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Banking Organization Capital Plans and Stress Tests

Federal Reserve Proposes Elimination of the Qualitative CCAR Assessment for Smaller Firms, Reduction in the *De Minimis* Exception for Additional Capital Distributions, and Other Notable Revisions to its Capital Plan and Stress Testing Rules

On September 26, 2016, the Federal Reserve released a proposal[1] that would modify its CCAR capital plan and stress testing rules applicable to bank holding companies ("*BHCs*") with $50 billion or more in total consolidated assets and U.S. intermediate holding companies ("*IHCs*") of foreign banking organizations (collectively, "*CCAR firms*").[2] Most notably, beginning with the upcoming 2017 CCAR and DFAST cycle, the proposal would exclude the capital plans of "large and noncomplex" CCAR firms (those with less than $250 billion of total consolidated assets, less than $10 billion of consolidated total on-balance sheet foreign exposure, and less than $75 billion of total nonbank assets) from CCAR's qualitative review. Beginning April 1, 2017, the proposal would also reduce the *de minimis* exception for capital distributions above the amount reflected in a CCAR firm's capital plan from 1 percent of Tier 1 capital to 0.25 percent of Tier 1 capital.

The proposal contemplates other changes beginning with the 2017 CCAR and DFAST cycle, including: (i) reduced reporting requirements for large and noncomplex CCAR firms, (ii) a longer transition period for BHCs that cross the $50 billion asset threshold to submit their first capital plan and first participate in DFAST as applicable to BHCs with $50 billion or more in assets,[3] and (iii) a "blackout period" during the second calendar quarter, when the Federal Reserve conducts the CCAR exercise, on notices to use the *de minimis* exception and requests for prior approval to make additional capital distributions that do not qualify for the *de minimis* exception. In addition, beginning with the 2018 CCAR and DFAST cycle, the

proposal would extend the period from which the Federal Reserve may select the "as-of date" for the trading and counterparty component applicable to certain CCAR firms.[4]

Key aspects of the proposal are discussed in greater detail below. Except as otherwise noted, the proposal would be effective for the 2017 CCAR and DFAST cycle.

- ***Eliminating the qualitative CCAR assessment for large and noncomplex CCAR firms.*** The Federal Reserve's CCAR exercise involves both a quantitative review and a qualitative review of CCAR firms' capital plans. Under the Federal Reserve's current capital plan rule, a CCAR firm must pass *both* reviews in order for its capital plan to receive a non-objection. There has been substantial debate as to whether the benefits of a qualitative review for all CCAR firms outweigh the challenges, supervisory cost and subjectivity, and the Supplementary Information accompanying the proposal observes that "the high public profile of the CCAR qualitative review could create a risk that large and noncomplex firms will over-invest in stress testing and capital planning processes that are unnecessary to adequately capture the risks of these firms."
  - The proposal would remove large and noncomplex CCAR firms from CCAR's qualitative review, and the capital plans of large and noncomplex CCAR firms would no longer be subject to potential objection on qualitative grounds. The capital plans of large and noncomplex CCAR firms would remain subject to the quantitative CCAR assessment.[5]
  - The Supplementary Information notes that the Federal Reserve would instead assess large and noncomplex CCAR firms' capital planning processes through regular supervisory reviews and targeted, horizontal reviews of specific areas of the capital planning process. These reviews would focus on the standards set forth in the Federal Reserve's capital plan rule and SR Letter 15-19,[6] and they would likely occur during the third quarter, the quarter following the qualitative CCAR assessment for other CCAR firms. Prior to the commencement of the supervisory review process, the Federal Reserve would inform each large and noncomplex CCAR firm of the scope of that year's review. Although not explained, it can be expected that the factors that would have caused a large and noncomplex CCAR firm to fail the qualitative CCAR assessment would be the subject of MRAs and MRIAs, which the large and noncomplex CCAR firm would have an obligation to remediate promptly.
  - The Supplementary Information describes the calibration of the thresholds to identify large and noncomplex CCAR firms. Notably, the $75 billion nonbank asset threshold appears intended to exclude certain IHCs that "engage in significant capital markets activities" from the population of large and noncomplex CCAR firms. The Federal Reserve believes those IHCs "have risk profiles that are more similar to those of the most complex U.S. financial firms." The other thresholds—$250 billion in total consolidated assets and $10 billion of consolidated total on-balance sheet foreign exposure—are consistent with the thresholds for the application of the advanced approaches risk-based capital rule[7] and the liquidity coverage ratio[8].
  - For the 2017 CCAR and DFAST cycle, CCAR firms would calculate nonbank assets by aggregating items already reported on regulatory reporting forms. Beginning with the 2018 CCAR and DFAST cycle, Form FR Y-9LP would be amended to include a new line item to report total nonbank assets of a CCAR firm's consolidated nonbank subsidiaries and a CCAR firm's direct investments in unconsolidated nonbank subsidiaries, associated nonbank companies and nonbank corporate joint ventures over which the CCAR firm exercises significant influence.[9] "Nonbank companies" would exclude depository institutions and any subsidiary of a depository institution, except nonbanking Edge or Agreement Corporations. For the new line item, intercompany assets and operating revenues among nonbank companies would be eliminated, but other intercompany assets and operating revenues would be included, including, among others, those with the CCAR firm, any depository institution and, in the case of an IHC, any branch or agency of the foreign banking

