SULLIVAN & CROMWELL LLP

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Banking Organization Capital Plans and Stress Tests

Federal Reserve Announces Limitation and Phase-Out of the Qualitative Objection to Capital Plans and Issues Instructions and Supervisory Scenarios for the 2019 Comprehensive Capital Analysis and Review and Dodd-Frank Act Stress Test Exercises

On March 6, 2019, the Federal Reserve amended[1] the CCAR capital plan rule applicable to bank holding companies ("*BHCs*") with $100 billion or more in total consolidated assets and U.S. intermediate holding companies ("*IHCs*") of foreign banking organizations (collectively, "*firms*") to limit and ultimately phase out the Federal Reserve's ability to object to firms' capital plans on "qualitative" grounds.[2] The Federal Reserve also issued its annual summary instructions for the 2019 CCAR exercise (the "*2019 CCAR Instructions*").[3] Previously, on February 5, 2019, the Federal Reserve had issued its three supervisory scenarios—baseline, adverse and severely adverse (together, the "*2019 DFAST/CCAR Scenarios*")—and exogenous add-on components applicable to certain firms for the 2019 exercise,[4] and had also announced that certain firms with between $100 billion and $250 billion in total consolidated assets would be subject to an extended stress test cycle, with the result that they would not be subject to supervisory stress testing, company-run stress testing, or CCAR for 2019.[5]

Firms that are required or that elect to submit capital plans to the Federal Reserve in 2019 must do so on or before April 5, 2019. The Federal Reserve will release the CCAR 2019 results and its objection or non-objection to submitted capital plans no later than June 30, 2019.

Important elements of these releases are summarized below, with a particular focus on the limitation and phase-out of the qualitative objection and on changes and clarifications to the 2019 CCAR Instructions and 2019 DFAST/CCAR Scenarios, as compared with those issued in 2018.[6]

- ***Limitation and Phase-Out of Qualitative Objection.*** In the 2017 and 2018 CCAR exercises, the only firms that were subject to the possibility of a qualitative objection were those that (i) had at least $250 billion in total consolidated assets, (ii) had at least $75 billion in average total nonbank assets or (iii) were BHCs identified as global systemically important BHCs under the Federal Reserve's capital rules (collectively, "*large and complex firms*"), as the Federal Reserve had previously eliminated the qualitative objection for other firms ("*large and noncomplex firms*").[7] The March 6 amendments to the capital plan rule limit the circumstances under which large and complex firms will face the possibility of the qualitative objection and provide for the eventual phase-out of the CCAR qualitative review.

  For large and complex firms subject to the capital plan rule as of January 1, 2019, the amended rule bifurcates between those that have been subject to CCAR and the possibility of a qualitative objection for any period of four consecutive years and those that have not.

  - If a firm's capital plan has been subject to review and potential qualitative objection for any period of four consecutive years and the firm does not receive a qualitative objection in the fourth year of that period, the firm will no longer be subject to the qualitative review. If a firm receives a qualitative objection in the fourth year, the firm will remain subject to the qualitative review until the year after the first year in which it does not receive a qualitative objection.
  - The materials released by the Federal Reserve provide that the only large and complex firms that are subject to the qualitative review for the 2019 exercise are IHCs that first became subject to CCAR in 2016 or 2017.[8] For a firm that first participated in CCAR in 2016, the period of four consecutive years will run through 2019, and, for a firm that first participated in CCAR in 2017,[9] the period of four consecutive years will run through 2020. For example, a large and complex firm that submitted its first capital plan pursuant to the capital plan rule beginning with the 2016 exercise would be subject to a qualitative objection of its annual capital plan through the 2019 exercise, and a large and complex firm that submitted its first capital plan and was subject to a confidential review process in the 2017 exercise would be subject to a qualitative objection of its annual capital plan through the 2020 exercise.[10]
  - After January 1, 2021, a large and complex firm will remain subject to the qualitative review only if it receives a qualitative objection in the final year of the applicable four-year period and in subsequent years.

  Notably, the amended capital plan rule provides that no firm that becomes subject to CCAR after January 1, 2019 will be subject to the possibility of a qualitative objection. Although the amended rule does not provide for a definitive date as of which the qualitative objection will be eliminated, it contemplates that the qualitative objection will eventually be eliminated for all firms.

