trust-only" company).

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therefore appears to be having the ultimate effect of reducing the number of SLHCs, especially those that are predominantly insurance enterprises.[13]

Ultimately, the Final Rules appear likely to impact insurance-centric SIFIs to a significant extent. As noted previously, insurers are not subject to equivalent requirements under state insurance law, and therefore the imposition of comprehensive stress testing requirements on a large, complex and internationally active insurance group would appear to be unprecedented in its own right. In addition, and as exemplified by the CCAR process for Title I BHCs, the Federal Reserve appears to have signaled that there will be substantial interrelationships between stress testing and capital planning requirements for SIFIs. Thus, insurance-centric SIFIs may eventually face restrictions on their ability to return capital to shareholders to the extent they are unable to demonstrate to the Federal Reserve their ability to maintain a strong capital position during "stressed" conditions, regardless of whether those "stressed" conditions relate to the actual risks that are most relevant to the insurance company balance sheet. Insurance companies potentially subject to designation as SIFIs may therefore wish to consider whether additional steps can be taken to educate the Federal Reserve about the development of a stress testing regime that takes appropriate account of the risks facing insurers, risks that may differ substantially from those facing Title I BHCs.

13 A Covered SLHC designated as a SIFI would become subject to the Final SIFI Rule. Thus, certain SLHCs may eventually become subject to the Final SIFI Rule despite the divestiture or restructuring of their affiliated savings associations.

The UK's New Financial Services Regulatory Structure – the Shape of Things to Come

Jeremy Hill and Edite Ligere

In June 2010, the UK's coalition government announced that it would embark on a major reform of the UK's financial services regulatory structure. The government's plan will abolish the UK's existing regulator of financial services, the Financial Services Authority (the "FSA") in its current form, and, in April 2013 establish three new regulatory bodies. The new regulatory bodies will be: (i) the Financial Policy Committee ("FPC"), which will be a committee of the Bank of England ("BoE"); (ii) the Prudential Regulation Authority ("PRA") which will be a subsidiary of the BoE; and (iii) the Financial Conduct Authority ("FCA") which will be a company limited by guarantee.[1] The Financial Services Act 2012 implements these structural changes.

The FPC will be responsible for macro-prudential regulation of the UK's financial services system. It will identify, monitor and respond to systemic risks by directing the PRA (and, where necessary, the FCA) to take appropriate and timely action to remediate identified risks. The FPC will not itself directly supervise firms. The PRA and the FCA will inherit the majority of the FSA's existing functions, and be given certain new powers.

The "Twin Peaks" Regulators: The Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA")

Since the beginning of 2012, the FSA has operated a "twin peaks" internal model in preparation for the split between the PRA and the FCA in 2013. The FSA has stated that it expects regulatory decision-making by the PRA and the FCA to be largely similar to that of the FSA. However, whereas the FSA has proceeded on a "principles-based" approach to financial regulation, the government has made it clear that the new financial regulatory bodies will adopt a "judgment-based" approach to financial regulation. This is intended to be more proactive and interventionist. Only time will tell quite what the difference between the two approaches will mean in practice.

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The PRA

The PRA will become the UK's prudential regulator for those firms which the government believes should be subject to significant prudential regulation, such as banks, building societies, credit unions, insurers, Lloyd's of London and certain investment firms. These firms will be referred to as "dual-regulated firms", as they will also be regulated by the FCA for conduct purposes.

The PRA will:

- have a variety of formal supervisory powers available to reduce a firm's risk. Among other things, the PRA may vary a firm's permission or impose a requirement;
- work cooperatively with firms in resolving supervisory issues but will use formal powers where appropriate;

1 A corporate structure used for not-for-profit organizations.

- use its authority to secure *ex ante*, preventative or remedial action. The PRA also will have a set of disciplinary and other enforcement powers, including imposing financial penalties or publishing public censures.

The FCA

The FCA will:

- be responsible for the conduct of business regulation of all firms, including dual-regulated firms;

- inherit the majority of the FSA's market regulatory functions, including the FSA's role as the UK Listing Authority ("UKLA"); and

- be responsible for the prudential regulation of firms not regulated by the PRA (referred to as FCA-authorised firms or FCA-only firms).

