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Bank Capital Plans and Stress Tests

Federal Reserve Issues Instructions and Guidance for the Comprehensive Capital Analysis and Review and Capital Plan Review Programs for 2013: Outline of Certain Key Aspects

On November 9, 2012, the Board of Governors of the Federal Reserve System (the "*Federal Reserve*") issued instructions and guidance[1] for:

- the Comprehensive Capital Analysis and Review program for 2013 ("*CCAR 2013*") applicable to the 19 bank holding companies ("*BHCs*")[2] with total assets of $50 billion or more that were previously subject to CCAR and the Supervisory Capital Assessment Program ("*SCAP*"); and
- the Capital Plan Review program for 2013 ("*CapPR 2013*") applicable to an additional 11 BHCs[3] with total assets of $50 billion or more that were not subject to prior CCARs or SCAP, but were subject to CapPR in 2012.

CCAR 2013 and CapPR 2013 are both being conducted under the Federal Reserve's previously adopted Capital Plan Rule.[4] In addition, elements of CCAR 2013 are being implemented in conjunction with the Federal Reserve's newly finalized Stress Test Rules[5] adopted pursuant to the separate stress test requirements of sections 165(i)(1) and (2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("*Dodd-Frank*"). The following is an outline of certain notable aspects of the CCAR 2013, CapPR 2013 and their respective instructions.

In certain instances, the instructions and guidance for CCAR 2013 and CapPR 2013 contain new provisions, while in others, the new instructions are largely congruous with procedures for previous CCAR and CapPR iterations. Important aspects of CCAR 2013 instructions include:

- ***Limited Adjustments to Planned Capital Actions.*** In contrast to past CCARs, the Federal Reserve will provide a BHC subject to CCAR 2013 ("*CCAR 2013 BHCs*") with the initial results of the supervisory "post stress analysis of capital results" and one opportunity to make a downward adjustment[6] to its planned capital distributions from its initial capital plan submission *before* the Federal Reserve renders a final public objection/non-objection decision with respect to the institution's proposed capital plan. Any downward adjustment in proposed capital distributions by the CCAR 2013 BHC will be taken into account in the Federal Reserve's final decision. Although this adjustment will nominally afford CCAR 2013 BHCs a limited opportunity to overcome a preliminary objection before a final decision is made, its value will be virtually non-existent unless there can be a robust dialogue with the Federal Reserve that would enable a CCAR 2013 BHC to understand the Federal Reserve's position and change the CCAR 2013 BHC's analysis. In addition, the Federal Reserve intends to publicly disclose an institution's capital ratios under the supervisory severely adverse stress test scenario using *both* the CCAR 2013 BHC's original planned capital actions *and* the capital actions that were revised under this limited adjustment mechanism.[7] As a consequence, even if a CCAR 2013 BHC ultimately receives a Federal Reserve non-objection to its capital plan based on adjusted capital distributions, the fact that the CCAR 2013 BHC did so will be effectively publicly disclosed, as will the fact, in certain circumstances, that the Federal Reserve would have objected to the original capital plan, for example, because the initial proposed capital distributions would have caused the institution to dip below the 5 percent minimum Tier 1 common equity requirement under the severely adverse scenario. The effectively public nature of the downward adjustment mechanism will likely further limit the practical value of the one-time adjustment for CCAR 2013 BHCs.

- ***Other Disclosure Provisions – Timing and Content*****.** Disclosure of the results of the Federal Reserve's supervisory stress tests under the supervisory severely adverse scenario will be published by March 31, 2013.[8] In contrast, disclosure under CCAR 2012 and SCAP occurred in mid-April – immediately prior to the time earnings are typically released. The Federal Reserve indicated it intends to disclose for each BHC "detailed results" of the supervisory stress tests, including stressed losses and revenues (which will include, among other information, detailed information related to loan losses, realized gains/losses on available-for-sale and held-to-maturity securities and trading and counterparty losses). Post-stress capital ratios will be published *both* (i) based on the standardized capital action assumptions across institutions in accordance with the Stress Test Rules (discussed further below)[9] and (ii) using each CCAR 2013 BHC's own planned capital actions in the institution's submitted capital plan and any adjustments to those planned capital actions. This dual disclosure raises the possibility that the actual amount of approved capital distributions for a particular institution may be reverse engineered.

