



# UNITED STATES

## FINANCIAL SECTOR ASSESSMENT PROGRAM

August 2020

### TECHNICAL NOTE—BANKING SUPERVISION AND REGULATION

This Technical Note on Banking Supervision and Regulation for the United States FSAP was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in July 17, 2020.

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July 17, 2020

## TECHNICAL NOTE

BANKING SUPERVISION AND REGULATION

Prepared By  
**Monetary and Capital  
Markets Department**

This Technical Note was prepared by IMF staff in the context of an IMF Financial Sector Assessment Program (FSAP) in United States held during October-November 2019 and February-March 2020. It was led by Ms. Michaela Erbenová. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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## Glossary

AMA	Advanced Measurement Approach
BCP	Basel Core Principles for Effective Banking Supervision
BHC	Bank Holding Company
CBO	Community Bank Organization
CP	Core Principle
CET1	Common Equity Tier 1
CCAR	Comprehensive Capital Analysis and Review
CECL	Current Expect Credit Losses
CLAR	Comprehensive Liquidity Analysis and Review
CRA	Congressional Review Act
CRO	Chief Risk Officer
CVA	Credit Valuation Adjustment
DAR	Detailed Assessment Report
DFA	Dodd Frank Act
EGRRCPA	Economic Growth Regulatory Relief Consumer Protection Act
eSLR	Enhanced Supplementary Leverage Ratio
GDP	Gross Domestic Product
IRR	Interest Rate Risk
IRRBB	Interest Rate Risk in the Banking Book
FBA	Federal Banking Agencies
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FBO	Foreign Banking Organization
FFIEC	Federal Financial Institutions Examination Council
FRB	The Federal Reserve System
FSAP	Financial Sector Assessment Program
FSOC	Financial Stability Oversight Council
GAAP	Generally Accepted Accounting Principles
GAO	Government Accountability Office
GFC	Global Financial Crisis
GSIB	Global Systemically Important Bank
LFBO	Large and Foreign Banking Organization
LFI	Large Financial Institution
LISCC	Large Institution Supervision Coordinating Committee
MRA	Matter Requiring Attention
MRBA	Matter Requiring Board Attention
MRIA	Matter Requiring Immediate Attention
NSFR	Net Stable Funding Ratio
OCC	Office of the Comptroller of the Currency
OIRA	Office of Information and Regulatory Affairs

RBO	Regional Banking Organization
RWA	Risk Weighted Assets
SCCL	Single-Counterparty Credit Limits
SLR	Supplementary Leverage Ratio
SNC	Shared National Credit
U.S.	United States

## EXECUTIVE SUMMARY AND KEY RECOMMENDATIONS

**This technical note leverages on the 2015 FSAP which concluded that the United States (U.S.) had a high degree of compliance with the Basel Core Principles (BCPs).** The FSAP reviewed the progress achieved in addressing the main weaknesses previously identified and the main supervisory and regulatory developments since then. The key focus are the steps taken by the U.S. authorities in recent years to recalibrate and further tailor the banking regulatory and supervisory framework and the role of stress tests in the supervision process. The FSAP team has not covered the impact of COVID-19 outbreak on banks supervision and has not discussed with authorities the related policy response. The FSAP recommendations are meant to be considered once the impact of the pandemic on the economy and the banking sector becomes clearer.

**The United States (U.S.) has a sound framework for the supervision of the banking sector.** The U.S. dual banking system with multiple Federal Banking Agencies (FBAs) which have distinct but overlapping responsibilities forms a complex framework, which puts an absolute premium on effective cooperation among the agencies. However, the clear roles and responsibilities assigned to each agency, an appropriate suite of tools and powers to conduct effective supervision and undertake timely corrective action, and a comprehensive and risk-based supervisory approach forms the base of a solid supervisory regime.

**The United States should implement remaining aspects of the BCPs, some of which persist from the previous assessment and require further attention.** Several key recommendations made in the 2015 FSAP have not been implemented. The authorities should introduce heightened standards on governance to large and complex banking holding companies, enhance the related-party framework, introduce rules on concentration risk management, and include more quantitative standards on interest rate risk in the banking book.

**The prudential framework should also be reviewed to address regulatory gaps which are emerging from a shifting balance between regulations, guidance and supervisory discretion.** For several topics such as those mentioned above, FBAs views have been traditionally articulated in guidance rather than regulations. While the 2018 interagency statement on the role of supervisory guidance has not changed the legal status of this type of instrument, there are signs that attitudes toward it are changing and thus incentivizing some banks to challenge the applicability of guidance. Authorities should take this opportunity to review the framework, aiming to address the regulatory gaps; streamline and simplify requirements which, sometimes, are spread in many documents from different agencies; and consider rewritten certain prudential guidance as regulation.

**The diversity of deposit-taking institutions that comprise the U.S. banking sector is conducive to a proportional approach to regulation, but all segments should be subject to rigorous prudential standards.** For the U.S. GSIBs, considered as internationally active banks by the authorities, capital and liquidity requirements meet and sometimes exceed the Basel standards. While the principle of proportionality is key for effective regulation, the focus should be on reducing disproportional compliance costs. The scope of application of the recently enacted tailoring reforms

is wide ranging, and we encourage U.S. authorities to maintain the overall stringency of prudential requirements for non-internationally active banks at a time when medium-term financial stability risks are rising. Regulatory changes will require fewer banks (other than the GSIBs) to be subject to the full set of Basel standards and will no longer require non-internationally active banks to comply with the full set of the Basel standards. In line with the BCPs, non-internationally active banks (Categories III and IV firms) should be required to comply with capital requirements that are broadly consistent with the Basel capital framework and appropriate large exposure limits. Authorities may also want to consider extending the full liquidity coverage ratio requirements to non-internationally active banks.

**It is also important to ensure that the supervisory and regulatory arrangements remain effective, independently of the charter choice of the supervised institutions.** The U.S. dual banking system with multiple Federal Banking Agencies (FBAs) which have distinct but overlapping responsibilities and numerous State supervisors forms a complex framework, which puts a premium on effective cooperation among the agencies. Despite the steps taken to reduce room for arbitrage, financial institutions have ample room to choose their charter, raising concerns that some institutions might seek more favorable supervisory treatment. The legal dispute between federal and state supervisors about the ability to grant a special purpose national bank charter to fintech firms suggests that the risks associated with charter shopping may rise. As new technologies blur lines between banks and some fintech firms and may allow these firms to potentially become systemic in a relatively short time, supervisors need to ensure that they will be appropriately supervised irrespective of their charter.

**Recent changes to the stress test program will likely result in lower regulatory capital requirements for many large banks, calling for caution.** Most banks subjected to the supervisory stress testing process consider it to be the main driver of their capital requirements. It will be important to ensure that the combined effect of all changes to the program and their interaction with the tailoring initiatives do not pose undue risks to the safety and soundness of affected banks. Supervisors are encouraged to intervene promptly to ensure that banks continue to adhere to sound capital planning practices and good governance and risk management.

**The new supervisory environment created by the regulatory tailoring further increases the importance of high-quality bank supervision.** The FBAs have been very successful fulfilling their mandate and enhancing the resilience of the banking sector. However, to effectively face new challenges arising from regulatory changes, rapid technological transformation of financial services, renewed industry pressure against supervisory actions and vulnerabilities that continue to build in a maturing credit cycle, it is key to maintain the intensity of supervisory scrutiny and to be agile in responding to new threats to financial stability. As supervisory stress tests become less frequent and capital and liquidity requirements less stringent for some non-internationally active banks, supervision needs to maintain an intrusive approach and continue enhancing its effectiveness. While regulation and supervision are not perfect substitutes, the FBAs can mitigate the risks using the full gamut of their toolkit to effectively address them.



**Table 1. United States: Main Recommendations**

<b>Recommendation</b>	<b>Priority</b>	<b>Timeline</b>
Amend the 2009 interagency statement on charter conversions to ensure that the supervisory arrangement remains effective, independently of the charter choice of the supervised institutions. (¶29)	High	NT
Streamline regulatory requirements, and consider rewriting certain prudential guidance as regulation. (¶30)	High	MT
Streamline and simplify the regulatory framework by reducing the number of guidance statements on the same topic, improving the consistency between all requirements and guidelines, and further developing interagency work. (¶70)	Medium	MT
Review capital requirements for non-internationally active banks (Category III and Category IV firms) and ensure that they are broadly consistent with the Basel standards and appropriate concentration limits. (¶70)	High	NT
Consider extending the full liquidity coverage ratio requirement to non-internationally active banks (Category III and Category IV firms). (¶70)	High	NT
Introduce a capital charge for operational risk for those non-internationally active banks and BHCs using standardized approaches and expand the scope of supervisory reporting of operational risk events and associated losses. (¶70)	High	MT
Introduce heightened standards on the governance of large and complex banking holding companies, enhance the related-party framework, introduce rules on concentration risk management, and include more quantitative standards regarding interest rate risk in the banking book. (¶70–71)	High	MT
Assess the combined impact of all recent reforms including changes to the stress test program and ensure that they do not pose risks to the safety and soundness of banks. (¶80)	High	NT
Continue work on exploring second-round effects, possibly by integrating capital and liquidity stress tests. (¶79)	Medium	MT
Leverage the stress test framework to probe the prudential implications of longer-term structural issues in the banking industry. (¶79)	Medium	MT
Take further actions to tackle aging resolution of matters requiring attention, including: actions to further improve communication; and introducing more explicit rules and processes to escalate supervisory actions in the absence of timely and appropriate responses from banks. (¶98)	High	NT
Enhance the early intervention framework with policy limits for issues such as concentration and interest rate risks. (¶99)	Medium	MT
NT = Near Term (within six months / one year); MT = Medium Term (within 23 years)		

# INTRODUCTION

## A. Scope and Approach

1. **This technical note analyzes the key aspects of the regulatory and supervisory framework for banks operating in the United States.** The analysis is part of the 2020 Financial Sector Assessment Program (FSAP) of the United States. It is based on the regulatory framework in place and the supervisory practices employed as of March 10, 2020.<sup>1</sup> The analysis was based on a review of regulations and supervisory guidance, meetings with the Federal Banking Agencies' (FBAs<sup>2</sup>) and review of their joint self-assessments and responses to questionnaires. The FSAP team also met with selected state bank supervisors and representatives from banks, consulting firms, credit rating agencies and industry associations.
2. **The 2015 FSAP performed a full assessment of compliance with the 2012 Basel Core Principles for Effective Banking Supervision (BCP), concluding that the United States had a high degree of compliance with the BCPs.** This technical note leverages that assessment by reviewing the progress achieved in addressing the main weaknesses previously identified and the main supervisory and regulatory developments since then. While the BCP served as the basis for the evaluation, no formal assessment has been conducted against BCP principles.
3. **A key focus this time around is the steps taken by the U.S. authorities in recent years to recalibrate and further tailor the banking regulatory and supervisory framework.** In response to the global financial crisis the 2010 by the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) led to an increase in supervisory intensity and increased the stringency of the regulatory framework. The U.S. authorities have argued that the sweeping scope and excessive costs imposed by the DFA have resulted in a slower rate of bank assets and loans growth; and that it was necessary to correct regulatory imbalances impacting market liquidity and the extension of credit.<sup>3</sup> In May 2018, the U.S. Congress passed The Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). It sought to recalibrate some regulatory requirements, notably for smaller banks and for those banks with assets between US\$50–250 billion that had been considered systemic under the DFA. The EGRRCPA also specifically directed the FBAs to tailor oversight of institutions. In response, the FBAs have been adjusting the regulatory and supervisory framework to the size and systemic importance of financial institutions.
4. **Special attention has also been devoted to the role of official stress tests within the regulatory and supervisory framework.** The importance of stress tests in the regulatory and

<sup>1</sup> The main authors of this technical note are Caio Ferreira and Luc Riedweg (IMF) and Lyndon Nelson (IMF expert, Deputy Chief Executive Officer of the Bank of England Prudential Regulatory Authority). Input was also provided by Mark Zelmer (IMF expert, former Deputy Superintendent at the Office of the Superintendent of Financial Institutions Canada).

<sup>2</sup> For the purposes of this assessment, the FBAs are the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), and the Office of the Comptroller of the Currency (OCC).

<sup>3</sup> U.S. Treasury report "A financial System that Creates Economic Opportunities – Banks and Credit Unions", June 2017.

supervisory framework has grown over the past five years. Supervisory stress tests and the CCAR qualitative reviews of bank capital plans and governance/risk management practices have become important tools for U.S. supervisors in their assessments of the soundness and resilience of large banks. Indeed, most banks subjected to the supervisory stress testing process and many observers consider it to be the main driver of bank capital requirements. Given this significant importance and several recent adjustments of the methodology, this FSAP analyzed the evolution and risk coverage of the stress testing program along with the balance between supervisory stress tests and other supervisory examination processes.

**5. The FSAP team has not been able to quantitatively assess the materiality of some regulatory reforms.** Regulatory proposals issued by FBAs are usually very granular, providing the public with valuable information, including impact analyses. However, additional details which are important to assess financial stability such as banks specific information as well as the combined effects of reforms are not available. The team believes that it is important that the FBAs put out a comprehensive and cumulative impact assessment based on all regulatory changes to provide the assurance that these measures will not lead to a material reduction in the capital and liquidity buffers that have been built up with the objective of reducing the likelihood and severity of the occurrence of systemic crises in the future

**6. The IMF mission thanks the authorities and private sector participants for their cooperation.** The FSAP team benefited greatly from the inputs received and exchanges of views during meetings with supervisors and market participants. The team sincerely thanks the FBA' staff for their professionalism, spirit of cooperation, and for making enormous efforts to respond to the team's requests and overcome logistical challenges.

## B. Financial Sector Structure

**7. The United States has a large and diverse financial sector.** With total assets at about US\$98 trillion and 480 percent of GDP, the U.S. financial sector is the largest in the world. The system is more diverse than those in other advanced countries. As a result, despite its sheer size, the share of banking sector assets in the financial system, about 19 percent, is smaller than in most countries.

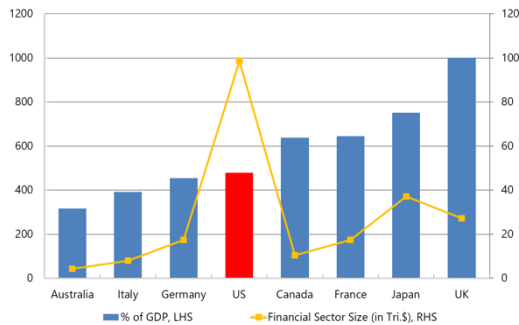
**8. Non-bank financial institutions have become increasingly important over the last decade.** Between 2008 and 2019, banking sector assets have grown at an average annual rate of 3 percent to US\$19.5 trillion (92 percent of GDP). The pension and investment funds sectors have grown considerably faster and are now larger than the banking sector (Figure 1).

**9. While banks are present in almost every credit market, other types of institutions play a large role in credit intermediation.** Banks are the main providers of mortgage credit, but Government Sponsored Enterprises have substantial mortgage credit risk exposure, largely because they provide a credit guarantee to investors on mortgage-backed securities. Banks also play an important role in consumer credit market (together with finance companies). Insurance sector and investment funds are the main source of financing of corporate debt securities.

**Figure 1. United States: Financial Sector Structure**

The U.S. financial system is large in absolute and relative terms.

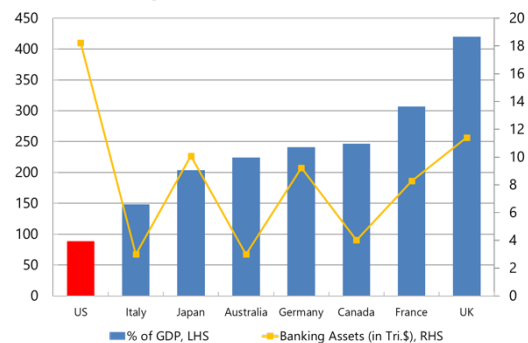
**Size of financial sector assets**  
(as end of 2018)



Sources: Flow of Funds, Haver Analytic.

Despite its very large size, the relative importance of the banking sector is lower than in most countries.

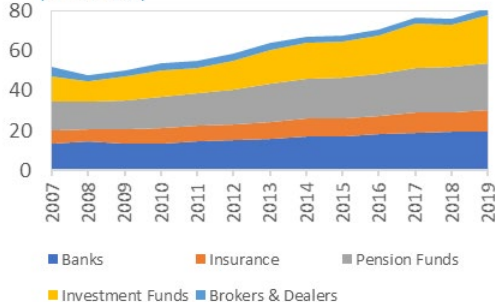
**Size of banking sector assets**



Sources: FSI database, Haver analytic.

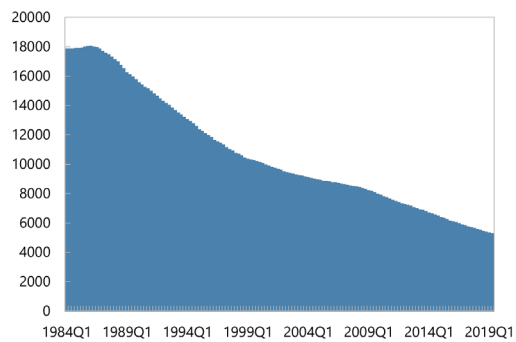
During the last decade banks have grown at a slower pace than the asset management industry.

**Total Assets**  
(Trillion USD)



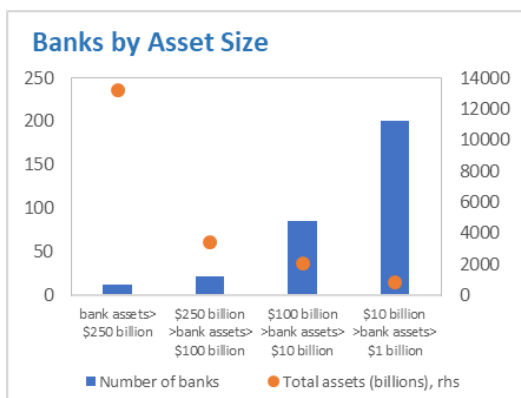
The banking sector is consolidating, and the number of banks has followed a long downward trend.

**Number of commercial banks - FDIC insured**



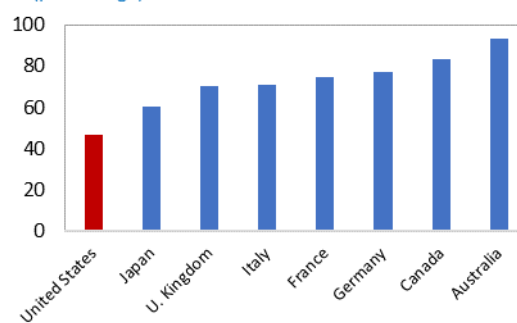
Sources: FDIC.

The large banks comprise the majority of the banking system assets.



But the system is less concentrated than in other advanced countries.

**Market share of top 5 banks**  
(percentage)



Sources: Flow of Funds; Global Financial Development Database, FRB, FDIC, IMF staff calculation.

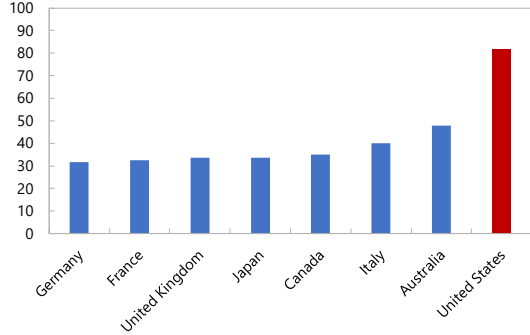
**Figure 2. United States: Banking Sector Indicators**

*Structural and regulatory specificities increase the average risk-weight of U.S. banks exposures....*

*...contributing to a relatively low leverage sector,...*

**Risk Weighted Assets-to-Total Assets**

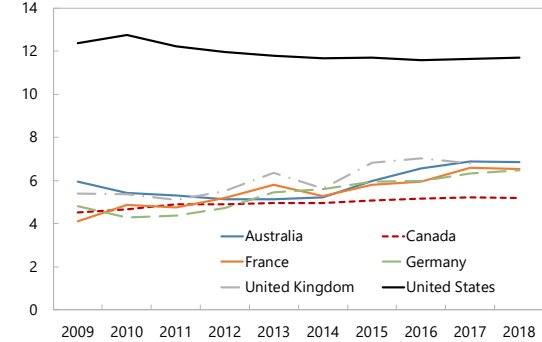
(In percent)



*...despite average capital ratios below peers.*

**Capital-to-Total Assets**

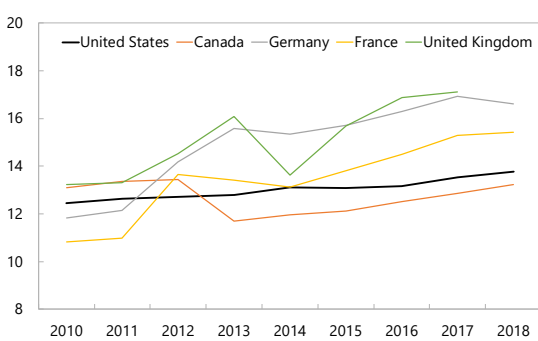
(In percent)



*Banks profitability is substantially above peers.*

**Tier 1 Capital-to-Risk Weighted Assets**

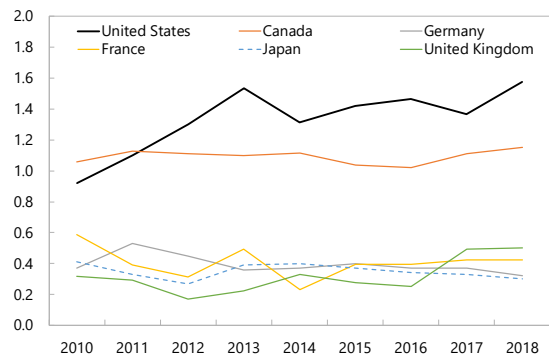
(In percent)



*Asset quality has improved during the last decade and is strong.*

**Return on Assets**

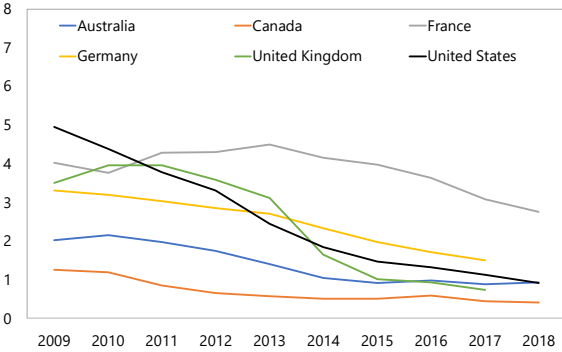
(In percent)



*Banks liquidity also compares favorably in relation to peers.*

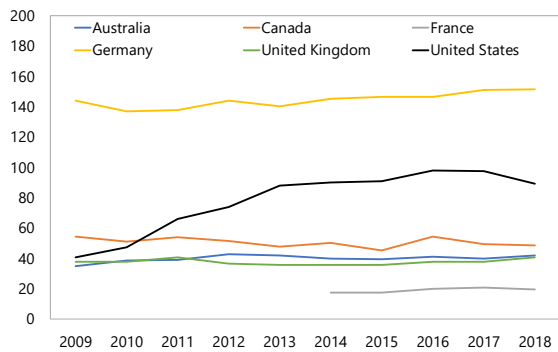
**Non-Performing Loans-to-Total Gross Loans**

(In percent)



**Liquid Assets-to-Short-Term Liabilities**

(In percent)



Sources: IMF, Financial Soundness Indicators database; IMF staff calculations.

