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Bank Capital Requirements, Capital Plans and Stress Tests

Federal Reserve Proposes Substantial Changes to CCAR and Its Capital Rules, Including New Stress Capital Buffer and Stress Leverage Buffer Requirements and the Elimination of the CCAR Quantitative Objection

SUMMARY

On April 10, 2018, the Federal Reserve issued a proposal¹ designed to create a single, integrated capital requirement by combining the quantitative assessment of CCAR² with the buffer requirements of the Federal Reserve's regulatory capital rules for bank holding companies with \$50 billion or more in total consolidated assets and U.S. intermediate holding companies of foreign banking organizations (collectively, "CCAR firms").³ Most significantly, for CCAR firms the proposal would:

- replace the current static 2.5 percent capital conservation buffer with a stress capital buffer ("SCB") requirement for standardized approach capital ratios, based on (i) the projected decrease in a CCAR firm's common equity tier 1 ("CET1") capital ratio in the severely adverse scenario of the Federal Reserve's supervisory stress test, *plus* (ii) the ratio of the firm's planned common stock dividends to projected risk-weighted assets for the fourth through seventh quarters of the planning horizon, subject to a floor of 2.5 percent; and
- eliminate the quantitative objection provisions of CCAR.

The Federal Reserve notes that the proposal would simplify its regulatory capital framework by reducing the total number of capital requirements from 24 to 14, since firms would no longer need explicitly manage to post-stress capital ratios based on CCAR stress tests.⁴ Although the proposal would eliminate the quantitative objection, the CCAR process and the Federal Reserve's supervisory stress test for the severely adverse scenario would continue to play a central role in establishing CCAR firms' binding capital constraints. Notably, however, the Federal Reserve would retain the CCAR qualitative assessment for those CCAR firms to which it currently applies.⁵ In addition to the SCB, the Federal

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Reserve proposed a new stress leverage buffer (“SLB”) requirement, based primarily on the projected decrease in a CCAR firm’s tier 1 leverage ratio in the severely adverse scenario of the Federal Reserve’s supervisory stress test. Under the proposal, if a CCAR firm’s tier 1 leverage ratio were not greater than the 4 percent minimum *plus* the CCAR firm’s SLB requirement, the CCAR firm would be subject to restrictions on capital distributions and discretionary bonus payments. In this way, the SLB requirement would operate in a similar manner as the SCB requirement and the existing regulatory capital buffer requirements.

The SCB and SLB requirements could constrain a CCAR firm’s ability to make capital distributions in two ways.

- First, under the proposed revisions to the capital rules, and as is currently the case,⁶ a CCAR firm would be required to maintain capital ratios above the applicable minimum requirements plus the applicable buffer requirements in order to avoid being subject to restrictions on capital distributions and discretionary bonus payments; such restrictions become more stringent as a CCAR firm’s capital levels approach the minimum requirements.
- Second, under the proposed revisions to the capital plan rule,⁷ a CCAR firm would face restrictions on its planned capital distributions if its own baseline scenario projections indicate that it would not satisfy applicable buffer requirements; specifically, the capital distributions included in a CCAR firm’s capital plan for any given quarter must be consistent with the projected capital distribution limitations that would apply in that quarter. As is currently the case, a CCAR firm would generally not be permitted to exceed the capital distributions reflected in its capital plan either on a gross basis or net of capital issuances without prior approval of the Federal Reserve.

Beyond the revisions to integrate and simplify the capital and capital planning requirements, the Federal Reserve also proposed modifications to the assumptions in its supervisory stress tests, which are intended to better align the assumptions with CCAR firms’ expected behavior in periods of stress. Specifically:

- The Federal Reserve would no longer assume that a CCAR firm makes all its planned capital distributions (including common stock dividends, repurchases of common stock and redemptions of other capital instruments) in all stress scenarios. The Federal Reserve would, however, effectively continue to assume that CCAR firms pay planned common stock dividends in the fourth through seventh quarters of the planning horizon because those dividends would factor into the calculation of the SCB and SLB. Common stock repurchases typically represent a larger portion of CCAR firms’ planned capital distributions than common stock dividends, and the revised framework could have a significant effect on the extent to which CCAR firms must pre-capitalize planned capital distributions on account of the CCAR stress tests.
- The Federal Reserve would assume that CCAR firms’ balance sheets remain constant, rather than grow, under stress, which is designed to achieve the Federal Reserve’s macroprudential objective of preventing CCAR firms from planning to “shrink to health” and restricting the availability of credit in stress while also addressing criticism that the growth assumption was unrealistic and overly distortive.

The proposal includes a number of other modifications to the capital rules and the capital plan rule, as well as CCAR and DFAST, that reflect and implement the proposed integrated framework, including the elimination of the 30 percent dividend payout ratio as a criterion for heightened scrutiny of a CCAR firm’s capital plan. The proposal would become effective December 31, 2018, and a CCAR firm’s first SCB and

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SLB requirements would become effective October 1, 2019.⁸ Because the proposal relates only to the capital requirements for CCAR firms, it would not affect the capital buffer requirements for bank holding companies that are not CCAR firms or for insured depository institutions, including subsidiaries of CCAR firms.

