SULLIVAN & CROMWELL LLP

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Banking Organization Capital Plans and Stress Tests

Federal Reserve Issues Instructions and Supervisory Scenarios for the 2018 Comprehensive Capital Analysis and Review and Dodd-Frank Act Stress Test Exercises

On February 1, 2018, the Federal Reserve issued information applicable to the 2018 capital plan review process for bank holding companies ("*BHCs*") with $50 billion or more in total consolidated assets and U.S. intermediate holding companies ("*IHCs*") of foreign banking organizations.[1] The Federal Reserve issuances included:

- its annual summary instructions (the "*CCAR 2018 Instructions*") for its supervisory CCAR program for 2018, which include aspects relating to the quantitative assessment and the Federal Reserve's disclosures regarding CCAR results, which are applicable to all firms, as well as aspects addressing the qualitative assessment, which are applicable only to firms subject to the Large Institution Supervision Coordination Committee framework ("*LISCC firms*") and "large and complex firms" (those that are U.S. global systemically important BHCs ("*G-SIBs*"), or that have $250 billion or more of total consolidated assets or $75 billion or more of total nonbank assets);[2]
- a letter providing information on the 2018 horizontal capital review applicable to firms that are "large and noncomplex firms" (those that are not G-SIBs, and that have less than $250 billion of total consolidated assets and less than $75 billion of total nonbank assets) (the "*Horizontal Review Letter*");[3] and
- its three supervisory scenarios—baseline, adverse and severely adverse (together, the "*2018 DFAST/CCAR Scenarios*")—and exogenous add-on components applicable to certain firms for CCAR 2018.[4]

All firms must submit their capital plans for 2018 to the Federal Reserve on or before April 5, 2018. The Federal Reserve will release the CCAR 2018 results and its objection or non-objection to the capital plans no later than June 30, 2018.

Important elements of these releases are summarized below, with a particular focus on changes and clarifications to the CCAR 2018 Instructions and 2018 DFAST/CCAR Scenarios compared with those from 2017.[5]

- ***Market Risk Components for IHCs with Significant Trading Activity in CCAR 2018.*** In December 2017, the Federal Reserve broadened the scope of applicability of the global market shock component ("GMS"), with the effect that the GMS will apply to six IHCs beginning with CCAR 2019.[6] For CCAR 2018, those six IHCs will be subject to interim market risk components designed to assess potential losses associated with trading books, private equity positions and counterparty exposures.[7]

  For the company-run stress tests, each of the six IHCs must reflect trading and counterparty losses in the adverse and severely adverse scenarios using a company-run market risk component that is tailored to the firm's risks as described in individual notices to each firm.

  For the supervisory stress tests, the Federal Reserve will apply a supervisory market risk component that is a "simplified version" of the GMS and the large counterparty default scenario component, both described below. The CCAR 2018 Instructions specify the loss rates that will be applied in the adverse and severely adverse scenarios to the applicable measures of exposures in connection with:

  - Securitized products losses;
  - Trading mark-to-market and trading incremental default risk losses;
  - Credit valuation adjustments; and
  - Large counterparty default losses.

  The loss rates are based on the losses used in the GMS and large counterparty default scenario components from 2014-2017. Consistent with the application of the GMS and large counterparty default scenario component, these losses will be reflected in the first quarter of the planning horizon. The Federal Reserve notes that it will use the same methodology for all six IHCs.

- ***Changes with Respect to Firms' Planned Capital Actions.*** The CCAR 2018 Instructions reflect the same assumptions regarding capital actions under the adverse and severely adverse scenarios[8] but expand slightly the adjustments firms may make to their planned capital actions between the Federal Reserve's completion of the supervisory stress tests and disclosure of the final CCAR results.[9]

  Consistent with prior years, the Federal Reserve specified that, for the supervisory baseline, adverse and severely adverse scenarios, firms should calculate post-stress capital ratios using their planned capital actions under the BHC baseline scenario. The Federal Reserve noted that it would likewise project capital ratios in the three supervisory scenarios using those planned capital actions.