**10. The banking sector is comprised of about 5,300 banks with a wide range of sizes and business models.** The overall number of banks has been on a downward trend since the early 1990s, but consolidation has not increased the asset share of the top banks during the last decade and the system remains less concentrated than the banking sector of other industrialized countries. The eight U.S. GSIBs and the four foreign bank organizations with complex operations in the United States have US\$12.3 trillion of assets, or approximately 61 percent of the total U.S. depository assets. These banks have complex business models and operate globally. The sector contains another 32 banks with total assets above US\$100 billion, which usually operates nationally and represent 31 percent of the system assets. The vast majority of the institutions are community banks, with total assets below US\$10 billion and relatively simple business models.

**11. Banks' balance sheets and income statements have strengthened.** Comparing to a period before the global financial crisis, banks are more liquid, holding more liquid assets and attracting more deposits. At the same time, banks are holding more capital, and are less leveraged. Nonperforming loans have fallen substantially during the last decade, improving asset quality. Profitability has also been improving, although average ratios remains low (Figure 2).

## INSTITUTIONAL SETTING

**12. The framework for banking supervision is complex, but well established.** Clear roles and responsibilities are assigned to the different agencies. The FBAs have a wide range of supervisory tools and powers to take measures against regulated firms that are in violation of laws and regulations or are engaging in unsafe or unsound business practices. However, the U.S. dual banking system with multiple FBAs which have distinct but overlapping responsibilities continues to put an absolute premium on effective cooperation and allows room for financial institutions to choose their supervisor. In addition, the prudential framework may need to be reviewed to address regulatory gaps which may emerge from a shifting balance between regulations, guidance and supervisory discretion.

### A. A Dual Banking System

**13. In the United States, a bank can be authorized to operate either by the Federal government or by a state.** The United States operates under a "dual banking system". Federal bank charters for "national banks" and "federal savings associations" are issued by the Office of the Comptroller of the Currency (OCC), while each of the 50 states has a banking authority that charters banks under its own laws and regulations to operate within the state in question. These banks are generally referred to as "state banks" or "state savings associations."

**14. Each U.S. bank, whether chartered under federal or state law, is subject to regulation, and supervision by a primary federal banking supervisor.** Following the DFA reforms, the division of responsibilities among the FBAs are:

- The OCC is responsible for all national banks and federal savings associations and for supervising federal branches and agencies of foreign banks.

- The FDIC is responsible for state banks and savings associations that choose not to be members of the Federal Reserve System. The FDIC also operates the federal deposit insurance program. As a result, it has the authority to examine for insurance purposes any bank, either directly or in cooperation with state or other federal supervisory authorities.
- The FRB has responsibility for state banks that are members of the Federal Reserve System; companies that own or control a national or state bank (a Bank Holding Company) or a state or federal savings association (a savings and loan holding company); and the U.S. operations of foreign banking organizations (including state-licensed branches and agencies of foreign banking organizations).

**15. In practice, most domestic banks have two or more federal supervisors.** For instance, an insured national bank that is owned by a Bank Holding Company (BHC) will be subject to supervision by the OCC, the FRB, and the FDIC. If the bank has assets above US\$10 billion, it will also be overseen by the Consumer Financial Protection Bureau (CFPB) with respect to compliance with certain consumer financial protection statutes.

### Coordination Among Supervisors

**16. This complex supervisory framework leads to substantial overlaps and duplications, putting a premium on effective coordination in establishing regulatory requirements and supervising financial institutions.** While the existence of multiple regulators can strengthen the supervisory framework by mitigating the risk of group thinking, taking advantage of this arrangement without excessively burdening the supervised institutions is challenging. The FBAs have enhanced coordination and established several formal and informal mechanisms for information sharing and cooperation to reduce the inevitable inefficiencies generated by the existing regulatory structure. Nonetheless, there is substantial duplication of supervisory effort, particularly in respect of entities in major banking groups, and the ongoing risk of inconsistent messages from the agencies.

**17. The FBAs, the CFPB, and state banking regulators formally coordinate examination policies through the Federal Financial Institutions Examination Council (FFIEC).** Prudential regulators have been engaging in a number of coordination activities to avoid duplication. For example, when exercising its backup examination authority, the FDIC coordinates with the primary federal prudential regulator and generally participates with them during its onsite examination activities. In addition, the FRB is required to rely on reports of examination made by other regulatory agencies in its role as the holding company supervisor and to avoid, to the fullest extent possible, duplication of examination activities. The FBAs have also increased joint supervisory presence at examinations of systemically important banks and joint participation in the FRB's horizontal reviews. In addition, several joint regulatory proposals demonstrate a stronger commitment to issue joint regulations and supervisory guidance.

**18. While the FBAs have made progress in coordinating their activities, there are areas for further improvement.** These include:

- **Supervisory cycle.** The ongoing efforts to collaborate could go further if supervisory planning cycles were aligned. Now, with supervisors beginning their planning at different time, there is a risk that resources are committed before another regulator has completed their plan and made a bid for assistance.<sup>4</sup>
- **Data and document sharing.** While supervisors of the FRB rely on information from primary federal regulators, access to this information varies and data processing challenges and miscommunications can lead to some documents being inaccessible for examiners.<sup>5</sup> System and processes that facilitates more efficient document sharing could help boost cooperation.
- **Guidance, rules and data requests.** While the FBAs have increased the issuance of joint supervisory guidance and rules, a meaningful amount of them on issues such as risk management and corporate governance continue to be issued separately, and sometimes, with different content.
- **Data requests and format.** The FFIEC has made substantial progress harmonizing call reports. However regulated entities mentioned requests from individual supervisors essentially asking for similar data in different formats.

### Charter Switching

**19. The dual banking structure allows room for banks to choose their supervisors, raising concerns that some institutions could switch charter in search of more favorable treatment.**

Banks can choose to operate under a state or federal charter to best accommodate their business needs. Further, state-chartered banks can choose to become a member of the Federal Reserve System, in effect choosing the FDIC or the FRB as their primary federal supervisor. While banks do need the approval of the new chartering authority, they do not need the approval of their current authority to make the switch. In practice, banks face no difficulties in switching charters if they are considered safe and sound. Evidence suggests that banks receive more favorable ratings from their new supervisor after they change charters.<sup>6</sup>

**20. The DFA and the prudential regulators have taken steps to reduce the room for arbitrage.** In a statement issued by the FFIEC in 2009, the members of FFIEC re-affirmed that charter conversion or changes in primary federal regulatory should only be conducted for legitimate

<sup>4</sup> For the Federal Reserve, the OCC's and FDIC's planning period is less relevant for companies under \$100B, because the Federal Reserve leverages their supervisory plans and exam results. See SR 16–11.

<sup>5</sup> See Office of Inspector General Evaluation Report 2018-SR-B-010, June 20, 2018.

<sup>6</sup> See Rezende, Marcelo 2014. "The Effects of Bank Charter Switching on Supervisory Ratings". *Federal Reserve Bank Staff Working Paper No. 2014–20*.



business and the prospective chartering authorities agreed to consult with the FDIC and the FRB (in the case of a holding company) on any conversion application involving an institution for which its current supervisor has either rated or proposes to rate that institution as less than satisfactory.<sup>7</sup> The statement is not legally binding but, in the immediate post-crisis period, seemed to curb charter switching for questionable reasons. The legal framework was enhanced in 2010 by the DFA which generally prohibits charter conversions while the institution concerned is subject to any formal enforcement actions that involve significant supervisory matters.<sup>8</sup> Further, by eliminating the Office of the Thrift Supervision and placing thrift holding companies under consolidated supervision of the FRB, the DFA removed the option for firms to choose their consolidated supervisor based on the type of depository institution subsidiary the firm owns.

**21. However, the potential for regime shopping still exist.** Many well-rated depository institutions currently fall outside the scope of both the DFA and the FFIEC statement on charter conversions. Data suggests that there seems to continue exist a steady stream of conversions. Between June 2014 and June 2019, 364 financial institutions surrendered their national charter through conversions to state charters (172) and mergers with state institutions (192). Five financial institutions converted into a national charter in the same period. In addition, the risk of charter shopping is likely to become more relevant as new technologies and the transformation of the financial sector allows fintech firms providing bank-like services to grow very quickly and become systemic in a relatively short period. The current legal dispute between federal and state supervisors about the potential grant of a special purpose national bank charter to fintech firms suggests that the risks associated with charter shopping may rise. The FBAs need to guard against perceptions of differences in supervisory style or treatment in their regional offices that could influence the choices made by banks and fintech firms in their charter choice.

## B. Supervisory Objectives, Powers, and Independence

**22. The FBAs have a clear mandate and commitment to promote the safety and soundness of the banking system.** They, however, have multiple objectives, and the primacy of the safety and soundness objective is not enshrined in legislation. The OCC has the added objectives of assuring fair access to financial services and fair treatment of customers. The FRB has the objectives of maintaining the stability of the financial system and containing systemic risk that may arise in financial markets and influencing money and credit conditions in the economy in pursuit of full employment and stable prices. The FDIC has an additional objective of minimizing the disruptive effects that can occur within the financial system when bank or nonbank financial firms fail. Currently there seems to be no confusion on the part of the agencies or the public that the focus of bank supervision relates to safety and soundness. However, with the FRB's much broader mandate which includes monetary policy goals of promoting maximum employment and stable prices, there is some potential for banking supervision actions to be seen as interacting with these goals.

<sup>7</sup> That means 3 or poorer in a rating system that range from 1 to 5, where 1 is assigned to banks that raise no supervisory concern and 5 is assigned to institutions that warrant immediate attention from supervisors.

<sup>8</sup> DFA, Section 612.

**23. Federal statutes provide for the operational independence of each agency.** The self-funding status of the agencies which does not come from Congressional appropriations and their strong transparency and accountability framework also contribute to their operational independence. The processes for the appointment of agency heads are well-established but there are no laws specifying the acceptable reasons for removal. Stakeholders confirmed that FBAs' practices and decision making are clear evidence of their independence.

**24. The legal framework provides supervisors an appropriate suite of powers to conduct effective supervision and undertake timely corrective action.** The FBAs have delegated authority for the imposition of prudential standards and they also issue guidance and manuals that describe supervisory expectations. The FBAs have the authority to examine supervised entities and their subsidiaries and obtain a broad array of information from them. In addition, the FRB has the authority to examine and obtain reports from bank holding companies, savings and loan holding companies, and their subsidiaries. The FBAs also have broad authority to take (or require a bank to take) remedial measures when, in their judgment, a bank or holding company is not complying with laws or regulations or is, or is likely to be, engaged in an unsafe or unsound practice.

### Potential Future Challenges

**25. The 2018 statement on the role of supervisory guidance might create obstacles to the implementation of key supervisory expectations.** In the U.S. framework, supervisory guidance traditionally addresses some critical issues such as corporate governance and risk management and, for many years, seem to have taken a meaningful role in corrective and other supervisory actions. In September 2018, responding to inquiries that the differences between supervisory guidance and laws and regulations could be unclear, the FBAs and other federal agencies issued a statement clarifying the role of supervisory guidance. The statement restates administrative law principles and clarifies that the agencies do not take enforcement actions based on supervisory guidance and do not criticize a supervised financial institution for a "violation" of supervisory guidance. While the statement doesn't change the legal interpretation about the role of supervisory guidance, in practice, attitudes toward it may change and thus incentivize some institutions to challenge the applicability of guidance in the future. Breaches of provisions included in guidance can solely lead to enforcement action if they are viewed as constituting unsafe and unsound practices or they violate statutes, regulations, or other enforceable conditions. However, for some topics, the safety and soundness requirements are very high level and the connection between them, and guidance and supervisory action is harder to make.

**26. In addition, the new procedures introduced for the operationalization of the Congress Review Act might impact the ability of the FBAs to independently issue new regulation and guidance.** The Congressional Review Act (CRA), enacted in 1996, establishes a mechanism by which Congress can exercise direct oversight of federal agencies' regulatory actions by requiring the notification to Congress of rules they have promulgated and giving them an opportunity to overturn these rules. In April 2019, the Office of Management and Budget (OMB) issued a memorandum for the heads of agencies providing guidance on compliance with the CRA. The memorandum indicated that non-binding guidance and other documents, in addition to regulations, are covered by the CRA

and outlines procedures for submitting agency rules to the OMB's Office of Information and Regulatory Affairs (OIRA) to determine whether the rule is "major" under the CRA. The memorandum sets forth for the first time a determination process whereby independent financial regulatory agencies conduct more extensive major-rule analysis under OIRA methodology for most rules (which may include guidance, general statement of policy, and interpretative rules), such analysis being reviewed by OIRA. Additionally, if OIRA were to reject the adequacy of the agency's major-rule analysis, OIRA could withhold providing to the agency its own major-rule determination which could delay the rule from going into effect. Currently the agencies are discussing the legal interpretation and the detailed implementation of the memorandum. A broader interpretation of the applicability of the CRA, could lead to the potential overturn of long-standing supervisory guidance<sup>9</sup> and represent a meaningful change from previous practices. Given the recentness of the memorandum, the FSAP team was not able to evaluate its practical implications.

### Proposals to Streamline the U.S. Regulatory Structure

**27. The United States' authorities have advocated for rationalization and streamlining of the U.S. regulatory structure.** In 2017, the U.S. Treasury argued that there exist significant opportunities to rationalize the U.S. regulatory framework and that doing so could improve its efficacy. Along the same line, the Government Accountability Office (GAO) suggested that the existing regulatory structure does not always ensure efficient and effective oversight.

**28. The Treasury recommended that Congress take action to reduce supervisory fragmentation and increase accountability for all regulators.** The Treasury suggested that measures could include consolidating regulators with similar missions and more clearly defining regulatory mandates. Treasury also recommended that Congress expand the Financial Sector Oversight Council (FSOC)'s authority to play a larger role in the coordination and direction of regulatory and supervisory policies, including by giving it the authority to appoint a lead regulator on any issue on which multiple agencies may have conflicting and overlapping regulatory jurisdiction. Finally, the Treasury also recommended increased accountability for all regulators which, in its views, could be achieved through oversight by an appointed board or commission or, in the case of a director-led agency, appropriate control and oversight by the Executive Branch, including the right of removal at will by the President. The FSAP team understands that, for the time being, no action has been taken in response to these recommendations.

## C. Recommendations

**29. The FBAs need to ensure that the supervisory arrangement is effective, independently of the charter choice of the supervised institutions.** The situations where charter switching is legally prohibited are relatively limited, raising concerns that some institutions could choose its charter in search of more lenient supervisory treatment. As new technologies may allow fintech firms

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<sup>9</sup> On October 22, 2019, the GAO expressed its legal opinion that three "guidance" letters issued by the FRB as long ago as 2011 are rules under the purposes of the CRA and thus are subject for consideration to be overturned by Congress. See GAO B-330843 available at <https://www.gao.gov/assets/710/702205.pdf>

to become potentially systemic in a relatively short period, the risks associated with charter shopping may rise. The FBAs and State bank supervisors need to discuss how to handle these cases and amend and complement their charter switching statement issued by the FFIEC in 2009 to ensure that banks and fintech firms will be soundly supervised irrespective of their charter.

**30. The prudential framework should be reviewed to address regulatory gaps which are emerging from a shifting balance between regulations, guidance and supervisory discretion.**

Following the 2018 statement on supervisory guidance, the FBAs will need to be mindful that their interpretations of rules, laws and regulations are well anchored and that if there are any gaps from a safety and soundness perspective, the laws and regulations are adjusted accordingly. Authorities could take this opportunity to review the framework, aiming to streamline and simplify requirements which, sometimes, are spread in many documents from different agencies; address some regulatory gaps; and consider whether there are any key prudential guidance that could be rewritten as regulation.

**31. While balanced by an effective accountability framework, it is important to safeguard the independence of the FBAs.**

Timely supervisory action requires institutional frameworks with decision making processes free from lobbying by the financial industry and political pressures. The FBAs independence, responsibilities and powers require appropriate mechanisms for checks and balances that are in place. As required by the BCP, changes to the accountability framework or to the ability of the FBAs to issue regulation need to ensure that the supervisor maintains operational independence, transparent processes and sound governance.

## PRUDENTIAL REGULATIONS AND REQUIREMENTS

**32. The wide range of institutions that form the U.S. banking sector is conducive to a proportional approach to regulation, but all segments should be subject to rigorous prudential standards.**

The FBAs are focused on increasing the efficiency of the regulatory framework by further tailoring it to banks size and complexity. Considering the diversity of institutions subjected to the regulation, this approach is appropriate. However, the EGRRCPA and related regulatory proposals have reduced the stringency of several prudential requirements for some large banks. While the principle of proportionality is key for effective regulation, the focus should be on minimizing disproportional compliance costs without reducing the rigor of the regulation.

### A. Regulatory Framework for Banking Supervision

**33. The U.S. prudential regulatory framework is complex and combines federal statutes, regulations and various forms of guidance.**

Under existing legislation, FBAs have delegated authority to formulate and enforce regulations. In addition, the FBAs issue various types of guidance to their respective supervised institutions, including interagency statements, bulletins, policy

statements, advisory and interpretive letters, and frequently asked questions.<sup>10</sup> Supervisory expectations are also included in several examination manuals. The banking statutes and regulations establish a framework of minimum prudential standards that banks and BHCs must comply with, while policy statements, interpretations, and supervisory guidance and manuals provide examples of safe and sound conduct, appropriate consumer protection and risk management practices, and other actions for addressing compliance with laws or regulations.

**34. The prudential supervisory regime is governed by numerous regulations and guidance.**

The implementing regulations, guidelines and manuals are required to be made publicly available, thus providing a high level of transparency. However, it is not uncommon to have several statements of guidance on the same topic. For example, the guidance on the roles and responsibilities of banks' board of directors are included in at least 27 supervisory letters issued by the FRB alone.

**35. For certain topics, FBAs' views have been articulated in guidance rather than regulations.**

For example, guidance issued covers governance and risk management standards including model risk management, expectations around various types of banking lending activities (commercial real estate lending, leverage loans, student loans, etc.), and principles for sound management of liquidity risk that apply to banks with less than US\$100 billion in assets.<sup>11</sup> Guidance that have been used for decades by FBAs often provide detailed and concrete examples of practices that the FBAs consider to be generally consistent with safety-and-soundness standards. Overall, post-crisis, the FBAs have been issuing a very large number of guidance statements to set supervisory expectations.<sup>12</sup> This has significant practical implications given that FBAs cannot criticize banks for a "violation" of supervisory guidance, as noted in the 2018 Interagency Statement Clarifying the Role of Supervisory Guidance, as already discussed.

**36. Regulations are frequently revised and updated in a transparent way.** Several statutes require the FBAs to review their regulations at regular intervals to ensure that they remain effective and relevant to changing industry and regulatory practices. These reviews are conducted through a process that allows for widespread public participation. Regulations only take effect after the FBAs have responded to comments on the proposal in a final rulemaking document.

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<sup>10</sup> FDIC Advisory Opinions, FDIC Statements of Policy, OCC's advisory and interpretive letters addressing various legal and banking issues, FRB's Supervision and Regulation (SR) Letters, etc. SR Letters address significant policy and procedural matters related to the Federal Reserve System's supervisory responsibilities.

<sup>11</sup> Examples of guidance statements include: Interagency Guidance on Leverage Lending, Guidance on Model Risk Management (market risk), Interagency Counterparty Credit Risk Management Guidance, Interagency Guidance on the New Accounting Standard on Financial Instruments – Credit Losses, Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than US\$50 Billion, Interagency Policy Statement on Funding and Liquidity Risk Management, Supervisory Guidance on Stress Testing.

<sup>12</sup> Individually or collectively (though joint statements or interagency guidance), the FBAs (FDIC, FRB and OCC, excluding CFTC, SEC and CFPB) and the FFIEC have issued 186 guidance documents and examination manuals since 2010: 16 in 2019 (as at September 30), 37 in 2018, 40 in 2017, 33 in 2016, 29 in 2015, 23 in 2014, 2 in 2013, 6 in 2012, but none in 2011 (source: <https://www.stlouisfed.org/federal-banking-regulations/#>). This site is not an authoritative listing of guidance, and several SR letters seem to have been omitted. The actual number should be higher.

**37. Prudential requirements are tailored to be more stringent for large, more systemic banks and less strict for smaller, less-systemic institutions.** Supervisory expectations in the United States have long been defined on a proportionate basis, considering the risks posed to the safety and soundness of firms and to U.S. financial stability generally. This is of particular relevance in a jurisdiction where some of the world largest and complex banks are headquartered and operating, alongside a large number of small mono-activity community banks relying on a relatively straightforward business model.

**38. This tiered approach to regulation is directly embedded in legislation.** Under Section 165 of the DFA, certain large BHCs, including foreign banking organizations are subject to enhanced prudential standards that are more stringent than standards applicable to other BHCs that do not present similar risks to U.S. financial stability.<sup>13</sup> These extensive enhanced prudential standards covering capital, liquidity, risk management, resolution planning, and concentration limits do not apply to smaller banks; nor do the requirements for stress testing. While a tiered approach has been one of the main features of the U.S. prudential regulatory framework, there is a growing tendency to further differentiate regulatory measures for different kinds of U.S. banks, as detailed below. More recently, the FBAs have introduced several categories within the universe of banking organizations that will drive the choice of applicable prudential requirements (tiered, or “segment” approach).

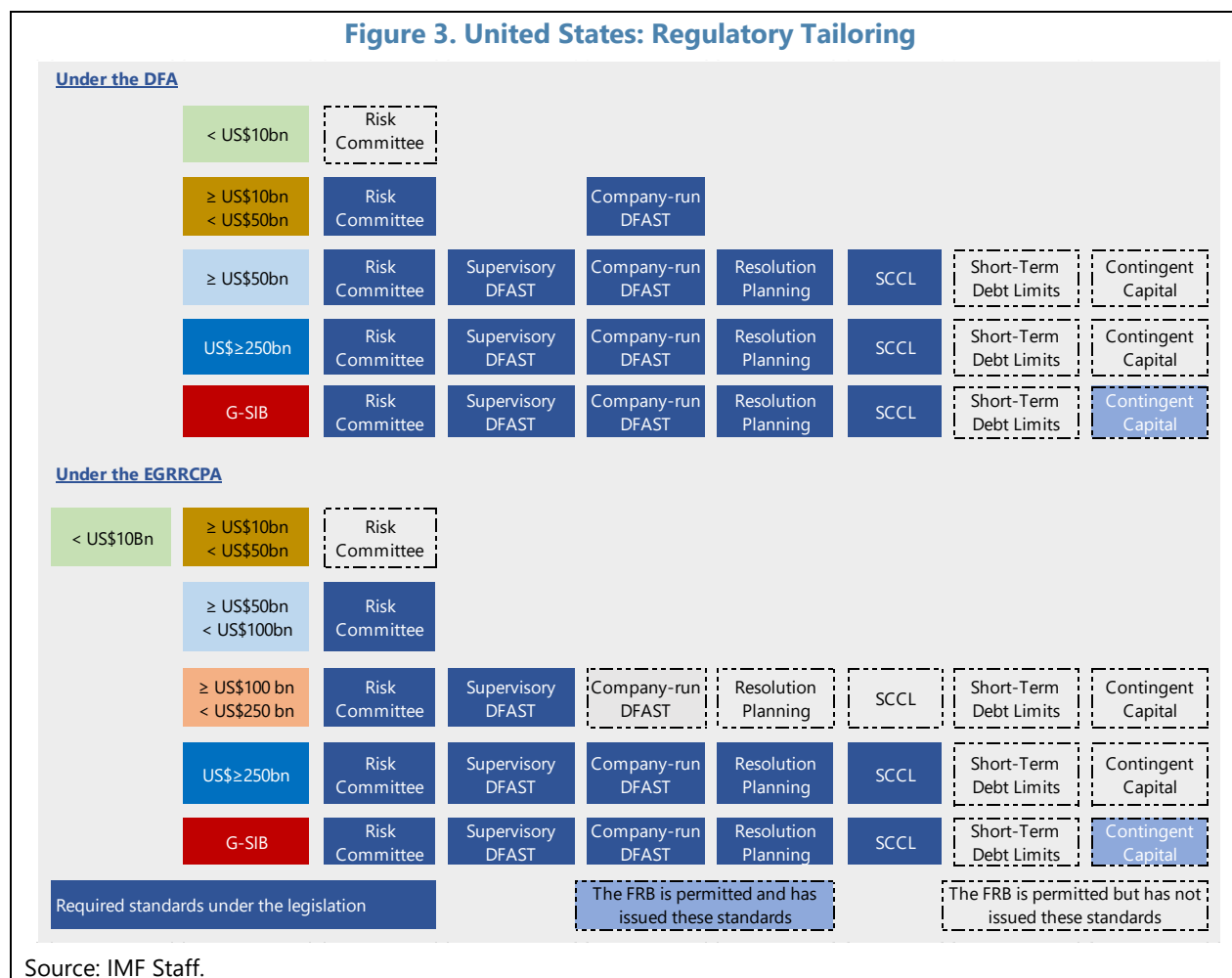
## B. Recent Changes: Tailoring Regulation to Risks

**39. The reforms adopted in the aftermath of the GFC represented a substantial strengthening of the regulatory framework.** The U.S. Congress introduced enhanced prudential standards as part of the financial sector reform in the DFA. In addition, in 2013 and 2014, the FBAs finalized rules – which improved the quantity and quality of regulatory capital and established a capital conservation buffer that were applied to all banking organizations. Further, banking organizations considered internationally active – generally, those with US\$250 billion or more in total consolidated assets or US\$10 billion or more in on-balance sheet foreign exposure – became subject to a wider set of prudential standards, consistent with all Basel standards (including, for example, the Liquidity Coverage Ratio, the Supplementary Leverage Ratio and the Countercyclical capital buffer).

