

December 27, 2018

Bank Capital Plans and Stress Tests

FDIC and OCC Propose Amendments to Their Stress Testing Rules

SUMMARY

On December 18, the FDIC and the OCC issued proposed rules that would amend their respective stress testing rules that implement the stress testing requirements of Section 165 of the Dodd-Frank Act.¹ Consistent with the requirements imposed by Section 401 of the Economic Growth, Regulatory Relief and Consumer Protection Act (“EGRRCPA”), the proposed rules would revise the minimum threshold for national banks, federal savings associations, and FDIC-supervised state nonmember banks and state savings associations to conduct stress tests from \$10 billion to \$250 billion, and would reduce the number of required stress testing scenarios from three to two by eliminating the supervisory “adverse” scenario.

The proposed rules would also revise the frequency by which certain national banks, federal savings associations and FDIC-supervised state nonmember banks and state savings associations would be required to conduct stress tests, and make certain other conforming changes to the agencies’ respective stress testing rules.

As of the date of this memorandum, the Federal Reserve has not issued a proposed rule to eliminate the supervisory “adverse” scenario for purposes of its stress testing rules applicable to the bank holding companies and state member banks it supervises and to make other corresponding changes that would be applicable to state member banks.² However, the FDIC notes in its memorandum accompanying its draft proposal that “the FDIC staff developed the proposed rule in coordination with the staff of the [Federal Reserve] and the [OCC], and it is anticipated that the [Federal Reserve] and OCC will contemporaneously issue consistent and comparable proposed rules.”³

Comments on the proposed rules are due February 19, 2019.

BACKGROUND

As originally enacted, Section 165(i)(2) of the Dodd-Frank Act required a bank holding company, savings and loan holding company or an insured depository institution with total consolidated assets of more than \$10 billion to conduct annual company-run stress tests using “baseline,” “adverse” and “severely adverse” scenarios and required the Federal banking regulators to issue consistent and comparable rules to implement these requirements. In October 2012, the FDIC, Federal Reserve and OCC issued their respective stress testing rules.⁴

On May 24, 2018, Section 401 of EGRRCPA amended Section 165(i)(2) by (i) raising the minimum asset threshold for stress tests from \$10 billion to \$250 billion, (ii) eliminating the “adverse” scenario requirement, and (iii) replacing the requirement for “annual” stress tests with a requirement for “periodic” stress tests.

These EGRRCPA amendments became effective immediately upon enactment for bank holding companies with less than \$100 billion in total consolidated assets and become effective 18 months after the date of enactment, which will be November 24, 2019, for insured depository institutions and savings and loan holding companies. To address this difference in the applicable effective date and the fact that, under EGRRCPA, insured depository institutions and savings and loan holding companies with less than \$100 billion in assets remain subject to Dodd-Frank Act company-run stress testing requirements until November 24, 2019, in July 2018, the FDIC, Federal Reserve and OCC delayed the deadline for all company-run stress testing requirements for institutions with less than \$100 billion in total consolidated assets until November 25, 2019. This relief effectively renders all institutions under the \$100 billion asset threshold, and not just bank holding companies, exempt from company-run stress testing requirements as of the enactment of EGRRCPA.⁵ The proposed rules therefore would codify this relief for insured depository institutions subject to the OCC’s and FDIC’s stress testing rules with between \$10 billion and \$100 billion in total consolidated assets. For banking organizations with \$100 billion or more in total consolidated assets, the deadline for the 2019 company-run stress tests is currently April 5, 2019. It remains to be seen whether banking organizations with between \$100 billion and \$250 billion in total consolidated assets will receive any form of early relief for the 2019 stress testing cycle.

KEY ASPECTS OF THE PROPOSED RULES

In addition to raising the asset threshold from \$10 billion to \$250 billion, the other key aspects of the FDIC and OCC’s proposed rules include the following:

- ***Stress Testing Scenarios.*** Section 401 of EGRRCPA no longer requires the use of the “adverse” stress testing scenario, and the agencies note that, in their experience, the “adverse” stress testing scenario has provided “limited incremental information” beyond what is already provided under the two other scenarios.⁶ The proposed rules would therefore remove the “adverse” scenario but retain the “baseline” and “severely adverse” stress testing scenarios. The proposals do not address, however, whether the agencies intend to provide relief from the “adverse” scenario requirements for

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purposes of the 2019 stress testing cycle. Under the agencies' stress testing rules, scenarios must be provided by February 15, 2019 for the 2019 stress testing cycle, which is before the end of the comment period and the effective date of the applicable EGRRCPA amendments.