The government intends to give the FCA a number of powers, including the power to:

- make temporary product intervention rules, allowing it to block an imminent product launch or to stop an existing product;

- require firms to withdraw or amend misleading financial promotions with immediate effect;

- publish details of the start of enforcement proceedings against a firm for rule breaches or compliance failings (an authority shared with the PRA); and

- impose requirements on certain unregulated parent undertakings that exert influence over authorised persons (along with the PRA). FCA-authorised firms will be firms for whom the FCA will be the sole regulator. If the firm's immediate group includes a dual-regulated firm, the FCA may need to consult the PRA in certain circumstances.

FCA and PRA Handbooks

The FCA and PRA will each have their own separate handbook of rules and, in the case of the FCA, guidance. In the short term, both regulators will adopt the relevant parts of the FSA's Handbook, with some parts being shared between the two regulators.[2]

"Dual-regulated" (or PRA-authorised) Firms

"Dual-regulated" firms (also known as PRA-authorised firms) are defined as systemically important institutions such as banks, insurers and significant investment firms. Such firms will have the PRA as their lead regulator. However, although they will be authorised by the PRA, their conduct will be regulated by the FCA. The FCA and the PRA will be under a statutory duty to co-ordinate their activities on regulatory processes (such as change in control and the approved persons regime) involving "dual-regulated" firms.

Impact of New Structure on Regulatory Processes

The new regulatory structure is likely to have a significant impact on existing regulatory processes, including the authorisation of new firms, the approved persons regime, change in control and passporting of financial services throughout the EU. This is due to the fact that both the PRA and the FCA will be involved in these processes in respect of some firms.

Authorisation to Carry On Regulated Activities under the New Regime

The FSA's existing functions under Part IV of the Financial Services and Markets Act 2000 ("FSMA") relating to the authorisation of firms to carry on regulated activities will be split between the PRA and the FCA. The PRA will deal with applications for authorisation of dual-regulated firms. Although the PRA will be responsible for deciding whether or not to grant permission, it will need the FCA's consent before doing so. Firms which are presently regulated by the FSA will be "grandfathered" into the new structure and will not need to reapply to the FCA or the PRA for authorisation.

The proposed authorisation process for applications for authorisation in respect of dual-regulated firms will be as follows:

2 The final handbooks are expected to be similar to the handbook currently used by the FSA. The rules will be made by the relevant body and will have binding effect.

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(a) Firms must apply to the PRA for authorisation if they wish to undertake an activity that requires them to be regulated by the PRA. They should not apply to the FCA separately;

(b) The PRA will lead on the authorisation process (although it must obtain the consent of the FCA before granting a permission). It will administer the application and be responsible for granting authorisation; and

(c) The PRA will assess applicant firms from a prudential perspective, using the same framework that will be used for the supervision of existing firms. The FCA will assess applicants from a conduct perspective.

Authorisation will not be granted unless both the PRA and the FCA are satisfied that it should be granted.

For new banks and insurers, the PRA will seek to adopt a flexible approach in its assessment of initial capital requirements, recognising that new banks are often small, unlikely to be of systemic importance and usually straightforward to resolve.

The FCA will be responsible for considering applications for authorisation by any person seeking to carry out regulated activities that do not include any PRA-regulated activities. However, if the applicant is a member of a group which includes a "dual-regulated" firm, the FCA will have to consult with the PRA before granting authorisation.

The new regime involves significant changes to the threshold conditions for authorisation to carry on regulated activities, including:

1. the application of different threshold conditions to dual-regulated and FCA-regulated firms; and
2. giving the PRA and the FCA the power to make "threshold condition codes".

Approved Persons and Controlled Functions

Responsibility for approving persons to exercise controlled functions will be split between the PRA and the FCA in line with each regulator's objectives.

Change of Control Applications

The PRA and the FCA will inherit the FSA's existing functions relating to the change of control regime under Part XII of FSMA.

The relevant prudential supervisor of the firm in which a holding is being acquired will consider the change of control application for that firm. Consequently, the PRA will consider applications for dual-regulated firms, while the FCA will consider applications in respect of FCA-authorised firms.

The relevant regulator considering a change of control application will be under a statutory duty to consult the other regulator where the application relates to a dual-regulated firm or an FCA-authorised firm which is part of a group containing a dual-regulated firm.