  As in prior years, firms will be permitted to adjust their planned capital actions upon completion of the supervisory tests but before disclosure of the final CCAR results, and the Federal Reserve will base its decisions to object or not object upon the adjusted capital actions, if applicable.

  In prior years, however, only adjustments to reduce planned capital *distributions* were permitted. The CCAR 2018 Instructions expand permissible adjustments to include increases to planned issuances of common stock in the third quarter of the planning horizon if a firm has already fully reduced its planned capital distributions to zero in the second through ninth quarters of the planning horizon. When such an adjustment is made, if there are no other grounds for objecting to a firm's capital plan, the Federal Reserve would generally expect to provide a conditional non-objection to a firm that increased its planned issuance of common stock in the third quarter, pending the issuance of the common stock. If the firm ultimately does not issue common stock in the third quarter, the Federal Reserve expects to object to the capital plan.

  Although the Federal Reserve does not state the reason for this change, it may reflect the increasing participation of IHCs in CCAR. Publicly traded BHCs typically have regular planned distributions (*e.g.*, quarterly dividends and common stock repurchase programs) and, accordingly, they can increase post-stress capital levels by reducing those regular planned distributions. IHCs, however, are intermediate-level entities within broader organizations and may approach capital distributions differently. Accordingly, IHCs may not have regular planned distributions that could be reduced in order to increase post-stress capital levels and avoid a quantitative objection. In addition, adjusting planned capital actions to include an issuance of common stock in the third quarter of the planning horizon effectively entails a pre-commitment to raise common equity during a specific future quarter given the Federal Reserve's statement that "[i]f the firm does not issue common stock in the third quarter, the Board expects that it would object to the capital plan."[10] For publicly traded BHCs, such a pre-commitment would normally not be practicable, as any significant issuance of common stock would ordinarily require a capital markets transaction and, accordingly, be subject to market conditions, including the price and trading volumes for the BHC's common stock. In contrast, an IHC could issue common stock to its parent, and the terms of the issuance would not depend on prevailing market conditions.

- ***Additional Guidance Regarding Treatment of Business Plan Changes.*** Although the guidance with respect to expected changes to business plans remains generally consistent with that in the 2017 instructions, the CCAR 2018 Instructions specify, "If a firm's December 31, 2017, FR Y-9C is not reflective of its risk profile and business activities, the firm should provide a description of the business plan changes that affect its starting data. The Federal Reserve may request additional information about any description of material changes to the starting data, including incremental impacts on the firm's starting balance sheet, income statement, capital, and risk-weighted assets."[11] This guidance is consistent with a CCAR FAQ from December 2017 noting that, in such situations, the Federal Reserve would take into account such additional information and may incorporate it into its projections if the information would likely have a material impact on a firm's capital adequacy and funding profile.[12]

- ***Reduction in Reporting Burdens Relating to Supporting Information.*** The CCAR 2018 Instructions state that, in an effort to reduce the burden associated with the submission of supporting documentation, the Federal Reserve will only require LISCC and large and complex firms to submit documentation related to elements that are in-scope for this year's exercise.[13] The instructions do not provide guidance as to what will be in-scope for CCAR 2018, but state that the Federal Reserve will issue letters to the firms providing them with additional details. For large and noncomplex firms, the CCAR 2018 Instructions provide that the details of the review process are described in supervisory communications sent to each firm.[14]

- ***Credit Loss Provisioning.*** The Federal Reserve provides that firms should not reflect the potential effect of the new U.S. accounting standard regarding credit loss provisioning (the current expected credit loss methodology, or "CECL") for CCAR 2018 and 2019, even if a firm early adopts CECL for financial reporting purposes in 2019. The Federal Reserve notes that it will provide additional guidance on reflecting the impact of CECL in CCAR 2020.[15]

- ***Other Guidance.*** The CCAR 2018 Instructions include additional guidance reflecting various other developments:

    - Firms must reflect the impact of the new tax law enacted in December 2017 in their December 31, 2017 financial statements and regulatory reports and CCAR 2018 projections, as applicable, and the Federal Reserve notes that it will publish a letter containing a description of material enhancements to the supervisory models, including those related to changes in tax law, by March 1, 2018.[16]

    - Beginning with the FR Y-14 reports with data as of December 31, 2017, LISCC firms that are BHCs must attest to the effectiveness of internal controls for FR Y-14 submissions filed throughout 2017, and LISCC firms that are IHCs must attest to the effectiveness of internal controls for the December 31, 2017 FR Y-14 submissions.[17]

    - The Federal Reserve recently extended certain transition provisions in the capital rules for non-advanced approaches firms and, accordingly, those firms are required to continue to apply the transition provisions applicable for calendar year 2017 for the affected items;[18] and

    - Consistent with last year's instructions, firms should not reflect the adoption of a new accounting standard unless the firm has already adopted the standard for financial reporting purposes, even if the firm expects to adopt the standard during the planning horizon.[19]

- ***Horizontal Review Letter.*** Consistent with last year, the Horizontal Review Letter provides that the Federal Reserve will assess the capital planning processes of large and noncomplex firms "through a horizontal review of specific areas of capital planning" that will begin during the third quarter of 2018 and "be conducted as part of the regular supervisory process," with "any supervisory findings and concerns with the [large and noncomplex] firms' capital planning processes . . . addressed through supervisory communications," that is, not through the public objection/non-objection framework for the CCAR qualitative assessment for LISCC and large and complex firms.[20]

- ***2018 DFAST/CCAR Scenarios.*** The Federal Reserve also published the three supervisory scenarios for its annual supervisory stress test program as well as the GMS, counterparty default and market risk components of the stress tests applicable to certain firms. The primary differences between these scenarios or components as compared to those provided in 2017 are outlined below.

    - The 2018 **adverse scenario** is similar to that of 2017 in that it is a global economic recession across economic sectors and regions; however, compared to the 2017 adverse scenario, the 2018 adverse scenario features lower long-term interest rates and a flatter yield curve across all of the economies in the scenario.[21] The path of the unemployment rate in the 2018 scenario is similar to that in the 2017 scenario, with a peak at seven percent in the seventh quarter of the scenario period (albeit from a lower starting rate) and a modest decline by the end of the scenario period. The magnitudes of the declines in house and commercial real estate prices, 12 percent and 15 percent, respectively, are the same as in the 2017 scenario.

    - The 2018 **severely adverse scenario** is a severe global recession accompanied by a global aversion to long-term fixed-income assets.[22] As a result, long-term rates do not fall and yield curves steepen in all the countries and regions included in the scenario. These developments lead to a broad-based and deep correction in asset prices—including in the corporate bond and real estate markets. The principal difference between this scenario and the 2017 severely adverse scenario is that this scenario features a more severe downturn in the U.S. economy. The unemployment rate increases almost six percent (compared to approximately five percent in the 2017 scenario), and house, commercial real estate and equity prices decline by 30, 40 and 65 percent, respectively (compared to 25, 35 and 50 percent, respectively, in the 2017 scenario). The Federal Reserve notes that the "increase in severity reflects the Federal Reserve's scenario design framework for stress testing, which includes elements that create a more severe test of the resilience of large firms when current economic conditions are especially strong."[23] This incorporates a so-called counter-cyclical approach.

    - Unlike the 2017 GMS, the 2018 **GMS** for the **adverse scenario** is regionally focused on a marked decline in the economic outlook for developing Asian markets. The shock in the Asian markets leads to increases in general risk premiums and credit risk, lower U.S. interest rates, declines in most global commodity prices and currencies of commodity exporters, and a broad decline in equity prices.[24] The GMS for the **severely adverse scenario** is designed around three main elements: a sudden sharp increase in general risk premia and credit risk, a rise and steepening of the U.S. yield curve and a general sell-off of U.S. assets relative to other developed countries. The major differences between this year's severely adverse GMS and that of 2017 are a rise and steepening of the U.S. yield curve, greater depreciation of the U.S. dollar relative to other advanced currencies, and more muted shocks to some credit-sensitive assets, such as non-agency residential mortgage-backed securities. These changes are intended to reflect a general sell-off in U.S. markets combined with a less severe stress to illiquid assets.