- **Frequency of Stress Testing.** The proposed rules would add a new defined term, "reporting year," as the year in which a subject insured depository institution must conduct, report and publish its stress test. Insured depository institutions that are subsidiaries of bank holding companies that are required to conduct stress tests annually under the Federal Reserve's stress testing rules⁷ would be required to conduct, report and publish stress test results on the same schedule as their bank holding company parent.⁸ All other subject insured depository institutions would be required to conduct, report and publish results of a stress test once every two years, rather than annually, beginning on January 1, 2020 and continuing every even-numbered year thereafter (i.e., 2022, 2024, 2026, etc.).⁹ Under the proposed rules, all subject institutions that would conduct stress tests on a biennial basis would be required to conduct their stress tests in the same year, which would allow the agencies to make comparisons across institutions for supervisory purposes.
- **Transition Provisions.** An insured depository institution that would be subject to the proposed rules as of December 31, 2019 would be required to conduct stress testing in the 2020 reporting year, whereas an institution that would first become subject to the proposed rules after December 31, 2019 (e.g., by exceeding the \$250 billion asset threshold as calculated under the rules) would be required to conduct its first stress test in the reporting year that begins more than three calendar quarters after the date it becomes subject to the rules (e.g., a bank that first became subject to the rules on March 31 of a non-reporting year such as 2023 would be required to first report its stress test in the subsequent reporting year, 2024, whereas a bank that became subject on April 1, 2023 would skip the 2024 reporting year and report its first stress test in the 2026 reporting year). The proposed rules would not, however, include a transition period for subject institutions that move from a biennial requirement to an annual requirement, as the agencies expect that these institutions "would be able to anticipate and make arrangements for this development."¹⁰ The agencies note, however, their supervisory discretion and reservation of authority would permit them to grant an extension where particular circumstances warrant.
- **Frequency of Board Review.** The proposed rules would revise the frequency with which an insured depository institution's board of directors (or board committee) would be required to review and approve stress testing policies and procedures from "annual" to "once every reporting year" to align this requirement with an institution's stress testing cycle under the proposed rules.
- **Reservations of Authority.** The proposed rules retain the reservation of authority pursuant to which each agency can revise the frequency and/or methodology of the stress testing requirements as appropriate for a particular subject insured depository institution, and further clarify that the agencies have the authority to exempt a subject institution from the requirement to conduct a stress test in a given reporting year.
- **Other Changes.** The proposed rules would also remove certain obsolete transitional language, and the FDIC's proposed rule would remove the reference to supervisory guidance in the rule's provisions related to methodologies and practices¹¹ and make certain other technical edits.

In addition to the above, the FDIC's proposed rule includes the following conforming change:

- **Revised Range for As-of Dates.** The Federal Reserve's, OCC's and FDIC's stress testing rules currently require a subject institution with significant trading activity to include trading and counterparty components in the adverse and severely adverse stress testing scenarios. In the FDIC's stress testing rule, the trading data to be used in this component is as of a date between January 1 and March 1 of a calendar year. To achieve consistency with the Federal Reserve's and OCC's stress testing rules, the FDIC's proposed rule would extend this range to run from October 1 of the calendar year preceding the year of the stress test to March 1 of the calendar year of the stress test, and thereby "increase the FDIC's flexibility to choose an appropriate as-of date."¹²

OBSERVATIONS

The FDIC notes in its memorandum accompanying its proposal that, because there are currently no state nonmember banks or state savings associations that exceed the \$250 billion asset threshold, approximately 30 FDIC-supervised institutions subject to the stress testing rules under the pre-EGRRCPA asset threshold will now be excluded from the requirements of Dodd-Frank Section 165(i)(2), and the proposed rule would not immediately apply to any FDIC-supervised institutions. The OCC notes in its Paperwork Reduction Act analysis that, due to the increase in the applicability threshold under the proposed rule, the estimated number of institutions that would be subject to the proposed rule is eight, four of which would become subject to a biennial reporting year.¹³