Passporting and Treaty Rights

The PRA will have the following responsibilities:

1. the PRA will be the lead regulator for any dual-regulated firms passporting out of the UK;
2. the PRA may make representations in respect of other firms passporting out of the UK if the applicant firm's group includes a dual-regulated firm;
3. for firms passporting into the UK, the PRA will be the lead regulator for any notifications relating to the Banking Consolidation Directive (2006/48/EC) (BCD), the Second Non-Life Directive (88/357/EEC), the Third Non-life Insurance Directive (92/49/EEC), the Consolidated Life Directive (2002/83/EC), and the Reinsurance Directive (2005/68/EC).

The PRA will be able to make representations in respect of other firms passporting into the UK if:

(a) the applicant firm is in the same group as a dual-regulated firm;

(b) the applicant firm will be prudentially regulated by the PRA; or

(c) the firm is likely to be designated for prudential regulation by the PRA as an investment firm.

The FCA will have the following responsibilities:

1. for firms passporting out of the UK, the FCA will be the lead regulator for any FCA-authorised firms passporting out the UK; and

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2. for firms passporting into the UK, the FCA will be the lead regulator for any notifications relating to all single market directives other than those for which the PRA is responsible. This means that the FCA will be responsible for notifications relating to the Markets in Financial Instruments Directive (2004/39/EC) (MiFID), the Insurance Mediation Directive (2002/92/EC) (IMD) and the UCITS IV Directive (2009/65/EC).

Further, the FCA will be required to consult the PRA about passporting applications by FCA-authorised firms if the immediate group of the firm includes a dual-regulated firm.

New Regulatory Powers over Unregulated Parent Entities

The Financial Services Act 2012 inserts a new Part 12A into the Financial Services and Markets Act 2000, which enables the FCA, the PRA and the Bank of England to impose regulatory requirements on unregulated U.K. parent companies that control or exert influence over regulated entities.

The new powers permit U.K. regulators to: (i) impose requirements on unregulated parent entities; (ii) gather information from these entities; and (iii) take enforcement action against these entities. The new powers are meant to ensure that a group's legal structure does not prevent U.K. regulators from taking appropriate action. For example, when an authorized firm is failing, a regulator might direct the firm's parent company to provide it with additional capital or liquidity. The term "parent entity" includes any U.K. incorporated unauthorized financial parent company in the chain of ownership, even if that company is not itself at the head of the ownership chain.

The powers which regulators may exercise over unregulated parent companies include requiring the unregulated parent either to take or refrain from taking specific action. The government expects that the power to direct unregulated parent entities will be used sparingly and only where the regulatory tools available for the regulated entity are not effective.

The Financial Services Act 2012 also gives the FCA, the PRA and the Bank of England the power to: (i) require unauthorized parent entities to provide information to them; and (ii) take enforcement action against an unregulated parent, including public censure and the imposition of financial penalties if the parent fails to comply with any regulatory requirements set out by the regulators. There will be a statute of limitations for regulatory action beginning with the first day on which the relevant regulatory body knew of the violation.

Reaction from the Industry

The reaction from the UK's financial services industry to the new regulatory structure has been cautious. In particular, it is feared that firms which will be "dual-regulated" under the new "twin-peaks" structure may face significant disruption. This is because such firms will need to adapt to supervision by two regulators instead of one and learn to navigate the new approach to regulatory processes such as, for example, the approved persons regime being split between two regulators.

Conclusion

It is likely to take some time before the financial services industry becomes comfortable with the UK's new financial regulatory structure. While the "twin-peaks" approach certainly has the potential to make the regulation of financial services in the UK more efficient, it also has the potential to cause confusion, especially as the regulators test the parameters of their new authority.

Federal Reserve Releases New Supervisory Framework for Large Financial Institutions

Paul D. Patton and Pratin Vallabhaneni

In its final Supervision and Regulation issuance in 2012, the Board of Governors of the Federal Reserve System (the "Federal Reserve") issued a new "Consolidated Supervision Framework for Large Financial Institutions ("SR 12-17" or the "Framework"),[1] which supersedes its prior supervisory framework[2] applicable to large financial institutions subject to Federal Reserve supervision. SR 12-17 generally broadens areas of supervisory emphasis to reflect prudential requirements mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). SR 12-17 does not mark a dramatic change in approach but is emblematic of the changes in the Federal Reserve's role as a prudential supervisor with responsibility for preventing future financial crises. The Federal Reserve notes that the consolidated supervision framework will be implemented in a multi-stage approach, and that additional supervisory and operational guidance will be developed to support implementation of the framework.