  In addition to the disclosure required under CCAR 2013 described above, under the Stress Test Rules, CCAR 2013 BHCs for the first time will have to disclose the results of their annual company-run stress tests between March 15, 2013 and March 31, 2013.[10] As is the case with the supervisory scenarios, only the results of the severely adverse company-run scenario must be disclosed.[11] The disclosure of both the supervisory and company stress test results will compound the so-called "black box" model problem (discussed below) inherent in the supervisory scenarios. BHCs will have little ability to explain the differences. Nonetheless, we anticipate that most BHCs will delay the publication of their company results until the supervisory results are available so that there is some opportunity to explain any differences.

- ***BHC-Run Scenarios.*** Consistent with the Capital Plan Rule and the Stress Test Rules, a CCAR 2013 BHC will be required to submit as part of its capital plan the results of its company-run stress test using three supervisory macro-economic scenarios to be provided by the Federal Reserve – supervisory baseline, adverse and severely adverse scenarios.[12] In addition, each CCAR 2013 BHC must conduct stress tests based on its own scenarios, which must include, at minimum, a stress scenario and a baseline scenario.[13] The instructions provide that the stress scenario should be based on a "coherent, logical narrative of a *severely adverse* economic and financial market environment and potential BHC-specific events".[14] This is presumably the equivalent of the supervisory severely adverse scenario.

- ***Assumptions Related to Capital Distributions.*** For each of the supervisory scenarios, a CCAR 2013 BHC is required to include in its capital plan *pro forma* capital projections using the standardized capital action assumptions common across institutions (for example, assuming (x) common stock dividends equal the quarterly average amount of common stock dividends for the previous year for purposes of quarters 2 through 9 of the planning horizon and (y) no redemption or repurchase of regulatory capital instruments) required under the Stress Test Rules. For the supervisory baseline and severely adverse scenarios, CCAR 2013 BHCs also must include *pro forma* projections using the CCAR 2013 BHC's own planned capital actions as reflected in the capital plan submitted.[15] For the BHC-baseline scenario, a CCAR 2013 BHC must use its planned capital actions when determining the *pro forma* projections.[16] For the BHC-stress scenario, a CCAR 2013 BHC must use its "alternative capital actions" (that is, a CCAR 2013 BHC's assumed capital actions in the event of its stress scenario, which may, of course, differ from its planned capital actions).[17]

- ***Treatment of Planned Capital Distributions Under Severely Adverse Conditions.*** Despite the requirement for a CCAR 2013 BHC to describe separately in its capital plan its contemplated alternative capital actions in the event that the BHC-stress scenario comes to pass,[18] the Federal Reserve's evaluation of an institution's capital plan and planned capital distributions will continue to rest on whether the CCAR 2013 BHC "would be capable of continuing to meet supervisory expectations for minimum capital ratios . . . and a tier 1 common capital ratio of at least 5 percent through the planning time horizon *even if* severely adverse stress conditions emerged and the [CCAR 2013] BHC *did not* reduce planned capital distributions."[19] This has the practical effect of limiting planned capital distributions to those that could be made in the severely adverse scenario.

- ***Transparency of Supervisory Models.*** The transparency of the models used by the Federal Reserve when conducting supervisory stress tests has been a significant source of concern. In the preamble to the final Stress Test Rules, the Federal Reserve acknowledged this concern and indicated that it was considering how to provide more transparency without reducing incentives to develop better internal stress test models reflecting idiosyncratic risks and consider the results of such models in the capital planning process.[20] Nevertheless, the CCAR 2013 instructions provide no additional clarity regarding the Federal Reserve's models other than to note that "[s]upervisory models and assumptions will be applied in a consistent manner across all [CCAR 2013] BHCs".[21] Likewise, the instructions do not address the related problem of communication between BHCs and the Federal Reserve regarding the process.

- ***Market Risk.*** In order to project risk-weighted assets over the nine-quarter planning horizon, certain CCAR 2013 BHCs with large trading portfolios that are subject to the Federal Reserve's market-risk capital rules will use (i) for the first quarter of the planning horizon, the market-risk capital rules in effect on December 31, 2012[22] and (ii) for the remaining eight quarters, the recently promulgated Market Risk Rules[23] that will go into effect on January 1, 2013.[24] The Market Risk Rules introduce new risk capital requirements, including an incremental risk capital requirement, that will require the development of new models. Before using any new internal model to calculate its market-risk capital requirement, however, a BHC must receive the prior written approval of the Federal Reserve.[25] Without approval to use one or more of its specific risk models prior to the submission of its capital plan,[26] a BHC must use the standardized measurement method for determining specific risk capital charges, the application of which could result in significantly higher capital charges for a covered position than would be assigned under an applicable internal model.