organization, or any of the foreign banking organization's non-U.S. subsidiaries or non-U.S. associated companies that are not held through the IHC.

- ***Retention of qualitative CCAR exercise for all other CCAR firms.*** CCAR firms subject to the LISCC framework[10] and any other CCAR firms that have $250 billion or more of total consolidated assets, $10 billion or more of consolidated total on-balance sheet foreign exposure, or $75 billion or more of total nonbank assets would continue to participate in the annual qualitative CCAR review, and the capital plans of those CCAR firms would remain subject to potential objection on qualitative grounds.

- ***Changes to the de minimis exception.*** Under the Federal Reserve's capital plan rule, capital distributions not reflected in a CCAR firm's capital plan are subject to prior notice (if *de miminis*) or prior approval (if greater than *de minimis*). The proposal would modify the *de minimis* exception in two ways.

  - First, it would reduce the threshold for the *de minimis* exception from 1 percent of Tier 1 capital to 0.25 percent of Tier 1 capital beginning April 1, 2017. The Supplementary Information explains that the *de minimis* exception was originally intended to address unanticipated events that improve capital levels (for example, tax rebates or litigation settlements for less than the reserved amount) but that the Federal Reserve had observed some CCAR firms treating the exception as an "automatic add-on to approved common stock distributions." The proposed revisions to the *de minimis* exception would lower the potential "add-on" amount but would not impose new requirements that seek to tie the exception to unanticipated events.

  - Second, it would impose a "blackout period" during the second calendar quarter, the period in which the Federal Reserve conducts the CCAR exercise, on the ability of a CCAR firm to submit a notice to use the *de minimis* exception or a request for prior approval to make an additional capital distribution that does not qualify for the *de minimis* exception. The proposal would require a CCAR firm seeking to make an additional capital distribution during the second quarter to submit a notice by March 15 (if the *de minimis* exception is available) or a request for prior approval by March 1 (if the *de minimis* exception is not available). The proposal would also require the CCAR firm's capital plan to reflect the additional distribution.

- ***Modified reporting requirements for large and noncomplex CCAR firms.*** The proposal includes three categories of changes to reduce reporting burdens for large and noncomplex CCAR firms relating to the Capital Assessments and Stress Testing Report (the Form FR Y-14 series of reports).

  - Form FR Y-14Q and the FR Y-14M do not require CCAR firms to submit data schedules for immaterial portfolios. The proposal would increase the materiality threshold from $5 billion or 5 percent of Tier 1 capital to $5 billion or 10 percent of Tier 1 capital. To reduce the incentive for large and noncomplex CCAR firms to submit data schedules for immaterial portfolios, the Federal Reserve would lower the loss rate it uses to model portfolios for which large and noncomplex CCAR firms do not submit data. The Federal Reserve would apply the median loss rate of CCAR firms that submit data instead of the current 75th percentile loss rate.

