

February 1, 2017

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

On January 30, 2017, the Federal Reserve published a final rule,¹ initially proposed on September 26, 2016,² that will modify the CCAR capital plan and stress testing rules applicable to bank holding companies (“BHCs”) with \$50 billion or more in total consolidated assets and U.S. intermediate holding companies (“IHCs”) of foreign banking organizations (collectively, “CCAR firms”).³ Most notably, beginning with the 2017 CCAR and DFAST cycle, the final rule will exclude the capital plans of “large and noncomplex” CCAR firms (those that are not global systemically important banks (“G-SIBs”), and that have less than \$250 billion of total consolidated assets and less than \$75 billion of total nonbank assets) from CCAR’s qualitative review, and the capital plans of large and noncomplex firms will no longer be subject to potential objection on qualitative grounds. Beginning April 1, 2017, the final rule will also reduce the *de minimis* exception for capital distributions above the amount reflected in a CCAR firm’s capital plan from 1 percent of Tier 1 capital to 0.25 percent of Tier 1 capital. These and other key elements of the final rule are summarized below, with a particular focus on changes and clarifications to the proposed rule and elements that were adopted as proposed, notwithstanding comments recommending changes.⁴

- ***Eliminating the qualitative CCAR assessment for large and noncomplex CCAR firms, with modified criteria for identifying such firms.*** The final rule adopts the proposal’s removal of large and noncomplex firms from CCAR’s qualitative review; however, it modifies the criteria for identifying a large and noncomplex firm.

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- Under the final rule, a firm will be considered “large and noncomplex” if (1) it is not a G-SIB (that is, it has not been identified as a global systemically important BHC based on its “Method 1” surcharge score)⁵, (2) it has total consolidated assets of at least \$50 billion but less than \$250 billion, and (3) it has nonbank assets of less than \$75 billion.⁶ The final rule also eliminates a requirement included in the proposal that the CCAR firm must have on-balance sheet foreign exposure of less than \$10 billion in order to be considered large and noncomplex. The Federal Reserve noted that the new requirement that all G-SIBs be treated as “large and complex” “mitigates the potential that the proposed foreign exposure test may include firms that are not complex,” while continuing to capture and apply the qualitative CCAR assessment to “the most systemically important U.S. banking organizations.”⁷
 - While the Federal Reserve will not object to the capital plan of a large and noncomplex firm on qualitative grounds, it will incorporate an assessment of the firm’s capital planning process into regular, ongoing supervisory activities and through targeted, horizontal assessments of particular aspects of capital planning.
- The Federal Reserve did not modify the final rule in response to comments that certain asset types—such as cash and bank-permissible assets—should be excluded from the calculation of nonbank assets for purposes of determining whether a firm is large and noncomplex. The Federal Reserve explained that all assets held by nonbank entities—including assets “that present low inherent risk”—should be included in the measure because those assets can be used in connection with “complex activities,” such as prime brokerage and trading activities.⁸ In addition, the Federal Reserve indicated that excluding specific assets from the measure could undermine the measure’s transparency.⁹
- The Federal Reserve clarified that firms meeting the large and noncomplex criteria above will be treated as large and noncomplex, and excluded from application of CCAR’s qualitative review, even if they are CCAR firms subject to the LISCC framework (“LISCC firms”).¹⁰
- The Federal Reserve also clarified that all LISCC firms (regardless of whether or not they are large and noncomplex) and all large and complex firms remain subject to the Federal Reserve’s “highest expectations for capital planning as set forth in SR Letter 15-18.”¹¹ The Federal Reserve also stated that it will amend the applicability thresholds in both SR Letter 15-18 and SR Letter 15-19¹² to reflect the definition of a large and noncomplex firm set forth in the final rule.¹³ As of the publication of this memorandum, the Federal Reserve has not posted the amended versions of these SR Letters. If the Federal Reserve revises the applicability criteria for SR Letter 15-18 to add a \$75 billion nonbank asset threshold and to remove the foreign exposure threshold, the amendments will be of most significance for CCAR firms that are not LISCC firms and that either (i) will not be treated as large and noncomplex firms (and therefore will become subject to SR Letter 15-18) because they have \$75 billion or more in nonbank assets or (ii) will be treated as large and noncomplex firms because of the elimination of the foreign exposure threshold (and therefore will no longer be subject to SR Letter 15-18).
- **Reducing the de minimis exception and imposing a “blackout period.”** The Federal Reserve is adopting without modification the proposed changes to the rules applicable to capital distributions not reflected in a CCAR firm’s capital plan.¹⁴
 - Beginning April 1, 2017, the *de minimis* threshold below which CCAR firms may provide prior notice (rather than obtain prior approval) for capital distributions not reflected in the CCAR firm’s capital plan will be reduced from 1 percent to 0.25 percent of Tier 1 capital.¹⁵ Consistent with the proposal, the Federal Reserve explained that this reduction is a response to an observed pattern of certain firms