**40. In the wake of the U.S. Department of Treasury’s review of the regulatory framework, several legislative and regulatory reforms and initiatives reduced the stringency of some standards.** The report issued in June 2017 (*A Financial System that Creates Economic Opportunities: Banks and Credit Unions*) made several detailed recommendations to improve regulatory efficiency and effectiveness, reducing regulatory burden by reducing unnecessary complexity, and tailoring the regulatory approach based on size and complexity of regulated firms. While these reforms detailed below preserve the core of the approach to regulation that was legislated under the DFA in the aftermath of the GFC, the recent trend has been a steady sequence of “fine-tuned” steps that

<sup>13</sup> Prior to the DFA which introduced the distinction between BHCs subject to enhanced prudential standards, another category existed that identified firms subject to the so-called advanced approaches risk-based capital requirements of Basel II.

reduced the stringency of some standards for a range of firms at a time when financial stability risks within the system as a whole are elevated by historical standards and rising. Changes resulted from the EGRRC Act, as well as from decisions and initiatives taken by the FBAs in response to legislative developments. Apart from changes mandated by statute, several other regulatory reforms have also been decided by the FBAs or are under way (Figure 3 and Box 1).<sup>14</sup>



<sup>14</sup> See <https://www.reginfo.gov/public/do/eAgendaMain>. As described on the OMB’s website, “The Trump Administration’s Unified Agenda of Regulatory and Deregulatory Actions (Agenda) reports on the actions administrative agencies plan to issue in the near and long term”.



### Box 1. Regulatory Changes

#### Following the package of reforms initiated after the GFC (DFA, U.S. rules implementing Basel III):

- All firms with US\$50 billion or more in assets were subject to enhanced standards, including supervisory stress tests, capital plan submissions, resolution plan requirements, single counterparty credit limits, and reduced LCR requirements.
- Firms with at least US\$250 billion in assets or US\$10 billion in on-balance-sheet foreign assets were also subject to the advanced approach risk-based capital requirements of Basel II, the Basel III supplementary leverage ratio (3 percent), a full LCR requirement, and the countercyclical capital buffer provision of Basel III.
- On top, each GSIB is subject to a leverage buffer of 2 percent under the Enhanced Supplementary Leverage Ratio (eSLR) rule; and meet higher risk-based capital requirements (GSIB surcharge).

#### The EGRRC Act passed in May 2018 raised the enhanced prudential threshold from US\$50 billion or more in assets to US\$250 billion.

The law also directed the U.S. banking regulators to tailor supervision and regulation of large banking organizations with more than US\$100 billion in assets. The Act eliminates the supervisory stress tests for BHC with less than US\$100 billion in assets, requires periodic (rather than annual) supervisory stress test for firms in the US\$100 to US\$250 billion range, and removes the company-run stress tests requirements for banking organizations with less than US\$250 billion in assets and other financial companies with US\$250 billion in assets or less. The law contains a number of other provisions: it includes a simplified regulatory regime for community banks that meet certain risk profile criteria (ability to opt for a capital requirement based on a simple leverage ratio), requires FBAs to amend the SLR rule for custodial banks to exclude from the leverage exposure measure qualifying deposits at certain central banks, mandates FBAs to amend the LCR rule to classify all investment-grade, liquid and readily-marketable municipal securities as level 2B liquid assets, introduce Volcker Rule exemptions, and a less restrictive definition of high volatility commercial real estate.

#### Consistent with the provisions of the EGRRC Act, the FBAs introduced in October 2019 a new round of changes to applicability thresholds for the more stringent regulatory capital and liquidity requirements.

Under the final rule, there will be four categories of regulatory standards for banks with over US\$100 billion in total consolidated assets, with standards increasing in stringency (Category I standards being the most stringent and Category IV standards the least stringent):

- Banks in category IV—generally those with US\$100 billion to US\$250 billion in consolidated assets—will no longer be subject to standardized liquidity requirements, such as the LCR or the proposed NSFR unless weighted short-term wholesale funding is higher US\$50 billion or more (in that case, requirements will be calibrated at 70 percent of the full LCR requirements). Liquidity stress testing requirements and risk management standards will be further tailored (e.g., with a reduction of the frequency of collateral calculation). Capital standards will continue to maintain the same applicable risk-based capital requirements and the U.S. leverage ratio. These banks will no longer be required to conduct company-run stress tests, and supervisory stress tests will be carried out every two years, instead of on an annual basis.
- Banks in Category III—generally those with assets in the US\$250 to US\$700 billion range—will have to comply with a reduced LCR and NSFR (i.e., 85 percent of the full LCR requirements, below the 100 percent contained in the Basel standards and reflected in the previous U.S. regulation). If weighted short-term wholesale funding for Category III institutions is higher than US\$75 billion, full LCR requirements would then apply. Category III banks will also be required to conduct company-run stress tests on a two-year cycle, rather than semi-annually, but will remain subject to annual supervisory stress tests. Capital standards will continue to include applicable risk-based capital requirements, the U.S. leverage ratio, the SLR, and the countercyclical capital buffer. However, these institutions that were previously advanced approaches institutions will no longer have to include unrealized gains and losses in regulatory capital.
- U.S. GSIBs (Category I) and banks having more than US\$700 billion in assets or more than US\$75 billion in cross-jurisdictional activity (Category II) will not see any changes to their liquidity and risk-based capital requirements.



### Box 1. Regulatory Changes (concluded)

Given their size, Category IV and Category III banks are unlikely to reach the US\$50 and US\$75 billion thresholds for the *weighted* short-term wholesale funding indicator that would trigger higher LCR requirements.<sup>1</sup> Currently, it is projected that no Category IV banks would have to meet reduced LCR requirements and one Category III bank would have to comply with the full LCR requirements. Therefore, the rule is likely to either eliminate or weaken the application of the LCR and NSFR for a significant part of the banking system. The FRB estimates that the changes would result in an aggregate 0.6 percent decrease in the required capital and a reduction of 2.5 percent of the liquid assets for all banks with over US\$100 billion in assets (given no changes to the largest banks—this implies significantly larger declines for banks in the US\$100 to 700 billion group).

A framework which is substantially the same has been introduced for Foreign Banking Organizations (FBOs) with US\$100 billion or more in combined U.S. assets (October 2019).

#### **FBA have advanced several additional proposals and tailored other prudential regulations:**

- Recalibration of the enhanced SLR for GSIBs and certain of their depository institution subsidiaries (April 2018): the proposal, issued by the OCC and the FRB would replace the current fixed leverage ratio buffer (2 percent) that applies uniformly to all GSIBs holding companies with a leverage buffer tailored to each GSIB, set at 50 percent of the GSIB risk-based surcharge, thereby mirroring the Basel approach.<sup>2</sup> The proposal would similarly tailor the fixed leverage ratio buffer that applies to depository institution subsidiaries of GSIBs that are regulated by the Board and OCC. Leverage ratio requirements would still be more stringent than international standards, as GSIB risk-based capital surcharges applicable to holding companies in the United States are more conservative than the ones prescribed by the BCBS. This is consistent with the fact that risk-weight densities are higher in the U.S. than in some other jurisdictions (for the leverage ratio to play a backstop role, it should therefore be higher than Basel standards). The final rule has not yet been issued.
- The FDIC proposed to ease collateral provisions of the 2015 interagency swap margin rule by removing the requirement that financial institutions post initial margin in derivatives transactions between their own affiliate (September 2019). This proposal is not the final rule.
- Simplification to the capital rules for non-advanced approaches banking organizations: the final rule replace the 10 percent of CET 1 capital deduction thresholds for each category (deferred tax assets, mortgage services rights, investments in unconsolidated financial institutions) with 25 percent of CET 1 capital thresholds, eliminates the aggregate 15 percent of CET 1 threshold for the combined impact of the three categories of deduction items, and allows banking organizations to include minority interest up to 10 percent of the parent banking organization's CET1 capital. Under the final rule, Category III, Category IV and all other firms will be allowed to use these less stringent regulatory adjustments to CET1 capital.
- Volcker Rule revisions (August 2019): the final rule establishes a three-tier compliance framework. Banks with \$20 billion or more of trading assets and liabilities would be subject to many of the compliance program requirements. Banks with moderate and limited trading assets and liabilities are exempted from a number of requirements (such as reporting, internal control, CEO attestation). If an instrument is held for longer than 60 days, banks can presume (subject to supervisory rebuttal) that the rule will not apply to such instruments.

**Lastly, the FBAs have finalized rules to tailor certain aspects of the stress testing rules** (as further discussed below in the stress tests section). On the positive side, the Stress Capital Buffer (SCB) rule issued in March 2020 will integrate two approaches (the capital rule and the CCAR process). Under the final rule, the GSIB surcharge will become additive to the SCB. This change is significant as a firm is not currently required to have enough capital on a post-stress basis to meet its GSIB surcharge. The SCB rule will also modify certain assumptions (a firm will have to "pre-capitalize" four quarters of planned dividends instead of having to pre-fund dividends and share buy-backs over a longer timer horizon) and the net impact will vary across the range of banks (including across GSIBs). Also, the final rule no longer includes a stress leverage buffer requirement.

<sup>1</sup> Based on the methodology for calculating the *weighted* short-term funding (wSTWF) (exposures are weighed in accordance with the remaining maturity and the type of collateral), it appears that a bank with US\$220 billion in total liabilities would need to raise more than US\$200 billion of wholesale funding secured by Level 1 assets to reach a wSTWF indicator of US\$50 billion.

<sup>2</sup> Given existing risk-based capital surcharges, the leverage buffer would be in the 0.75 –1.75 percent range (compared to 2 percent under the existing rule).

**41. In principle, regulating banks in a proportionate manner using a risk-based approach is appropriate.** The FBAs emphasized that the intention is to make the current regulatory supervisory environment more efficient, transparent and simple and ensure that compliance burden for less complex firms, especially community banks is minimized without compromising firms' safety and soundness. Regulating banks in an efficient manner obviously requires technical adjustments at regular intervals to take into consideration lessons from experience. Further, there is arguably scope for better tailoring certain aspects of the U.S. regulatory framework and reducing compliance costs arising from the multiplicity of rules and guidance. In this regard, the implementation of a simplified regulatory regime for community banks falls into this objective. Similarly, the review of the Volcker Rule is warranted based on the experience to date (i.e., implementation challenges for both regulators and banks).

### Potential Risks and Concerns

**42. Compared to the previous regime, fewer banks will have to comply with full Basel standards.** In addition to proposing a revision of certain rules such as the leverage ratio requirements for GSIBs that were previously implemented in a manner more stringent than the international standard, the FBAs have narrowed the scope of firms' subject to full Basel standards. Under the final rule, only Category I banks (with the eight U.S. GSIBs) and Category II banks (one U.S. firm) will have to comply with standards generally consistent with standards developed by the BCBS, whereas Category III and Category IV will include fewer standards (reduced or no LCR and NSFR requirements; less stringent deductions to CET1 capital; and reduced scope of the large exposure framework). While there is no expectation that Basel III should be fully applied to non-international active banks, the BCP specify that the capital requirements applied to non-internationally active banks should be broadly consistent with the principles of the applicable Basel standards relevant to internationally active banks.<sup>15</sup> The review of the final tailoring rule reveals that regulatory adjustments to CET1 capital are not broadly consistent with the Basel framework for Category III and Category IV banks.<sup>16</sup> There will be more differences between the U.S. regime and the Basel

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<sup>15</sup> "For non-internationally active banks, capital requirements, including the definition of capital, the risk coverage, the method of calculation, the scope of application and the capital required, are broadly consistent with the principles of the applicable Basel standards relevant to internationally active banks." (CP 16 Additional criteria 1). Additional criteria were introduced to better assess jurisdictions that are important financial center.

<sup>16</sup> For DTAs, MSRs and investments in unconsolidated financial entities, there is a limited recognition in capital capped at 25 percent of CET1 for each category (instead of only 10 percent in the Basel standard), the amount of the three items that remains recognized after the application of all regulatory adjustments is not capped (a 25 percent cap is included in the Basel framework). Further, firms have the option to exclude gains and losses from regulatory capital (i.e., unrealized losses are not deducted from capital). This is less conservative under stressful conditions.

framework, on top of existing ones, such as the absence of operational risk and CVA charges (for firms that are not included in Category I or II), the limited scope of the market risk rule, and the scope of the Countercyclical Capital Buffer (that does not apply to Category IV banks and all other firms with less than US\$100 billion in assets).<sup>17</sup>

**43. The mission supports the authorities' goals of building a proportionate and simpler regulatory framework but has concerns about a potential reduction of the stringency of the regulation.** Category III and Category IV banks that will be subject to less stringent prudential requirements are large institutions. While individually they are considered less systemically important than Category I and II firms, their size and complexity pose risks to the financial system. As whole, non-LISCC banking organizations (U.S. firms and FBOs) with more than US\$100 billion in consolidated assets hold a combined US\$6.2 trillion in assets as of December 2018 (compared to US\$12.1 trillion for the LISCC firms).<sup>18</sup> Reduced prudential standards could facilitate increased risk taking by these large but not GSIB firms without the countervailing regulatory constraints that were provided by the previous regime. Other things being equal, reduced capital and/or liquidity requirements make the distress or failure of a bank due to firm-specific idiosyncratic factors more likely, and more costly when failure occurs. Likewise, such institutions would be less resilient in the case of a systemic crisis.

**44. The tailoring approach is largely driven by the size of the banks.** FBAs have tailored the regulatory and supervisory approach *"to account for the size, complexity, risk profile, and systemic importance of regulated firms"* (Table 2). However, the tailoring is, in practice, largely driven by size-related indicators, including the total size of firms (See Appendix 1 for more details on the indicator-based approach). It is important to note that several large FBOs will fall into Category III while being supervised under the LISCC program which has been precisely designed to cover firms posing the greatest risk to U.S. financial stability.

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<sup>17</sup> See Appendix I for a comparison between the prudential framework in the U.S. and the Basel requirements.

<sup>18</sup> The LISCC supervisory framework provides heightened supervision of 12 large firms that may pose elevated risks to U.S. financial stability: eight U.S. GSIBs and four FBOs with large and complex U.S. operations.

**Table 2. Capital and Liquidity Requirements**

	Category I	Category II	Category III	Category IV
	U.S. G-SIBs	≥ US\$700 bn Total Assets or ≥ US\$75 bn in Cross-Jurisdictional Activity	US\$250 bn Total Assets or US\$75 bn ≥ in nonbank assets, wSTWF, or off-balance sheet exposure	Other firms with US\$100 to 250 bn Total Assets
<b>Capital</b>				
Risk-based capital framework	Advanced approaches	Advanced approaches	Standardized approaches	Standardized approaches
G-SIB surcharge	Yes	N/A	N/A	N/A
Deduction to capital - simplified regime	No	No	Yes	Yes
AOCI capital inclusion opt-out	No opt-out	No opt-out	Allow opt-out	Allow opt-out
Supplementary leverage ratio	Yes	Yes	Yes	No
Single-counterparty credit limit (SCCL)	Yes	Yes	Yes	No
Countercyclical capital buffer	Yes	Yes	Yes	No
<b>Stress testing</b>				
Annual supervisory stress testing	Yes	Yes	Yes	Every other year
Annual company-run stress testing	Yes	Yes	Every other year	No
Annual capital plan submission	Yes	Yes	Yes	Yes
<b>Liquidity</b>				
LCR and proposed NSFR	Yes	Yes	Reduced LCR and NSFR 1/	No LCR and NSFR 2/
Reporting FR 2052a	Daily	Daily	Monthly	Quarterly
Liquidity stress testing	Monthly	Monthly	Monthly	Quarterly
Liquidity risk management	Yes	Yes	Yes	Tailored
Source: Federal Reserve				
1/ Full LCR requirements if wSTWF ≥ US\$75 bn				
2/ Reduced LCR (70%) if wSTWF ≥ US\$50 bn				

**45. Taken together, the changes have the potential to meaningfully reduce prudential requirements.** The scope of application of these reforms is wide ranging, and a vast majority of the adjustments are made in the same direction (lower), capital and liquidity requirements may risk being inconsistent with Basel III standards, and the driving factor of differentiation is mostly size and not risk.

- **Liquidity requirements.** The modified LCR and proposed NSFR requirements represent a material reduction in the liquidity regulatory framework for U.S. banks with US\$100–700 billion in consolidated assets.
- **Leverage requirements.** The FRB has estimated that the proposed recalibration of the eSLR for GSIBs would reduce the amount of Tier 1 capital required across the insured deposit institutions (IDI) subsidiaries of the GSIBs by approximately US\$121 billion. Alternatively, this could lead GSIBs to increase their leverage exposures (by about US\$4 trillion according to some studies from the banking industry). The removal of the stress leverage buffer requirement may also contribute to increase leverage. Despite this, leverage ratio requirements would still be more stringent than international standards.
- **Capital requirements.** The simplification of capital rules for non-advanced approaches firms will entail less stringent regulatory adjustments to be applied to regulatory common equity Tier 1. While the FBAs stated that they expect that these changes will not have a significant impact on

the capital ratio of most non-advanced approach banks, the quantitative impact of the new rules has not been publicly released.

- **Stress capital buffer.** Requiring firms to prefund four quarters of dividends (instead of nine as now) will reduce the capital buffer when planned dividends are high. According to the FRB, considering the period from 2013 to 2019, the impact of the final rule on CET1 capital requirements ranges from a decline of US\$59 billion to an increase of US\$78 billion, with an average increase of US\$11 billion, or 1 percent of current requirements. The SCB, however, will substantially reduce capital requirements in the current stage of the cycle, when dividends are relatively high. See section on stress tests.
- **Impact of the reforms.** The proposals issued by FBAs are extremely detailed, providing the public with valuable information, including impact analyses. However, certain important details are missing (e.g., potential reduction of high-quality liquid assets for each category of banks), and the combined effect of these reforms have not been analyzed (e.g., impact of the revised eSLR and the removal of the stress leverage buffer). It is fair to recognize the difficulty associated with assessing the cumulative impact of reduced quantitative requirements and relaxed qualitative requirements. Similarly, it is not straightforward to quantify the impact of some measures, such as the reduced scope of the single-counterparty credit limits regime that will no longer apply to Category IV banks. Given these are inherent limitations, the results of the quantitative impact studies should be carefully interpreted.

**46. The new rules will shift the burden to supervisors to ensure that banks maintain adequate capital levels and liquidity.** While the simplifications to the capital rule provide non-advanced banking organization with flexibility when deciding which investments in the capital of unconsolidated financial institutions to risk weight and which to deduct in certain cases, the FBAs have indicated that they would be able to address any potential safety and soundness concerns that may arise from this flexible treatment through the supervisory process. During the meeting with the FSAP team, the FBAs explained that a broader set of regulatory and supervisory tools than the LCR will continue to be used to ensure that banks maintain an adequate liquidity risk profile (internal liquidity stress testing requirements, extensive supervisory reports, qualitative requirements, and enforcement measures). However, supervision should not be used to compensate for reduced regulatory requirements. Also, as further discussed below, there will be a challenge to maintain supervisory intensity and intrusion given stronger pressure and challenges by banks.

## C. Specific Prudential Requirements

### Corporate Governance and Risk Management

**47. The regulatory framework for corporate governance and risk management of banks includes a combination of various laws, regulations and guidelines.** The safety and soundness provisions of the Federal Deposit Insurance Act ("FDIA") (section 39) require each FBA to prescribe—by regulation or by guideline—standards relating to internal controls, information systems, and internal audits, among other topics. The Interagency Guidelines Establishing Standards for Safety

and Soundness implement these provisions. Also, the FBAs have taken significant additional steps to enhance corporate governance and risk management standards. The OCC, for example, through its Heightened Standards Guidelines places corporate and governance requirements on banks with total consolidated assets of US\$50 billion or more, while reserving right to impose on others.<sup>19</sup> The FBAs have also issued several new guidance documents, promoting the expectation that banks should have independent risk management functions covering all material risks<sup>20</sup> and have provided additional detailed guidance on risk management practices for specific products.<sup>21</sup> Expectations regarding corporate governance and risk management are generally tailored for institutions of different sizes, scope of operations, activities, and systemic importance. For example, board risk committees are required only for banks covered under Heightened Standards Guidelines or publicly traded BHCs with total consolidated assets of US\$50 billion or more.

**48. There is a strong emphasis on governance and risk management throughout supervisory processes.** The FBAs have high expectations of banks' risk management. Several Handbooks and Examination Manuals of the FBAs provide detailed direction to examiners in assessing the quality of risk management, along with compliance to applicable laws and regulations, as part of any focus area. Governance and risk management activities are assessed by the FBAs through combinations of regular onsite inspections, horizontal examinations and off-site monitoring. The FBAs' supervision approach and activities are tailored to the size, complexity, and risk profile of the supervised entity with continual supervision practiced for the larger and more complex financial institutions. At the holding company level, the Governance and Controls Program, which includes horizontal reviews and firm-specific onsite examinations, is a key component of the FRB's LISCC supervisory framework. The FRB's new Large Financial Institution (LFI) rating system implemented in 2019 reflects three core areas that are considered critical to an LFI's strength and resilience, one of them being governance and controls. As part of the governance and controls component, it includes an evaluation of the effectiveness of a firm's board of directors, management of business lines and independent risk management and controls, and recovery planning.<sup>22</sup> For

<sup>19</sup> The OCC guidelines are enforceable and establish standards for the design and implementation of a risk governance framework that defines the bank's approach to effectively manage risk through its risk culture, risk appetite, and risk management system. The formal risk governance framework establishes responsibilities and delegates authorities, for such things as a board risk committee, a chief risk officer, and an independent risk management function. A chief risk executive must have unrestricted access to the board of directors.

<sup>20</sup> Such statements of guidance include: FRB Supervision and Regulation Letter SR 12-17 "Consolidated Supervision Framework for Large Financial Institutions"; and SR "16-11 "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than US\$50 Billion". OCC bulletins provide supervisory guidance relative to the assessment of risk management that includes board oversight for the given supervision topic.