Comments are due within 60 days of the publication of the proposal in the *Federal Register*.⁹

DISCUSSION

- **Creation of the SCB Requirement and Elimination of the CCAR Quantitative Objection.** The most significant element of the Federal Reserve's proposal is the creation of the SCB requirement, intended to make each CCAR firm's capital requirements better tailored to its risk profile and potential vulnerability to stress.¹⁰ The SCB requirement would replace the current static 2.5 percent component of the capital conservation buffer requirement for purposes of standardized approach capital ratios. In order to avoid restrictions on capital distributions, CCAR firms would be required to maintain risk-based capital ratios, including CET1 capital ratios, in excess of the applicable minimum requirement, *plus* the CCAR firm's SCB requirement, *plus* the CCAR firm's G-SIB surcharge (if applicable), *plus* the countercyclical capital buffer (if applicable). This SCB-based requirement (the "*Standardized Approach Capital Conservation Buffer Requirement*," or "*SA-CCB Requirement*") applies only to risk-based capital ratios calculated using the standardized approach. CCAR firms subject to the advanced approaches would also be required to comply with a separate non-SCB-based capital buffer requirement for risk-based capital ratios calculated using the advanced approaches (the "*Advanced Approaches Capital Conservation Buffer Requirement*," or "*AA-CCB Requirement*"), which would continue to reflect the static 2.5 percent capital conservation buffer and, thus, be less than or equal to the SA-CCB Requirement.
- **Calculation of the SCB Requirement.** In effect, the SCB would require CCAR firms to pre-capitalize stressed losses and four quarters of planned common stock dividends in order to avoid limitations on capital distributions and discretionary bonus payments under the buffer requirements in the capital rules.¹¹ Specifically, the SCB requirement would be a start-to-trough measure equal to a CCAR firm's starting CET1 capital ratio, *minus* the CCAR firm's lowest projected CET1 capital ratio under the severely adverse scenario in the Federal Reserve's supervisory stress test, *plus* the sum of the ratios of the dollar amounts of the CCAR firm's planned common stock dividends to projected risk-weighted assets ("*RWAs*") for each of the fourth through seventh quarters of the planning horizon.¹² The SCB requirement would be subject to a floor of 2.5 percent, in order to prevent the SCB from falling below the existing static capital buffer requirement.¹³

As is currently the case, only the standardized approach would be used to calculate risk-based capital ratios in connection with CCAR, including those used to calculate a CCAR firm's SCB requirement. The Federal Reserve explains that the advanced approaches are not used in connection with CCAR or the SCB requirement due to the "significant resources required to implement the advanced approaches on a pro forma basis and due to the complexity and opaqueness associated with introducing the advanced approaches in supervisory stress test projections."¹⁴ The Federal Reserve also observes that "both the supervisory stress test and the advanced approaches are calibrated to reflect tail-risks; thus, it could be duplicative to require a firm to meet the requirements of the advanced approaches on a post-stress basis."¹⁵

This observation about duplication between CCAR stress tests and the advanced approaches is notable because it may provide some indication for how the Federal Reserve will approach the interaction of CCAR and the standards recently released by the Basel Committee to finalize the Basel III capital framework (commonly referred to as "*Basel IV*").¹⁶ At this time, it is unclear whether and, if so, how the standardized approaches in the Basel IV

output floor but not the current U.S. standardized approach (*i.e.*, operational risk and credit valuation adjustment (“CVA”) risk) will be incorporated into the U.S. capital rules and CCAR. Simply revising the U.S. standardized approach to incorporate requirements for operational risk and CVA risk, without any adjustment to CCAR, would result in double-counting; in CCAR, projections reflect, among other things, operational risk and CVA losses. Under the Basel IV operational risk capital requirements, operational risk losses directly affect one of the components—the Internal Loss Multiplier—used to calculate operational risk RWAs.¹⁷ A stressed operational risk loss could thus be recognized in capital twice: once through a reduction in earnings (and, therefore, the numerator of capital ratios) and a second time through increasing operational risk RWAs. Similar issues could arise in connection with CVA, as the losses relating to changes in the credit quality of a counterparty are already captured through CVA adjustments and reflected in the numerator. The Federal Reserve’s observations suggest that the Federal Reserve is cognizant of potential double-counting of risk elements in stress testing and may seek to avoid double-counting in CCAR if the U.S. standardized approach incorporates operational risk and/or CVA risk in connection with the U.S. implementation of Basel IV.

The Federal Reserve’s commentary on the reasons for not using the advanced approaches in connection with CCAR also highlights important issues relating to the upcoming implementation of the new accounting standard for the recognition of credit losses (the current expected credit loss methodology or “CECL”), which will take effect in January 2020 for SEC reporting companies, including most CCAR firms. Under current U.S. GAAP, a company reflects credit losses on financial assets measured on an amortized cost basis only when the losses are probable or have been incurred, and generally considers only past events and current conditions in making these determinations. CECL prospectively replaces this approach with a forward-looking methodology that reflects the expected credit losses over the lives of financial assets, starting when such assets are first acquired. Under CECL, credit losses will be measured based on past events, current conditions and reasonable and supportable forecasts that affect the collectability of financial assets. Compared to current U.S. GAAP, CECL will result in earlier recognition of credit losses and, potentially, greater volatility in allowances for credit losses.¹⁸ Because of CECL’s incorporation of a forward-looking methodology and forecasts, as well as the recognition of losses over the lives of financial assets, the interaction of CECL and CCAR raises similar issues as the use of the advanced approaches in stress testing—specifically, issues relating to complexity, opaqueness, duplication of risk elements and calibration of the stress tests. On April 13 and 17, 2018, the Federal Reserve, FDIC and OCC released a joint proposed rule that would revise the agencies’ capital rules to phase in the day-one adverse effects on regulatory capital resulting from the implementation of CECL and to revise their stress test rules so that the effects of CECL are not reflected in stress test results until the 2020 stress test cycle.¹⁹ It remains to be seen how the Federal Reserve will address the interaction of CECL, CCAR and the new stress buffer requirements.