- ***Basel III[27] "Glide Path".***

  - As in CCAR 2012, CCAR 2013 requires a CCAR 2013 BHC to demonstrate that "it can achieve, readily and without difficulty, the ratios required by the Basel III framework as it would come into effect",[28] and confirms that the "Basel III framework" for purposes of CCAR 2013 is as reflected in the federal banking agencies'[29] recent notices of proposed rulemakings implementing Basel III in the U.S.[30] The CCAR 2013 instructions, however, do not appear to reference the application of the newly proposed Standardized Approach notice of proposed rulemaking.

  - Even if a CCAR 2013 BHC meets the Basel III minimums during the transition period, if it is below the 7 percent common equity tier 1 ("*CET1*") target (which comprises the sum of the CET1 minimum and capital conservation buffer capital requirements) on a fully phased-in basis, the CCAR 2013 BHC would be expected to maintain "prudent earning retention policies".[31]

- Although the federal banking agencies have yet to enact or propose rules implementing the capital surcharge on global systemically important banks ("*G-SIBs*") in the U.S., the CCAR 2013 instructions provide that, as part of its required Basel III transition plan, a CCAR 2013 BHC should include its "best estimate" of any capital surcharge for systemically important financial institutions that may be required along with an explanation of its estimate.[32] However, given that under the proposal, the G-SIB surcharge would not technically come into effect until 2016 – outside the nine quarter planning horizon for CCAR 2013 – it is unclear whether this requirement would need to be considered for purposes of the *pro forma* capital calculations, as opposed to the Basel III transition plan, for CCAR 2013.[33]

- ***Global Market Shock Component of Scenarios.*** As in CCAR 2012, six CCAR 2013 BHCs with large trading operations will be required to include a global market shock component in their capital plans. In particular, these CCAR 2013 BHCs will be required to include this global market shock component in their supervisory adverse and severely adverse scenarios, and conduct a stress test of their trading book, private equity positions and counterparty credit exposures as of a particular market close date.[34]

As noted, CapPR 2013 is, like CCAR 2013, an application of the Capital Plan Rule. Unlike CCAR 2013, however, CapPR is not being conducted pursuant to the Stress Test Rules for this year – BHCs subject to CapPR 2013 ("*CapPR 2013 BHCs*") will not be subject to those requirements until the stress test cycle that commences in the fall of 2013. Although the requirements of CCAR 2013 and CapPR 2013 are largely comparable, with each requiring a substantial amount of information and, as a result, devotion of substantial time and resources by the affected BHCs, CapPR 2013's requirements are generally less rigorous than those of CCAR 2013. Notable additional distinctions between the two programs include:

- Consistent with CapPR 2012, the Federal Reserve will not disclose BHC-specific results for CapPR 2013 or assess the capital plans of BHCs subject to CapPR 2013 ("*CapPR 2013 BHC*") based on supervisory estimates derived from supervisory models.
- Unlike CCAR 2013, CapPR 2013 will not require CapPR 2013 BHCs to submit results using the adverse supervisory scenario, although institutions will need to submit results (i) related to the baseline and severely adverse supervisory scenarios, and (ii) based on their own scenarios, including, at minimum, a baseline and stress scenario.
- CapPR 2013 BHCs are not required also to use the capital action assumptions from the Stress Test Rules when determining the results of applicable BHC and supervisory scenarios.[35]

In addition, in both the CCAR 2013 instructions and CapPR 2013 instructions, the Federal Reserve states that a BHC subject to the Capital Plan Rule "should notify the Federal Reserve as early as possible before issuing any capital instrument that counts as regulatory capital and that was not included in its capital plan", and then notes that distributions on a newly issued instrument not contemplated by the BHC's capital plan (non-cumulative perpetual preferred stock, for example) is subject to the prior approval (if more than *de minimis*) or prior notice (if *de minimis*) provisions of the Capital Plan Rule.[36]