<sup>21</sup> For example: Interagency Guidance on Home Equity Lines of Credit (SR 14-5/CA 14-4) (July 2014), Guidance on Private Student Loans (SR 15-2/CA 15-1) (January 2015), Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending (SR 15-17) (Dec. 2015), Supervisory Expectations for Risk Management of Reserve-Based Energy Lending Risk (SR 16-17).

<sup>22</sup> The FBAs assign CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) ratings to banking organizations. The LFI rating system is used to evaluate and communicate the supervisory condition of BHCs with total consolidated assets of US\$100 billion or more; all non-insurance, non-commercial savings and loan holding companies with total consolidated assets of US\$100 billion or more; and



purposes of determining whether a firm is “well managed,” each component in the LFI rating system must be rated either “*Broadly Meets Expectations*” or “*Conditionally Meets Expectations*.” Overall, the FBAs employ a range of actions (informal and formal measures) to require supervised firms to correct corporate governance deficiencies. This is evidenced by several examples of formal enforcement actions, as well as non-public supervisory findings. Various examples were provided to the FSAP team.

#### 49. Further action is warranted in a number of areas:

- Apart from the OCC’s Heightened Standards and the Safety and Soundness Provisions which are enforceable, the supervisory expectations on risk governance framework and risk management are almost entirely included in statements of guidance.
- The OCC’s Heightened Standards guidelines strengthen the governance and risk management practices of large national banks (with total consolidated assets of US\$50 billion or more) are comprehensive and thorough. However, general risk management standards contained in the Interagency Guidelines Establishing Standards for Safety and Soundness that are applicable to all firms, regardless of the size, are not detailed. Apart from requirements on credit risk and IT risk, the safety and soundness standards provide very broad objectives<sup>23</sup> and do not prescribe specific requirements in a number of areas (model risk management, concentration risk for example). Moreover, while the FRB’ guidance (SR 16 –11) clarifies risk management expectations for institutions with total consolidated assets of less than US\$50 billion, enhanced standards have not yet been defined for larger firms (with assets of US\$50 billion or more) supervised by the FRB. A corporate governance proposal was issued by the FRB in August 2017, but the supervisory expectations have not been finalized. Consequently, these firms including the large and complex BHC remain solely subject to the safety and soundness provisions and older guidance.<sup>24</sup>
- Several 2015 FSAP recommendations have not been implemented. Clear requirements on the arrangement for the removal of Chief Risk Officers (CROs) have not been introduced by all FBAs (only the OCC Heightened Standards prescribes that a bank’s board or its risk committee shall approve the removal of the CRO). Similarly, explicit requirements that banks promptly inform the

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U.S. intermediate holding companies of FBOs with combined U.S. assets of US\$50 billion or more. It replaces the current BHC rating system (known as the “RFI rating system”) for these firms. Unlike the RFI/C(D) system and the CAMELS ratings, the LFI rating system does not include a standalone composite rating.

<sup>23</sup> For example, concerning interest rate exposures, the safety and soundness guidelines simply mention that an institution should manage interest rate risk in a manner that is appropriate to the size and complexity of its assets and liabilities and provide for periodic report to management and the board of directors, without specifying any additional guidance. Similarly, requirements on compensation arrangements are not detailed. Similarly, concerning large BHCs, expectations around the risk governance framework and the content of the risk appetite statement are not described in detail either in the Safety and Soundness Guidance or in applicable Supervision and Regulation Letters (SR 12–17 for example).

<sup>24</sup> Large and complex BHCs have total consolidated assets of US\$250 billion or more or consolidated total on-balance sheet foreign exposure of US\$10 billion or more.

supervisors about material developments that may affect the fitness and propriety of Board directors and senior management have not been specified. Lastly, the FRB's guidance (SR 16–11) that provides clarification on and distinguishes supervisory expectations for the roles and responsibilities of the board of directors and senior management for an institution's risk management only applies to institutions with total consolidated assets of less than US\$50 billion.

- No detailed guidelines have been issued on risk data aggregation and risk monitoring and the FBAs are still in the process of preparing a rule related to Pillar 3 compensation disclosure.<sup>25</sup> In some cases, standards have not been specified in a systematic fashion across FBAs. For example, the OCC has issued a guidance on new products, but the FRB has not done so.

### Credit and Concentration Risk

**50. The regulatory framework for credit risk is well developed.** Banks and BHCs are subject to detailed credit risk management requirements. According to the Interagency Guidelines Establishing Standards for Safety and Soundness, regulated firms should establish a system that is commensurate with the institution's size and the nature and scope of its operations to maintain prudent underwriting practices, identify problem assets and prevent deterioration in those assets while considering the size and potential risks of material asset concentrations.<sup>26</sup> The FBAs have also provided additional topical guidance on specific aspects of credit risk. Firms follow U.S. GAAPs and FBAs supplement U.S. GAAPs with policies and guidance. Pursuant to the safety and soundness provision of the FDI Act, the FBAs have introduced in their examination manuals several criteria for identifying an asset as "impaired" and measuring the impairment on such an asset using criteria consistent with U.S. GAAPs.

**51. The large exposure regime only applies to a subset of banks.** Under the FRB single-counterparty credit limits (SCCL) rule issued in June 2018 in accordance with the provisions of the EGRRC Act and recently amended by the final tailoring rule, the aggregate net credit exposure of a U.S. GSIB and any BHC or SLHC subject to Category II or III standards to a single counterparty is subject to a limit of 25 percent of CET1 capital (reduced to 15 percent when a GSIB has a credit exposure to another GSIB). Additionally, the OCC's Heightened Standards require firms to have policies and supporting processes in their risk management framework that effectively identify, measure, monitor and control the firm's concentration of risk. Banks are expected to monitor a range of credit concentrations, including, but not limited to: single and related borrowers, product type, geographic, industry and collateral type. However, with the exception of Commercial Real Estate (CRE) Lending, these expectations are solely included in publicly available supervision manuals. The Interagency Statement on Prudent Risk Management for CRE Lending provides that

<sup>25</sup> While the OCC's Heightened Standards Guidelines provide that banks should have risk data aggregation and reporting capabilities sufficient to provide reporting on material risks, concentrations, and emerging risks in a timely manner to the board, no specific requirements have been defined in terms of accuracy, granularity and data availability.

<sup>26</sup> 12 CFR part 30, Appx. A (OCC), 12 CFR part 364, Appx A (FDIC), 12 CFR part 208 Appx D-1 (FRB).



financial institutions should identify, measure, monitor, and manage concentration risk in their CRE lending activities. It is unclear whether the FBAs can still refer to the thresholds used to identify banks with significant CRE concentration risk (300 percent or more of a firm's total risk-based capital), as these criteria were introduced in non-binding guidance issued in 2006.

**52. Supervision on credit risk is based on an overall robust process.** The FBAs have taken a lot of efforts, through offsite surveillance and onsite examinations, to ensure accuracy of banks' loan classification and adequacy of allowance for loan and lease loss provisions. The CAMELS rating system has a specific component to rate asset quality, using quantitative metrics as well as qualitative evaluations. Under the FBAs' statutory examination authority, supervisors may review all books and records maintained by a bank (and its affiliates) subject to the FBAs' supervision. As already noted in the 2015 Detailed Assessment Report (DAR), the FBAs have a long-established and rigorous process for evaluating banks' approaches to problem assets and maintenance of an adequate level of provisioning. The FBAs conduct regular risk-focused onsite examinations that include an evaluation of internal credit risk management processes coupled with credit file review to assess the borrower's creditworthiness and ensure that internal risk management policies are adequately implemented. Methodologies used to validate the adequacy of loan provisions are described in detail in the relevant examination manual and handbook. Examiners routinely challenge loan classifications and require banks to increase provisions as necessary. Additionally, the FBAs conduct semi-annual Shared National Credit (SNC) onsite examinations to assess the largest and most complex credit facilities owned or agented by supervised institutions.<sup>27</sup> Lastly, FBAs issue a public report based on SNC findings on an annual basis. It is noted that the impact of the new approach on banks' CET1 capital has not been precisely quantified by the FBAs, but CECL is generally expected to require earlier provisioning of credit losses.<sup>28</sup>

**53. Further enhancements are, however, necessary:**

- The large exposures limits under the SCCL rule do not apply to U.S. BHCs that are not subject to Category I, II, or III standards or FBOs that are not subject to Category II or III standards or who otherwise have less than US\$250 billion in total global consolidated assets. Considering the adverse effect of excessive concentration risk, regardless of size, the total absence of regulatory limits applied to other BHCs raises concerns (the smaller the bank, the less diversified the portfolio). Also, the new regulatory report under the SCCL rule was not finalized at the time of the first FSAP mission. The OCC's lending limits regime which applies only to national banks and savings association appears to be less rigorous, as loans to corporate groups can be as much as 50 percent of a bank's capital and surplus (comprising Tier 1 and Tier 2 capital), despite

<sup>27</sup> The SNC program run by the FBAs reviews on a biannual basis a selection of syndicated loans and assign to each sampled obligor a rating (the SNC rating) that is communicated to the firms forming the banking pool.

<sup>28</sup> The CECL standard will become effective for SEC-reporting firms for the fiscal year beginning after December 15, 2019. FASB proposed in July 2019 to delay the implementation until January 2023 for small reporting companies, non-SEC public companies and private companies. FBAs have adopted a final rule that provide an option to phase-in the Day one effect. One large regional bank [PNC] has indicated that aggregate reserve levels may increase by 15 to 25 percent as a result of the new accounting standard.

generally limiting borrowers to 15 percent of a bank's capital and surplus, and the definition of these groups is narrower than that of connected borrowers.

- The FBAs argue that all banking organizations, regardless of size, should have the capacity to analyze the potential impact of adverse outcomes on their financial condition. Requirements are, however, necessarily weakened given that company-run stress tests requirements no longer apply to banks with less than US\$250 billion in assets and less than \$75 billion in cross-jurisdictional activity, nonbank assets, weighted short-term wholesale funding and off-balance sheet exposures.
- The existing report on concentration risks has limitations.<sup>29</sup> It collects information on a bank's exposure by broad categories (real estate, agricultural, commercial and industrial, municipals loans, etc.), but it does not provide a comprehensive bank-wide view of all significant sources of concentration risk, including market risk or other risk concentration where a bank is exposed to particular asset classes, products or collateral. Such a report could not be used, for example, to measure the size of a bank's direct and indirect exposures to leveraged corporates.<sup>30</sup>
- As already noted in the 2015 DAR, there are no requirements that credit risk exposure exceeding a certain amount or percentage are to be decided by the bank's board or senior management.
- Concerning exposures to OTC derivatives, banking organizations that are not subject to advanced approach capital requirements do not have to calculate capital charges for CVA risk.

## Market and Operational Risk

**54. The regulatory and supervisory framework for market risk is generally comprehensive but recent BCBS reforms remain to be implemented.** Banks with aggregate trading assets and liabilities of at least US\$1 billion or 10 percent of their total assets are subject to the market risk rule that is consistent with the BCBS' Revisions to the Basel II capital framework published in February 2011.<sup>31</sup> Like in other major jurisdictions, the revision to the market risk framework adopted by the BCBS in January 2019 has not yet been implemented. Additionally, banks subject to Category I, II, or III standards have to conduct company-run stress tests using scenarios provided by the FBAs that may include a market shock scenario. Also, under the CCAR, the FRB uses a "global market shock" scenario in its supervisory stress tests for banks with aggregate trading assets and liabilities of US\$50 billion or more (or 10 percent or more of their total consolidated assets). FBAs rely on ongoing supervisory monitoring programs, targeted firm-specific inspections and common scope horizontal examinations to determine whether banks have comprehensive risk management policies and processes for identifying, evaluating, monitoring, and controlling or mitigating market risks. Guidance on effective model risk management have been provided and additional examinations

<sup>29</sup> FFIEC's Uniform Bank Performance Report (Analysis of Concentrations of Credit - Page 7B).

<sup>30</sup> Direct and indirect exposures may include, but are not limited to: leveraged loans originated and kept on their balance sheets; loans extended to non-banks which may in turn underwrite leveraged loans; collateralized loan obligations bought by banks; credit derivatives sold to counterparties which seek protection against leveraged loan (or CLO) defaults.

<sup>31</sup> These banks are using the advanced approaches to calculate capital requirements.

procedures have been developed for bank market activities. For the largest banks with significant trading activities, the FBAs have indicated that examiners conduct in-depth reviews of independent price verification and perform sample testing of valuation adjustments. The FSAP team has not been provided with documentation to demonstrate that this process works effectively in practice.

**55. Drawing on lessons learned, the FBAs have appropriately focused increasingly on operational risk issues.** Operational failures, fraud, and non-compliance issues have resulted in major losses to U.S. banks. Banks are heavily reliant on IT technology and vulnerabilities have intensified (cyber risk). Under this heightened risk environment, banks are required to adhere to general risk management requirements complemented with tailored guidelines dealing more specifically with operational risk. In addition to the safety and soundness provisions that contain guidelines establishing information security standards, the FBAs have issued several new guidance documents and the OCC has issued its Heightened Standards Guidelines, emphasizing the importance of risk data aggregation processes. The FBAs have also issued detailed supervisory guidance on various aspects of operational risk management, including outsourcing of financial services, supervision of technology service providers, payment systems, internal audit, and business continuity planning. Internal risk management practices are expected to be commensurate with the size, complexity, and risk profile of the entity. Only Category I and Category II banks must hold capital against operational risk by using the Advanced Measurement Approach (AMA) (under the previous regime, all banks with total consolidated assets of US\$250 billion or more, or at least US\$10 billion in foreign exposure had calculate capital charges for operational risk). The FBAs are, in line with Basel III, considering a move away from such advanced approaches.

**56. The FBAs assess operational risk through regular onsite review activities and have intensified outreach and communication efforts.** FBA examiners evaluate, through on-site exams, whether banks have established appropriate policies and processes to assess, manage, and monitor operational risk. At larger and more complex institutions, horizontal reviews are conducted, and continuous monitoring maintained. Several individual handbooks provide detailed guidance to examiners on how to assess, inter alia, information security risks, IT governance issues and IT operations, the effectiveness of business continuity, retail payment systems and the risks associated with e-banking activities.<sup>32</sup> The FBAs have also increased their scrutiny of third-party service providers, and the OCC has created a dedicated examination team comprised of senior examiners who are solely focused on addressing the risks inherent in the operation of these service providers through ongoing monitoring and periodic examinations.<sup>33</sup> Further, communication to the industry and sharing of best practices constitute an essential component of the FBAs' actions: the FFIEC has issued a Cybersecurity Assessment Tool that institutions may use to evaluate their risks and cybersecurity preparedness; various statements to inform the industry of evolving cyber risks have been issued; the OCC issued supervisory letters to participating large banks to highlight the findings

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<sup>32</sup> For example, FFIEC IT Examination Handbook Management Booklet.

<sup>33</sup> The Bank Service Company Act, 12 U.S.C. § 1861 et seq., allows the FBAs to examine third-parties that perform services for banks. FBA examinations serve to identify risks and operational issues inherent within the performance of these services.

of the Large Bank Supervision's horizontal examination of Independent Operational Risk Management, etc. These are commendable efforts.

**57. Despite substantial improvements, the regulatory framework for managing operational risks is, however, still fragmented and incomplete.**

- No capital is explicitly required to be held against operational risk by regulation other than by those banks that have adopted the advanced approach under Basel. Most of the applicable qualitative standards have been provided through guidance.
- There are no general requirements for reporting operational risk related incidents to the FBAs.<sup>34</sup>
- A series of detailed, but somewhat disparate guidelines are available, but a guidance document setting out overarching principles for managing operational risk is clearly missing, especially with regards to the role of the board of directors, management, internal monitoring and reporting mechanisms, control environment, and loss data collection and analysis. This issue is particularly relevant for banking organizations and BHCs that are neither subject to the OCC's Heightened Standards Guidelines nor to the Interagency Guidance on the Advanced Measurement Approaches for Operational Risk.<sup>35</sup>

### Liquidity Risk

**58. The qualitative framework has been supplemented with quantitative requirements.**

The FBAs' historical approach to supervising liquidity risk had been qualitative in nature, focusing on sound practices and related estimates of liquidity needs by banks' instead of a standardized minimum quantitative standard. The adoption of the LCR rule in 2014 represented a very significant advance in enhancing quantitative liquidity requirements and mitigating risks by ensuring that banking organizations have liquid assets to withstand severe liquidity shocks. Under the LCR Rule, banking organizations and other institutions subject to the rule are required to implement and maintain appropriate policies and procedures and systems to enable them to exercise operational control over high-quality liquid assets to ensure that they are available for use by the banking organization to provide liquidity to withstand a 30-day stress period. The LCR rule complements the cash flow projections, contingency funding planning and liquidity stress testing requirements for covered firms under the FRB's Regulation YY.<sup>36</sup> The FBAs proposed in June 2016 to implement the NSFR. To date, the FBAs have not adopted a final NSFR and timing is uncertain.

<sup>34</sup> However, as required by the OCC Heightened Standards, national banks have to send appropriate reports to regulatory and law enforcement agency in the event of unauthorized access to customer information systems.

<sup>35</sup> High-level principles such as those defined by the Basel Committee (Principles for Sound Management of Operational Risk) are, at best, available in different guidance documents (interagency guidance on AMA, OCC's Heightened Standards, Federal Reserve SR 16-11) that need to be combined to understand supervisory expectations. The fact remains that the scope of application of these guidance documents differ and do not encompass all banks, irrespective of their size and their federal primary regulator.

<sup>36</sup> Regulation YY implements the enhanced prudential standards required under Section 165 of the DFA.

**59. The liquidity risk regime is robust for large banks.** Category I and Category II banks are subject to full liquidity requirements (LCR and planned NSFR). Moreover, banking organizations with US\$100 billion or more in total consolidated assets must meet enhanced liquidity standards in Regulation YY that contains several detailed provisions requiring banks to have a robust risk management framework, maintain a contingency funding plan, conduct internal liquidity stress tests and establish limits. The LISCC liquidity program assesses the quality of certain firms' liquidity position and liquidity risk-management practices through both horizontal reviews under the Comprehensive Liquidity Analysis and Review (CLAR), firm-specific examinations and ongoing monitoring. The regime is supported by extensive reporting that has improved the FBAs' monitoring of the firms' liquidity risk profile.<sup>37</sup>

**60. But liquidity requirements have been reduced for other firms:**

- The final tailoring rule issued in October 2019 eliminated or weakened the application of the LCR and planned NSFR for a significant part of the banking system (reduced quantitative requirements for Category III banks and no LCR and NSFR requirements for Category IV banks).<sup>38</sup>
- The FBAs have also adjusted the frequency of internal liquidity stress test (now on a quarterly basis for Category IV banking organizations), while maintaining liquidity reports on a monthly basis.
- Liquidity stress testing requirements will be maintained for banks with US\$100 billion or more in assets, but these draw on internal models and cannot provide a substitute for the simplicity and transparency of the LCR or NSFR. According to the FRB, although the liquidity risk in the Regional Banking Organization Portfolio is considered low or moderate, examiners have observed some deterioration in liquidity positions (as noted in the November 2018 Supervision and Regulation Report). The FBAs have argued that (i) Category III and Category IV banking organizations remain subject to internal liquidity stress testing requirements, which helps avoid excessive risk taking and that (ii) a Horizontal Liquidity Review is conducted for all banks in the LFBO portfolio with total assets of US\$100 billion or more. However, the requirements included in the Regulation YY are not very prescriptive, as banking organizations are free to choose the scenarios' assumptions with minimal regulatory constraints. The FSAP team was provided with a sample of onsite examination reports and supervisory files showing that supervisors periodically review banks liquidity stress tests and liquidity assumptions. However, the examinations were

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<sup>37</sup> FR 2052a report collects very detailed and granular quantitative information on selected assets, liabilities, funding activities, and contingent liabilities. FBO LISCC firms and U.S. firms with US\$700 billion or more in total consolidated assets or US\$10 trillion or more in assets under custody must submit a report on each business day.

<sup>38</sup> As detailed in Box 3, given their size, Category IV and Category III banks are unlikely to reach the US\$50 and US\$75 billion thresholds for the *weighted* short-term wholesale funding indicator that would trigger higher LCR requirements.

not comprehensive and covered a limited set of activities of the LFBO portfolio (e.g., broker dealer and securities firms' businesses in 2018, FBO branches in 2019).<sup>39</sup>

- Liquidity risk management requirements under Regulation YY have been significantly reduced for Category IV banking organizations.<sup>40</sup> Firms with less than US\$100 billion in assets that are only expected to follow a statement of guidance issued in 2010 (Interagency Policy Statement on Funding and Liquidity Risk Management) that provides relatively high-level general considerations

**61. In the evolving banking environment, liquidity risks should not be underestimated.**

Advances in technology may lead to an increase depositor mobility as has been seen in other jurisdictions. As a result, banks may experience unexpected, adverse and rapid shifts in their liability mix or increased costs that increase liquidity risk or impact earnings. Therefore, maintaining adequate supervisory scrutiny and well-calibrated prudential requirements is paramount. Where liquidity requirements are no longer applied, FBAs can only resort to supervisory tools such as enforcement measures that may occasionally be taken too late. It is also more difficult to identify outlier banks when supervisors cannot rely on standardized approaches and have to use banks' internal measures such (e.g., results of internal stress testing) that might not be consistent across banks.

**Interest Rate Risk in the Banking Book**

**62. The FBA's approach toward interest rate risk in the banking book (IRRBB) is principles based.** The FBAs define IRRBB to be the current or prospective risk to both earnings and capital arising from adverse interest rate movements that affect the bank's and holding company's banking book. Examination procedures follow the principles outlined in the 1996 Joint Agency Policy Statement on Interest Rate Risk and the 2010 Interagency Advisory on Interest Rate Risk Management. These guidance documents specify, inter alia, that the board of directors is responsible for setting the tolerance for interest rate risk, monitoring the overall interest rate risk profile and ensuring that the level of interest rate is maintained at prudent levels, while senior management is tasked with ensuring that interest rate risk is managed appropriately. The 2010 Advisory also reminds banks that internal stress testing, which includes both scenario and sensitivity analysis, is an integral part of interest rate risk management and highlights that the reasonableness of assumptions that underlie an institution's IRR exposure estimates should be regularly reassessed (asset prepayments, non-maturity deposit price sensitivity, etc.).

**63. No material changes have occurred since the 2015 FSAP.** The recommendation made by the FSAP team in 2015 to revise the 1996 guidance to include more quantitative guidelines

<sup>39</sup> The sample of files shared with the FSAP team also included the 2015 "Coordinated Liquidity review" for LBOs, but related documents did not include any assessment of internal liquidity stress test practices at LBOs.

<sup>40</sup> Lower frequency of internal liquidity stress tests (on a quarterly basis rather than a monthly basis), lower frequency of collateral valuation of collateral (monthly instead of a weekly calculation), no requirements to monitor the sources of liquidity risk and establish limits on liquidity risks.

regarding interest rate risk in the banking book has not been implemented because it was determined by the FBAs to not be the preferred approach to IRRBB supervision. While sound principles and supervisory expectations for the identification, measurement, monitoring and control of IRRBB are clearly defined, no standardized methodologies have been defined to measure change in economic value of equity and change in net interest income. The base methodology to identify outlier banks have not been adopted. Nor have standardized disclosure requirements been defined. Moreover, banks are not required to hold capital against changes in interest rates under a Pillar 2 approach. Certainly, banks participating in the CCAR are required to hold capital for IRRBB as revenues and expenses projected vary based on changes in the economic conditions over the nine quarters of the planning horizon including changes in interest rates. However, the CCAR process is limited to 19 firms (albeit likely the most important ones) and earnings simulations have inherent limitations in quantifying interest rate risk exposure.<sup>41</sup> For that reason, the BCBS has recommended considering capital adequacy for IRBBB in relation to the risks to economic value.<sup>42</sup>

**64. Off-site and onsite examination mainly rely on ad hoc information provided by firms on a non-standard basis.** There is arguably a strong focus on interest rate risk management. When weaknesses are identified, FBAs formally recommend corrective action. Banks and BHCs are expected to have oversight programs commensurate with their size and complexity of operations. For large and complex banks, the assessment of IRR is achieved mainly through a combination of firm-specific and horizontal work that is conducted both onsite and offsite. Regular meetings are organized to understand changes in IRR profile, scenarios' assumptions, balance sheet strategies and risk tolerance. Detailed information is requested from banks to form a view on the adequacy of risk management (managements reports, model risk assessments, committees' minutes and background documents, etc.). For smaller firms, IRR-related information is obtained through onsite examinations. In all cases, the extent of regulatory data (submitted through supervisory returns on a routine basis) that can be used by offsite examiners to assess the IRR profile is limited. Supervisors have the authority to request any IRR information at any time.