- ***Rationale for Limitation and Phase-Out of Qualitative Objection.*** The Federal Reserve notes that the original rationale for the qualitative review and objection framework was to incentivize firms to address the shortcomings in risk management and capital planning practices that it observed during the financial crisis.[11] The limitation and phase-out of the qualitative objection reflect (i) "the continued progress that [CCAR] firms have made in their risk management and capital planning processes," as "most firms either meet or are close to meeting the Federal Reserve's supervisory expectations for capital planning," (ii) firms' "significantly strengthened capital positions," and (iii) "changes to the [Federal Reserve's] supervisory processes."[12]

  With regard to supervisory processes, the Federal Reserve states that, instead of the using the qualitative review, it will "incorporate a robust qualitative assessment of capital planning practices into the traditional supervisory approach."[13] The Federal Reserve also explains that it has already increasingly done so over the past several years,[14] pointing in particular to its recent adoption of a new rating system for large financial institutions (the "*LFI rating system*"). The LFI rating system has a component devoted to capital planning and positions,[15] which "will give supervisors the opportunity to provide more regular, ongoing feedback to firms regarding their capital planning processes."[16] This component includes an evaluation of: (i) the effectiveness of a firm's governance and planning processes used to determine the amount of capital necessary to cover risks and exposures and to support activities through a range of conditions; and (ii) the sufficiency of a firm's capital positions to comply with applicable regulatory requirements and to support the firm's ability to continue to serve as a financial intermediary through a range of conditions.[17] The component rating will reflect a broad assessment of a firm's capital planning and positions, based on horizontal reviews and firm-specific supervisory work focused on capital planning and positions.

- ***Exemption of Certain Firms from CCAR 2019.*** Prior to the enactment of the Economic Growth, Regulatory Relief, and Consumer Protection Act ("*EGRRCPA*") in May 2018, the annual CCAR exercise and other enhanced prudential standards under the Dodd-Frank Act applied to BHCs with total consolidated assets of $50 billion or more. EGRRCPA raised the asset threshold for application of these requirements[18] from $50 to $250 billion, with the changes immediately effective for BHCs with total consolidated assets of less than $100 billion and effective 18 months after enactment for other BHCs. EGRRCPA also provides that BHCs with total consolidated assets of between $100 billion and $250 billion will remain subject to "periodic" supervisory stress tests and that the Federal Reserve has discretion to apply other enhanced prudential standards to those BHCs if it determines that application is appropriate to prevent or mitigate risks to U.S. financial stability or to promote the safety and soundness of the BHCs. In October 2018, the Federal Reserve proposed rules that would subject certain BHCs in this range to supervisory stress testing on a biennial, instead of an annual, basis, and exempt those BHCs from company-run stress testing.[19] In connection with that proposal, the Federal Reserve also stated that it expected to propose amendments to its capital plan rule and CCAR process, including revisions to align with the proposed two-year supervisory stress testing cycle for certain BHCs and removal of certain company-run stress testing requirements.

  In February 2019, the Federal Reserve issued letters to certain firms with total consolidated assets of between $100 billion and $250 billion exempting them from mandatory submission of their capital plans and participation in supervisory stress testing in 2019. For exempt firms, their capital distributions for the 2019 stress test cycle will largely be based on the results from the 2018 supervisory stress tests.[20] Although exempt firms are not required to submit a capital plan to the Federal Reserve in 2019, they may elect to do so. Both the 2019 CCAR Instructions and the 2019 DFAST/CCAR Scenarios reflect this exemption.[21]

- ***Market Risk Components for IHCs with Significant Trading Activity in CCAR 2019.*** In December 2017, the Federal Reserve broadened the scope of applicability of the global market shock component ("*GMS*"), with the effect that the GMS applies to certain IHCs for the first time in CCAR 2019.[22] In addition, these IHCs are also subject to the Counterparty Default Scenario Component for CCAR 2019. In CCAR 2018, instead of applying the GMS and Counterparty Default Scenario Component, the Federal Reserve had subjected these IHCs to interim risk components in the supervisory adverse and severely adverse scenarios.

- ***2019 DFAST/CCAR Scenarios.*** The Federal Reserve published the three supervisory scenarios for its annual supervisory stress test program as well as the GMS and Counterparty Default Scenario Component of the stress tests applicable to certain firms. The primary differences between these scenarios or components as compared to those provided in 2018 are outlined below.