using the *de minimis* exception as an “add-on” to “increase their common stock repurchases by the maximum amount allowed under the exception,” rather than to address unanticipated events that improve capital levels, which the Federal Reserve identified as the exception’s intended purpose.¹⁶ The Federal Reserve also indicated that use of the exception as an “add-on” instead of for its intended purpose could “call into question the strength of a firm’s capital planning processes.”¹⁷ Consistent with the proposal, the Federal Reserve did not, however, add requirements to its capital plan rule that would seek to tie use of the *de minimis* exception to unanticipated events.

- Effective for CCAR 2017, the Federal Reserve will impose a “blackout period” during the second calendar quarter (the period in which the Federal Reserve conducts the CCAR exercise) on the ability of a CCAR firm to submit prior notice of its intention to use the *de minimis* exception or to submit a request for prior approval for a capital distribution that is not reflected in the firm’s capital plan to which it has received a non-objection.¹⁸ The Federal Reserve explained that this blackout period will ensure that its CCAR assessment is a comprehensive assessment of the BHC’s capital adequacy “based on information that is as accurate and complete as possible.”¹⁹ Noting that “firms should be able to plan the capital distributions for the [second quarter] and include those planned distributions in their CCAR exercise,” the Federal Reserve suggested that, should an exigent circumstance arise, a firm may resubmit its capital plan and, depending on the circumstances, the Federal Reserve may expedite its review of the resubmitted plan.²⁰
- The Federal Reserve clarified that, in making a determination on a CCAR firm’s capital distribution request, it will take into account the size and complexity of the requesting firm.²¹ Thus, a capital distribution request from a LISCC or a large and complex firm will likely require stronger justification and more supporting evidence (such as updated stress test results) than a request from a large and noncomplex firm.²²
- ***Modest changes to reporting requirements for large and noncomplex CCAR firms.*** The Federal Reserve is adopting, generally as proposed, modifications to the Capital Assessments and Stress Testing Report (the Form FR Y-14 series of reports) intended to reduce burdens for large and noncomplex firms.
 - The Federal Reserve is adopting, as proposed, an increased materiality threshold used to identify material portfolios for purposes of submitting data schedules to FR Y-14Q and FR Y-14M.²³ Under the final rule, a “material portfolio” is a portfolio with asset balances greater than either \$5 billion or 10 percent of Tier 1 capital (increased from 5 percent of Tier 1 capital), applicable beginning with the first “as of” date following the final rule’s becoming effective.²⁴
 - In modeling losses on immaterial portfolios, the Federal Reserve will apply the median loss rate, rather than the loss rate equal to the 75th percentile, among firms that report data to the Federal Reserve to *all* firms subject to the supervisory stress test.²⁵ Under the proposal, the Federal Reserve would have applied the median loss rate only to large and noncomplex firms.²⁶ The Federal Reserve expanded the use of the median loss rate to avoid discouraging firms from reporting a portfolio as immaterial.²⁷
 - As in the proposal, large and noncomplex CCAR firms will not be required to include in their capital plan submissions certain supporting documentation regarding their models (although they must produce such supporting materials upon request) and will no longer be required to complete certain sub-schedules of the FR Y-14A Schedule A (Summary).²⁸ The Federal Reserve did not modify the final rule in response to comments requesting that it also exempt some or all CCAR firms from other FR Y-14A requirements, stating that it will continue to use the information

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provided in response to those requirements in connection with the CCAR qualitative assessment for large and complex firms and the supervisory reviews of capital planning of large and noncomplex firms.²⁹

- The Federal Reserve similarly did not modify the final rule in response to requests that it remove the requirement that firms perform a stress test in the adverse scenario and/or that it reduce the FR Y-14A reporting requirements related to the adverse scenario.³⁰ The Federal Reserve explained that the adverse scenario stress test is a statutory requirement of the Dodd-Frank Act and that it uses the information on the adverse scenario to inform its qualitative capital plan review and to assess, on a macroeconomic level, the ability of firms to withstand a variety of economic conditions.³¹