- ***Elimination of CCAR Quantitative Objection; Retention of Qualitative Objection.*** The Federal Reserve states that a central purpose of the proposal is to “simplify the capital regime applicable to firms subject to the capital plan rule.”²⁰ Accordingly, the proposal would end the CCAR quantitative objection in order to “eliminat[e] the need for firms to manage to both potential sources of limitations on capital distributions,”²¹ *i.e.*, to the post-stress requirements in the capital plan rule and the capital buffer requirements in the capital rules. The capital plan rule and CCAR would still operate to place certain restrictions on a CCAR firm’s ability to make capital distributions, but those restrictions would be integrated with the requirements of the capital rules.

Notably, however, the proposal would retain the qualitative objection for CCAR firms subject to the Large Institution Supervision Coordination Committee framework and for “large and complex” firms (*i.e.*, those that are U.S. global systemically important bank holding companies, or that have \$250 billion or more of total consolidated assets or \$75 billion or more of total nonbank assets). The Federal Reserve does, however, specifically request

comment on the advantages or disadvantages of removing or adjusting the qualitative objection for those CCAR firms.²² In light of recent comments by Vice Chairman Quarles²³ and former Governor Tarullo²⁴ about the future of the qualitative objection, as well as the Federal Reserve's recent proposal to implement a new rating system for large financial institutions designed to align with the supervisory program for those institutions,²⁵ the request for comment suggests that the Federal Reserve may be considering whether to eliminate the qualitative objection for additional—or potentially all—CCAR firms.

- **Advanced Approaches Capital Conservation Buffer Requirement.** In addition to the SA-CCB Requirement, which would apply to all CCAR firms, the AA-CCB Requirement would apply to the advanced approaches capital ratios of CCAR firms subject to the capital rules' advanced approaches.²⁶ The AA-CCB Requirement would be equal to 2.5 percent, *plus* the G-SIB surcharge (if applicable), *plus* the countercyclical capital buffer (if applicable).²⁷ Thus, the AA-CCB Requirement essentially retains the existing capital buffer requirement with respect to advanced approaches capital ratios. Because the SCB is subject to a floor of 2.5 percent, the SA-CCB Requirement for an advanced approaches CCAR firm would always be greater than or equal to its AA-CCB Requirement.

The proposal discusses the importance of stress testing in the Federal Reserve's supervisory program for large financial institutions.²⁸ By integrating the Federal Reserve's capital planning and stress testing requirements with the standardized approach in a manner that would generally result in higher capital buffer requirements for the standardized approach than for the advanced approaches, the proposal has the potential to significantly increase the relevance and relative stringency of the standardized approach. In this regard, it is notable that Basel IV expressly provides that a jurisdiction will be compliant with the Basel framework even if it does not implement some or all of the model-based approaches. If adopted, the proposal would likely contribute to further uncertainty as to the future role and relevance of the advanced approaches in the U.S. capital rules.

- **Creation of the SLB Requirement.** In addition to the SCB requirement, the proposal would also introduce the SLB requirement (together with the SCB requirement, the "*stress buffer requirements*").²⁹ The proposal would require a CCAR firm to maintain its tier 1 leverage ratio above the 4 percent minimum, *plus* the CCAR firm's SLB requirement in order to avoid restrictions on capital distributions and discretionary bonus payments. According to the Federal Reserve, this new requirement would "help to maintain the current complementary relationship between the risk-based and leverage capital requirements in normal and stressful conditions" and to "continue the current practice of evaluating a CCAR firm's vulnerability to declines in its leverage ratio under stressful conditions."³⁰

The method for calculating the SLB requirement would be analogous to that for calculating the SCB. Specifically, a CCAR firm's SLB requirement would equal its starting tier 1 leverage ratio, *minus* the CCAR firm's lowest projected tier 1 leverage ratio under the severely adverse scenario in the supervisory stress test, *plus* the sum of the ratios of the dollar amounts of the CCAR firm's planned common stock dividends to projected leverage ratio denominator for each of the fourth through seventh quarters of the planning horizon.³¹ The SLB requirement would not have a floor, reflecting that there is not currently a generally applicable leverage buffer under the capital rules. Notably, the stress buffer concept would not extend to the supplementary leverage ratio because "[a] single stress leverage ratio, applicable to all firms, would provide a sufficient backstop and avoid adding additional complexity."³²

- **Limits on Capital Distributions Under the Proposed Revisions to the Capital Rules and Capital Plan Rule.** Under the proposal, as currently is the case, both the capital rules and the capital plan rule would place restrictions on the ability of CCAR firms to make certain capital distributions. The capital rules place graduated constraints on a banking organization's (including a CCAR firm's) ability to make capital distributions or discretionary bonus payments based on the amount of any shortfall in satisfying applicable minimum capital requirements and applicable buffer requirements.³³ The capital plan rule would generally not permit a CCAR firm to make capital distributions in excess of those included in its capital plan, on a gross basis or net of

capital issuances without the prior approval of the Federal Reserve, and a CCAR firm would be required to reduce its planned capital distributions if its own baseline scenario projections indicate that the CCAR firm's distributions would not be consistent with applicable capital distribution limitations throughout the planning horizon.³⁴

- **Restrictions on Capital Distributions and Discretionary Bonus Payments Under the Capital Rules.** With respect to each of the three buffer requirements addressed in the proposal (*i.e.*, the SA-CCB Requirement, the AA-CCB Requirement (if applicable), and the SLB requirement), a CCAR firm would be subject to restrictions on its ability to make capital distributions and discretionary bonus payments if a capital ratio falls below the applicable minimum requirement plus any buffer requirement. The stringency of the limitations would become more severe as a ratio approaches the regulatory minimum.