Finally, in addition to the BHC-level stress tests required under CCAR 2013 and CapPR 2013, separate company-run subsidiary depository institution-level stress tests are required for certain institutions under the stress test rules adopted by the federal banking agencies pursuant to stress test requirements under sections 165(i)(1) and (2) of Dodd-Frank.[37] These depository institution-level stress tests generally use the same three macro-economic scenarios as will be used for CCAR 2013 and CapPR 2013.[38] State banks that are members of the Federal Reserve System and are subsidiaries of SCAP BHCs must comply with the annual company-run stress test requirements starting with the initial 2012/2013 stress test cycle.[39] National bank and state non-member bank subsidiaries of CCAR and CapPR 2013 BHCs with average total assets of $50 billion or more (irrespective of whether the institution was subject to SCAP) must also comply with the annual company-run stress test requirements starting with the initial 2012/2013 stress test cycle.[40] The results of these depository institution-level company-run stress tests, in all cases, must be publicly disclosed, although a depository institution subsidiary of a BHC may generally rely on the disclosure of its parent BHC to satisfy the disclosure requirement.

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ENDNOTES

1 *See* Federal Reserve, *Comprehensive Capital Analysis and Review 2013: Summary Instructions and Guidance* (Nov. 9, 2012) (the "*CCAR 2013 instructions*"); Federal Reserve, *Capital Plan Review: Summary Instructions and Guidance* (Nov. 9, 2012) (the "*CapPR 2013 instructions*").

2 The institutions subject to CCAR 2013 are: Ally Financial Inc.; American Express Company; Bank of America Corporation; The Bank of New York Mellon Corporation; BB&T Corporation; Capital One Financial Corporation; Citigroup Inc.; Fifth Third Bancorp; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Keycorp; MetLife, Inc.; Morgan Stanley; The PNC Financial Services Group, Inc.; Regions Financial Corporation; State Street Corporation; SunTrust Banks, Inc.; U.S. Bancorp; and Wells Fargo & Company.

3 The institutions subject to CapPR 2013 are: BBVA USA Bancshares Inc.; BMO Financial Corp.; Citizens Financial Group Inc.; Comerica Inc.; Discover Financial Services; HSBC North America Holdings Inc.; Huntington Bancshares Inc.; M&T Bank Corporation; Northern Trust Corporation; UnionBanCal Corporation; and Zions Bancorporation.

4 *See* 12 C.F.R. § 225.8 (the "*Capital Plan Rule*"). The Capital Plan Rule became effective December 30, 2011. For additional information, please refer to our memorandum, dated November 29, 2011, titled *Bank Capital Plans: Federal Reserve Board Issues Final Rule Regarding Capital Plan and Formal Stress Test Requirements for Certain Large Bank Holding Companies*. This memorandum is available at http://www.sullcrom.com/Bank-Capital-Plans-11-29-2011/.

5 *See* Federal Reserve, *Supervisory and Company-Run Stress Test Requirements for Covered Companies*, 77 Fed. Reg. 62378 (Oct. 12, 2012) (to be codified at 12 C.F.R., subparts F and G to part 252) (the "*Stress Test Rules*"). For additional information, please see our memorandum, dated October 26, 2012, titled *Stress Test Rules: Federal Banking Agencies Publish Final Stress Test Rules on Supervisory and Company-Run Stress Test Requirements Imposed by Dodd-Frank* ("*Dodd-Frank Stress Test Memorandum*"). This memorandum is available at http://www.sullcrom.com/Stress_Test_Rules/.

6 This adjustment mechanism does not permit a BHC to *increase* the amount of planned capital distributions based on the Federal Reserve's initially reported supervisory stress test results.

7 *See* CCAR 2013 instructions, at 29 (Table A.3). Table A.3 is the template for the Federal Reserve's proposed disclosure of minimum stressed Tier 1 common ratios for each of the CCAR 2013 BHCs for Q4 2012 to Q4 2014 under the supervisory severely adverse scenario. The template instructions contemplate disclosure both using the capital actions reflected in capital plans as initially submitted in January 2013 and as revised pursuant to the limited adjustment mechanism discussed above.

8 *Id.*, at 2, 21, 22.

9 *Id.*, at 15. *Id.*, at 21, 22, Appendix 2.

10 12 C.F.R. § 252.148(c).

11 *Id.* § 252.148(b).

12 *See* CCAR 2013 instructions, at 2.

13 A BHC is permitted to use the supervisory baseline macro-economic scenario as its company-generated baseline scenario if the supervisory scenario "appropriately represents its view of the most likely outlook for the risk factors salient to the BHC". *Id.*, at 5, fn. 20.

14 *Id.*, at 6 (emphasis added).

15 *Id.*

16 *Id.*, at 5, 6.

ENDNOTES (continued)

17 *Id.*, at 6.