  - The 2019 **severely adverse scenario** is a severe global recession accompanied by a period of heightened stress in commercial real estate markets and corporate debt markets, with the U.S. unemployment rate climbing to a peak of ten percent and real GDP falling about eight percent from its pre-recession peak.[23] As a result, both short- and long-term Treasury rates fall, with long-term rates falling by a somewhat smaller amount, resulting in a mildly steeper yield curve. Financial conditions in corporate and real estate lending markets are stressed severely, causing a widening of spreads between yields on both investment-grade corporate bonds and mortgage rates and yields on Treasury securities. The principal difference between this scenario and the 2018 severely adverse scenario is that the 2019 scenario features a more severe recession and a greater increase in the unemployment rate in the United States. The unemployment rate increases over six percent (compared to just under six percent in the 2018 scenario). In both the 2018 and 2019 severely adverse scenarios, the unemployment rate peaks in the seventh quarter of the planning horizon (3Q 2019 for the 2018 scenario and 3Q 2020 for the 2019 scenario). Asset prices, including house, commercial real estate and equity prices, drop, by 25, 35 and 50 percent, respectively, albeit not as sharply as under the 2018 scenario (which featured declines of 30, 40 and 65 percent, respectively). The Federal Reserve notes that the increase in severity in the recession and rise in unemployment rate "reflects the Board's Policy Statement on the Scenario Design Framework for Stress Testing, which calls for a more pronounced economic downturn when current conditions are especially strong."[24]

- Unlike the 2018 adverse scenario, which featured a hypothetical economic downturn that was qualitatively distinct from the 2018 severely adverse scenario, the 2019 **adverse scenario** features an economic downturn that is generally similar to that of the 2019 severely adverse scenario, but more moderate in magnitude. Under this scenario, the unemployment rate increases to seven percent instead of ten percent under the 2019 severely adverse scenario, and asset prices decline less steeply. The Federal Reserve notes that the approach of using a moderated version of the severely adverse scenario for the adverse scenario "allow[s] for an investigation of the relationship between firm-specific outcomes and the intensity of economic and financial dislocations."[25]

- The 2019 **GMS** for the **adverse scenario** is generally consistent with the 2018 GMS for the adverse scenario, in that it 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.[26] The GMS for the **severely adverse scenario** features a significant weakening in European economic conditions that leads to global market dislocations, affecting the U.S. and developing Asian and other emerging markets.[27] The major differences between this year's severely adverse GMS and that of 2018 include a heightened stress to European assets, a decline in the U.S. yield curve, an appreciation of the U.S. dollar relative to most other currencies, and more muted shocks to U.S.-based assets. These differences are intended to reflect the more Europe-focused nature of the stress and a general flight-to-quality to U.S. markets.[28]

- The 2019 **counterparty default scenario component** for the adverse and severely adverse scenarios is the same as applied in 2018. 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.

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ENDNOTES

1 Federal Reserve, *Amendments to the Capital Rule*, 82 Fed. Reg. 8953 (Mar. 13, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-03-13/pdf/2019-04515.pdf.

2 "*CCAR*" refers to the Federal Reserve's Comprehensive Capital Analysis and Review of capital plans filed 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.

3 Federal Reserve, *Comprehensive Capital Analysis and Review 2019: Summary Instructions* (Mar. 6, 2019), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190306b2.pdf (hereinafter, the "*2019 CCAR Instructions*").

4 Federal Reserve, *2019 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule* (Feb. 2019), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190213a1.pdf (hereinafter, the "*2019 DFAST/CCAR Scenarios*"). On February 13, 2019, the Federal Reserve released corrected scenarios to correct an error in the historical dataset used in its 2019 stress tests. This memorandum refers to the corrected scenarios.

5 Federal Reserve, *Federal Reserve Board releases scenarios for 2019 Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Act stress test exercises* (Feb. 5, 2019), *available at* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190205b.htm.

6 *See* Federal Reserve, *Comprehensive Capital Analysis and Review 2018: Summary Instructions* (Feb. 1, 2018), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180201a2.pdf (hereinafter, the "*2018 CCAR Instructions*"); 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 (hereinafter, the "*2018 DFAST/CCAR Scenarios*"). For a discussion of the 2018 CCAR instructions and scenarios, please see our Memorandum to Clients entitled *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* (Feb. 5, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Banking_Organization_Capital_Plans_and_Stress_Tests_02_05_2018.pdf.

