February 22, 2019

Bank Capital Plans and Stress Tests

Federal Reserve Seeks to Enhance Transparency of Its Stress Testing Program Through Amendments to Its Scenario Design Framework, a New Stress Testing Policy Statement, and Enhancements to Supervisory Stress Test Disclosure

On February 5, the Federal Reserve finalized changes[1] to its stress testing program intended to enhance the transparency of the program, which includes the supervisory stress tests applied to U.S. bank holding companies with total consolidated assets of $100 billion or more and U.S. intermediate holding companies of foreign banking organizations in connection with CCAR and DFAST.[2] The changes are largely consistent with those proposed in December 2017.[3]

Specifically, the Federal Reserve:

- Finalized amendments[4] to its Policy Statement on the Scenario Design Framework for Stress Testing[5] (the "*Scenario Design Framework Policy Statement*") that:
  - provide specific guidance regarding when the rise in the unemployment rate in the severely adverse scenario would be expected to be lower than the typical increase; and
  - include a quantitative guide for the path of house prices in the severely adverse scenario;
- Adopted a Stress Testing Policy Statement[6] describing the Federal Reserve's approach for developing, implementing, and validating the models used in its supervisory stress tests; and
- Provided notice of enhancements[7] to the public disclosures relating to supervisory stress test models and results, stating that future disclosures would include:
  - enhanced descriptions of supervisory models;
  - modeled loss rates on loans and, over time, non-loan portfolios with the data grouped by important risk characteristics, as well as summary statistics associated with the instruments in each group; and
  - portfolios of hypothetical loans and the estimated loss rates associated with the loans in each portfolio.

The proposals are described in detail in our December 2017 Memorandum to Clients.[8] The final versions were generally adopted as proposed. Notable clarifications, commentary, and revisions to the December 2017 proposals are described below.

- ***Amendments to the Scenario Design Framework Policy Statement.***
  - ***Delaying inclusion of short-term wholesale funding costs in the adverse and severely adverse scenarios.*** In the preamble to the proposed revisions to the Scenario Design Framework Policy Statement, the Federal Reserve stated that it intended to incorporate explicit factors in the adverse and severely adverse scenarios to capture the cost of funds, particularly wholesale funds, to banking organizations.[9] The inclusion of a funding stress was expected to increase the stringency of the stress test. In the preamble to the final revisions to the Scenario Design Framework Policy Statement, the Federal Reserve noted that it would delay finalizing this element of the proposal.[10] The Federal Reserve added that "reliance by banking organizations on certain runnable liabilities is a key risk dimension that is not currently addressed in the supervisory stress test" and that the Federal Reserve "will continue to research appropriate methods for capturing the impact on capital adequacy of changes in wholesale funding conditions under stress."[11]
  - ***Continuing to consider whether to publish scenarios for comment.*** In the preamble to the final revisions to the Scenario Design Framework Policy Statement, the Federal Reserve noted that it had received comments supporting and opposing the publication of the supervisory scenarios for comment.[12] Commenters opposed to publication cautioned that such publication could incent firms to modify their businesses to change the results of the stress test without modifying their risk profiles, while commenters supporting publication noted that a fully transparent scenario would allow the Federal Reserve to best achieve the benefits of public disclosure.[13] The Federal Reserve "is considering these comments and weighing the costs and benefits of publishing the scenarios for comment."[14]
- ***Stress Testing Policy Statement.***
  - ***Meaning of "highly material" model changes.*** The final Stress Testing Policy Statement specifies that a model change would generally be considered "highly material," and thereby subject to phase-in over two years, if it results in a change in the CET1 ratio of 50 basis points or more, relative to the model used in prior years' supervisory stress tests, for one or more firms.[15] The proposal did not include a quantitative test or guidance regarding which changes would be considered "highly material."
  - ***Scope of changes considered for phase-in.*** The Federal Reserve also clarified that the phase-in of "highly material" model changes applies only to "conceptual changes to models," and not to model changes related to changes in accounting or regulatory capital rules or to "model parameter re-estimation based on newly available data," which are implemented immediately.[16]
    - Although the Federal Reserve did not discuss the implications of this policy for the upcoming implementation of the Current Expected Credit Losses ("*CECL*") method for calculating credit expense and allowances, in December 2018 the Federal Reserve issued a policy statement that delays the incorporation of CECL into the supervisory stress tests.[17] Specifically, the Federal Reserve stated that it "plans to maintain the current framework for calculating allowances on loans in the supervisory stress test until the impact of CECL on banking organizations' financial reporting is better known and understood."[18] The Federal Reserve added that it "intends to maintain this framework for the 2020 and 2021 supervisory stress test cycles and to evaluate appropriate future enhancements to this framework as best practices for implementing CECL are developed."[19]