In this article, we describe the Framework's general scope and applicability. We then review the Framework's main objectives and then summarize its main elements. An Appendix is provided that reproduces the breadth of the Framework in full detail.

Scope and Applicability

The Framework applies by its terms to three categories of institutions, as follows:

1. **Large Institution Supervision Coordinating Committee ("LISCC")[3] Firms**
   These are the largest, most complex United States and foreign financial organizations subject to consolidated supervision by the Federal Reserve, including any nonbank financial companies designated by the Financial Stability Oversight Counsel (the "FSOC") for supervision by the Federal Reserve;

2. **Large Banking Organizations**
   These are domestic bank and savings and loan holding companies with consolidated assets of $50 billion or more that are not included in the LISCC portfolio; and

3. **Large Foreign Banking Organizations**
   These are foreign banking organizations with combined assets of operations in the United States of $50 billion or more that are not included in the LISCC portfolio.

Community banks, defined as institutions supervised by the Federal Reserve with total consolidated assets of $10 billion or less, are not subject to the Framework. However, as is often the case with supervisory policy expectations, this Framework is likely to be viewed as "best practices" even for firms that are neither large or complex. Importantly, the Framework clarifies that it merely establishes a baseline level of supervisory expectations, on top of which further formal and informal enforcement actions may be placed for institutions that are not in at least "satisfactory condition" or that have "material weaknesses or [other] risks."

Overview and Objectives of the Framework

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1 SR Letter 12-17, "Consolidated Supervision Framework for Large Financial Institutions."

2 *See* SR Letter 99-15, "Risk Focused Supervision of Large Complex Banking Organizations; *see also* SR Letter 08-9, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations."

3 The LISCC is a multidisciplinary body that overseas supervision and evaluates conditions of supervised firms. The committee also develops cross-firm perspectives and monitors interconnectedness and common practices that could lead to greater systemic risk.

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The Framework broadly sets forth two primary objectives:

1. **Enhancing Resiliency of a Firm to Lower the Probability of its Failure or Inability to Serve as a Financial Intermediary**
   Each firm is expected to ensure that the consolidated organization (or the combined operations in the United States in the case of foreign banking organizations) and its core business lines can survive under a broad range of internal or external stresses. This requires financial resilience by maintaining sufficient capital and liquidity, and operational resilience by maintaining effective corporate governance, risk management and recovery planning.

2. **Reducing the Impact on the Financial System and the Broader Economy in the Event of a Firm's Failure or Material Weakness**
   Each firm is expected to ensure the sustainability of its critical operations and banking offices under a broad range of internal or external stresses. This requires, among other things, effective resolution planning that addresses the complexity and the interconnectivity of the firm's operations.

These objectives inform the specific requirements and standards imposed by the Federal Reseve on the largest financial institutions that pose greater levels of systemic risk by virtue of their size and complexity.

A. Enhancing Resiliency of a Firm

1. **Capital and Liquidity Planning and Positions**
   In explaining its approach to supervision of capital and liquidity management and planning, the Federal Reserve noted that during the financial crisis it had identified significant weaknesses in the adequacy of point-in-time regulatory capital positions to address accumulated and prospective risks, which contributed to the failure or near failure of many financial firms. To address these shortcomings, SR 12-17 mandates that firms take various steps to ensure that capital and liquidity management and planning processes are sufficient to promote financial resiliency through periods of financial stress. This approach is generally consistent with the Federal Reserve's actions in implementing the prudential requirements of Section 165 of the Dodd Frank Act, including capital and liquidity planning requirements for large banking organizations.[4] Correspondingly, additional emphasis is placed on the internal modeling process for capital and liquidity positions, such as under adverse scenarios.[5] The Federal Reserve will also review the involvement of the Board in setting appropriate goals for capital and liquidity positions.