**65. However, there are limits to such an approach in the current economic and market environment.** As noted by the OCC, increased competition for deposits may result in less stable deposits and/or increased costs, as technological advances make it easier for depositors to move funds quickly between institutions.<sup>43</sup> Therefore, it is essential to measure accurately the IRR exposure based on different scenarios, including different sensitivities regarding the stability of deposits, and identify banks with excessive IRR exposure. OCC Bulletin 2010-1 provides guidance on conducting scenario analysis and provides scenarios that banks should include in their model runs. That said, regard, relying on information solely provided by firms that can define the scenarios and the related assumptions may lead to possible inconsistencies when reviewing banks' IRR profile across the

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<sup>41</sup> The economic-value approach focuses on a longer-term time horizon, captures all future cash flows expected from existing assets and liabilities, and is more effective in considering embedded options in a typical institution's portfolio, etc.

<sup>42</sup> BCBS standards on IRRBB, April 2016.

<sup>43</sup> OCC, Semiannual Risk Perspective from the National Risk Committee (Spring 2019).



banking system (the risk being that excessive IRR might not be detected in due time). The risk is compounded when banks have limited expertise to conduct stress testing and sensitivity analysis. Introducing standardized approaches for measuring IRR and standardized disclosure would help identify “outlier” banks requiring heightened supervision.

## Related Parties

**66. The regulatory framework for related parties covers transactions with affiliates and insiders.** Several legislative and regulatory provisions are designed to prevent the misuse of a bank’s resources through preferential transactions with its affiliates and impose a number of restrictions on extensions of credit between a bank and its insiders and to insiders of its affiliates.<sup>44</sup>

**67. The U.S. related-parties framework still exhibits gaps with the international standards, some of which persist from past FSAP assessments:**

- **Limited scope of related parties and transactions.** The definition of “affiliate” excludes nonbank operational subsidiaries of the bank, and the definition of “related interest” of insiders does not explicitly include family members although, the definition of principal shareholder explicitly provides that shares owned or controlled by a member of an individual’s immediate family are considered to be held by the individual. The definition of “covered transactions” does not include all claims and dealings, such as service and construction contracts, and lease agreements.
- **Insufficient banks’ boards involvement.** While the regulation specifies that extensions of credit to an insider have to be reviewed and approved by the bank’s board if the aggregate exposure to that insider would exceed the higher of US\$25,000 or 5 percent of the bank’s capital and surplus, or if the aggregate exposure would exceed US\$500,000 upon consummation of the new credit facility, it does not require prior board approval of transactions with affiliated parties or of the write-off of related party exposures exceeding specified amounts. Similarly, the regulation does not require board oversight of related party transactions and exceptions to policies, processes and limits.
- **Limited regulatory powers to mitigate risks.** Regulatory limits applied to affiliates are generally stricter than those for other counterparties.<sup>45</sup> Insider transactions are, however, only subject to the single-borrower limits and aggregate amount of loans to insiders can go up to 100 percent of a bank’s capital and surplus. For banks with deposits of less than US\$100 million,

<sup>44</sup> Provisions are included in the Federal Reserve Act and implementing regulations (Regulation O and W). The term “affiliate” includes any entity that directly or indirectly controls, or is under common control with, the bank, but does not include nonbank operational subsidiaries of the bank. Insiders include executive officers, directors, and principal shareholders of a bank, as well as their related interests (companies controlled by such insiders). Insiders of affiliates are also subject to restrictions.

<sup>45</sup> The regulation applies a general limit of 10 percent of the bank’s capital and surplus to the aggregate amount of covered transactions with any one affiliate and a limit of 20 percent of the bank’s capital and surplus to the aggregate amount of covered transactions with all affiliates. Further, loans, extensions of credit, and credit exposures arising from derivative and securities borrowing and lending transactions are subject to strict collateral requirements.



the limit is two times a bank's capital and surplus, if the bank is in satisfactory condition. Moreover, no regulatory limits apply to holding company transactions with their affiliates or insiders, as already noted in the 2010 and 2015 DARs. This may give rise to arbitrage, by booking exposures in the BHC to avoid limits.

## D. Recommendations

### 68. Authorities are strongly encouraged to further enhance the prudential framework by:

- Streamlining and simplifying the regulatory framework by reducing the number of individual statements of guidance on the same topic, improving the consistency between all requirements and guidelines, and further developing interagency work, so that the same guidance could be adopted by all of the FBAs where appropriate.
- Ensuring that categories III and IV banks have capital requirements broadly consistent with the Basel standards.<sup>46</sup>
- Introducing rules on concentration risk management for BHCs and banking organizations, explicit requirements for board approval of loans exceeding a certain amount or percentage; and requiring banks to comply with appropriate large exposure limits.<sup>47</sup>
- Introducing harmonized approaches for measuring IRR, strengthen disclosure requirements, identify outlier banks, and ensure that all banks with material exposures hold capital against IRR.
- Enhancing the related-party framework. It is recommended to introduce the requirement for board approval for related party transactions and write-off of their loans exceeding specified amounts, widen the definition of "related interests," to include those mentioned in the CP 20, introduce limits for BHC transactions with affiliate or insiders, and review the aggregate limits for lending to insiders.
- Including a capital charge for operational risk for banks and BHCs using standardized approaches.<sup>48</sup> It is also recommended to consider expanding the scope of supervisory reporting of operational risk events and associated losses, and to consolidate and develop a comprehensive guidance on operational risk management in line with international standards to ensure that FBAs' supervisory expectations and minimum standards are well understood.
- Considering extending the scope of the LCR and the proposed NSFR to other large banks.

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<sup>46</sup> See BCP 16, EC3 and AC1.

<sup>47</sup> See BCP 17, EC1; and BCP 19, EC1 and AC1.

<sup>48</sup> See BCP 16, EC3 and AC1.

**69. The authorities could further strengthen the corporate governance and risk management by:**

- Introducing enhanced standards on the governance of large and complex BHCs while clarifying supervisory expectations around the role of the board of directors and senior management and strengthening the risk management requirements for smaller firms that are not subject to provisions such as those included in the OCC Heightened standards.
- Specifying requirements that banks inform promptly the supervisors about material developments that may affect the fitness and propriety of Board directors, introduce requirement for the removal of CROs, and strengthen regulations and supervisory processes to fully implement compensation principles in accordance with the BCPs (CP 15, EC 7).

## STRESS TESTS AND CAPITAL PLANNING

**70. The rigorous and comprehensive U.S. regulatory capital stress test program is a key tool for assessing bank's capital plans.** Going forward authorities are encouraged to continue work on exploring second-round effects, possibly by integrating capital and liquidity stress tests, and consider leveraging the stress test framework to probe the prudential implications of longer-term structural issues in the banking industry. Considering that most banks subjected to the supervisory stress testing process consider it to be the main driver of their capital requirements, it is important to be mindful of the cumulative effects of changes to the program. Recent changes will likely result in lower regulatory capital requirements for several large banks, and possibly also for the GSIBs in the current stage of the economic cycle.

### A. The Stress Test Program

**71. The U.S. regulatory capital stress test program consists of the Dodd-Frank Act Stress Test (DFAST) and the CCAR.** DFAST is a forward-looking quantitative evaluation of bank capital that evaluates how a hypothetical stress scenario developed by the FRB would affect the capital ratios of large banks. CCAR includes a quantitative assessment for all banks subject to the DFAST supervisory stress test plus a qualitative assessment of certain banks' capital planning practices.<sup>49</sup> Those exercises, or more precisely their Supervisory Capital Assessment Program predecessor, were introduced by the FRB in 2009 at the height of the global financial crisis to help restore confidence in the largest banks by providing public information on how those banks would fare in prescribed

<sup>49</sup> Under the capital plan rule (12 CFR 225.8), a subject bank must include in its annual capital plan an assessment of the expected sources and uses of capital over the planning horizon under expected and stressful conditions, a detailed description of the bank's processes for assessing capital adequacy, the bank's capital policy, and a discussion of any expected changes to the bank's business plan that are likely to have a material impact on the bank's capital adequacy or liquidity. Further details on the DFAST and CCAR programs can be found in: Board of Governors of the Federal Reserve System. July 2019. *Comprehensive Capital Analysis and Review 2019: Assessment Framework and Results*. Available at: <https://www.federalreserve.gov/publications/files/2019-ccar-assessment-framework-results-20190627.pdf>; and in the FRB's stress testing rules (12 CFR 252, subparts E and F).

stress scenarios. Since then DFAST and CCAR have become well-established components of the FRB's supervision program for large banks.<sup>50</sup> Per the Dodd-Frank Act, the OCC and FDIC have also implemented DFAST requirements for covered institutions at the company (non-holding company) level.<sup>51</sup>

**72. As part of the CCAR assessment, the FRB has the opportunity each year to publicly object to bank capital plans if it has concerns about the adequacy and appropriateness of those plans.** The stress tests encompass the key risks to which large U.S. banks are exposed (Box 2). They are also independent in that the FRB runs its own stress tests using its own models and estimates so that its supervisors can formulate their own perspectives on the risks to which large banks are exposed and the losses that may accrue in a stress scenario without relying on the risk models used by individual banks. The OCC and FDIC implementations of DFAST do not include a public object/non-object component. Rather, any concerns with the submissions are discussed as part of the on-going supervisory process.

### Box 2. Summary of the Stress Test Programs<sup>1</sup>

**The DFAST and CCAR stress tests are conducted by the FRB staff using detailed portfolio data provided by banks.** The FRB runs the stress tests using its own models and estimates so that it can formulate its own perspective on the risk exposures of banks and the losses that may accrue in response to stress scenarios of its own devising. This enables the FRB to compare results across banks using a common measurement system and provide the public and the banks it regulates with credible, independent assessments of each bank's capital adequacy under stress.

**The stress tests are comprehensive, spanning credit risk, market risk, operational risk, interest rate risk, incremental default risk in the trading book,** as well as probing potential losses in the event of failure of each bank's principal trading counterparties. The stress tests seek to capture how the balance sheet, risk-weighted assets (RWAs), and net income of banks would be affected by the macroeconomic and financial conditions described in the supervisory scenarios over a nine-quarter planning horizon,<sup>2/</sup> given the characteristics of each bank's loan and securities portfolios; trading, private equity, and counterparty exposures from derivatives and securities financing transactions (SFTs); business activities; and other relevant factors. Projected net income, adjusted for the effect of taxes, is combined with capital action assumptions and other components of regulatory capital to produce post-stress capital ratios. The FRB's approach to modeling post-stress capital ratios generally follows U.S. generally accepted accounting principles (GAAP) and the regulatory capital framework.

**Stress tests are run using data collected from regulatory reports as well as proprietary third-party industry data.** Projections rely on aggregate information from the Financial Accounts of the United States (Z.1) statistical release, which is a quarterly publication of national flow of funds, and additional data collected by the FRB, including the Consolidated Financial Statements for Holding Companies (FR Y-9C)

<sup>50</sup> Randall K. Quarles, "Refining the Stress Capital Buffer," Remarks at Program on International Financial Systems Conference; Frankfurt, Germany. September 5, 2019. Available at [www.federalreserve.gov](http://www.federalreserve.gov). As noted by the U.S. authorities, opinions of individual Board do not necessarily reflect the position of the FBAs.

<sup>51</sup> For the OCC see <https://www.occ.gov/publications-and-resources/forms/dodd-frank-act-stress-test/index-dodd-frank-act-stress-test.html>; for the FDIC see <https://www.fdic.gov/regulations/laws/rules/2000-4400.html>.

### Box 2. Summary of the Stress Test Programs (concluded)

regulatory report, which contains consolidated income statement and balance sheet information for each bank. The FR Y-9C also includes off-balance sheet items and other supporting schedules, such as the components of RWAs and regulatory capital. Most of the data used in the FRB's stress test projections are collected through the Capital Assessments and Stress Testing (FR Y-14) information collection, which include a set of annual, quarterly, and monthly schedules (FR Y-14A/Q/M). These reports collect detailed data on pre-provision net revenue (PPNR), loans, securities, trading and counterparty risk, losses related to operational-risk events, and business plan changes. Banks are required to submit detailed loan and securities information for all material portfolios.

<sup>1</sup> Board of Governors of the Federal Reserve System. *Dodd-Frank Act Stress Test 2019: Supervisory Stress Test Methodology March 2019*. Available at [www.federalreserve.gov](http://www.federalreserve.gov)

<sup>2</sup> In the case of the trading book the stress tests assume that market prices react instantaneously to the stress scenario. As for the banking book, the projection of credit losses also takes account of provisions for credit losses that are expected to emerge in the subsequent four quarters. This effectively allows the stress tests to take account of potential credit losses that may emerge over a thirteen-quarter horizon.

#### 73. Potential losses under stress are calculated independently by supervisors and banks.

To avoid potential overreliance on supervisors' models, banks are required to estimate their potential losses in a stress scenario determined by the FRB. The highest loss between the supervisor's estimate and the bank's estimate becomes the binding constraint for the capital plan.<sup>52</sup> In addition, the CCAR and the broad supervisory examination processes actively probe the broader range of risks to which individual banks are exposed and more importantly the quality and integrity of bank capital planning processes. As a result of this process, supervisors routinely make recommendations for banks to improve their models and risk managements practices. However, as supervisors' models tend to be more conservative, they end up playing the decisive role in capital plans approval decisions. The OCC and FDIC do not estimate supervisory models as part of their DFAST implementation.

## B. Recent Changes

**74. U.S Authorities have been taking steps over the last couple of years to simplify the regulatory framework and tailor the stress test exercise to the systemic importance of the banks.** The authorities claim that the changes that have been finalized have been mainly designed to reduce the administrative burden of the stress test exercises and qualitative reviews on banks that pose less systemic risk to the U.S. financial system and enhance the transparency of the stress test program itself without compromising the safety and soundness of the financial system or that of individual banks. Some of the more material changes which have been implemented include:

<sup>52</sup> The maximum amount of capital that can be distributed is driven by the higher amount of the stressed losses that are estimated (i) by the firm (when determining the distributions in the first place, a firm needs to keep enough capital to absorb the losses it has estimated) or (ii) by the supervisor (a firm that do not have enough capital to make the planned distributions and absorb losses based on supervisory models has to revise its capital plan).

- **Removal of the Qualitative Objection.** In February 2017, the FRB amended the capital plan rule to no longer subject banks considered large and noncomplex to provisions whereby the FRB could object to a capital plan due to qualitative deficiencies in the bank’s capital planning processes (“qualitative objection”). In April 2019, the FRB amended the rule to remove the qualitative objection for any bank that has been subject to the qualitative objection for four consecutive years and that does not receive a qualitative objection in the fourth year of that period. Going forward, despite of the removal of the qualitative objection, the heightened supervisory expectations will be maintained and the capital planning practices of large bank holding companies will continue to be reviewed through the supervisory process.
- **Scope and frequency:** The EGRRC Act eliminates the supervisory stress tests for BHC with less than US\$100 billion in assets, requires periodic (rather than annual) supervisory stress test for firms in the US\$100 to US\$250 billion range, and removes the company-run stress tests requirements for banking organizations with less than US\$250 billion in assets and other financial companies with US\$250 billion in assets or less (see Box 1).
- **The transparency of the stress test exercises has been significantly enhanced.** In order to better balance the costs and benefits of disclosure, in February 2019, the FRB adopted changes which increased the transparency of its stress testing program.<sup>53 54</sup>

**75. The implementation of the Stress Capital Buffer (SCB) will lead to further significant changes to the stress testing program.** The FRB finalized in March 2020 the rule creating the SCB. The FRB’s objective is to simplify its large bank capital framework by integrating its forward-looking stress tests capital rules with its more traditional regulatory capital requirements (Box 3). Under the new rules, a bank whose capital buffers are below its minimum capital requirement plus its stress losses and any applicable GSIB surcharge and countercyclical capital buffer would be subject to automatic restrictions on capital distributions. While the addition of the GSIBs surcharge makes the stress testing programme more rigorous, other changes in assumptions and parameters might reduce the stringency of the capital requirement by:

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<sup>53</sup> The changes included amendments to the FRB’s Policy Statement on the Scenario Design Framework for Stress Testing along with the adoption of a new stress testing policy statement and a notification of enhanced disclosure of the models used in the supervisory stress test. Regarding the latter, in March 2019 the FRB published enhanced disclosures on two of the key models that it uses in stress testing. It also published estimated loss rates for groups of loans with distinct characteristics, to show how supervisory models treat specific assets under stress. The FRB has publicly committed to publishing disclosures about two additional models in 2020 and each year thereafter until it has provided more transparency for each of its stress test models.

<sup>54</sup> Commenters to the proposals for enhanced disclosure issued by the FRB in 2017 were divided in their views on the appropriate level of transparency. Some commenters recommended full disclosure of supervisory models published by the Board through the public notice and comment process, suggesting that this would result in more accurate models. Other commenters expressed the view that the FRB should fully disclose material aspects of the models such as underlying formulas, equations, model backtesting, validation outcomes, and limitations, to enable the public to evaluate the reliability of the Federal Reserve’s results. However, other commenters opposed full transparency of supervisory models, indicating that it is important for the stress test to remain flexible and for it not to be perfectly predictable by the companies subject to it.

- Removing the current assumption in CCAR that a bank will carry out all nine quarters of its planned capital actions (e.g., dividends, repurchases, and issuances) in the stress test and instead require banks to prefund only four quarters of planned common stock dividends.
- Modifying the current assumption in CCAR that effectively requires that a bank's balance sheet grows under stress to an assumption that the bank's balance sheet size remains constant under stress.<sup>55</sup>
- Removing the 30 percent dividend payout ratio that had been used as a threshold for heightened supervisory scrutiny.
- Removing the stress leverage buffer requirement. Under the SCB final rule, banks will no longer have to comply with any leverage buffer under stress conditions (i.e., the SLR and the U.S. leverage ratio will no longer be considered as post stress capital requirements).
- Allowing firms to increase their planned capital distributions in excess of the amount included in their capital plans without prior approval of the FRB.

**76. Recent changes to the stress test program will likely reduce regulatory capital requirements for many large banks.** While the consideration of the GSIBs surcharge in the stress capital rules off-set at least part of the impact for the GSIBs, the other banks that participate in the program have a meaningful reduction in regulatory requirements, albeit from a strong starting point. In addition, the new rules might become more procyclical. The prefund of dividends has the useful property of helping banks strengthen their capital positions when times are good. Requiring banks to prefund only four quarters of dividends, instead of nine, reduces this countercyclical feature. Finally, the removal of the post-stress leverage requirements substantially reduces tier 1 capital requirements (Table 3).

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<sup>55</sup> It is also worth noting that credit risk-weight densities are assumed to be stable in the stress tests (as opposed to rising as credit conditions deteriorate, which would be the case in internal bank models of credit risk) because the tests are run using the U.S. standardized framework for credit risk in order to provide consistent results across banks. The latter applies stable risk weights for credit risk that are typically more conservative than the implicit credit risk-weights generated by bank internal models in normal times.

### Box 3. Overview of the Stress Capital Buffer

**The main objective of the FRB’s March 2020 stress capital buffer (SCB) rule is to simplify the regulatory capital framework by integrating the FRB’s forward-looking stress tests capital rules with the current capital conservation buffer.**

- Under the current capital rule, a bank is subject to restrictions on its capital distributions and certain discretionary bonus payments if the bank does not maintain a CET 1 capital conservation buffer of at least 2.5 percent of risk-weighted assets over and beyond the minimum CET 1 risk-based capital requirements of 4.5 percent. The capital conservation buffer is expanded by the applicable surcharge if a bank is a global systemically important bank (GSIB) plus any prevailing countercyclical capital buffer requirement.
- At the same time, the FRB may also restrict capital distributions if a bank has not demonstrated an ability to maintain capital levels above minimum regulatory capital requirements under stressful conditions (CCAR quantitative objection) assuming that the bank makes all planned distributions included in its capital plan.

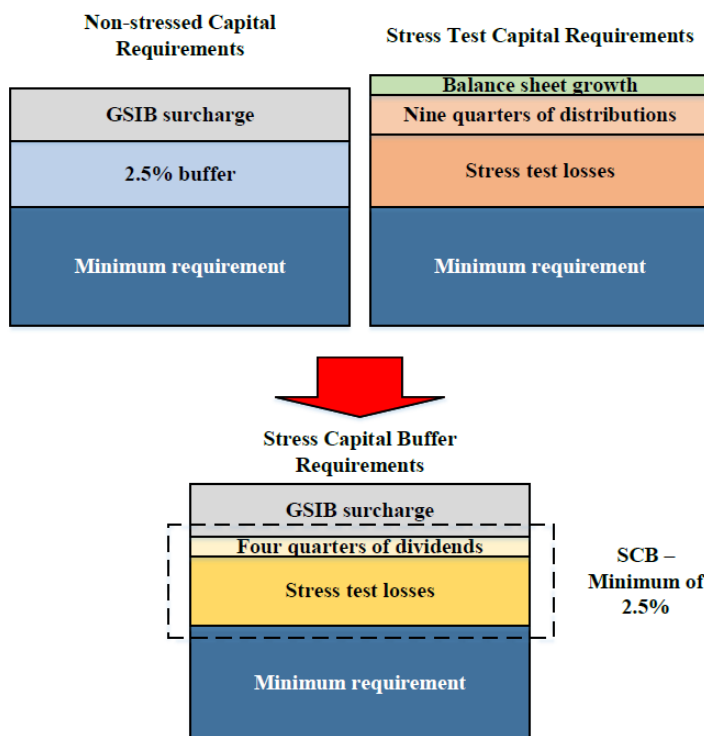
**The FRB’s stress capital buffer rule seeks to integrate these two approaches.** For example, under the SCB rule the total capital buffer requirement for a GSIB, above the minimum capital requirements would equal the sum of (i) the stress capital buffer, subject to a floor of 2.5 percent of risk-weighted assets; (ii) the GSIB surcharge, and (iii) the countercyclical buffer (if deployed).

**Under the final rule, the GSIB surcharge will be added to the Stress Capital Buffer.** This change is significant because, under the CCAR, a bank is currently required to have enough capital to absorb its peak-to-trough stress losses plus its planned capital distributions and meet its minimum capital requirements (i.e., a 4.5 percent CET1 risk-based capital ratio) on a post-stress basis without having to meet its GSIB surcharge. This approach will be more conservative for GSIB banks.

**The final rule will also relax certain assumptions.** Banks will no longer have to “pre-capitalize” all nine quarters of their planned capital distributions in their capital plans. Instead, they would only be expected to “capitalize” four quarters of planned common share dividends. In addition, the rule also eliminates the assumption of balance sheet growth over the stress testing horizon that is part of the current CCAR framework and replace it with a less onerous stable balance sheet assumption.