A CCAR firm would be subject to the most stringent distribution limitation, if any, under any of the applicable buffer requirements, including these three requirements and, as applicable, the enhanced supplementary leverage ratio ("eSLR") and the TLAC buffer requirements.³⁵

- **Restrictions on Capital Distributions Under the Capital Plan Rule.** As is currently the case, under the proposal, a CCAR firm would be required to submit an annual capital plan detailing its planned capital actions over a nine-quarter planning horizon. CCAR firms would generally not be permitted to exceed the capital distributions included in their capital plans, either on a gross basis or net of capital issuances without the prior approval of the Federal Reserve.³⁶ The proposal would retain the *de minimis* exception for capital distributions above the amount reflected in a CCAR firm's capital plan equal to 0.25 percent of tier 1 capital.³⁷ Unlike the capital rules, the capital plan rule would not directly impose limits on discretionary bonus payments, and a CCAR firm would not be required to include discretionary bonus payments in its capital plan.³⁸

Although the proposal would eliminate the quantitative objection, it would introduce a new requirement that all planned capital distributions for any given quarter of the planning horizon be consistent with the capital distribution limitations in effect for that quarter under the capital rules and, if applicable, the TLAC rule. A CCAR firm's compliance with the anticipated capital distribution limitations for a quarter is based on the CCAR firm's projected ratios for that quarter under the CCAR firm's own baseline scenario.³⁹ Given that a CCAR firm would not know its stress buffer requirements beginning with the fourth quarter of the planning horizon at the time it submits its capital plan, the Federal Reserve proposed codifying the CCAR "mulligan" in the capital plan rule. Like the existing "mulligan" that has been included in the CCAR instructions, the proposal would provide CCAR firms with a two-business-day period to reduce their planned capital distributions after they receive initial notice of their stress buffer requirements.

- **Continued Significance of the Supervisory Severely Adverse Scenario in Determining Effective Capital Requirements.** Under the proposal, a CCAR firm's stress buffer requirements would be determined by the CCAR firm's projected financial performance in the supervisory severely adverse scenario of the Federal Reserve's supervisory stress test. Potentially in light of the continued—and perhaps enhanced—significance of this scenario, the Federal Reserve has specifically requested comment on the advantages and disadvantages of publishing for notice and comment the severely adverse scenario used in calculating a CCAR firm's stress buffer requirements.⁴⁰
- **Additional Scrutiny and Relevance of the BHC Baseline Scenario.** The proposal would introduce a new requirement that a CCAR firm must reduce its planned capital distributions if its own projections for its own baseline scenario (commonly referred to as the "*BHC baseline scenario*") indicate that its capital distributions would not be consistent with applicable buffer distribution limitations in each quarter of the planning horizon. The Federal Reserve recognizes that "[b]asing capital distribution restrictions on a firm's projections in its BHC baseline scenario may create incentives for a firm to be overly optimistic about its baseline projections in order to increase the amount of permissible capital distributions."⁴¹

Accordingly, to provide CCAR firms with incentives to “project realistic baseline earnings,” the Federal Reserve notes that “[a] pattern of materially underperforming baseline projections for earnings, capital levels, or capital ratios may be indicative of weaknesses in the firm’s capital planning and result in heightened scrutiny in the qualitative assessment,” and that CCAR firms may be required to resubmit if their capital plans in certain circumstances if they materially underperform their projections.⁴²

The relevance of the BHC baseline scenario would increase under the proposal. Under the current CCAR framework, in practice, the BHC baseline scenario does not determine whether a CCAR firm receives a quantitative objection and faces limits on capital distributions under the capital plan rule; under the proposal, the BHC baseline scenario projections directly affect a CCAR firm’s distribution capacity. In addition, the Federal Reserve stated that it “intends to monitor and evaluate a firm’s quarterly performance relative to its baseline projections to help ensure that the firm adopts processes that a realistically project performance and capital levels.”⁴³ The new focus on the BHC baseline scenario is notable because the Federal Reserve’s supervisory guidance—such as SR Letters 15-18 and 15-19—had previously centered on CCAR firms’ own stress scenarios.⁴⁴

- ***Reduced Significance of the Supervisory Baseline and Adverse Scenarios in Determining Effective Capital Requirements.*** The Federal Reserve would calculate both stress buffer requirements using the severely adverse scenario in its supervisory stress test. Under the current CCAR framework, it is highly unlikely that a CCAR firm would pass the quantitative assessment in the supervisory severely adverse scenario but fail in either the supervisory adverse or baseline scenarios. Because the proposal would practically eliminate the relevance of the supervisory adverse and baseline scenarios in CCAR, proponents of simplifying the supervisory stress testing framework by reducing the number of scenarios may cite the proposal as further reason to eliminate the adverse scenario.⁴⁵
- ***Timing of Annual Calculation of and Updates to the Stress Buffer Requirements.*** The Federal Reserve would calculate a CCAR firm’s stress buffer requirements for the fourth quarter of one year through the third quarter of the next year in connection with the annual CCAR process, which would continue to be concentrated in the second quarter of the year. CCAR firms would continue to be required to submit their capital plans by April 5, and the Federal Reserve would complete its assessment of the plans, which includes the application of the supervisory stress tests, by June 30. Under the proposal, the Federal Reserve would provide each CCAR firm with initial notice of its stress buffer requirements by June 30.⁴⁶ The proposal would provide that adjustments may be made to the stress buffer requirements in certain circumstances. The Federal Reserve would provide a CCAR firm with its final stress buffer requirements by August 31.⁴⁷ These final requirements would take effect on October 1, and would apply to the CCAR firm through September 30 of the following year.⁴⁸ The Federal Reserve would recalculate a CCAR firm’s stress buffer requirements, potentially using an updated severely adverse scenario, if a CCAR firm resubmitted its capital plan.⁴⁹
- ***Process and Requirements for Adjustments to Capital Plans and Reconsideration of Stress Buffer Requirements.*** Notably, a CCAR firm would not know its stress buffer requirements for the fourth through ninth quarters of the planning horizon, and therefore the capital requirements and capital distribution limits for those quarters, at the time it submits its capital plan. A CCAR firm would not receive notice of its updated stress buffer requirements until after the Federal Reserve has completed its assessment of the capital plans and provided initial notice, which would occur by June 30. To account for this, the Federal Reserve has proposed to codify the “mulligan” in the capital plan rule. Specifically, the proposal would incorporate into the capital plan rule itself a process by which CCAR firms must revise their planned capital distributions if the capital distributions included in their capital plans are not consistent with the capital distribution limitations that are projected to apply throughout the planning horizon. The proposal also includes a process by which CCAR firms may request reconsideration of their stress buffer requirements.