2. **Corporate Governance**
   SR 12-17 brings the review of firm corporate governance into stark focus, and sets forth a number of recommended actions to promote effective corporate governance. These include: maintaining a clearly articulated corporate strategy and institution risk appetite, ensuring that there is an appropriate level expertise and engagement within senior management to manage a firm's operations, promoting a culture that emphasizes the importance of compliance and ensuring that there are strong independent audit, compliance and risk management functions. Significantly, maintaining management information systems to support the Board's oversight responsibilities is also specifically highlighted. The Framework also reiterates Dodd-Frank Act-mandated requirements regarding sound incentive compensation.[6]

> Perhaps the largest change from any prior prudential framework implemented by the Federal Reserve is SR 12-17's commitment to ensuring that firms engage in robust recovery planning . . .

4 Capital Plans, 76 Fed. Reg. 74631 (Dec. 1, 2011); SR Letter 10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management.".

5 SR Letter 11-7, "Guidance on Model Risk Management."

3. Recovery Planning
Perhaps the largest change from any prior prudential framework implemented by the Federal Reserve is SR 12-17's commitment to ensuring that firms engage in robust recovery planning, which the Federal Reserve describes as "central to ensur[ing] the ongoing resiliency of a firm's consolidated operations as well as its core business lines, critical operations, banking offices and other material entities." SR 12-17 calls for firms to maintain clearly documented recovery plans containing both quantitative and qualitative triggers for implementation of specific elements of the remediation plan, including escalation procedures if initial remediation activities prove insufficient. An additional objective is to ensure that recovery planning is fully integrated into the firm's processes for resolution planning, capital and liquidity planning, crisis management and business continuity planning. Firms will need to coordinate these separate processes to ensure that they are sufficiently cohesive to promote a firm's financial resiliency under a broad range of market- and firm-specific stresses.

4. Management of Core Business Lines
The Framework reflects the fact that the largest firms are managed by business lines that may span multiple legal entities and legal jurisdictions. Accordingly the Framework requires significant corporate governance provisions to "extend to each business line," meaning that firm oversight requires having effective governance over business lines. A "core business lines" for purposes of SR 12-17 is defined as a business line (including associated operations, services, functions and support) that, in the firm's view, upon failure would result in a material loss of revenue, profit or franchise value, which tracks the definition in Section 165(d) resolution planning regulations.

B. Reducing the Impact of a Firm's Failure

1. Management of Critical Operations
The Framework, as with its focus on core business lines, imposes its corporate governance expectations on the management of a firm's critical operations. A "critical operation" is defined as an operation (including associated services, functions and support) that if it were to fail or be discontinued could pose a threat to the financial stability of the United States, which also tracks its definition of in the Section 165(d) resolution planning regulations. Additionally, the Framework prescribes that each critical operation should be sufficiently resilient in the event of failure or material financial or operational distress. The provision should be reflected in the firm's recovery and resolution plan.

2. Support for Banking Offices
The Framework rearticulates the Federal Reserve's long-standing policy that a consolidated organization should serve as a source of financial and managerial strength to its banking offices, which include the institution's subsidiaries and United States branches and agencies. The Framework provides that a parent company and its nondepository subsidiaries should not present material risks to affiliated banking offices, the consolidated organization itself or to the consolidated organization's ability to support its banking offices. The Framework clarifies that failing to address risks to a firm's banking offices may pose risks to the payment system, the Federal Reserve's discount window and possibly federal deposit insurance funds. SR 12-17 thus reflects the Federal Reserve's expectations that firms prioritize protecting the banking operations from potential risks presented by the consolidated organization.

3. Resolution Planning
The Framework reiterates requirements set forth in Section 165(d) of the Dodd-Frank Act pertaining to financial stability and orderly resolutions. Specifically, each bank holding company with consolidated assets of $50 billion or more

6 Guidance on Sound Incentive Compensation Policies, 75 Fed. Reg. 36395 (June 25, 2010).

as well as nonbank financial companies designated by the FSOC will be required to develop and maintain plans for rapid and orderly resolution in the event of material financial distress or failure. As noted by Federal Reserve and FDIC staff, although the planning process itself does not call for reorganization of a large financial firm, the regulators do anticipate, even if not expressed formally, that firms will modify their businesses to reduce areas of high complexity and difficult resolvability for purposes of Section 165(d) of the Dodd Frank Act.