Other important elements of the proposal that will be adopted without further modification include:

- **Expansion of period for market shock “as-of” date.** The Federal Reserve may require CCAR firms with significant trading activity to include a trading and counterparty component (or “global market shock”) in their company-run stress tests.³² Starting with the 2018 CCAR cycle the beginning of the window for the as-of date for this market shock will be changed from January 1 of the year of the relevant stress test cycle to October 1 of the prior year.³³ As a result, the window for the 2018 CCAR cycle will be October 1, 2017 to March 1, 2018.³⁴ The Federal Reserve clarified that it will not change its practice of allowing firms to use data from weekly internal risk reporting for the week of the chosen as-of date, and that the reporting deadlines for FR Y-14 schedules that are related to the global market shock will also remain the same.³⁵
- **Expansion of transition period for new CCAR BHCs.** Consistent with the proposal, the final rule modifies the timeline within which a BHC that crosses the \$50 billion asset threshold (a “new CCAR BHC”) must submit capital plans and comply with reporting requirements and the Federal Reserve’s DFAST rules.³⁶
 - Most notably, the final rule moves from December 31 to September 30 the cutoff date after which a new CCAR BHC must submit a capital plan by April 5 of the second year after it crosses the threshold (for example, April 5, 2019 if it crosses the asset threshold after September 30, 2017).³⁷ A new CCAR BHC that crosses the threshold on or before September 30 of a given year must submit its capital plan by April 5 of the following year (for example, April 5, 2018, if it crosses the asset threshold on or before September 30, 2017).
 - In addition, a new CCAR BHC will become subject to Subparts E and F of the Federal Reserve’s DFAST rules, dealing with supervisory and company-run stress tests, in the year following the first year in which it submits a capital plan (for example, 2020, if it crosses the asset threshold after September 30, 2017).³⁸ The final rule also extends the onboarding period for regulatory reporting requirements for new CCAR BHCs.³⁹
- **Confirmation that SR Letter 11-7 applies to all firms.** In response to comments requesting clarification, the Federal Reserve confirmed that SR Letter 11-7’s guidance on model risk management⁴⁰ continues to apply to all firms and explained that SR Letter 15-19 is intended to describe a particular application of SR Letter 11-7 for capital planning to large and noncomplex firms.⁴¹

In its release accompanying the final rule, the Federal Reserve indicated that the scenarios and instructions for the 2017 CCAR cycle will be released by the end of this week

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ENDNOTES

- ¹ Federal Reserve System, *Amendments to the Capital Plan and Stress Test Rules*, available at <https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20170130a1.pdf> (Jan. 30, 2017) (hereinafter, the “*Final Rule*”).
- ² Federal Reserve System, *Amendments to the Capital Plan and Stress Test Rules*, 81 Fed. Reg. 67,239 (Sept. 30, 2016).
- ³ “CCAR” refers to the Federal Reserve’s Comprehensive Capital Analysis and Review of capital plans filed annually by CCAR 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.
- ⁴ For a detailed discussion of the proposal, please see our Memorandum to Clients entitled *Bank Capital Plans and Stress Tests: Federal Reserve Proposes 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* (Sep. 30, 2016), available at https://sullcrom.com/siteFiles/Publications/SC_Publication_Banking_Organization_Capital_Plans_and_Stress_Tests_09_30_2016.pdf.
- ⁵ 12 C.F.R. § 217.402.
- ⁶ *Final Rule* at 19-20; 12 C.F.R. § 225.8(d)(9)
- ⁷ See *Final Rule* at 19-20.
- ⁸ *Final Rule* at 25-26.
- ⁹ *Final Rule* at 25-26.
- ¹⁰ *Final Rule* at 23. The Large Institution Supervision Coordinating Committee (“LISCC”) framework is designed to materially increase the financial and operational resiliency of systemically important financial institutions to reduce the probability of, and cost associated with, their material financial distress or failure. The firms currently in the LISCC portfolio include certain CCAR firms, certain foreign banking organizations, and nonbank financial companies supervised by the Federal Reserve. See www.federalreserve.gov/bankinforeg/large-institution-supervision.htm. The proposal was unclear on this point. The proposed rules did not address the LISCC framework in the criteria for large and noncomplex firms; however, the accompanying release indicated that LISCC firms would remain subject to the qualitative assessment independent of whether they met the criteria for large and noncomplex firms. 81 Fed. Reg. 67,245.
- ¹¹ *Final Rule* at 23; Federal Reserve System, *SR Letter 15-18, Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms* (April 4, 2011), available at <https://www.federalreserve.gov/bankinforeg/srletters/sr1518.htm>. The Federal Reserve noted, however, that it would evaluate whether a large and noncomplex firm’s activities and risk profile continue to warrant the LISCC designation.
- ¹² Federal Reserve System, *SR Letter 15-19, Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms* (Dec. 18, 2015), available at <https://www.federalreserve.gov/bankinforeg/srletters/sr1519.htm>.
- ¹³ *Final Rule* at 23.
- ¹⁴ *Final Rule* at 30, 34.
- ¹⁵ 12 C.F.R. §§ 225.8(g)(2)(D), 225.8(g)(3)(iii)(F).
- ¹⁶ *Final Rule* at 28-29.
- ¹⁷ *Final Rule* at 28-29.