  - Large and noncomplex CCAR firms would not be required to include certain documentation regarding their models in their capital plan submissions, including model inventory mapping documents, methodology documentation, model technical documents, and model validation documentation. The Supplementary Information notes that large and noncomplex CCAR firms would need to be able to produce those materials to the Federal Reserve upon request.

  - Large and noncomplex CCAR firms would no longer be required to complete certain sub-schedules of the FR Y-14A Schedule A (Summary).

- ***Transition Period for New CCAR BHCs.*** Under the Federal Reserve's current capital plan rule, a BHC that crosses the $50 billion threshold on or before December 31 of a calendar year must submit a capital plan by April 5 of the next year. The proposal would move the cutoff date to September 30, and a BHC that crossed the asset threshold in the fourth quarter of a calendar

year would be required to submit its initial capital plan by April 5 of the second following year (for example, April 5, 2018, if the threshold were crossed on December 31, 2016). The proposal would also align the cutoff date for the initial application of Subparts E and F of the Federal Reserve's DFAST rules—which apply supervisory and company-run stress testing requirements to CCAR firms—for BHCs that become CCAR firms. A BHC that crosses the $50 billion asset threshold would become subject to Subparts E and F in the year following the first year in which it submitted a capital plan (for example, 2019, if the asset threshold were crossed on December 31, 2016). Currently, a BHC that crosses the $50 billion asset threshold on or before March 31 of a calendar year becomes subject to Subparts E and F the following year, and a BHC that crosses the threshold after March 31 of a calendar year becomes subject to Subparts E and F the second following year.

  - The proposal would not affect the transition periods for IHCs that were required to be established or designated by July 1, 2016, which (if not previously subject to the Federal Reserve's capital plan rule) must file their initial capital plans by April 5, 2017 and comply with the DFAST rules beginning in 2018.
  - For IHCs required to be established or designated after July 1, 2016, the proposal would establish a September 30 cutoff date under the capital plan rule. An IHC required to be established or designated in the fourth quarter of a calendar year would be required to submit its capital plan by April 5 of second following year. It is not clear whether the proposal would alter the transition period for a new IHC to comply with DFAST.

- ***As-of Date for Add-On Component.*** The Federal Reserve may require CCAR firms with significant trading activity to include a trading and counterparty component in their company-run stress tests.[11] Under the current DFAST rules, the window for the as-of date for the component is January 1 to March 1 for the relevant cycle (for example, January 1, 2016 to March 1, 2016 for the 2016 CCAR and DFAST cycle). Beginning with the 2018 CCAR and DFAST cycle, the proposal would lengthen the window to commence on October 1 of the preceding year (the window for the 2018 cycle would be October 1, 2017 to March 1, 2018). The Supplementary Information explains that the longer window is intended to address the possibility that CCAR firms could artificially reduce risk in their portfolios around the anticipated as-of date and to account for seasonality in trading activity.

Comments on the proposal are due by November 25, 2016.

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ENDNOTES

[1] Federal Reserve System, *Amendments to the Capital Plan and Stress Test Rules*, 81 Fed. Reg. 67,239 (Sept. 30, 2016).

[2] "*CCAR*" refers to the Federal Reserve's Comprehensive Capital Analysis and Review of capital plans filed annually by CCAR firms under the Federal Reserve's capital plan rule, Section 225.8 of Regulation Y, and supervisory and company-run stress tests under its Dodd-Frank Act Stress Test ("*DFAST*") rules, Subparts E and F of Regulation YY, 12 C.F.R. Part 252.

[3] 12 C.F.R. Part 252, Subparts E and F.