4. **Additional Macroprudential Supervisory Approaches to Address Risks to Financial Stability**
   The Framework presents a range of areas in which the Federal Reserve will focus on to ensure financial stability. Notably, the Federal Reserve appears to be signaling through the Framework that it will increase the use of horizontal reviews to monitor "industry practices, common investment or funding strategies, changes in degree or form of financial interconnectedness". Additional areas of focus will be stress tests, review of financial market utility supervision, FSOC coordination and international financial body coordination. As a goal, the Federal Reserve aims to reduce systemic risks by increasing the capacity of firms and markets to absorb shocks and reduce the costs in the event of distress or failure.

Conclusion

The Framework generally presents a useful guidance document that outlines the Federal Reserve's primary areas of supervisory focus. Large financial firms are well advised to review the guidance carefully and to adjust their operations to keep abreast of the Federal Reserve's post-Dodd-Frank Act expectations. The Framework introduces a level of corporate governance that is somewhat novel in its articulation, and firm boards of directors and managers should take particular note of the requirements. The Framework will be implemented in a multi-stage approach, and firms should actively incorporate further guidance as it emerges.

APPENDIX: COMPREHENSIVE FRAMEWORK ELEMENTS AS OF DECEMBER 17, 2012

Capital and Liquidity Planning and Positions

Each firm should:

- Maintain strong capital and liquidity positions that not only comply with regulatory requirements, but also support the firm's ongoing ability to meet its obligations to creditors and other counterparties, as well as continue to serve as a financial intermediary through periods of stress;
- Have in place robust internal processes that enable the firm to maintain capital and liquidity commensurate with its unique risks under normal and stressful conditions, and to provide timely restoration of financial buffers in the event of drawdown;
- Maintain processes that enable the identification and measurement of potential risks to asset quality, earnings, cash flows and other primary determinants of capital and liquidity positions;
- Utilize comprehensive projections of the level and composition of capital and liquidity resources, supported by rigorous and regular stress testing to assess the potential impact of a broad range of expected and potentially adverse scenarios;
- Maintain sound risk measurement and modeling capabilities, supported by comprehensive data collection and analysis, independent validation, and effective governance, policies and controls;
- Establish goals for capital and liquidity positions that are approved by the firm's board of directors and reflect the potential impact of legal or regulatory restrictions on the transfer of capital or liquidity between legal entities; and

Maintain independent internal audit and other review functions with appropriate staff expertise, experience, and stature in the organization to monitor the adequacy of capital and liquidity risk measurement and management processes.

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Corporate Governance

Each firm's board of directors and committees, with support from senior management, should:

- Maintain a clearly articulated corporate strategy and institutional risk appetite. The board should set direction and oversight for revenue and profit generation, risk management and control functions and other areas essential to sustaining the consolidated organization;
- Ensure that the firm's senior management has the expertise and level of involvement required to manage the firm's core business lines, critical operations, banking offices, and other material entities (subsidiaries or foreign offices of the firm that are significant to the activities of a core business line or critical operations). These areas should receive sufficient operational support to remain in a safe and sound condition under a broad range of stressed conditions;
- Maintain a corporate culture that emphasizes the importance of compliance with laws and regulations and consumer protection, as well as the avoidance of conflicts of interest and the management of reputational and legal risks;
- Ensure the organization's internal audit, corporate compliance, and risk management and internal control functions are effective and independent, with demonstrated influence over business-line decision making that is not marginalized by a focus on short-term revenue generation over longer-term sustainability;
- Assign senior managers with the responsibility for ensuring that investments across business lines and operations align with corporate strategies, and that compensation arrangements and other incentives are consistent with the corporate culture and institutional risk appetite; and
- Ensure that management information systems support the responsibilities of the board of directors to oversee the firm's core business lines, critical operations and other core areas of supervisory focus.

Recovery Planning

Each firm should:

- Maintain clearly documented quantitative and qualitative criteria that would trigger timely implementation of specific elements of the firm's recovery plan and provide for more rigorous remediation activities if initial actions prove insufficient.
- Ensure that trigger events reflect a sufficiently broad range of market- and firm-specific stresses across financial, operational, reputational, legal and compliance risks;
- Ensure that recovery planning reflects a holistic view of sustainability and resiliency. Recovery planning should be closely integrated with resolution planning, capital and liquidity planning and other aspects of financial contingency, crisis management and business continuity planning;
- Undertake recovery testing and training exercises that consider a broad range of internal and external risk scenarios and account for interconnectivities across operations and legal entities;
- Ensure that the recovery plan is updated as needed and reflects lessons learned from reviews of trigger events, testing and training exercises; and
- Ensure that recovery planning is sufficiently integrated into corporate governance structures and processes, subject to independent validation, and effectively supported by related management information systems reporting to the board and its committees.