- **Policy of credit supply maintenance.** As proposed in December 2017, the final Stress Testing Policy Statement provides that the Federal Reserve will assume that firms' balance sheets remain consistent or would grow in the supervisory stress test. In April 2018, the Federal Reserve proposed to revise its rules relating to CCAR and DFAST to implement stress capital requirements for covered firms.[20] In connection with that proposal, the Federal Reserve proposed to revise the Stress Testing Policy Statement to provide that the Federal Reserve would assume that firms maintain constant balance sheets and RWAs in the supervisory stress tests. The Federal Reserve notes in the preamble to the final Stress Testing Policy Statement that the April 2018 proposed changes remain pending and are not being finalized as part of the adoption of the Stress Testing Policy Statement.[21]

- ***Enhanced Model Disclosure.***
  - ***Scope of models to be included in enhanced disclosure.*** The Federal Reserve clarified that it plans to provide enhanced disclosure with respect to all models currently addressed in the model description appendix of the Federal Reserve's DFAST results publication.[22]
  - ***Contents of enhanced model disclosure.*** The Federal Reserve clarified that enhanced disclosure of the supervisory models would include key model equations and key input variables.[23] With respect to the model used to project pre-provision net revenue ("*PPNR*"), the Federal Reserve intends to include projections of certain components of PPNR, including net interest income, noninterest income, and noninterest expense, for each covered company in the Federal Reserve's DFAST results publication.[24]
  - ***Scope and timing of disclosure of modeled loss rates.*** The Federal Reserve clarified the scope of portfolios for which it intends to provide detailed disclosure of modeled loss rates as well as its planned timing for introducing the enhanced disclosures. The Federal Reserve intends to publish modeled loss rates for the "most material loan portfolios" over the next several years, starting with two portfolios in 2019.[25] "Over time," the Federal Reserve plans to extend modeled loss rate disclosures to non-loan portfolios, such as securities.[26] The Federal Reserve noted that specific portfolios for which it will provide enhanced disclosure and the level of detail provided for each portfolio will depend on constraints related to the data reported to the Federal Reserve.[27] The Federal Reserve also stated that it expects to publish the disclosures in the first quarter of each year, beginning with the first quarter of 2019.

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ENDNOTES

[1] *See Federal Reserve Board finalizes set of changes that will increase the transparency of its stress testing program for nation's largest and most complex banks* (February 5, 2019), *available at* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190205a.htm. These changes are consistent with the views recently expressed by Vice Chairman for Supervision Randal Quarles that "[t]ransparency of the stress test and its inputs and outputs is key to the credibility of the stress test," and that "it is prudent to review all our [stress testing] practices to ensure that they are as efficient and transparent as possible and that they remain appropriate in light of changes in the industry that have been achieved." Speech of Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System, entitled *New Chapter in Stress Testing* at the Brookings Institution, Washington D.C. (Nov. 9, 2018), *available at* https://www.federalreserve.gov/newsevents/speech/quarles20181109a.htm. Vice Chairman Quarles has also noted that a current priority "is to preserve the strength of the [stress] test, while improving its efficiency, transparency, and integration into the post-crisis regulatory framework." Speech of Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System, entitled *Inviting Participation: The Public's Role in Stress Testing's Next Chapter* at the Council for Economic Education, New York, New York (Feb. 6, 2019), *available at* https://www.federalreserve.gov/newsevents/speech/quarles20190206a.htm.