ENDNOTES (CONTINUED)

- 18 *Final Rule* at 31-32; 12 C.F.R. §§ 225.8(g)(2)(D), 225.8(g)(4).
- 19 *Final Rule* at 32, 33.
- 20 *Final Rule* at 32-33.
- 21 *Final Rule* at 31.
- 22 *Final Rule* at 31.
- 23 *Final Rule* at 35.
- 24 *Final Rule* at 35.
- 25 *Final Rule* at 35.
- 26 *Final Rule* at 35.
- 27 *Final Rule* at 35.
- 28 *Final Rule* at 36-37.
- 29 *See Final Rule* at 37.
- 30 *Final Rule* at 37.
- 31 *Final Rule* at 37.
- 32 12 C.F.R. § 252.54(b)(2)(i). The Federal Reserve may also require firms to include other components, such as the counterparty default scenario. 12 C.F.R. § 252.54(b)(2)(ii). In addition, the Federal Reserve may apply these components in the supervisory stress tests. 12 C.F.R. § 252.44.
- 33 12 C.F.R. § 252.54(b)(2)(B).
- 34 *Final Rule* at 43.
- 35 *Final Rule* at 43.
- 36 *See Final Rule* at 42.
- 37 *Final Rule* at 39; 12 C.F.R. § 252.53.
- 38 *See Final Rule* at 39-40, 42; 12 C.F.R. §§ 252.43(b), 252.53(b).
- 39 *Final Rule* at 40. The final rule requires a new CCAR firm to begin preparing its initial FR Y-14M as of the end of the third month after it first meets the \$50 billion asset threshold (rather than as of the month in which the bank holding company crosses the threshold) and to submit its first FR Y-14M within 90 days after the end of that month (at which time, data for the three intervening months would be due).
- 40 Federal Reserve, SR Letter 11-7, *Guidance on Model Risk Management* (April 4, 2011), available at <https://www.federalreserve.gov/bankinfo/srletters/sr1107.htm>.
- 41 *Final Rule* at 16.

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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 | chatterjee@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 |
| Rebecca J. Simmons | +1-212-558-3175 | simmonsr@sullcrom.com |
| Donald J. Toumey | +1-212-558-4077 | toumeyd@sullcrom.com |
| Marc Trevino | +1-212-558-4239 | trevinom@sullcrom.com |
| Benjamin H. Weiner | +1-212-558-7861 | weinerb@sullcrom.com |

SULLIVAN & CROMWELL LLP

| | | |
|--------------------|-----------------|----------------------------------------------------------------------|
| Mark J. Welshimer | +1-212-558-3669 | welshimerm@sullcrom.com |
| Michael M. Wiseman | +1-212-558-3846 | wisemanm@sullcrom.com |

Washington, D.C.

| | | |
|------------------------|-----------------|------------------------------------------------------------------|
| Sarah C. Flowers | +1-202-956-7630 | flowerss@sullcrom.com |
| Eric J. Kadel, Jr. | +1-202-956-7640 | kadelej@sullcrom.com |
| William F. Kroener III | +1-202-956-7095 | kroenerw@sullcrom.com |
| Sean M. Memon | +1-202-956-7620 | memons@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 |
|--------------|-----------------|----------------------------------------------------------------|