18 *Id.*

19 *Id.*, at 17, 18 (emphasis added).

20 77 Fed. Reg. 62378, 62378.

21 CCAR 2013 instructions 2013, at 2.

22 *See* 12 C.F.R., Appendix E to Part 225.

23 *See* 77 Fed. Reg. 53060 (Aug. 30, 2012) (the rules set forth therein, the "*Market Risk Rules*").

24 CCAR 2013 instructions, at 11.

25 12 C.F.R., Appendix E to Part 225, § 3(c)(1); Market Risk Rules, § 3(c)(1).

26 Whether model approval has been received would be determined on a specific model by model basis. CCAR 2013 instructions, at 11.

27 "*Basel III*" generally refers to the capital and liquidity framework set forth in the following documents published by the Basel Committee on Banking Supervision (the "*Basel Committee*"): *Basel III: A global regulatory framework for more resilient banks and banking systems* and *Basel III: International framework for liquidity risk measurement, standards and monitoring*.

28 *Id.*, at 2. *See also Id.*, at 18 (discussing Basel III transition plans).

29 As used in this memorandum, the "*federal banking agencies*" refers to the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

30 *See* 77 Fed. Reg. 52792 (Aug. 30, 2012); 77 Fed. Reg. 52978 (Aug. 30, 2012); 77 Fed. Reg. 53060 (Aug. 30, 2012).

31 CCAR 2013 instructions, at 18. CCAR 2013 BHCs that exceed the transition targets but do not meet the fully phased-in targets are expected to submit plans reflecting an increase of capital at a sufficient pace to demonstrate "continual progress toward full compliance with the proposed Basel III framework as proposed to implemented in the United States". *Id.* In addition if a CCAR 2013 BHC's projections suggest it would fall below the Basel III transitional targets, it must propose actions that "reflect affirmative steps to improve the [CCAR 2013] BHC's capital ratios", including actions such as capital raises. *Id.*

32 *Id.*, at 2, 14, 18. The Financial Stability Board (the "*FSB*") has recently released preliminary assignments of the 28 G-SIBs previously identified by the FSB, including U.S. G-SIBs, to buckets corresponding to the required level of additional loss absorbency. *See* FSB, *Update of Group of Global Systemically Important Banks (G-SIBs)*, Annex I (Nov. 1, 2012). In light of the foregoing, it is somewhat unclear why the CCAR 2013 instructions require BHCs to use an estimate rather than allowing them to simply rely on the FSB's recent assignment. One possible explanation is that the FSB's allocation was based on "end-2011" data and will be updated in the future, including in November 2013. *Id.*, ¶ 6. As a result, BHCs may need to consider whether circumstances have or may change in the future in a way that may impact their applicable G-SIB surcharge, if any.

33 The Basel Committee recently adopted principles for national regulators to apply for purposes of determining capital surcharges for "domestic" (as opposed to "global") systemically important financial institutions ("*D-SIBs*"). Basel Committee on Banking Supervision, *A Framework for Dealing with Systemically Important Banks* (Oct. 2012), *available at* http://www.bis.org/publ/bcbs233.pdf. The CCAR 2013 instructions do not appear to require a CCAR 2013 BHC to take into account the Basel Committee's D-SIB proposal – likely because the proposed methodology is less well defined at this point than the G-SIB framework (for example, the Basel Committee's D-SIB principles do not establish "surcharge buckets" or percentage

capital surcharges for those buckets) and are subject to a great deal of discretion by national regulators.

[34] CCAR 2013 instructions, at 6, 12.

[35] CapPR 2013 instructions, at 5.

[36] *Id.*, at 18; CCAR 2013 instructions, at 22.

[37] Federal Deposit Insurance Corporation ("FDIC"), *Annual Stress Test*, 77 Fed. Reg. 62417 (Oct. 15, 2012); Federal Reserve, *Annual Company-Run Stress Test Requirements for Banking Organizations with Total Consolidated Assets Over $10 Billion Other Than Covered Companies*, 77 Fed. Reg. 62396 (Oct. 12, 2012); Office of the Comptroller of the Currency (the "OCC"), *Annual Stress Test*, 77 Fed. Reg. 61238 (Oct. 9, 2012).

[38] *See, e.g.*, 77 Fed. Reg. 61238, 61243 (OCC).

[39] *See* 12 C.F.R. § 252.153(a)(2).

[40] *See Id.* § 46.2(b)(2) (OCC); *Id.* § 325.203(a)(3) (FDIC).

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