[4] The trading and counterparty component—also referred to as the "global market shock"—is one of two add-on components the Federal Reserve has included in recent CCAR exercises for certain CCAR firms. Although the Federal Reserve's DFAST rules do not set forth a specific window for the as-of date for the other component—the counterparty default scenario—the Federal Reserve previously has used the same as-of date for the global market shock and the counterparty default scenario components.

[5] In a September 26, 2016 speech, Federal Reserve Governor Tarullo previewed potential revisions to the Federal Reserve's CCAR stress test rules and procedures and its risk-based capital rules. Governor Tarullo indicated that the potential revisions would increase the required capital for U.S. G-SIBs and may reduce the required capital for other BHCs that participate in CCAR, including those that are large and noncomplex. Although Governor Tarullo did not comment on whether the potential revisions would apply to IHCs, it appears likely that IHCs that are also BHCs would be subject to the new standards. For a discussion of Governor Tarullo's speech, see our memorandum to clients *Banking Organization Capital Plans and Stress Tests: Federal Reserve Governor Tarullo Previews Proposal for Multiple Revisions to Capital Plans and Stress Tests That Will Increase Effective Capital Requirements for G-SIBs and May Reduce Effective Capital Requirements for Other CCAR Banking Organizations* (Sept. 26, 2016), available at: https://www.sullcrom.com/banking-organization-capital-plans-and-stress-tests.

[6] Federal Reserve, *Supervision and Regulation Letter* SR 15-19 (Dec. 18, 2015) relating to Large and Noncomplex Firms ("*SR Letter 15-19*"), available at http://www.federalreserve.gov/bankinforeg/srletters/sr1519_PW.pdf. For a discussion of SR Letter 15-19, see our memorandum to clients *Bank Capital Plans and Stress Tests: Federal Reserve Board Issues Consolidated Guidance on Supervisory Expectations for Capital Planning at Large Bank Holding Companies* (Dec. 30, 2015), available at https://www.sullcrom.com/bank-capital-plans-and-stress-tests-12-30-15.

[7] 12 C.F.R. § 217.100(b).

[8] 12 C.F.R. § 249.2(b). The same threshold would apply for the proposed net stable funding ratio. *See* Federal Reserve System, *Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements*, 81 Fed. Reg. 35,124 (June 1, 2016).

[9] For purposes of Form FR Y-9LP, (i) a subsidiary is a company in which the CCAR firm directly or indirectly owns more than 50 percent of the outstanding voting stock; (ii) an associated company is a company in which the CCAR firm, directly or indirectly, owns 20 to 50 percent of the outstanding voting stock and over which the CCAR firm exercises significant influence; and (iii) a corporate joint venture is a company owned and operated by a group of companies, no one of which has a majority interest, as a separate and specific business or project for the mutual benefit of that group of companies. *See* Federal Reserve, *Instructions for Preparation of Parent Company Only Financial Statements for Large Holding Companies* (September 2016), available at http://www.federalreserve.gov/reportforms/forms/FR_Y-9LP20160930_i.pdf.

[10] The Large Institution Supervision Coordinating Committee ("*LISCC*") framework is designed to materially increase the financial and operational resiliency of systemically important financial institutions to reduce the probability of, and cost associated with, their material financial distress or failure. The firms currently in the LISCC portfolio include certain CCAR firms, certain foreign

ENDNOTES (CONTINUED)

banking organizations, and nonbank financial companies supervised by the Federal Reserve. *See* www.federalreserve.gov/bankinforeg/large-institution-supervision.htm. The Supplementary Information notes that all LISCC firms that are also CCAR firms are large and complex: they have $250 billion or more of total consolidated assets, $10 billion or more of consolidated total on-balance sheet foreign exposure, or $75 billion or more of total nonbank assets.

[11] 12 C.F.R. § 252.54(b)(2)(i). The Federal Reserve may also require firms to include other components, such as the counterparty default scenario. 12 C.F.R. § 252.54(b)(2)(ii). In addition, the Federal Reserve may apply these components in the supervisory stress tests. 12 C.F.R. § 252.44.

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