Management of Core Business Lines

Each core business line should have:

- Business-line senior management with qualifications and experience commensurate with the size and complexity of related activities and operations;
- A strategic planning process that ensures areas of growth and innovation are effectively managed;

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- Appropriate compensation and other incentives that are consistent with the institutional risk appetite and in compliance with laws and regulations;
- An independent and strong risk-management framework that supports identification, measurement, assessment and control of the full spectrum of risks; and
- Timely identification and resolution of audit, compliance and regulatory issues.

Management of Critical Operations

See discussion of management of core business lines.

Support for Banking Offices

Each firm should:

- Provide for the strength and resiliency of its banking offices, ensuring prompt financial and operational support so that each office remains in a safe and sound condition under a broad range of stressed conditions;
- Ensure that the activities of the parent company and nondepository institution subsidiaries do not present undue direct or indirect risks to the safety and soundness of banking offices. This includes the transmission of financial, operational, legal, compliance or reputational risks that may undermine public confidence in the financial strength of its banking offices;
- Maintain sufficient liquidity, cash flow and capital strength at the parent company and nondepository institution subsidiaries to service debt obligations and cover fixed charges. The parent company needs to consider whether there are any legal or regulatory restrictions on financial transfers between legal entities within the organization; and
- Implement and maintain effective policies, procedures and systems to ensure compliance with applicable laws and regulations. This includes compliance with respect to covered transactions subject to the Board's Regulation W, which implements Sections 23A and 23B of the Federal Reserve Act and limits a bank's transactions with affiliates.

Resolution Planning

Resolutions plans should address:

- The firm's strategic analysis describing its plans for rapid and orderly resolution under the United States Bankruptcy Code (or other relevant insolvency regimes). This strategy must not pose systemic risk and must exclude reliance on extraordinary support from the United States or any other government to prevent failure of the firm;
- The firm's strategy for maintaining and funding material entities, critical operations and core business lines in the event of material financial distress;
- Analysis of potential impediments to resolution and actions to make the firm more resolvable or otherwise reduce its complexity and interconnectivity;
- Analysis of whether the failure of a major counterparty would likely result in the material financial distress or failure of the firm;
- The manner and extent to which an insured depository subsidiary is adequately protected from risks arising from the activities of non-depository subsidiaries;
- For a United States firm with foreign operations, its strategy for addressing the risks arising from these foreign operations to its United States operations and its ability to maintain core business lines and critical operations in foreign jurisdictions; and
- Analysis of whether resolution planning is sufficiently integrated into corporate governance structures and processes, subject to independent validation, and effectively supported by related management information systems reporting to the board of directors and its committees.

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Additional Macroprudential Supervisory Approaches to Address Risks to Financial Stability

Macroprudential supervisory approaches will include:

- Using insights developed through microprudential supervision and related data collection and analysis to identify, understand and assess potential systemic risks. Areas of review could include, for example, emerging trends in critical operations, interconnectedness, rapidly expanding markets, cyclical industries and financial products lacking substitutes or effecting large market segments;
- Identifying potential risks to financial stability indicated by the information in supervisory stress tests and through trends in scenarios employed by firms in their internal stress tests;
- Using comparative and aggregate analysis to monitor industry practices, common investment or funding strategies, changes in degree or form of financial interconnectedness or other developments with implications for financial stability;
- Coordinating with the Federal Reserve's supervision of systemically important financial market utilities to identify and address risks related to payment, clearing and settlement activities, as well as to identify potential structural vulnerabilities;
- Working closely with the FSOC and other regulators and supervisors to support the designation and supervision of systemically important nonbank firms and to enhance the monitoring of systemic risk; and
- Enhancing international coordination with foreign counterparts, including national supervisors and international bodies such as the Basel Committee on Bank Supervision, the Financial Stability Board and the Senior Supervisors Group. These activities focus on enhancing oversight of internationally active financial firms and markets and on minimizing the opportunities for firms to take advantage of weaker or inconsistent regulations.