Source: FRB, IMF staff

#### Changes to the capital regime for GSIBs





**Table 3. United States: Impact of Stress Capital Buffer on Capital requirements.**

	Average change (2013-2019)		Current 1/	
	US\$ billion	Impact as a % of current requirement	US\$ billion	Impact as a % of current requirement
<u>Impact on CET1 capital</u>				
GSIBs	46	7%	-6	-1%
Category II-IV	-35	-10%	-53	-15%
<b>Total</b>	<b>11</b>	<b>1%</b>	<b>-59</b>	<b>-5%</b>
<u>Impact on Tier 1 capital</u>				
GSIBs	0	0	-40	-5%
Category II-IV	-49	-12%	-62	-15%
<b>Total</b>	<b>-49</b>	<b>-4%</b>	<b>-102</b>	<b>-8%</b>

Source: Federal Reserve and statement by Governor Brainard on March 4, 2020 concerning the impact of the SCB on the Tier 1 capital requirements of GSIBs and Categories II-IV firms

1/ Based on high level of dividends such as those observed in 2019

## C. Recommendations

**77. The stress test framework is comprehensive and rigorous but could be further improved.** The FRB has been evolving its stress test program over time as modeling practices and data sources improve. Potential improvements include:

- **More explicit recognition of second-round effects might help to further enhance the stress test exercises.** As presently designed, the FRB's stress tests do not explicitly take account of potentially material second-round effects that may emerge in response to adverse macroeconomic shocks. These effects can include macroeconomic disruptions arising from associated disruptions to bank funding markets; contagion effects that can spread from one bank to another when a bank encounters stress; and potential asset fire-sales that may emerge when multiple institutions seek to sell assets at the same time to boost their liquidity positions. U.S. authorities argue that these effects are already implicitly captured in the stress tests given the severity of the scenario chosen, which is largely based on events and correlations observed during the last financial crisis. However, the historically observed stress events also implicitly include the actions that were taken by the authorities during the period to contain the broader damage to the financial system and the broader economy. Stress tests should ideally explore additional mechanisms to understand how bank capital will behave under stress in the absence of such actions. Modelling second-round effects remains a work-in-progress in most jurisdictions. These effects are particularly relevant for macroprudential purposes but can also be informative to analyze the capital needs of individual banks. The U.S. authorities are encouraged to continue exploring how they might further enhance their supervisory stress testing program

to identify and analyze these effects in a more explicit fashion. One possible way forward might be to begin by considering how best to integrate the solvency and liquidity stress testing.

- **Consider leveraging the stress test program to probe more structural issues.** In the future, the FRB may wish to consider leveraging their stress test program to explore the potential impact of longer-term structural issues on the safety and soundness of regulated banks. The UK's experience in using stress test exercises to probe potential prudential issues associated with climate risks or "low-for-long" interest rate scenario are examples of the type of analysis that might prove useful from a prudential perspective. Another topic that could be explored is the impact of the low levels of interest rates for a prolonged time on the banking sector.

**78. In conjunction with finalizing any other reforms, it would be important to assess the combined impact of all recent reforms, including the regulatory tailoring, and ensure that they do not pose risks to the safety and soundness of banks.** The FBAs usually prepare detailed impact assessments for each reform. The stress test proposals will interact with other changes, including the regulatory tailoring and SLR adjustments and need to be carefully assessed to ensure that the combined effect do not pose any undue risks to the safety and soundness of regulated firms.

**79. Removing the CCAR qualitative objection places added pressure on bank supervision.** The qualitative objection was included as part of the stress test program to help address shortcomings in bank capital planning practices and the supervision thereof that had existed prior to the crisis. The FRB has decided to set aside the qualitative objection process because it believes that banks have achieved significant progress in correcting the weaknesses that had previously existed in these practices. Going forward, banks will be given an opportunity to privately address any supervisory concerns expressed as Matters Requiring Attention before the issues are more formally escalated to the point where more public tools like enforcement actions need to be deployed to correct bank (mis)behavior. The main outstanding question is whether supervisors will be willing to escalate issues and deploy their more public tools on a timely basis in the absence of the CCAR qualitative objection process.

## SUPERVISORY APPROACH AND PRACTICES

**80. The FBAs have a well-developed and tailored supervisory approach in which stress tests play a key role on supervisory assessments of the resilience of the banking sector.** Supervisors conduct on-site and off-site analysis to develop a thorough understanding of the risk profile of each bank. Going forward, the easing of regulatory constraints for some categories of banks increases the importance of high quality and independent banking supervision to mitigate potential risks. In addition, as the memory of the GFC recedes, the challenge is to maintain supervisory intensity and intrusion in the face of stronger pressure and challenges by banks.

## A. Methods of Ongoing Supervision

**81. The supervisory process is comprehensive, highly structured and risk-based.** The FBAs utilize their authorities to develop and maintain a thorough understanding of the operations of individual banks and holding companies. During the supervisory cycle, the agencies formally assess the risk profile of each institution to determine the supervisory strategy. Risk assessments are updated on a regular basis through off-site monitoring programs and on-site examinations. These risk assessments include a forward-looking assessment of the risk profile of the banks, particularly in relation to safety and soundness, and the use of a uniform rating process that provides a consistent methodology and terminology for assessing and assigning risk ratings across banks. The supervisors have a framework in place for early intervention; and have plans to act to resolve banks in an orderly manner if they become non-viable.

**82. Under U.S. law, the FBAs conduct full-scope on-site examinations of banks at least and holding companies.** Banks that have assets of less than US\$3 billion, have a composite CAMELS rating of outstanding or good, that are considered well-managed and well-capitalized, and meet certain other criteria may be eligible for an eighteen months cycle, while all other banks have a 12-month examination cycle. The full-scope examination addresses all key areas of a bank's operations, including capital adequacy, asset quality, management strength and quality of oversight from the bank's board of directors, quality and sustainability of earnings, adequacy of liquidity sources, and sensitivity to market risk. For many larger banks and holding companies, full scope examinations/inspections consist of a series of targeted reviews during the examination cycle which culminate in a roll-up process where ratings are assigned based upon the results of these targets and the continuous monitoring activities. Additionally, for many of the largest banks and holding companies, one or more of the banking agencies maintains a full-time examination staff on-site at the banks to monitor the banking organizations' condition and activities.

**83. The Prompt Corrective Action (PCA) framework is the main plank of the early intervention framework and has clear triggers.** The PCA statute provides the FBAs with authority to promptly resolve capital deficiencies at insured depository institutions, and thereby reduce bank failures. The PCA imposes mandatory and discretionary restrictions on an insured depository institution's capital position to ensure a minimum level of capital is maintained or, in the absence of appropriate capital, requires the chartering government agency to close or seize the bank. The FBAs also have informal and formal supervisory actions linked with the supervisory ratings of the institutions. While the corrective actions are not automatic, they are presumed when the ratings of the institutions are poor.

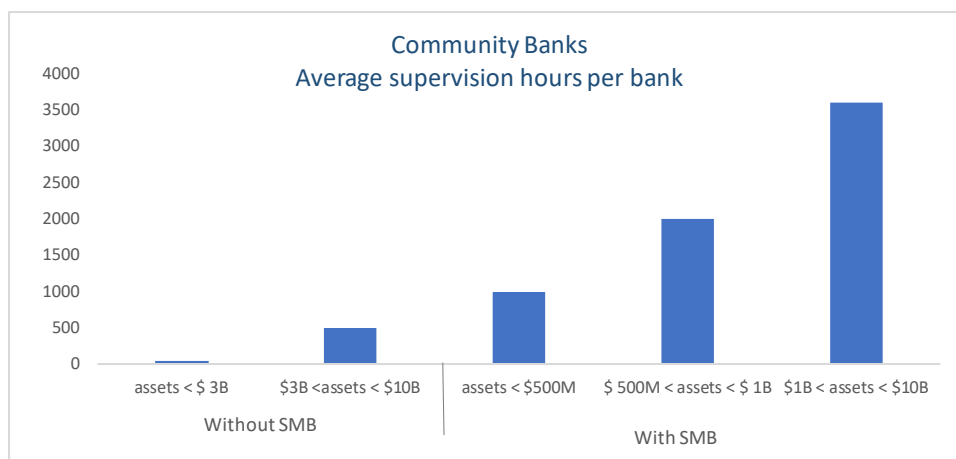
### Tailoring of the Oversight Framework

**84. The FBAs take a proportional approach to supervision which ensures additional focus and resources for weaker and more systemically important institutions.** All FBAs divide the banks for examination purposes according to their size and complexity; although these categories are not aligned with the ones created for regulatory purposes. Generally, the supervisors use a US\$10 billion threshold as a key dividing point in the intensity of supervision. Typically, this is the

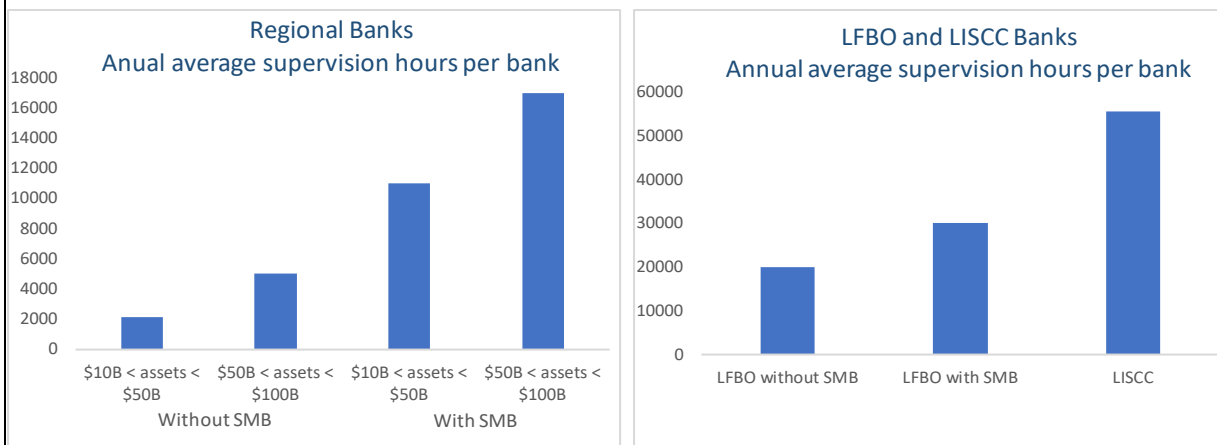
point where supervisors carry out continuous assessment of firms. These assessments are usually supported by resident examination teams for firms with more than US\$100 billion, rather than a periodic examination (Appendix 4). Supervision intensity grows with the systemic importance of the institutions. The most intensive form of supervision is reserved for the U.S. GSIBs and a small group of foreign bank organizations (FBOs) with large and complex operations in the U.S. This proportional approach to supervision is clearly reflected in the number of supervision hours used for each type of institution (Figure 4).

**Figure 4. United States: FRB Supervision Hours per Institution**

*The FRB, on average, spent the least amount of time supervising the holding companies of community banks without State member banks (SMB) whose primary federal regulator was either the OCC or FDIC. Among those institutions primarily supervised by the FRB, the average number of hours increase substantially with size.*



*LISCC firms, a group of 12 banks considered systemically important, are subject to the most rigorous supervision with the most supervisory resources per firm—over 55,000 hours on average.*



Source: FRB Bank, Supervision and Regulation Report, May 2019. Includes only the supervision done by the FRB.

**85. New efforts to further tailor the supervisory framework focus on reducing the regulatory burden for small banks.** The EGRRCPA directed the FBAs to tailor the oversight of banks. In response the FBAs have been increasing the emphasis on risk-focused examination activities for regional and community banks, conducting more in-depth examinations for banks with high-risk activities and less-intensive examinations for lower-risk banks. In addition, the FBAs have taken steps to reduce the information collection requirements for smaller banks and minimize the burden associated with their examinations by conducting larger portions of examinations away from bank premises (off-site). Specific examples of recent supervisory actions to further tailor the supervisory approach include:

- The FBAs, under the auspices of the FFIEC, implemented a new streamlined regulatory reporting for eligible small institutions.<sup>56</sup> This streamlined report resulted in 24 fewer pages and reduced data items required to be reported by small banks by 40 percent.
- The FRB increased the reporting asset threshold for holding companies from US\$1 billion to US\$3 billion. As a result, nearly 55 percent of holding companies are eligible to file a substantially shorter parent-company-only form semiannually (instead of quarterly).
- The FRB is conducting more supervisory activities off-site and simplifying pre-examination requests for documentation to ease the burden associated with community bank examinations. The Bank Exams Tailored to Risk (BETR) program relies upon regulatory reporting data and examiner judgement to classify areas of risk, allowing supervisors to direct their resources to areas of heightened risk and to minimize excessive burden on low-risk areas and institutions.
- Recognizing that banks are increasing use of digital loan files to manage their documents, in 2018, the FDIC began piloting a technology to facilitate off-site loan file review, aiming to enhance efficiency and reduce banks' burden.

### **Communication of Supervisory Concerns and Enforcement Action**

**86. Generally, the FBAs identify problems or deficiencies at a bank or holding company during on-site examinations.** Many minor problems or deficiencies are resolved informally during the examination, when the bank or holding company immediately takes steps to correct or commits to promptly correct the deficiencies and address the regulatory concerns. At the end of the examination of a bank, supervisors send a written "Report of Examination" to the bank for review by all directors and senior officers. The report assesses the condition of the bank's capital, asset quality, management, earnings, liquidity and sensitivity to market risk (CAMELS); identifies violations of law; and addresses compliance with consumer laws and regulations, information technology, and the CRA. The narrative of the report of examination also calls attention to "concerns" or matters that need attention (MRAs and MRAs/MRBAs).

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<sup>56</sup> Call report FFIEC 051.

**87. However, there are many cases where banks take an excessive time to address the concerns of supervisors.** The regulators employ progressive enforcement regimes to address supervisory concerns that arise during the examination cycle. If the institution does not respond to the concern in a timely manner, the regulators may take informal or formal enforcement action, depending on the severity of the circumstances. Informal enforcement actions include obtaining an institution's commitment to implement corrective measures under a memorandum of understanding. Formal enforcement actions include issuance of a cease-and-desist order or assessment of a monetary penalty, among others. Notwithstanding these procedures, in practice MRAs can take a long time to be closed and old MRAs/MRIAs are not uncommon.

**88. There is room to improve communication with banks and ensure that their managements are more responsive in addressing supervisor concerns.** A review of supervisory files revealed that the quality of correspondence with banks varies within and across agencies. There are areas for improvements, particularly on strategic level communication. Supervisors communication with banks does not always sufficiently prioritize MRAs and MRIAs and the findings from horizontal reviews take place throughout the year. Sometimes, the team found that supervisors seemed to settle back into prescribed formats that have a tendency of being excessively formulaic and compartmentalized. Key actions can be hidden in long texts and a nuanced and sometimes vague language that does not make clear what is the expected action by the banks. In addition, the procedures and terminology for notification of supervisory concerns is not harmonized across the FBAs, which might generate confusion.

**89. The FBAs are aware of the communication challenges and have taken steps to improve them.** It is important that the ongoing efforts continue. Communicating more clearly with banks where their action (or inaction) is giving rise to risks to safety and soundness is critical. Providing boards with a clear sense of priority could help them monitor whether deficiencies are fully addressed by management and ensure more timely corrective actions.

## B. Potential Future Challenges

**90. The new environment created by the regulatory tailoring and doubts as to the enforceability of guidance increases the importance of high-quality bank supervision.** As supervisory stress tests become less frequent and capital and liquidity requirements less stringent for some banks, supervision needs to sharpen its tools and procedures to ensure that banks remain appropriately governed, controlled and financially resilient to the risks that the banks take and intend to take. While regulation and supervision are not perfect substitutes, the FBAs can mitigate the risks using the full gamut of their toolkit to effectively address them.

**91. These new challenges are emerging at a time when supervisors might face additional push backs from the banking industry.** The context in which supervision takes place is cyclical. As financial resilience for the largest U.S. banks moves away from a near and present threat one might expect that banks may push back against supervisory requirements that are costly and would impact their profitability. Discussions with the private sector made clear the intention of some institutions to challenge what they consider "excessive" or ungrounded requirements from supervisors. FBAs have

been clear that a bank cannot “buy their way out of control weaknesses with high levels of capital and liquidity,” but they recognize that the potential for push back is there. In addition, as discussed in the institutional setting section, the FBAs statement on the role of guidance seems to have potential to impact on supervisory corrective action, albeit FBA management believe that this is in areas where supervisors had either not made a sufficient link between the guidance and a rule or that they had sought to “enforce” the guidance on a line by line basis rather than looking at the totality.

**92. Guidance is an important articulation by the FBAs of their consideration of how rules should be applied.** This is very important when looking at such an overarching rule as a safety and soundness, but it applies throughout the regulations. The FSAP team reviewed SR 13-13 / CA 13-10: Supervisory Considerations for the Communication of Supervisory Findings, which was the FRB’s key statement on communicating findings. It sets clear expectations of supervisors that they will use the following language when communicating an MRIA – *“The board of directors (or executive-level committee of the board), or banking organization is required to immediately...”*. This guidance appears to remain valid in relation to the criteria used in that SR; specifically that (1) matters that have the potential to pose significant risk to the safety and soundness of the banking organization; (2) matters that represent significant noncompliance with applicable laws or regulations; and (3) in the case of consumer compliance examinations, matters that have the potential to cause significant consumer harm. To the extent that the third criteria (repeat criticisms that have escalated in importance due to insufficient attention or inaction by the banking organization) do not qualify under any of the other three criteria, it will be incumbent on supervisors to make a clear and strong link between the inaction and rules such as safety and soundness.

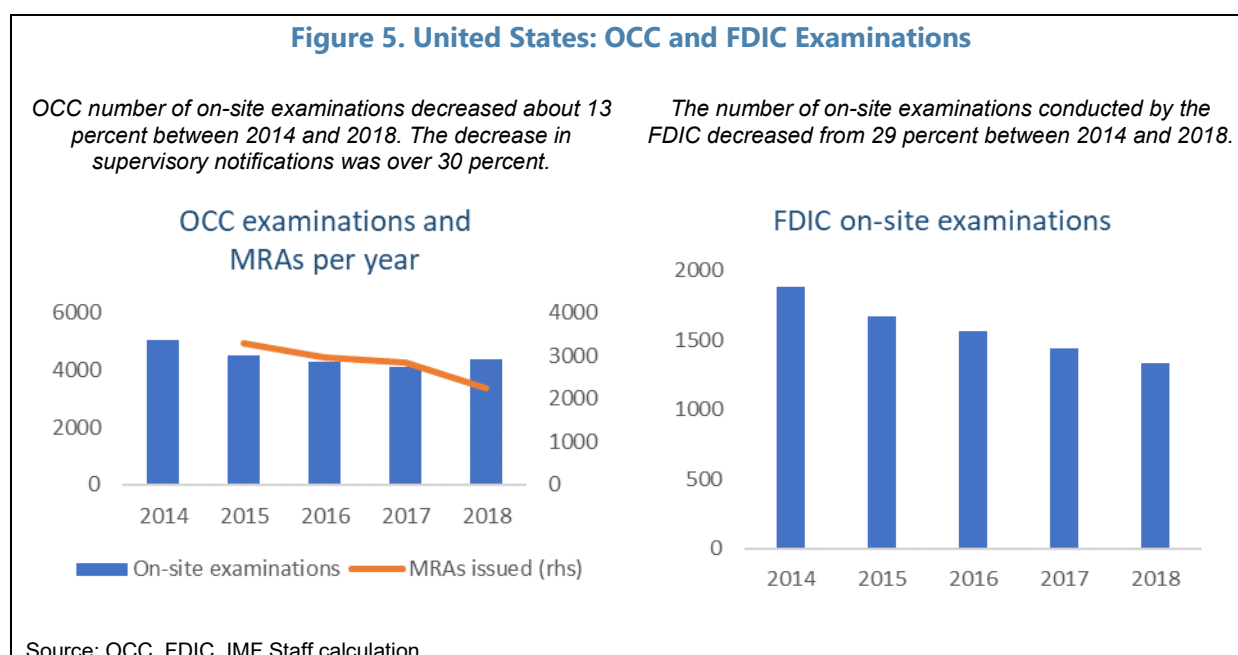
**93. Ratings are an important part of the communication to banks.** There are different rating methodologies used by the FBAs for banks and by the FRB for BHCs. The changes brought about by the FRB for rating large holding companies (SR 19-3 / CA 19-2: Large Financial Institution (LFI) Rating System), while overall useful, does create a transitional challenge for the FRB. The LFI is still in its very earliest days of implementation and typically ratings models take some time to bed down. The FSAP team felt that there were three challenges in particular, that should receive focus: (i) preventing the “Conditionally Meets Expectations” rating being a default rather than transitory, which is the intention. This will involve a clear articulation of risk appetite between the rating of “broadly meets expectations” (itself encapsulating that there can be some minor deficiencies) and “Deficient-1”; (ii) the guidance on ratings has been written at a very broad level of aggregation and consequently it may be difficult to see how the much more granular work carried out by supervisors is related to the ratings (creating a further communication challenge); and (iii) the loss of a composite rating presents a significant operating shift and there is a risk that one of the three LFI ratings is perceived to be the natural successor to the composite.

**94. In addition, risks less familiar to bank supervisors are coming to the fore.** Rapid technological progress in financial services, cyber risks and transition risks to a low carbon economy are gaining prominence due their potential systemic implications. The FBAs have a supervisory approach that is effective in tackling traditional risks and have taken steps to include some of these



new challenges. To continue being effective it is key to develop processes which allow the necessary agility tackling new risks. The team noted the commitment by the FBAs to try and develop a common and shared supervisory approach to cyber. This initiative is still in its early stages and the team was not able to review any material.

**95. Finally, as the memory of the GFC recedes, it is key to fight complacency and maintain supervisory intensity and intrusiveness.** The number of on-site examinations has declined considerably for both large and small banks. FRB’s examinations of the 12 most systemic banks in the United States have fallen from 468 in 2015 to 301 in 2018 (Figure 6). FDIC total on site examinations decreased about 29 percent between 2014 and 2018 while OCC’s examination decreased 13 percent (Figure 5). The number of MRAs and MRIAs declined even more: above 30 percent in most portfolios and above 50 percent for the large bank holding companies (LISCC and LBO). These indicators can be partly explained by the effectiveness of supervisors that have increased the resilience of the financial institutions over the last decade and the consolidation of the sector. However, it is key that at this stage of the business cycle, considering the buoyant market sentiment and the continued buildup of market vulnerabilities, supervisors do not back-off from new issues and risks, and do not scale back scrutiny of banks practices.