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ENDNOTES

- ¹ Department of the Treasury, Office of the Comptroller of the Currency, *Amendments to the Stress Testing Rules for National Banks and Federal Savings Associations* (Dec. 18, 2018) (hereafter, the “OCC proposal”); Federal Deposit Insurance Corporation, *Company-Run Stress Testing Requirements for FDIC-Supervised State Nonmember Banks and State Savings Associations* (Dec. 18, 2018) (hereafter, the “FDIC proposal”).
- ² On October 31, the Federal Reserve released a proposal to tailor how certain aspects of the post-crisis bank regulatory framework apply to large U.S. bank holding companies. This proposal would, among other things, revise the Federal Reserve’s rules on company-run stress tests to exempt bank holding companies with less than \$100 billion in total consolidated assets as well as “Category IV” bank holding companies, namely those that have \$100 billion or more but less than \$250 billion in total consolidated assets and that do not have \$75 billion or more in cross-jurisdictional activity, nonbank assets, weighted short-term wholesale funding, or off-balance sheet exposures. This proposal would also revise the frequency of Dodd-Frank Act company-run stress tests for “Category III” bank holding companies. See Board of Governors of the Federal Reserve System, *Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies*, 83 Fed. Reg. 61408 (Nov. 29, 2018). For further information about this proposal and a related proposal issued jointly by the Federal Reserve, the OCC and the FDIC, please see our Memorandum to Clients, *Regulatory Tailoring for Large U.S. Banking Organizations: Federal Bank Regulators Propose Significant Revisions to the Application of Enhanced Prudential Standards and Capital and Liquidity Requirements for Large U.S. Banking Organizations* (Nov. 5, 2018), available at <https://www.sullcrom.com/files/upload/SC-Publication-Regulatory-Tailoring-for-Large-US-Banking-Organizations.pdf>.
- ³ Memorandum from Doreen R. Eberley, Director, Division of Risk Management Supervision, to the FDIC Board of Directors regarding the *Notice of Proposed Rulemaking: Company-Run Stress Testing Requirements for FDIC-supervised State Nonmember Banks and State Savings Associations* (Dec. 18, 2018) (hereafter, the “FDIC Memorandum”).
- ⁴ The agencies’ stress testing rules are codified at 12 C.F.R. Part 46 (OCC), 12 C.F.R. Part 325 (FDIC) and 12 C.F.R. Part 252 (Federal Reserve).
- ⁵ For further information please see our Memorandum to Clients, *Implementation of Financial Services Regulatory Reform Legislation: Federal Banking Agencies Release Statements on How They Will Implement Provisions of the Economic Growth, Regulatory Relief, and Consumer Protection Act That Have Immediate Effect* (July 12, 2018), available at <https://www.sullcrom.com/files/upload/SC-Publication-Implementation-of-Financial-Services-Regulatory-Reform-Legislation.pdf>
- ⁶ FDIC proposal, at 7; OCC proposal, at 8.
- ⁷ This would include global systemically important bank holding companies or bank holding companies with \$700 billion or more in total consolidated assets or \$100 billion or more in total consolidated assets and cross-jurisdictional activity of \$75 billion or more under the proposed amendments to the Federal Reserve’s stress testing rules at 12 C.F.R. Part 252.
- ⁸ See note 2.
- ⁹ The dates and deadlines under the proposed rules would be interpreted relative to the subject institution’s reporting year. For example, a bank subject to a biennial stress testing requirement preparing its 2022 stress test would rely on financial data as of December 31, 2021, use stress test scenarios provided by the appropriate Federal banking agency by no later than February 15, 2022, provide its report of the stress test by April 5, 2022 and publish a summary of the results of its stress test in the period beginning on June 15, 2022 and ending on July 15, 2022. OCC proposal, at 6; FDIC proposal, at 6.
- ¹⁰ FDIC proposal, at 8; OCC proposal, at 9.
- ¹¹ See 12 C.F.R. § 325.5(b)(1). The OCC’s proposed rule does not propose a corresponding change to delete the reference to supervisory guidance in its stress testing rule at 12 C.F.R. § 46.6(c)(1).
- ¹² FDIC Memorandum, at 6. The Federal Reserve and the OCC each published a final rule making this change on February 3, 2017 and February 23, 2018, respectively.

¹³ OCC proposal, at 13.

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