    - The 2018 **counterparty default scenario component** for the adverse and severely adverse scenarios is the same as applied in 2017. Each firm subject to the counterparty default scenario component will be required to estimate and report the potential losses and capital impacts associated with the default of the counterparty (other than certain sovereign entities and designated central clearing counterparties) that would generate the largest net stressed losses across the firm's securities financing and derivatives activities, calculated by applying the GMS to revalue exposures and collateral.

- As noted above, CCAR 2018 will feature **market risk components** as transitional measures for the six IHCs that meet the threshold for applicability of the GMS in light of the December 2017 changes described above. The 2018 DFAST/CCAR Scenarios also describe these components.

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ENDNOTES

1 "*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. In CCAR, the Federal Reserve uses the same stress test results as in DFAST, except that the CCAR projections reflect firms' planned capital actions instead of the capital action assumptions that are required under the DFAST rules.

2 Federal Reserve, *Comprehensive Capital Analysis and Review 2018: Summary Instructions* (Feb. 1, 2018), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180201a2.pdf (the "*CCAR 2018 Instructions*").

3 Federal Reserve, Division of Banking Supervision and Regulation, *2018 Horizontal Capital Review for Large and Noncomplex Firms* (Feb. 1, 2018) (the "*Horizontal Review Letter*"), *available at* https://www.federalreserve.gov/bcreg20180201a3.pdf.

4 Federal Reserve, *2018 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule* (Feb. 1, 2018), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180201a1.pdf (the "*2018 DFAST/CCAR Scenarios*").

5 *See* Federal Reserve, *Comprehensive Capital Analysis and Review 2017: Summary Instructions for LISCC and Large and Complex Firms* (Feb. 2017), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170203a4.pdf; Federal Reserve, *2017 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule* (Feb. 3, 2017), *available at* https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20170203a5.pdf. For a discussion of the CCAR 2017 instructions and scenarios, please see our Memorandum to Clients entitled *Federal Reserve Issues Instructions, Guidance and Supervisory Scenarios for the 2017 Comprehensive Capital Analysis and Review Program* (Feb. 6, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Banking_Organization_Capital_Plans_and_Stress_Tests_02_06_17.pdf.

6 82 Fed. Reg. 59608 (Dec. 15, 2017). The FR Y-14Q now provides that a firm is subject to the GMS if it (1) has aggregate trading assets and liabilities of $50 billion or more, or aggregate trading assets and liabilities equal to ten percent or more of total consolidated assets, and (2) is not a "large and noncomplex firm" under the Federal Reserve's capital plan rule. The GMS previously applied only to firms with average of total consolidated assets of $500 billion or more.

7 CCAR 2018 Instructions, at 10.

8 2018 CCAR Instructions, at 11-12.

9 2018 CCAR Instructions, at 20.

10 2018 CCAR Instructions, at 20.

11 2018 CCAR Instructions, at 14.

12 Federal Reserve, *Comprehensive Capital and Analysis Review and Dodd-Frank Act Stress Tests: Questions and Answers*, Q (GEN0184), *available at* https://www.federalreserve.gov/publications/comprehensive-capital-analysis-and-review-questions-and-anwers.htm.

13 2018 CCAR Instructions, at 3 and 14.

14 2018 CCAR Instructions, at 1.

15 2018 CCAR Instructions, at 3. For additional information regarding the new CECL accounting standard, please see our Memorandum to Clients entitled *FASB Expected Credit Loss*

ENDNOTES (CONTINUED)

Methodology (June 23, 2016), *available at* https://www.sullcrom.com/siteFiles/Publications/S_Pubication_Client_AlertFASB_Expected_Credit_Loss_Methodology.pdf.