- **Requirements and Process for Adjusting Planned Capital Distributions in a Capital Plan.** Under the proposal, within two business days of receipt of initial notice of stress buffer requirements, a CCAR firm would be required to assess whether its planned capital distributions are consistent with the effective capital distribution limitations that would apply on a pro forma basis under the CCAR firm's projections for the BHC baseline scenario.⁵⁰ In doing so, a CCAR firm must generally assume that the countercyclical capital buffer and the G-SIB surcharge, in each case, if applicable, would remain constant over the period, unless it knew that a change will take effect (for example, if it knew a higher G-SIB surcharge would apply beginning in the fifth quarter of the planning horizon).⁵¹ If the CCAR firm's planned capital distributions would not be consistent with the applicable capital distribution limitation limitations under the buffer requirements, it would be required to reduce the capital distributions in its capital plan to be consistent with the limitations, and provide notice of these reductions to the Federal Reserve.⁵² The Federal Reserve would then recalculate the stress buffer requirements based on the adjusted planned capital actions and would provide the final stress buffer requirements, based on the adjusted planned capital actions, and confirmation of the CCAR firm's final planned capital distributions for the coming year by August 31. As noted above, the final stress buffer requirements would become effective on October 1.

The August 31 deadline for CCAR firms to be informed of their final stress buffer requirements appears to be intended to accommodate the timeline for the reconsideration process. If a CCAR firm adjusts its planned capital distributions but does not request reconsideration of its stress buffer requirements, it is likely that the Federal Reserve would be able to inform the CCAR firm of its final stress capital buffer well in advance of August 31. The proposal does not address whether the Federal Reserve expects to inform CCAR firms of their final stress buffer requirements at different times depending on whether they only adjust their planned capital actions or seek reconsideration of the requirements.

Even if a CCAR firm's planned capital distributions are consistent with the requirements and it is therefore not *required* to reduce its planned capital distributions after receiving the initial notice, it will be permitted to do so.⁵³ It may choose to modify its planned capital distributions to, for instance, lower the stress buffer requirements that will apply to it over the coming year.

Although not directly discussed, the proposal appears to indicate that the Federal Reserve would revise the approach and sequencing for disclosing DFAST and CCAR results in connection with the introduction of stressed buffer requirements. In particular, the proposal indicates that the Federal Reserve would concurrently notify CCAR firms and publicly disclose initial stress buffer requirements, after which CCAR firms would have two business days to revise their planned capital distributions.⁵⁴ This approach would differ from the current sequencing, in which CCAR firms are informed of their results in the CCAR stress tests, and have the opportunity to revise their planned capital distributions, before the Federal Reserve publicly announces CCAR results, including both original and revised planned capital actions.

- **Process to Request Reconsideration of the Stress Buffer Requirements.** Within 15 calendar days of receipt of the notice of its stress buffer requirements, a CCAR firm may submit a request for reconsideration.⁵⁵ The request must contain a detailed explanation of why reconsideration should be granted and all supporting reasons for the request. If the request includes information that was not originally provided in the capital plan submission, the request should also explain why the additional information should be considered.⁵⁶ The Federal Reserve would consider the request and notify the CCAR firm of the decision to affirm or modify the initial stress buffer requirement within 30 calendar days of receipt of the notice.⁵⁷ This same process would also apply to a CCAR firm's request for reconsideration of a qualitative objection.

The updated stress buffer requirements or the qualitative objection, as applicable, would not be effective during the pendency of a request for reconsideration.⁵⁸ If the Federal Reserve has not yet indicated its non-objection for planned capital distributions for a quarter that falls

within this pendency, then a CCAR firm would be permitted to make capital distributions so long as they do not exceed the four-quarter average of capital distributions to which the Federal Reserve indicated its non-objection for the previous capital plan cycle, unless otherwise determined by the Federal Reserve.⁵⁹

- **Modified Assumptions Under the Supervisory Stress Test.** In addition to the proposals that would integrate and simplify the requirements under the capital rules and capital plan rule, the Federal Reserve proposed several changes to the assumptions it makes in its supervisory stress tests. These assumptions would impact the projected changes in CET1 capital and tier 1 leverage ratios in the severely adverse scenario of the Federal Reserve's supervisory stress test and, therefore, the calculation of the stress buffer requirements.
- **Narrowing the Set of Planned Capital Actions Assumed to Occur.** Currently, the Federal Reserve assumes that a CCAR firm will make all of its planned capital actions, including dividends, repurchases and issuances of regulatory capital instruments. Some CCAR firms have argued that this assumption is unrealistic and overly distortive, as CCAR firms are unlikely to continue making planned capital distributions irrespective of the stress they are under, and fails to take into account that such distributions may not be permitted under the capital rules. In response to these comments, the Federal Reserve has proposed narrowing the set of planned capital actions that it will assume occur for purposes of the stress tests.