### C. Recommendations

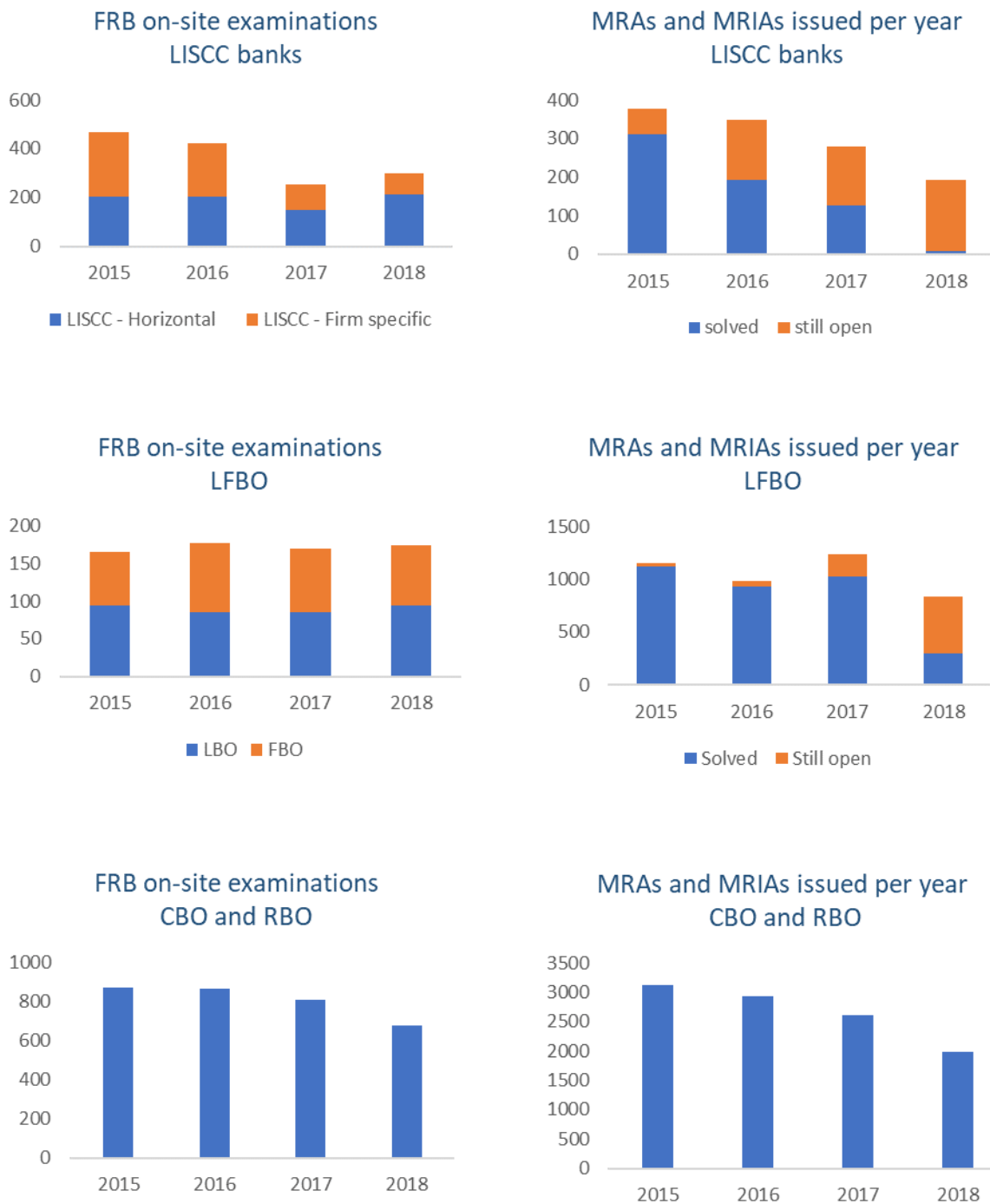
**96. The FBAs are encouraged to consider further actions to tackle aging resolution of matters requiring attention (MRAs).** The long period taken by banks to solve supervisory concerns represent an unnecessary risk to financial stability and might contribute to undermine the authority of supervisors. The FBAs could consider:

- Actions to further improve communication such as (i) harmonizing the procedures and terminology for notifications; (ii) providing streamlined letters to banks using more candid and clear language; and (iii) enhancing the prioritization of the supervisory concerns.
- Introducing more explicit rules and processes to escalate supervisory actions in the absence of timely and appropriate responses from banks to aging MRAs/MRIAs. The lack of specific and measurable guidelines for escalation of supervisory concerns, in some cases, leads to excessive reliance on the judgment of examiners, which can result in inconsistent escalation practices.

**97. The FBAs could consider further developing the framework for promoting early action for other issues than bank capital and liquidity.** The PCA framework is the main plank of the early intervention framework and has clear triggers. The authorities could consider enhancing the prudential framework by developing policy limits for other issues such as concentration and interest rate risks. These limits could work as a red-flags for further examinations and potential, but not always necessary, corrective actions. Such policy limits would provide a signal as to what authorities' regard as acceptable and, as such, it can have a powerful preventative effect. They would also provide a useful reference point for offsite and continuous monitoring and can indicate when a bank might need to be reviewed by on-site supervision. Finally, they could help shortening the time gap between breaking a threshold and action.

**98. Maintain supervisory intensity and intrusiveness and continue adapting the supervisory approach to new challenges and risks.** The FBAs have been very successful fulfilling their mandate and enhancing the resilience of the banking sector since the GFC. To effectively face new challenges arising from regulatory changes, renewed industry pressure against supervisory actions, shifts in the balance of risks and vulnerabilities that continue to build in a maturing credit cycle it is key to maintain the intensity of supervisory scrutiny and being agile in responding to new threats to financial stability.

**Figure 6. United States: FRB Examinations Per Year**



Source: FRB. IMF staff

## Appendix I. Tailoring Rule and Indicator-based Approach

**Consistent with the EGRRCP Act, the FBAs introduced a new round of changes to applicability thresholds for the more stringent regulatory requirements** (See Table below).

**Fewer banking organizations will have to comply with all full Basel standards.** This will accentuate differences between the U.S. regime and the Basel framework that already exist, which will further complicate any comparative exercise. The Collins Amendment to the DFA imposes a prudent permanent capital floor on banks based on the standardized approach risk-based capital rules<sup>1</sup>, but the U.S. standardized approach excludes capital charges for operational risk and for Credit Value Adjustment (CVA) risk. Whilst the GSIB surcharge is more conservative than international standards, no D-SIBs has been identified in the United States.

**Taken together, these changes may impact large banks:**

- **Banking organizations with assets of at least US\$100 billion are considered as “large financial institutions” by the Federal Reserve.**<sup>2</sup> Fourteen of 20 largest banks in the United States are in the US\$100 to US\$700 billion range.<sup>3</sup>
- **Potential impact on risk taking.** Reduced prudential standards could, in turn, facilitate increased risk taking by these large but not GSIB firms without the countervailing regulatory constraints that was provided by the previous regime. Quantitative liquidity rules requiring banks to hold liquid assets to deal with unpredictable events do reduce the probability of runs and help avoid destabilizing bank failures or high liquidation cost of assets that would occur in the absence of high-quality liquid assets. Simulation exercises have shown that liquidity requirements such as the LCR can be as effective as capital requirements in mitigating contagion risk arising from fire sales across the banking system. Empirical evidences suggest that the LCR is associated with a lower individual bank’s marginal contribution to systemic risk and is a useful indicator in predicting *ex ante* which banks are most exposed to a crisis.<sup>4</sup>

<sup>1</sup> Currently, a banking organization using the advanced approaches calculates risk-based capital ratio under both the standardized and advanced approaches and uses the lower of the two ratios as its operative capital ratio. This 100 percent floor is more conservative than the output floor introduced in the Basel framework (set at 72.5 percent of the RWA calculated under the standardized approach).

<sup>2</sup> According to the Federal Reserve, “Large financial institutions generally pose the greatest risk to the financial system as a result of their size, complexity, and interconnectedness. [...] These institutions fall into two primary categories. The largest, most complex bank holding companies and nonbank financial companies--designated by the Financial Stability Oversight Council for Federal Reserve supervision--are considered the institutions posing the greatest systemic risk to the U.S. economy. A second category of institutions are those with total consolidated assets of at least US\$100 billion, which are not considered to be systemically important. [...]”.

<sup>3</sup> Also, it is worth noting that 58 of the world’s 100 largest banks have less than US\$750 billion in assets.

<sup>4</sup> See for example: Charles W. Calomiris, Florian Heider, Marie Hoerova, 2015. “A Theory of Bank Liquidity Requirements”. Hyun Song Shin, 2004. “Liquidity Risk and Contagion”. Douglas W. Diamond and Anil K Kashyap, 2016. “Liquidity requirements, liquidity choice, and Financial Stability”. Brian Du, 2019. “How Useful Is Basel III’s Liquidity Coverage Ratio? Evidence from U.S. Bank Holding Companies”.

- **Potential impact on financial stability.** Both in terms of risk profile, scope of activities, complexity of internal organization and information systems, large banks including regional banks are very different from small community banks that, even collectively, cannot pose systemic threats to financial stability. Experience in the United States as well as in other jurisdictions has shown that the distress of large institutions that would not qualify today as GSIBs (Countrywide, Indymac, Wachovia, Washington Mutual for example) may pose a significant risk to financial stability in certain situations where their business models are closely associated with broader financial system vulnerabilities. It is worth mentioning that, based on the new four-tier framework, the most stringent prudential standards such as the full LCR requirements and the most stringent regulatory adjustments to CET1 capital would have not applied to Washington Mutual (i.e., the largest bank failure in the U.S. history and the sixth-largest FDIC-insured institution in 2008) that held US\$307 billion in assets when it was resolved by the FDIC in 2008. As noted by the former chairman of the FDIC, M. Gruenberg, regional banks *“pose very significant resolution challenges to the FDIC distinct from those posed by GSIBs and by smaller banks. Their size, complexity, and reliance on market funding and uninsured deposits would present very substantial risks in resolution, with potential systemic consequences.”*<sup>5</sup>

#### **The tailoring approach is somewhat complex and largely driven by the size of the banks:**

- **Key features of the approach.** Relying on different metrics, thresholds, and ways to combine them, the indicator-based approach is relatively complex, which somehow contradicts the primary objective of simplifying the regulatory framework and reducing compliance costs. Paradoxically though, only one domestic bank would be placed in a different category than what would simply result from its size. Further, the approach is subject to cliff or threshold effects, with banks having to meet more (or less) stringent prudential requirements and bear higher (or lower) compliance costs when they move, even temporarily, to another category. Conversely, a banking organization that would manage to keep the cross-jurisdictional activity, short-term wholesale funding, nonbank assets and off-balance sheet exposures indicators below their respective thresholds could grow up to US\$700 billion in assets without having to (i) meet prudential requirements fully consistent with all Basel standards<sup>6</sup> and to (ii) hold additional capital reflecting their systemic importance, as no D-SIBs have been identified by the FBAs.<sup>7</sup>

<sup>5</sup> [As noted by the U.S. FBAs, opinions of individual Board do not necessarily reflect the position of the FBAs.](#)

<sup>6</sup> For example, a firm (i) with US\$680 billion in assets (including derivatives—exclusively contracted with foreign counterparties—representing a net exposure of US\$100 billion), (ii) with wholesale funding of US\$300 billion (secured by Level 1 assets), and (iii) with off-balance sheet exposures of US\$70 billion (representing the potential future exposure of the derivative contracts) would fall in Category III despite an extremely aggressive risk profile. In that case, the weighted short-term funding indicator would be US\$75 billion, and the off-balance exposure (that excludes derivatives) would amount to US\$70 billion. Assuming that no transactions other than the derivatives are concluded with foreign banks, the cross-jurisdictional activity indicator would be 0.

<sup>7</sup> As indicated in the BCBS RCAP (June 2016), the Federal Reserve replicated the GSIB assessment methodology in the U.S. D-SIB framework, which includes a measurement of cross-jurisdictional activity. Based on the results, no additional D-SIB has been identified (beyond those already designated as GSIBs).

- Size is the main driver.** Apart from the designation of firms as GSIBs (falling by construction into Category I) that reflects their systemic importance in accordance with the BCBS methodology, the classification is essentially driven by the size (total assets) and size-related indicators (off-balance sheet exposures, size of the of the portfolio of investment in nonbanking assets) and not by the risk profile and/or the complexity of activities.<sup>8</sup> Indeed, other measures of systemic importance such as interconnectedness, complexity and substitutability are not captured by the indicators-based approach. The cross-jurisdictional activity indicator excludes assets and liabilities from derivatives exposures, which is questionable considering the role played by derivatives in spreading distress across countries in 2008-09. Similarly, the use of nonbank assets that are simply defined as assets held by nonbank subsidiaries regardless of their characteristics does not capture any risk component. The importance of short-term wholesale funding (arguably a risk-based indicator) is solely used to classify banks with less than US\$700 billion in assets between category III and category IV and potentially impose higher LCR requirements in these two categories. Overall, size remains a crude measure of complexity and does not reflect the risk profile. As noted in an FRBNY staff report, *“complexity cannot be equated with institution size.”*<sup>9</sup>
- Limited impact on supervision.** There seems to be a slight disconnect between the broad categories used for regulatory purposes (i.e., identifying which rules are applicable to a given regulated firm) and the supervisory practices, which suggests that these categories might be somewhat “artificial” or insufficiently risk-based. Concerning the supervision of banks with more than US\$100 billion in assets, there is a clear and important distinction between the banks supervised under the LISCC program, on the one hand, and the Large Banks Organizations on the other hand (i.e., other large banks with more than US\$100 billion in assets that are not GSIBs). The distinction between Category II, Category III, and Category IV has not yet been translated into distinct supervisory practices.

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<sup>8</sup> As a matter of fact, in order to distinguish between complex and noncomplex holding companies, the Federal Reserve evaluates a number of relevant factors which are not taken into consideration in the tiering system: structure of the company; the extent of intercompany transactions between IDI subsidiaries and the holding company or its non-depository subsidiaries; the risk, scale, and complexity of activities of any non-depository subsidiaries; and the degree of leverage at the holding company, including the extent of debt outstanding to the public. Companies are also designated “complex” if material risk management processes for the holding company and its affiliates are consolidated at the parent company (SR 16-4). Complex BHCs are subject to more intense supervision than noncomplex BHCs.

<sup>9</sup> Complexity in Large U.S. Banks, FRBNY Staff Report, 2019.

Table I.1. United States: Regulatory Tailoring

Applicable regulation	Before EGRRCPA					After EGRRCPA, considering final tailoring rules						
	G-SIBs	\$250b +	\$50-\$250b	\$10-\$50b	<\$10b	Category 1 U.S. G-SIBs	Category 2 >\$700bi	Category 3 >\$250bi	Category 4 >\$100bi	\$50-\$100b	\$10-\$50b	<\$10b
<b>Comprehensive Capital Analysis &amp; Review (CCAR)</b>												
Qualitative Fed-run process review	yes	yes	yes	no	no	yes	yes	yes	no	no	no	no
Quantitative Fed-run stress tests	yes	yes	yes	no	no	yes	yes	yes	every other	no	no	no
<b>Dodd-Frank Act Stress Tests (DFAST)</b>												
Quantitative Fed-run stress tests	yes	yes	yes	no	no	yes	yes	yes	every other	no	no	no
Company run stress tests	yes	yes	yes	yes	no	yes	yes	every other	no	no	no	no
<b>Capital Standards</b>												
Risk-based												
G-SIB capital buffers	yes	no	no	no	no	yes	no	no	no	no	no	no
Countercyclical capital buffer	yes	yes	no	no	no	yes	yes	yes	no	no	no	no
Advanced Approaches	yes	yes	no	no	no	yes	yes	no	no	no	no	no
Risk-based (i.e., Basel III)*	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	no
Leverage ratio												
Enhanced Supplementary LR (eSLR)	yes	no	no	no	no	yes	no	no	no	no	no	no
Supplementary LR (SLR) of 3%	yes	yes	yes	no	no	yes	yes	yes	no	no	no	no
U.S. Leverage ratio	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	yes	no
Option for 9 percent average ratio	no	no	no	no	no	no	no	no	no	no	no	yes
TLAC	yes	no	no	no	no	yes	no	no	no	no	no	no
<b>Liquidity Requirements</b>												
Liquidity Coverage Ratio (LCR)	yes	yes	reduced	no	no	yes	yes	reduced	no reduced	no	no	no
Net stable funding ratio (NSFR), proposal	yes	yes	reduced	no	no	yes	yes	reduced	no	no	no	no
<b>Concentration limits</b>												
Resolution plans	yes	yes	yes	no	no	yes	yes	every six ye	no	no	no	no
<b>Establishment of Risk Committee</b>												
	yes	yes	yes	yes	no	yes	yes	yes	yes	yes	no	no

\*Requirement does not include a capital charge for Operational Risk and CVA  
Source: FBAs, IMF staff



Table I.2. Comparison between U.S. and Basel standards.

	Basel standards	U.S. standards				
		Category I (U.S. GSIBs)	Category II (*)	Category III (*)	Category IV (*)	Other firms
<b>Capital rules</b>						
GSIB surcharge	From 1% to 3.5%	From 1% to 5.5%	N/A			
DSIB surcharge	Principle-based approach	N/A	No surcharge as no D-SIBs have been identified in the US		N/A	
Banks operate above the minimum regulatory capital ratios (to reflect banks' risk profile and changes in economic conditions)	Pillar 2 (**)	Stressed risk-based capital requirements (**)			No Pillar 2 and no stressed risk-based capital requirements	
Countercyclical capital buffer (CCyB)	From 0% to 2.5%	In line with Basel		No CCyB		
Higher leverage ratio requirements for GSIBs (eSLR in the US)	3% + leverage buffer (50% of the GSIB surcharge) Leverage buffer in the 0.5-1.75% range	3% + leverage buffer (50% of the US GSIB surcharge) Leverage buffer in the 0.5-2.75% range	N/A			
Leverage ratio (SLR in the US)	3%	N/A	3% (SLR is aligned with Basel)		No SLR	
Regulatory adjustments to CET1	- For DTAs, MSRs and investments in unconsolidated financial entities: limited recognition in capital capped at 10% of CET1 for each category - The amount of the three items that remains recognized cannot exceed 15% of CET1 - Limited recognition of minority interests	In line with Basel	In line with Basel	- Limited recognition capped at 25% of CET1 for each category  - The amount of the three items that remains recognized after the application of all regulatory adjustments is not capped  - Banking organizations can include minority interest up to 10 percent of the parent banking organization's CET1 capital		
Impact of unrealized gains and losses	Unrealized gains and losses are included in regulatory capital	Unrealized gains and losses are included in regulatory capital	Unrealized gains and losses are included in regulatory capital	Firms have the possibility to exclude gains and losses from regulatory capital (i.e., unrealized losses are not deducted from capital). This is less conservative under stressful conditions when firms are likely to accumulate underlying losses		
<b>Calculation of RWAs</b>						
Floor for firms using internal model approach	72.50%	100% (***)	100% (***)	N/A		
Operational risk	Standardized approach (Business Indicators)	AMA (****)	AMA (****)	No capital charge	No capital charge	No capital charge
Market risk	Framework applies to all banks regardless of the size of the trading book	Framework applies to banks with significant market risk exposures (with aggregated trading assets and liabilities of at least US\$ 1 bn or 10% of total assets). Given scoping criteria, all		Framework applies to banks with significant market risk exposures (with aggregated trading assets and liabilities of at least US\$ 1 bn or 10% of total assets)		
CVA risk	Yes	Yes	Yes	No capital charge	No capital charge	No capital charge
<b>Liquidity rules</b>						
LCR	Full LCR requirements	Full LCR requirements	Full LCR requirements	Reduced LCR	No LCR	No LCR
NSFR	Full NSFR requirements	Full NSFR requirements if implemented (*****)	Full NSFR requirements if implemented (*****)	Reduced NSFR if implemented (*****)	No NSFR	No NSFR

(\*) Category II firms: ≥ US\$700 bn in total assets or ≥ in cross-Jurisdictional activity. Category III: US\$250 bn total assets or US\$75 bn ≥ in nonbank assets, short-term funding, or off-balance sheet exposure. Category IV: Other firms with US\$100 to 250 bn in assets

(\*\*) Comparing the Pillar 2 approach in the Basel framework and the CCAR process in the US is extremely difficult -if not impossible- given the conceptual differences. It is all about implementation.

(\*\*\*) A prudent permanent capital floor on banks based on the standardized approach risk-based capital rules (100%) is implemented, but the U.S. standardized approach excludes capital charges for operational risk and for Credit Value Adjustment (CVA) risk

(\*\*\*\*) The FBAs are considering introducing a standardized approach

(\*\*\*\*\*) The NSFR rule has not been finalized and timing is uncertain

The objective was not to assess whether banks in each segment are internationally active or not, but rather to make a comparison between the Basel standards and the U.S. standards. As this is not an RCAP exercise, the materiality of the differences has not been measured. Standards that apply to noninternationally banks (Categories III and IV) should be broadly compliant with the Basel framework

More conservative than Basel standards      Less conservative than Basel standards

## Appendix II. Federal Reserve Stress Test Models Updates

The FRB strives to ensure that its stress test models keep pace with best practices. This has resulted in an ongoing program of model changes since the last FSAP. The most significant changes are as follows.

- 2015**
- Modest changes to accrual loan loss models.
  - Refinement of risk factors used in selected securities models.
  - Simpler approach to reduce volatility in noninterest income and expenses.
  - Interest expense on subordinated debt now based on more granular instrument-level information
  - Model used to project regulatory capital and capital ratios enhanced to incorporate more detailed data from regulatory reports so that it better aligns with revised regulatory framework and related accounting guidance.
- 2016**
- An average of the historical simulation and panel regression models introduced to project operational risk losses.
  - Operational risk projections for each bank holding company (BHC) incorporated large historical losses (in terms of severity and frequency) observed across all BHCs, scaled to bank size, rather than an individual bank's own historical data. Additionally, projections of losses from the historical simulation model were set at percentiles of the loss distribution that correspond to the severity of the supervisory scenarios.
  - Models used to estimate several components of MRWA were modified in order to better differentiate the sensitivity of each component to scenario variables and to align the estimation more closely to the market risk rule in the Board's Regulation Q.
  - Several changes to the supervisory capital calculation were introduced to improve precision. The main model enhancements include: Incorporating greater precision in the adjustments to the regulatory capital ratio denominators; and modifying assumptions regarding the relationship between mortgage servicing assets (MSAs) and associated deferred tax liabilities (DTLs).
- 2017**
- Operational risk model enhanced to capture losses from operational risk events and mortgage repurchase expenses, and the use of the mortgage repurchase model used in prior years was discontinued.
  - An enhanced regression-based model was introduced that forecasts total losses for operational risk at the industry level and then distributes those losses to each bank based on its asset size.
  - Models that estimate certain components of Pre-Provision Net Revenue (PPNR)—such as net interest income, noninterest income, and noninterest expense—were enhanced to better account for differences in post-crisis performance across banks.
  - Estimation process for commercial real estate loan loss models was streamlined by combining two datasets before model estimation. In addition, in the process of re-estimating the model, the model's macroeconomic variables were updated to better capture loan losses under stress.
  - Supplementary leverage ratio added to the calculation of projected capital.

- 2018**
- Models that project other-than-temporary impairments (OTTI) for debt securities and losses on auto loans, first-lien mortgages, home equity loans, and credit cards were enhanced.
  - Phase-in of material enhancements to the model that estimates certain components of pre-provision net revenue (PPNR) was completed; the PPNR model was updated to include a more granular model of deposit expenses; and changes were made to the calculation of projected post-stress capital to account for the passage of the Tax Cuts and Jobs Act.
- 2019**
- The probability of default (PD) and loss given default (LGD) components of the auto loan model were enhanced. These refinements include changes to the way certain risk drivers are captured in the model, which reduces volatility from historical macroeconomic movements, and an adjustment to newly originated accounts to better reflect their higher credit risk compared to otherwise similar accounts.
  - The way in which the credit card model treats uncollected interest and fees in the exposure at default (EAD) component of the model was refined. Data from more recent periods that include a larger set of banks supported a slight reduction in the assumed percentage of uncollected interest and fee income.
  - Treatment of missing data in the corporate loan portfolio was refined to align with that of other portfolios. Under the refined treatment, the FRB assigns a conservative loss rate for an entire portfolio when a certain proportion of the loans are missing required model inputs. Analysis suggests the refined treatment remains appropriately conservative.
  - Certain models used to project fair value for debt securities were enhanced to increase modeling flexibility and better align with historical trends. The risk drivers for agency mortgage-backed securities (MBS), such as option-adjusted spread (OAS), now flexibly vary over the planning horizon. A new model was also adopted to project the OAS for sovereign bonds. In DFAST 2018, the OAS was projected using a scenario-based regression model. The new model projects the OAS based on high-percentile historical movements in sovereign bond spreads.
  - Commercial real estate (CRE) Loss-Given-Default (LGD) model was refined and a number of other minor changes to the CRE loan-loss model were introduced. The previous LGD model relied on reported charge-off and loan reserve data, which led to idiosyncratic reporting differences across banks. The change improves consistency by using a common data source and framework for the projection of LGD. Additionally, the process for calculating auxiliary risk drivers was simplified. A single conceptual framework is now used to project auxiliary risk drivers, which increases consistency and decreases complexity.
  - PPNR models were re-estimated with more data to better reflect recent performance in PPNR while keeping the structure of the model unchanged. Additionally, longer time-series data for new intermediate holding companies (IHCs) and historical data revisions changed the estimation data.