16 2018 CCAR Instructions, at 2 and 18-19.

17 2018 CCAR Instructions, at 3 and 15. For additional information regarding these requirements, please see our Memoranda to Clients entitled *Federal Reserve Finalizes Rule Revising FR Y-14 Forms to Include CFO Attestation Requirements for Certain Large Bank Holding Companies* (Jan. 26, 2016), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Plans_and_Stress_Tests_01_26_16; and *Federal Reserve Finalizes Attestation Requirement for Intermediate Holding Companies of Foreign Banking Organizations and Addresses the Introduction of the Supplementary Leverage Ratio as a Post-Stress Minimum Requirement for the 2017 CCAR Cycle* (Dec. 22, 2016), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Plans_and_Stress_Tests_12_22_16.pdf.

18 2018 CCAR Instructions, at 2. For a more detailed discussion of these extensions, please see our Memorandum to Clients entitled *Federal Banking Agencies Extend Certain Transition Provisions for Non-Advanced Approaches Banking Organizations* (Nov. 22, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_112217.pdf.

19 2018 CCAR Instructions, at 3.

20 Horizontal Review Letter, at 1.

21 2018 DFAST/CCAR Scenarios, at 5.

22 2018 DFAST/CCAR Scenarios, at 5.

23 2018 DFAST/CCAR Scenarios, at 6.

24 2018 DFAST/CCAR Scenarios, at 7.

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CONTACTING SULLIVAN & CROMWELL LLP

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CONTACTS

New York

Thomas C. Baxter Jr.	+1-212-558-4324	baxtert@sullcrom.com
Jason J. Cabral	+1-212-558-7370	cabralj@sullcrom.com
Whitney A. Chatterjee	+1-212-558-4883	chatterjeew@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Elizabeth T. Davy	+1-212-558-7257	davye@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelm@sullcrom.com
Michael T. Escue	+1-212-558-3721	escuem@sullcrom.com
Jared M. Fishman	+1-212-558-1689	fishmanj@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
Wendy M. Goldberg	+1-212-558-7915	goldbergw@sullcrom.com
Charles C. Gray	+1-212-558-4410	grayc@sullcrom.com
Joseph A. Hearn	+1-212-558-4457	hearnj@sullcrom.com
Shari D. Leventhal	+1-212-558-4354	leventhals@sullcrom.com
Erik D. Lindauer	+1-212-558-3548	lindauere@sullcrom.com
Mark J. Menting	+1-212-558-4859	mentingm@sullcrom.com
Camille L. Orme	+1-212-558-3373	ormec@sullcrom.com
Stephen M. Salley	+1-212-558-4998	salleys@sullcrom.com
Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com
Donald J. Toumey	+1-212-558-4077	toumeyd@sullcrom.com
Marc Treviño	+1-212-558-4239	trevinom@sullcrom.com
Benjamin H. Weiner	+1-212-558-7861	weinerb@sullcrom.com

Mark J. Welshimer	+1-212-558-3669	welshimerm@sullcrom.com
Michael M. Wiseman	+1-212-558-3846	wisemanm@sullcrom.com
Washington, D.C.		
Kathryn E. Collard	+1-202-956-7615	collardk@sullcrom.com
Eric J. Kadel, Jr.	+1-202-956-7640	kadelej@sullcrom.com
William F. Kroener III	+1-202-956-7095	kroenerw@sullcrom.com
Stephen H. Meyer	+1-202-956-7605	meyerst@sullcrom.com
Jennifer L. Sutton	+1-202-956-7060	suttonj@sullcrom.com
Andrea R. Tokheim	+1-202-956-7015	tokheima@sullcrom.com
Samuel R. Woodall III	+1-202-956-7584	woodalls@sullcrom.com
Los Angeles		
Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
William F. Kroener III	+1-310-712-6696	kroenerw@sullcrom.com
Tokyo		
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com