The Federal Reserve would no longer assume that a CCAR firm makes any repurchases or redemptions of any capital instrument, but would effectively retain the assumption that CCAR firms execute certain planned capital actions because, as described above, four quarters of planned common stock dividends are factored into the calculation of a CCAR firm's stress buffer requirements.⁶⁰ The Federal Reserve notes that the assumption that CCAR firms would make planned distributions on common stock is consistent with experience in the recent financial crisis, when banking organizations continued to make distributions on common stock even as their capital conditions worsened.⁶¹ The Federal Reserve also explains that it would expect similar action in any future recessions because publicly traded CCAR firms would want to avoid the negative stock price reaction that a reduction in dividends may cause.⁶²

The Federal Reserve would continue to assume that a CCAR firm would make payments on any instrument that qualifies as additional tier 1 or tier 2 capital equal to the stated dividend, or contractual interest or principal due on such instruments.⁶³ It would also assume that a CCAR firm does not make any planned issuance of regulatory capital instruments, other than in connection with a planned merger or acquisition (to the extent that merger or acquisition is reflected in the CCAR firm's pro forma balance sheet estimates).⁶⁴

In addition to revising these assumptions with respect to the supervisory stress test, the Federal Reserve would amend the DFAST rules applicable to CCAR firms' own stress tests to require CCAR firms to incorporate these assumptions into their DFAST company-run stress tests as well.⁶⁵

- **Assuming a Constant Balance Sheet Under Stress.** The proposal would also modify the Federal Reserve's assumption with respect to the behavior of CCAR firms' balance sheets under stress. The Federal Reserve has generally assumed that CCAR firms' balance sheets expand under stress in order to prevent CCAR firms from "shrinking to health" and reducing the credit supply in periods of stress. Some CCAR firms have noted that this assumption is unrealistic and overly distortive, both because the credit demand itself would likely contract in periods of stress, and because the assumption does not account for certain elements of the balance sheet which are unlikely to grow under stress, for example, legacy portfolios in run-off.

The Federal Reserve proposed to modify the balance sheet assumption and assume that the size of a CCAR firm's balance sheet remains constant under stress.⁶⁶ As a corollary to this, the Federal Reserve would also assume that a CCAR firm's RWAs and leverage ratio

denominator remain unchanged over the planning horizon. In both cases, there would be exceptions for changes primarily related to deductions from regulatory capital or changes to the Federal Reserve's regulations, as well as the projected impact of a planned merger or acquisition or completed or contractually agreed-on divestiture.⁶⁷

- **Elimination of Heightened Scrutiny for Dividend Payout Ratios Above 30 Percent.** The Federal Reserve has also proposed modifying its treatment of capital plans that imply a common stock dividend payout ratio above 30 percent.⁶⁸ The Federal Reserve has previously subjected such plans to heightened scrutiny. Under the proposal, the Federal Reserve would eliminate this 30 percent dividend payout ratio as a criterion for heightened supervisory scrutiny of a CCAR firm's capital plan. This elimination, together with other aspects of the proposal, signifies a shift away from assessing capital adequacy based on the amount of capital payouts, and toward assessing it based on capital levels, which would grant more flexibility to CCAR firms in their capital planning going forward.
- **Impact Assessment.** The Federal Reserve notes that the impact of the proposal would vary through economic and credit cycles based on the risk profile and planned capital actions of individual CCAR firms, as well as the severity of the supervisory severely adverse scenario. In general, the Federal Reserve estimates that the proposal would result in lower CET1 capital requirements for non-G-SIBs with over \$50 billion in assets and result in similar or in some cases higher CET1 capital requirements for G-SIBs.⁶⁹ Based on data from the 2015, 2016 and 2017 CCAR cycles, the Federal Reserve estimates that the impact of the proposal would range from an aggregate reduction in required CET1 capital of approximately \$35 billion (based on 2017 data) to an aggregate increase in required CET1 capital of approximately \$40 billion (based on 2015 data).⁷⁰ For G-SIBs, the increase in CET1 aggregate capital requirements is estimated to range from \$10 billion (based on 2017 data) to \$50 billion (based on 2015 data), but for non-G-SIBs the decrease in CET1 aggregate capital requirements is estimated to range from approximately \$45 billion (based on 2017 data) to \$10 billion (based on 2015 data).⁷¹

The Federal Reserve also estimates that the proposal would generally lower the amount of tier 1 capital required in connection with the assessment of the leverage ratio in stress, although it does not quantify this estimate.⁷² The proposed modifications to the capital distribution and balance sheet assumptions in the Federal Reserve's supervisory stress tests would reduce the projected fall in a CCAR firm's tier 1 leverage ratio in stress, and therefore the amount of tier 1 capital required to pre-capitalize stressed losses, though the inclusion of four quarters of dividends in the SLB requirement would partially offset the revised capital distribution assumptions. On April 11, 2018 the Federal Reserve and the OCC proposed to recalibrate the eSLR requirements applicable to U.S. G-SIBs and their subsidiary insured depository institutions that are state member banks, national banks or Federal savings associations.⁷³ That proposal would also impact the amount of tier 1 capital that CCAR firms that are U.S. G-SIBs are required to hold in order to avoid limitations on capital distributions and discretionary bonus payments. Although the Federal Reserve has separately estimated the impacts of the eSLR and stress buffer proposals on a stand-alone basis, it has not analyzed the cumulative impact of the two proposals. In particular, the Federal Reserve has not addressed how the elimination of the quantitative objection and the requirement for certain CCAR firms, including the U.S. G-SIBs, to satisfy the minimum SLR requirement on a post-stress basis would affect the impact analysis in the eSLR proposal.