[2] "CCAR" refers to the Federal Reserve's Comprehensive Capital Analysis and Review of capital plans filed annually by covered companies 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.

Prior to the enactment of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 ("EGRRCPA") in May 2018, supervisory stress testing requirements under DFAST and other enhanced prudential standards under the Dodd-Frank Act applied to bank holding companies ("BHCs") with total consolidated assets of $50 billion or more. EGRRCPA raised the asset threshold for application of these requirements 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 to supervisory stress testing on a biennial, instead of an annual, basis, and exempt those BHCs from company-run stress testing. 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 proposed removal of certain company-run stress testing requirements. 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.

[3] *See Federal Reserve Board requests comment on package of proposals that would increase the transparency of its stress testing program* (Dec. 7, 2017), *available at* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171207a.htm.

[4] Amendments to Policy Statement on the Scenario Design Framework for Stress Testing (Feb. 5, 2019), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190205a1.pdf (hereinafter "*Scenario Design Framework Policy Statement Release*").

[5] 12 C.F.R. 252 App. A.

ENDNOTES (CONTINUED)

6 Stress Testing Policy Statement (Feb. 5, 2019), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190205a3.pdf (hereinafter "*Stress Testing Policy Statement Release*").

7 Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test (Dec. 8, 2017), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190205a2.pdf (hereinafter "*Enhanced Model Disclosure Notice*").

8 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.

9 Amendments to Policy Statement on the Scenario Design Framework for Stress Testing, 82 Fed. Reg. 59333, 59537 (Dec. 15, 2017), *available at* https://www.govinfo.gov/content/pkg/FR-2017-12-15/pdf/2017-26858.pdf.

10 Scenario Design Framework Policy Statement Release at 11.

11 *Id*.

12 *Id.* at 15.

13 *Id*.

14 *Id.*

15 Stress Testing Policy Statement Release at 24.

16 *Id.*

17 Board of Governors of the Federal Reserve System, *Statement on the Current Expected Credit Loss Methodology (CECL) and Stress Testing* (Dec. 21, 2018), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181221b1.pdf (hereinafter, "*CECL Stress Testing Policy Statement*"). For additional information, see our Memorandum to Clients entitled *Bank Capital Requirements: Federal Banking Agencies Release Final Rule Regarding the Implementation of CECL, and Federal Reserve Provides Guidance on CECL and CCAR* (Dec. 27, 2018), *available at* https://www.sullcrom.com/files/upload/SC-Publication-CECL-Final-Rule-on-Phase-In-and-FRB-Guidance-on-CECL-and-CCAR.pdf.

18 The Federal Reserve specifies that it plans to maintain the current assumption that a firm's allowance for loan and lease losses ("*ALLL*") covers losses over the next four quarters and to spread out differences between actual and stressed ALLL over nine quarters. The Federal Reserve also notes that its projection of expected credit losses on securities will be incorporated into its credit loss estimates, reflecting that CECL will modify the treatment of available-for-sale debt securities by requiring firms to recognize credit losses on individual AFS debt securities through credit loss allowances, instead of through direct write-downs, as is currently the case under U.S. GAAP.

19 CECL Stress Testing Policy Statement at 2.

20 For additional information, see our Memorandum to Clients entitled *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* (Apr. 19, 2018), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_Capital_Plans_and_Stress_Tests.pdf.

21 Stress Testing Policy Statement Release at 12-13.

22 Enhanced Model Disclosure Notice at 8-9.

ENDNOTES (CONTINUED)

[23] *Id.* at 9.

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *See id.* at 9-10.

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