**Source:** *Dodd-Frank Act Stress Test: Supervisory Stress Test Methodology and Results*

(This is an annual publication. Above details are for years 2015 through 2019; model changes each year are summarized in a box in the chapter on supervisory stress test framework and model methodology. Details presented here have been condensed for sake of brevity).

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## Appendix III. Evolution of Federal Reserve Stress Test Procedures

The FRB has been taking steps over the last couple of years to streamline the regulatory burden associated with its stress test exercises. The following is a summary of the changes that have been proposed or implemented to date.

Date	Status	Change	Rationale	FRB Impact Assessment
February 2017	Implemented	Qualitative objection removed for banks defined as large and noncomplex (those with total consolidated assets of at least US\$50 billion but less than US\$250 billion, nonbank assets of less than US\$75 billion, and that are not US global systemically important bank holding companies)	Better tailor the Board's regulatory requirements with the risk of large and noncomplex banks  Note: In November 2018 Governor Quarles publicly indicated in speeches that improvements in bank risk management and capital levels combined with introduction of the LFI supervisory system enable the FRB to migrate the qualitative objection to the supervisory system	None provided  Note: In principle, there should not be any material impact on regulatory capital or liquidity requirements if the supervisory system turns out to be at least as effective as the qualitative objection process
April 25, 2018	Proposed rule (finalized March 2020)	Capital conservation buffer to be replaced with stress capital buffer tied to stress test results  Stress capital buffer to incorporate four quarters of planned common stock dividends instead of all planned capital distributions over stress test horizon  In September 2019, Governor Quarles gave a speech outlining his vision of the stress capital buffer that would abolish that and introducing instead either a higher floor or a more stringent countercyclical buffer requirement	Simplify capital regime	Cumulative impact assessments contained in the proposal indicated:  CET 1 regulatory capital requirements for GSIB banks estimated increase of US\$10 to US\$50 billion (15–75 basis points of risk-weighted assets)  CET 1 regulatory capital requirements for non-GSIB banks with assets exceeding US\$50 billion estimated decline of US\$10 to US\$45 billion (27–121 basis points of risk-weighted assets)

Date	Status	Change	Rationale	FRB Impact Assessment
		<p>SCB would also be based on a constant risk-weighted asset assumption over the stress horizon rather than the previous assumption that credit supplied would not contract</p> <p>Removal of 30 percent dividend payout threshold that would otherwise trigger heightened supervisory scrutiny</p> <p>Proposal also included establishment of a stress leverage buffer sized by a bank's stress losses that would sit on top of the 4 percent U.S. leverage ratio.</p> <p>In his September 2019 speech, Governor Quarles mentioned that he would support removing the stress leverage buffer requirement.</p> <p>Note: Under the April 2018 proposal, the stress capital buffer still subject to a 2.5 percent CCB floor though, as indicated above, Governor Quarles noted the potential for this floor being increased</p>		
May 24, 2018	Economic Growth, Regulatory Relief and Consumer Protection (EGRRCP) Act passed into law	<p>Asset threshold for automatic application of enhanced prudential standards raised from US\$50 to US\$250 billion.</p> <p>FRB allowed to apply enhanced prudential standards to bank holding companies with consolidated assets of US\$100– 250 billion.</p>	<p>Smaller less complex banks should have requirements tailored to their risk profile.</p> <p>Note: Governor Quarles speech in July 2019 also suggested that stress testing less useful for smaller less complex banks.</p>	No impact assessment available

Date	Status	Change	Rationale	FRB Impact Assessment
		EGRRCP Act requires FRB to conduct a supervisory stress test on a periodic basis to all bank holding companies with assets of between US\$100 billion and US\$250 billion		
October 10, 2018	Implemented	Stress test threshold for state member banks raised from US\$10 billion to US\$250 billion Frequency of stress tests for state member banks reduced from annually to once every other year except for state member bank subsidiaries of more systemic holding companies Removal of "Adverse" scenario throughout the FRB's stress test rules	Implement section 401 of EGRRCP Act	Not expected to have a significant economic impact on affected banks
February 2019	Implemented	Board action to exempt certain less complex banks with assets less than US\$250 billion in assets from stress test requirements and CCAR for the 2019 cycle		No material impact on regulatory capital requirements expected
February 2019	Implemented	FRB updated its scenario design framework to make it less pro-cyclical and more transparent by introducing a guide to determine house price shocks and further clarify its process for selecting the annual increase in the unemployment rate (within its previously defined range of 3 to 5 percentage points to a minimum of 10 percent)	Reduce pro-cyclical in bank capital requirements	No material impact expected to severity of economic scenarios used in stress test framework  Greater transparency may increase risk of gaming of the exercise by banks, which will need to be managed through the supervisory process
February 2019	Implemented	FRB published policy statement on stress test principles	Enhance transparency of stress test process	No material impact on regulatory capital requirements

<b>Date</b>	<b>Status</b>	<b>Change</b>	<b>Rationale</b>	<b>FRB Impact Assessment</b>
March 13, 2019	Rule issued in final form / Implementation in progress	Qualitative objections to bank capital plans removed for all banks subject to a potential qualitative objection for four consecutive years, and the bank did not receive a qualitative objection in the fourth year of that period. In addition, except for certain banks that have received a qualitative objection in the immediately prior year, the Board will no longer issue a qualitative objection to any bank effective January 1, 2021	Improvements in bank risk management and capital levels combined with introduction of LFI supervisory system enable the FRB to migrate the qualitative objection to the supervisory system	No quantifiable impact on regulatory capital requirements
March 2019	Implemented	FRB published inaugural report outlining details on stress test methodology  Details of other models used for stress testing to be published annually in coming years	Enhance transparency of stress test process	No quantifiable impact on regulatory capital requirements
July 2019	Implemented	FRB hosts conference on stress testing program	Enhance transparency of stress test process and gather feedback on possible enhancements	
October 10, 2019	Final Rule / Implemented	Four categories to allocate large banks based on their systemic importance and safety and soundness risks Removed mid-cycle stress test requirements for all banks Banks subject to Category IV requirements migrated to an extended supervisory stress test cycle (i.e., once every two years). These banks also no longer required to run company-run stress tests	Implement section 401 of EGRRC Act & tailor enhanced prudential requirements in accordance with systemic risks posed by large banks	No material change in regulatory capital requirements for Category I and II banks  CET 1 regulatory capital requirements for Category III and IV banks estimated to decline by about 60 basis points of risk-weighted assets
March 2020	Final rule	The SCB requirement is the difference between the bank starting and	Integrate capital rule and CCAR	The impact of the final rule on CET1 capital requirements ranges from a



Date	Status	Change	Rationale	FRB Impact Assessment
		<p>minimum projected CET1 capital ratios under the severely adverse scenario in the supervisory stress test plus four quarter of dividends as a percentage of RWAs. The GSIB surcharge and the CCyB (if activated) are added. It will be assumed that firms maintain a constant level of assets over the planning horizon. SCB requirement cannot be lower than 2.5 percent of RWAs</p>		<p>decline of US\$59 billion to an increase of US\$78 billion</p>

## Appendix IV. Application of Proportionality in Supervision

Portfolio	Number of institutions (Total assets)	Supervisory approach
<b>FRB</b>		
<p><b>LISCC – Large Institution Supervision Coordinating Committee.</b> Eight U.S. GSIBs and four FBO with large and complex operations in the U.S.</p>	12 (US\$12.1 trillions)	<ul style="list-style-type: none"> <li>• National program that uses both horizontal and firm-specific supervisory activities to assess the financial resiliency and risk-management practices.</li> <li>• Supervision conducts a continuous assessment of firms supported by firm-specific examination teams.</li> <li>• This group is subject to heightened supervisory expectations and the most rigorous supervision with the most supervisory resources per firm.</li> </ul>
<p><b>LFBO – Large and Foreign Banking Organizations.</b> Non-LISCC U.S. firms with total assets US\$100 billion and greater and non-LISCC FBOs</p>	179 (US\$7.3 trillions)	<ul style="list-style-type: none"> <li>• Supervision includes some horizontal elements, but firm-specific teams at the local Reserve Bank conduct most of the supervisory work, subject to oversight by the Board.</li> <li>• Supervision conduct a continuous assessment of firms supported by firm-specific examination teams.</li> </ul>
<p><b>RBO – Regional Banking Organizations.</b> Total assets between US\$10 billion and US\$100 billion</p>	82 (US\$1.8 trillions)	<ul style="list-style-type: none"> <li>• The Board of Governors establishes the program and policies and the Reserve Banks execute the program. The supervision model is decentralized with greater flexibility provided to local Reserve Banks.</li> <li>• Central Point of Contact (CPC) assigned to oversee supervision of each company (develops supervisory plan, risk assessment, exam plan and directs examination process and serves as a liaison between the company and FRB).</li> <li>• Full-scope on-site exam every 12 months; usually fulfilled by aggregating several targets (some work can be completed off-site). The bank is subject to continuous monitoring, and off-site surveillance. Exam activities are intensified based on the complexity of the organization, risk profile and severity of issues at the bank.</li> </ul>
<p><b>CBO – Community Banking Organizations.</b> Total assets less than US\$10 billion</p>	3980 (US\$2.4 trillions)	<ul style="list-style-type: none"> <li>• The Board of Governors establishes the program and policies and the Reserve Banks execute the program. The supervision model is decentralized with greater flexibility provided to local Reserve Banks.</li> <li>• Periodic full scope assessments considering cycle of 12 or 18 months and the companies are subject to periodic surveillance.</li> <li>• State banks rated CAMELS composite “1” and “2” may be eligible for an AEP which allow exams conducted in alternating years or alternating 18-month periods, as appropriate, to be conducted by the state banking agency.</li> </ul>

Portfolio	Number of institutions (Total assets)	Supervisory approach
<b>OCC</b> (as of June 30, 2019)		
<b>Large Banks</b> Firms with total assets US\$50 billion and greater (asset size not sole criterion); and Federal branches and agencies of FBOs	Large Banks: 20 Federal Branches and Agencies: 47  (\$11.2 trillion)	<ul style="list-style-type: none"> <li>• An examiner-in-charge is assigned full time to each large bank to provide day-to-day supervision with the help of an on-site team of examiners determined by bank's risk profile.</li> <li>• The full scope examination requirement is fulfilled by aggregating several ongoing supervision and target exams activities through annual supervisory cycle.</li> <li>• Examinations typically use the highest amount of resources and expertise.</li> <li>• Supervision of most federal branches is similar to the community bank model, with an assigned portfolio manager and a combination of off-site monitoring and on-site exams typically conducted every 12 or 18 months.</li> <li>• A small number of large, complex federal branches have resident examiners assigned.</li> </ul>
<b>Midsize Banks</b> Total assets between US\$8 billion and US\$60 billion (asset size not sole criterion)	48 (\$916 billion)	<ul style="list-style-type: none"> <li>• An examiner-in-charge is assigned full time to each midsize bank to provide day-to-day supervision with the help of general and specialist examiners.</li> <li>• The full scope examination requirement is fulfilled by aggregating several supervisory activities.</li> <li>• Dedicated supervision staff assigned to each institution conduct both off-site and on-site supervisory activities.</li> <li>• The amount of resources and expertise of examiners are higher for midsize than community banks, due to their complexity.</li> </ul>
<b>Community Banks</b> Total assets less than US\$8 billion	1,061 (\$728 billion)	<ul style="list-style-type: none"> <li>• Each community bank is assigned a portfolio manager who serves as the OCC's primary contact for bank management and the board on an ongoing basis.</li> <li>• Banks must receive a full-scope, on-site examination every 12 or 18 months which is usually fulfilled in one examination.</li> </ul>
<b>FDIC</b>		
<b>Large Banks</b> Total assets greater than US\$10 billion	38	<ul style="list-style-type: none"> <li>• Banks are subject to a continuous examination program.</li> <li>• Conducted by regional staff embedded on-site at the institutions with support from the Regional Office and Washington Office</li> <li>• Procedures require an annual risk assessment that aids in determining a supervisory plan tailored to each institution that combines on-site examination work and ongoing monitoring.</li> <li>• Exam activities are intensified based on the severity of issues at the bank.</li> </ul>
<b>Community banks</b> Total assets less than US\$10 billion		<ul style="list-style-type: none"> <li>• Periodic full scope assessments considering cycle of 12 or 18 months.</li> <li>• Can be complemented by limited scope reviews.</li> </ul>

Portfolio	Number of institutions (Total assets)	Supervisory approach
		<ul style="list-style-type: none"> <li>Some state banks rated CAMELS composite "1" and "2" may be eligible for an AEP which allow exams conducted in alternating years or alternating 18-month periods, as appropriate, to be conducted by the state banking agency.</li> </ul>
Source: FBAs, IMF Staff. . Data as of June 30, 2019.		

## Appendix V. Status of the Recommendations of the 2015 FSAP

CP	Recommendations of the U.S. FSAP 2015 for Banking Supervision	Status
1.	<p>FBA's revisit their "mission and vision" statements to ensure they give primacy to safety and soundness and to clarify that the pursuit of other objectives must be consistent with, and if necessary, subordinate to, that goal.</p> <p>FBA's and the CFPB explore ways to reduce duplication of effort, in matters such as risk reviews, and over time look to pursue opportunities for a more coherent division of responsibilities between safety and soundness, and consumer protection.</p>	<p>No change since 2015.</p> <p>Ongoing. Coordination efforts with significant improvements. Division of responsibilities remain the same.</p>
2.	The Federal Reserve further assure the independence of its supervisory role by making the governance rules for the boards of Federal Reserve district banks consistent with emerging global good practice.	The FRB has adopted bright-line restrictions on the roles of directors of the Federal Reserve district banks in order to address any potential for the appearance of conflicts of interest.
3.	FBA's ensure that the preparation of supervisory plans is on the same cycle, if practicable, and consider other ways of ensuring that collaboration becomes fully engrained in the <i>modus operandi</i> of each agency.	Coordination between agencies with signs of clear improvements. Supervisory plans not fully aligned.
5.	Incorporate handover "protocols" that would discourage inappropriate regime shopping in the FFIEC Statement on Regulatory Conversions.	No change since 2015.
6.	Introduce explicit requirement for banks to immediately report if they find that a major shareholder is no longer suitable.	No change since 2015.
8.	Develop interagency approach to communicate issues of supervisory importance to banks (MRAs, MRAs, MRBAs).	Each of the FBA's employ guidance that differentiate between levels of severity for supervisory concerns and specify when to communicate them to boards of directors at the depository institutions. Approach not fully align across agencies.
8.	Develop interagency method of prioritization of such matters requiring attention.	Ongoing. The FBA's are making efforts to improve communication, but further improvements are needed.
8.	Introduce requirements for banks to report developments to the supervisor, in particular for banks under less intensive supervision.	No change since 2015. There is no explicit regulatory requirement for banks to immediately report if they find that a major shareholder is no longer suitable.
8.	Develop guidance to clearly distinguish, in supervisory recommendations and matters requiring attention, which are of Boards responsibility and which are the responsibility of senior management.	Ongoing. The FBA's making efforts to improve communication, but further improvements are needed.

CP	Recommendations of the U.S. FSAP 2015 for Banking Supervision	Status
8.	Implement interagency guidance with more clarity regarding aging of MRAs.	Aging MRAs remain an issue despite efforts done by the agencies.
8.	Carry out a combined interagency planning process for individual firms	Ongoing. The FBAs making efforts to improve communication, but further improvements are needed. Planning cycles are still not aligned.
8.	Develop a supervisory best practice approach for horizontal reviews, which includes initial statements of expected minimum standards and the expected process of feedback to those that participate and the feedback to the wider population of firms to which it might be relevant.	After the horizontal review, findings are vetted by the horizontal team and shared with the individual firms.
11.	Implement rules/policies promoting early action also for other issues than bank capital and liquidity.	Ongoing. The FBAs have also developed presumed corrective actions associated with ratings, but the PCA framework remains the main plank for supervisory corrective actions.
11.	Implement more explicit rules for supervisory action, such as setting timelines for completion, partially or fully, of remedial action and requiring regular reporting of progress.	No change since 2015. Explicit rules and processes to escalate supervisory actions in the absence of timely and appropriate responses from banks to aging MRAs have not been introduced.
12.	Develop and implement regulatory and supervisory rules, guidance, and a formal rating system for SLHCs.	(1) The guidance documents that are applicable to SHLCs have been precisely identified; (2) The FRB issued an advance notice of proposed rulemaking inviting comment on conceptual frameworks for capital standards that could apply to insurance company SLHCs in June 2016; and (3) The FRB adopted a final rule to apply the RFI rating system on a fully implemented basis to non-insurance and non-commercial SLHCs with total consolidated assets less than US\$100 billion, and the LFI rating system for non-insurance or non-commercial SLHCs with total consolidated assets of US\$100 billion or more in November 2018. The FRB will continue to assign an indicative RFI rating to SLHCs engaged in significant insurance or commercial activities, regardless of asset size.
14.	Introduce clearer expectations and requirements for corporate governance also for banks not subject to heightened standards.	While the FRB's guidance (SR 16-11) clarifies risk management expectations for institutions with total consolidated assets of less than US\$50 billion, enhanced standards have not yet been defined for larger firms (with assets of US\$50 billion or more) supervised by the FRB.
14.	On issues where still lacking, clarify supervisory expectations and requirements on the role and responsibilities of the bank board versus those of the bank management.	The FRB's guidance (SR 16-11) that provides clarification on and distinguishes supervisory expectations for the roles and responsibilities of the board of directors and senior management for an institution's risk management only apply to institutions with total consolidated assets of less than US\$50 billion.
14.	Introduce explicit requirement that banks inform the supervisors promptly about material developments that affect the fitness and propriety of Board directors or senior management.	No change since 2015.

CP	Recommendations of the U.S. FSAP 2015 for Banking Supervision	Status
15.	Introduce clear expectations and requirements regarding risk management standards applicable to banks with less than US\$10 billion of assets.	No requirements have been introduced since 2015 regarding risk management standards applicable to banks with less than US\$10 billion of assets.
15.	Introduce clear guidance on responsibilities of the Board with regards to risk management.	The OCC issued Heightened Standards prescribing operational and managerial standards for national banks and updated guidance relating to the responsibilities of boards of directors and senior management of banks. While the FRB' guidance (SR 16-11) clarifies risk management expectations for institutions with total consolidated assets of less than US\$50 billion, enhanced standards have not yet been defined for larger firms (with assets of US\$50 billion or more) supervised by the FRB.
15.	Introduce clear requirements on the arrangements for the removal of CROs.	Clear requirements on the arrangement for the removal of Chief Risk Officers (CROs) have not been introduced by all FBAs. Only the OCC through its Heightened Standards prescribes that a bank's board or its risk committee have to approve the removal of the CRO.
15.	Introduce clearer supervisory guidance on the severity of scenarios for stress tests run by the firms.	The FRB publishes on a yearly basis the supervisory scenarios that firms have to use when conducting company-run stress tests.
15.	Introduce clearer feedback mechanisms to firms on the components of supervisory run stress tests.	Ongoing. Significant achievements, but improvements needed.
16.	Introduce a comprehensive capital framework for savings and loan holding companies with substantial insurance or commercial activities.	Ongoing. The FRB has issued a proposal but has not finalized capital standards that would apply to insurance company SLHCs.
16.	Clarify requirements for capital to be held against operational risk by non-AMA banks.	No change since 2015.
16.	Clarify supervisory expectations for capital to be held against interest rate risk in the banking book.	No change since 2015.
17.	Introduce specific requirements that major credit risk exposures exceeding a certain amount or percentage of the bank's capital are to be decided by the bank's Board or senior management.	No change since 2015.
17.	Introduce specific requirements that credit risk exposures that are especially risky or otherwise not in line with the mainstream of the bank's activities must be decided by the bank's board or senior management.	No change since 2015.
19.	Reassess the supervisory force of the thresholds for commercial real estate exposures.  Develop a robust supervisory framework and supervisory guidance for other risk concentrations comparable to that for credit concentration risk.  Review the separate and additional limits for money market investments and security holdings by banks, with a view to including them within the 15 plus 10 limits.	No change since 2015.  No change since 2015.  No change since 2015.

CP	Recommendations of the U.S. FSAP 2015 for Banking Supervision	Status
	<p>Review the 50 percent limit on exposures to a corporate group, which could result in excessive risk concentrations.</p> <p>The Federal Reserve complete the development of its large exposures' framework, with limits, for large bank holding companies and foreign banking organizations.</p>	<p>No change since 2015.</p> <p>Only applies to U.S. GSIBs, BHCs subject to Category II or III standards, and FBOs subject to Category II or III standards or that otherwise have total global consolidated assets of US\$250 billion or more. Limits those firms to a single counterparty to 25 percent of CET1 capital.</p>
20.	<p>Introduce formal requirements for prior board approval of transactions with affiliated parties and the write-off of related party exposures exceeding specified amounts.</p> <p>Introduce formal requirements for board oversight of related party transactions and exceptions to policies, processes and limits on an ongoing basis.</p> <p>Amend the coverage and details of the "related party" regime to bring it into line with this CP.</p> <p>Introduce limits for holding company transactions with their affiliates or insiders</p> <p>Review the aggregate limit for lending to insiders of 100 percent of a bank's capital and surplus (and 200 percent for smaller banks).</p>	<p>No change since 2015.</p> <p>No change since 2015.</p> <p>No change since 2015.</p> <p>No change since 2015.</p> <p>No change since 2015.</p>
21.	Introduce <i>de minimis</i> regime to be applied to all categories of banks and include savings associations.	The FSAP team did not review CP 21.
21.	Introduce explicit reference to country risk in guidance and rules on stress tests guided by the authorities.	The FSAP team did not review CP 21.
23.	Revise the 1996 guidance to include more quantitative guidelines regarding interest rate risk in the banking book.	No change since 2015.
25.	<p>Introduce guidance on operational risk management and supervisory expectations applicable to non-AMA banks.</p> <p>Introduce appropriate reporting regime regarding operational risk.</p>	Several statements of guidance have been issued, but a guidance document setting out overarching principles for managing operational risk is clearly missing. There are no general requirements for reporting operational risk related incidents to the FBAs.
27.	Introduce requirements for all banks to issue full financial statements in accordance with agreed accounting standards that are reviewed by an independent accountant in accordance with independent audit requirements.	The FSAP team did not review CP 27.
27.	Introduce requirement for external auditor to report immediately directly to the supervisor, should they identify matters of significant importance.	The FSAP team did not review CP 27.
27.	Review supervisory powers to allow the supervisor to set the scope of the external audit.	The FSAP team did not review CP 27.



<b>CP</b>	<b>Recommendations of the U.S. FSAP 2015 for Banking Supervision</b>	<b>Status</b>
27.	Introduce a requirement for non-public banks to rotate their external auditors.	The FSAP team did not review CP 27.
29.	Supervisors should explicitly require, rather than “expect”, that a bank’s decision to enter into relationships with high-risk accounts and countries, including with foreign and domestic PEPs, should be escalated to the senior management level.	The FSAP team did not review CP 29.
29.	Current legal and regulatory framework does not require the identification of the ultimate beneficiary owner of legal entity clients. Proposed amendments open for public consultation will introduce requirements to address this deficiency. Assessors welcome the proposed rule and understand its approval and implementation will improve compliance with this CP.	The FSAP team did not review CP 29.