Because the proposal relates only to the capital requirements for CCAR firms, it would not affect the capital buffer requirements for bank holding companies that are not CCAR firms or for insured depository institutions, including subsidiaries of CCAR firms.

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ENDNOTES

- ¹ Federal Reserve System, *Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules*, available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180410a2.pdf> (April 10, 2018) (hereinafter, the “Proposal”).
- ² “CCAR” refers to the Federal Reserve’s Comprehensive Capital Analysis and Review of capital plans filed annually by 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 217.
- ⁴ Federal Reserve Staff Memorandum re: Proposed rule regarding the stress buffer requirements (April 5, 2018) at 2 and 18, available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180410a1.pdf>.
- ⁵ The qualitative assessment is applicable only to certain firms. In January 2017, the Federal Reserve eliminated the qualitative assessment for “large and noncomplex” firms (*i.e.*, those that are not “large and complex”). See Federal Reserve System, *Amendments to the Capital Plan and Stress Test Rules*, 82 Fed. Reg. 9308 (February 3, 2017), available at <https://www.gpo.gov/fdsys/pkg/FR-2017-02-03/pdf/2017-02257.pdf>. For a discussion of the amendments, see our Memorandum to Clients entitled *Banking Organization Capital Plans and Stress Tests: Federal Reserve Finalizes 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* (Feb. 1, 2017), available at <https://sullcrom.com/banking-organization-capital-plans-and-stress-tests-02-01-2017>.
- ⁶ 12 C.F.R. § 217.11.
- ⁷ 12 C.F.R. § 225.8.
- ⁸ For the third quarter of 2019, the proposal would provide that CCAR firms could make capital distributions that do not exceed the four-quarter average of the capital distributions in their capital plans for the 2018 CCAR cycle.
- ⁹ As of the publication of this Memorandum, the proposal has not been published in the *Federal Register*.
- ¹⁰ Proposal, at 18.
- ¹¹ CCAR firms would also have to pre-capitalize stated payments on additional tier 1 and tier 2 capital instruments, such as non-cumulative perpetual preferred stock and subordinated debt, because the Federal Reserve would continue to assume that a firm makes all such payments in the supervisory stress tests. Proposal, at 27.
- ¹² Proposal, at 24.
- ¹³ *Id.*
- ¹⁴ Proposal, at 19.
- ¹⁵ *Id.*
- ¹⁶ Basel Committee, *Basel III: Finalising post-crisis reforms* (Dec. 2017), available at <https://www.bis.org/bcbs/publ/d424.pdf>. For additional information regarding Basel IV, please see our Memorandum to Clients entitled *Bank Capital Requirements: Basel Committee Releases Standards to Finalize Basel III Framework* (Dec. 19, 2017), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_12_192017.pdf.

ENDNOTES (CONTINUED)

- 17 At national discretion, authorities may set the value of the Internal Loss Multiplier equal to a fixed coefficient of one, with the result that operational risk RWAs and capital requirements are a function of only the other component, the Business Indicator Component.
- 18 For additional information on CECL, see our Memorandum to Clients entitled *FASB Expected Credit Loss Methodology* (June 23, 2016), available at <https://www.sullcrom.com/client-alert-fasb-expected-credit-loss-methodology>.
- 19 Federal Reserve, FDIC and OCC, *Regulatory Capital Rules: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations* (Apr. 17, 2018), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180417a1.pdf>. The CECL-related proposal will be addressed in a forthcoming Memorandum to Clients.
- 20 Proposal, at 1.
- 21 Proposal, at 31.
- 22 Proposal, at 47-48.
- 23 Vice Chairman for Supervision Randal K. Quarles, *Semiannual Supervision and Regulation Testimony* (April 18, 2017) at 6 (“Recently, we have solicited comment on whether that approach [eliminating the qualitative CCAR assessment] should be applied to a broader range of firms. I believe that our supervisory goal of ensuring a robust capital planning process at most firms can be achieved using our normal supervisory program combined with targeted horizontal assessments without compromising the safety and soundness of the financial system.”), available at <https://www.federalreserve.gov/newsevents/testimony/files/quarles20180417a.pdf>.
- 24 Governor Daniel K Tarullo, *Departing Thoughts* (April 4, 2017) at 21 (“So I think the time may be coming when the qualitative objection in CCAR should be phased out, and the supervisory examination work around stress testing and capital planning completely moved into the normal, year-round supervisory process, even for the G-SIB.”), available at <https://www.federalreserve.gov/newsevents/speech/files/tarullo20170404a.pdf>.
- 25 For a discussion of the proposed new LFI rating system, see our Memorandum to Clients entitled *Federal Reserve Proposes New Rating System: Federal Reserve Proposes to Establish a New Rating System for the Supervision of Large Financial Institutions Designed to Align with the Supervisory Program for Those Institutions and to Enhance the Clarity and Consistency of Supervisory Assessments* (August 7, 2017), available at https://sullcrom.com/siteFiles/publications/SC_Publication_Federal_Reserve_Proposes_New_Rating_System.pdf.
- 26 Advanced approaches CCAR firms are generally those with \$250 billion or more in total consolidated assets or \$10 billion or more in foreign exposures. Intermediate holding companies of foreign banking organizations that meet the advanced approaches definition are not required to determine their risk-based capital ratios using the advanced approaches.
- 27 Proposal, at 19.
- 28 Proposal, at 6-10.
- 29 Proposal, at 19.
- 30 Proposal, at 19.
- 31 Proposal, at 25.
- 32 Proposal, at 20. U.S. G-SIBs are subject to an enhanced supplementary ratio (“eSLR”) requirement, which includes a 2 percent buffer in addition to the 3 percent minimum. On April 11, 2018 the Federal Reserve and the OCC proposed to recalibrate the eSLR requirements