7 In January 2017, the Federal Reserve amended the capital plan rule to exclude the capital plans of "large and noncomplex" firms (those that are not global systemically important BHCs, have less than $250 billion of total consolidated assets, and have less than $75 billion of total nonbank assets) from the possibility of facing an objection on qualitative grounds. For additional details on that amendment, please 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://www.sullcrom.com/siteFiles/Publications/SC_Publication_Banking_Organization_Capital_Plans_and_Stress_Tests_02_01_2017.pdf.

8 *See* CCAR Instructions, at 2, note 4.

If an IHC has a BHC subsidiary that previously participated in CCAR, the Federal Reserve will not consider the IHC to be a successor to the BHC subsidiary for purposes of determining the commencement of the four-year period. The Federal Reserve notes that it will otherwise consider whether a firm is a successor for purposes of the four-year period on a case-by-case basis. In addition, if the Federal Reserve has permitted a foreign banking organization to establish two or more IHCs, the Federal Reserve will consider the first year that the first IHC participated in CCAR to be the commencement of the four-year period for all of the foreign banking organization's IHCs. 84 Fed. Reg. 8955.

9 For IHCs that submitted their first capital plan subject to a confidential review process, the year of that submission will be considered the first year of the consecutive period of four years. *Id.*

10 *Id*. If the Federal Reserve previously permitted a foreign banking organization to form two or more IHCs under 12 CFR 252.153(c)(4)(ii), the Federal Reserve will consider the first year that the first IHC submitted a capital plan to be the first year of the four-year period for all of the foreign banking organization's IHCs. *Id.* If a foreign banking organization's first IHC submitted its first capital plan in 2017 and the foreign banking organization was permitted to form a second IHC that submitted its first capital plan in 2018, the first year of the four-year period would be 2017 for both IHCs. *Id.*

11 *Id.* at 8954.

12 *Id.* at 8955.

13 *Id.*

14 *Id.* at 8954.

15 83 Fed. Reg. 58725.

16 84 Fed. Reg. 8955.

17 83 Fed. Reg. 58724. The rule establishing the LFI Rating System took effect on February 1, 2019. The FRB will assign initial ratings under the LFI Rating System in 2019 for those BHCs and U.S. IHCs that are subject to the Large Institution Supervision Coordinating Committee framework and in 2020 for all other large financial institutions. For additional details regarding the LFI Rating System, please see our Memorandum to Clients entitled *New Supervisory Rating System for Large Banking Organizations* (Nov. 5, 2018), *available at* https://www.sullcrom.com/files/upload/SC-Publication-New-Supervisory-Rating-System-for-Large-Banking-Organizations.pdf.

18 Although not adopted pursuant to Section 165 of the Dodd-Frank Act, the Federal Reserve has treated the capital plan rule and CCAR exercise as an enhanced prudential standard, including in connection with its implementation of EGRRCPA. For additional information regarding the Federal Reserve's planned approach to implementing provisions of EGRRCPA, please see our Memorandum to Clients entitled *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* (Jul. 12, 2018), *available at* https://www.sullcrom.com/files/upload/SC-Publication-Implementation-of-Financial-Services-Regulatory-Reform-Legislation.pdf.

19 For additional information regarding the October 2018 proposal, see our Memorandum to Clients entitled *Regulatory Tailoring 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.

20 These letters are available on the Federal Reserve's website. Federal Reserve, *Comprehensive Capital Analysis and Review*, *available at* https://www.federalreserve.gov/supervisionreg/ccar.htm.

21 *See* 2019 CCAR Instructions, at 2; 2019 DFAST/CCAR Scenarios, at 1.

ENDNOTES (CONTINUED)

[22] 82 Fed. Reg. 59608 (Dec. 15, 2017). The FR Y-14Q 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 total consolidated assets of $500 billion or more. For CCAR 2018, those IHCs were subject to interim market risk components designed to assess potential losses associated with trading books, private equity positions and counterparty exposures.

[23] 2019 DFAST/CCAR Scenarios, at 4.

[24] 2019 DFAST/CCAR Scenarios, at 5.

[25] 2019 DFAST/CCAR Scenarios, at 5.

[26] 2019 DFAST/CCAR Scenarios, at 6.

[27] 2019 DFAST/CCAR Scenarios, at 6-7.

[28] 2019 DFAST/CCAR Scenarios, at 7.

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