ENDNOTES (CONTINUED)

- applicable to U.S. G-SIBs and their subsidiary insured depository institutions that are state member banks, national banks or Federal savings associations. For additional information on this proposal, see our Memorandum to Clients entitled *Bank Capital Requirements: Federal Reserve and OCC Propose Amendments to the Enhanced Supplementary Leverage Ratio Requirements for U.S. G-SIBs* (April 17, 2018), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_04_17_18.pdf (hereinafter, the “eSLR Memo”).
- 33 Proposal, at 20.
- 34 Proposal, at 34-36.
- 35 For additional information on the eSLR and TLAC buffer requirements, see note 32 and our Memorandum to Clients entitled *Loss Absorbency Requirements: Federal Reserve Adopts Final TLAC and Related Requirements for U.S. G-SIBs and U.S. Intermediate Holding Company Subsidiaries of Non-U.S. G-SIBs* (Dec. 16, 2016), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Loss_Absorbency_Requirements_12_16_16.pdf.
- 36 Proposal, at 34.
- 37 The *de minimis* exception currently applies on a cumulative basis to capital distributions from the third through sixth quarters of the planning horizon. The proposal would revise the *de minimis* exception to the cumulative net distribution limit so that capital distributions would be measured against the 0.25 percent limit beginning with the fourth quarter of the planning horizon (12 C.F.R. § 225.8(k)(3)(iii)(E) (as proposed), but the *de minimis* exception to the cumulative gross distribution limit would continue to measure capital distributions against the 0.25 limit from July 1 of one calendar year through June 30 of the following calendar year (12 C.F.R. § 225.8(k)(2)(i)(C) (as proposed). The proposal does not address why time periods are different.
- 38 Proposal, at 35.
- 39 Proposal, at 34.
- 40 Proposal, at 47-48. In December of 2017, the Federal Reserve requested comment on a series of proposals designed to increase the transparency of the supervisory stress tests. These proposals would provide for enhanced disclosure relating to the supervisory scenarios, but would not subject the scenarios to public notice and comment. For further discussion of these proposals, see our Memorandum to Clients entitled *Bank Capital Plans and Stress Tests: Federal Reserve Proposes a New Stress Testing Policy Statement, Several Enhancements to Supervisory Stress Test Model Disclosure and Amendments to its Stress Testing Scenario Design Framework* (Dec. 12, 2017), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Plans_and_Stress_Tests_121217.pdf. In recent testimony, Vice Chairman for Supervision Randal Quarles indicated that the Federal Reserve is considering subjecting the supervisory scenarios to public notice and comment, stating, “We are continuing to think about how we can make the stress testing process more transparent without lowering the strength of the test itself or undermining the usefulness of the supervisory stress test. I personally believe that our stress testing disclosures can go further, and that we should consider additional measures, such as putting our stress scenarios out for comment. Vice Chairman for Supervision Randal K. Quarles, *Semiannual Supervision and Regulation Testimony* (April 17, 2018) at 9, available at <https://www.federalreserve.gov/newsevents/testimony/files/quarles20180417a.pdf>.
- 41 Proposal, at 37.
- 42 *Id.*
- 43 *Id.*

ENDNOTES (CONTINUED)

- 44 For additional information on SR Letters 15-18 and 15-19, see our Memorandum to Clients entitled *Bank Capital Plans and Stress Tests: Federal Reserve Board Issues Consolidated Guidance on Supervisory Expectations for Capital Planning at Large Bank Holding Companies* (December 30, 2015), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Plans_and_Stress_Tests_12_30_15.pdf.
- 45 Last month, the United States Senate approved a bill that would, among other things, eliminate the adverse scenario as a mandatory scenario in DFAST. See S. 2155, 115th Cong. § 401 (2018), available at <https://www.congress.gov/115/bills/s2155/BILLS-115s2155es.pdf>. For additional information, see our Memorandum to Clients entitled *Financial Services Regulatory Reform Legislation: Senate Approves Bipartisan Regulatory Reform Bill* (Mar. 18, 2018), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Financial_Services_Regulatory_Reform_Legislation_3_18_2018.pdf.
- 46 Proposal, at 38.
- 47 12 C.F.R. § 225.8(h)(5) (as proposed).
- 48 Proposal, at 30.
- 49 Proposal, at 46-47.
- 50 Proposal, at 39.
- 51 12 C.F.R. § 225.8(e)(2)(i)(C) (as proposed).
- 52 Proposal, at 39.
- 53 *Id.*
- 54 Proposal, at 40 (By June 30, “[t]he [Federal Reserve] provides to a firm and publishes initial notice of the firm’s stress buffer requirements, and for each large and complex and LISCC firm, the [Federal Reserve’s] decision to object or not object to the capital plan on a qualitative basis.”) (emphasis added).
- 55 Proposal, at 42.
- 56 Proposal, at 42-43.
- 57 Proposal, at 43.
- 58 *Id.*
- 59 Proposal, at 43-44.
- 60 Proposal, at 26.
- 61 *Id.*
- 62 *Id.*
- 63 Proposal at 27.
- 64 *Id.*
- 65 Proposal, at 27-28.
- 66 Proposal, at 28.
- 67 Proposal, at 29.
- 68 Proposal, at 28.
- 69 Proposal, at 32.

ENDNOTES (CONTINUED)

70 Proposal, at 33.

71 *Id.*

72 *Id.*

73 Federal Reserve, OCC, *Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions: Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies*, 83 Fed. Reg. 17317 (April 19, 2018), available at <https://www.gpo.gov/fdsys/pkg/FR-2018-04-19/pdf/2018-08066.pdf>. For more information relating to this proposal, please see the eSLR Memo, *supra* note 32.

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