

# Client Update

## Federal Reserve Board Proposes Capital Plan and Stress Testing Changes

### NEW YORK

Gregory J. Lyons  
gjlyons@debevoise.com

David L. Portilla  
dlportilla@debevoise.com

Zila R. Acosta-Grimes  
zracosta@debevoise.com

Chen Xu  
cxu@debevoise.com

### WASHINGTON, D.C.

Satish M. Kini  
smkini@debevoise.com

David A. Luigs  
daluigs@debevoise.com

On September 26, 2016, the Board of Governors of the Federal Reserve System (the “FRB”) proposed (the “Proposed Rule”) revisions to its capital plan and stress test rules for bank holding companies (“BHCs”) with \$50 billion or more in total consolidated assets and U.S. intermediate holding companies (“IHCs”) of foreign banking organizations required to be formed or designated by the FRB’s enhanced prudential standards (collectively “Covered Holding Companies”).<sup>1</sup> In discussing the Proposed Rule, Governor Daniel K. Tarullo stated that the FRB “consciously shaped [these modifications] in accordance with the principle that financial regulation should be progressively more stringent for banking organizations of greater importance, and thus potential risk, to the financial system.”<sup>2</sup> Along these lines, the Proposed Rule relaxes requirements for smaller banking organizations, while the standards for larger and more complex organizations largely remain the same. Comments on the Proposed Rule are due by November 25, 2016.

### BACKGROUND

The FRB’s capital plan and stress test framework for Covered Holding Companies consists of two related programs: (1) the Comprehensive Capital Analysis and Review (“CCAR”), conducted pursuant to the FRB’s capital plan rule, and (2) stress tests (“DFAST”) conducted pursuant to regulations adopted to implement mandates in the Dodd-Frank Wall Street Reform and Consumer Protection Act. The FRB conducts CCAR in order to assess Covered Holding Companies’ capital planning processes and their ability to maintain sufficient

<sup>1</sup> See Press Release, FRB, Federal Reserve Board invites public comment on proposed rule to modify its capital plan and stress test rules for 2017 cycle (Sept. 26, 2016). To access a copy of the proposed rule see the FRB’s website [here](#). To access a copy of the draft report forms see the FRB’s website [here](#).

<sup>2</sup> Governor Daniel K. Tarullo, Next Steps in the Evolution of Stress Testing, Address at the Yale University School of Management Leaders Forum (Sept. 26, 2016), available [here](#).

levels of capital under expected and stressful conditions. Pursuant to DFAST, the FRB conducts annual supervisory stress tests of Covered Holding Companies and requires Covered Holding Companies to conduct annual and mid-cycle company-run stress tests.

In December 2015, the FRB issued Supervision and Regulation (“SR”) Letters 15-18 and 15-19.<sup>3</sup> These SR letters describe capital plan and stress test expectations for the larger and more complex banking organizations (covered by SR 15-18), as well as for banking organizations that are relatively smaller and less complex (covered by SR 15-19). The Proposed Rule represents a further tailoring of the FRB’s capital planning and stress test expectations for banking organizations covered by SR 15-19 and proposes a new framework for identifying large and noncomplex banking organizations. At the same time, Governor Tarullo has spoken about the FRB’s plans to increase capital plan and stress test expectations for the largest, most complex BHCs, including by incorporating a stress buffer into CCAR that would take into account existing buffers that are not currently incorporated into CCAR, including the G-SIB capital surcharge.<sup>4</sup>

### SUMMARY OF PROPOSED CHANGES

The Proposed Rule would:

- establish a framework for identifying certain “large and noncomplex firms”;
- remove the qualitative assessment component of CCAR for large and noncomplex firms;
- reduce certain reporting requirements for large and noncomplex firms;
- streamline the initial applicability of the capital plan and stress test rules for new Covered Holding Companies; and
- increase the *de minimis* threshold for capital distributions under the capital plan rule and impose a one-quarter “blackout period” on any such distributions.

---

<sup>3</sup> SR 15-18, Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms (Dec. 18, 2015), available [here](#); SR 15-19, Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms (Dec. 18, 2015), available [here](#).

<sup>4</sup> Tarullo Speech, *supra* note 2.

### Identifying Large and Noncomplex Firms

The Proposed Rule identifies a Covered Holding Company as large and noncomplex if, as of December 31 of the calendar year prior to the capital plan cycle in question, the Covered Holding Company had:

- average total consolidated assets of \$50 billion or greater but less than \$250 billion;
- consolidated total on-balance sheet foreign exposure of less than \$10 billion; and
- average total nonbank assets of less than \$75 billion.

For the purposes of the 2017 capital plan cycle, average total nonbank assets would be determined by reference to line items on various reporting forms.<sup>5</sup> From CCAR 2018 onward, average total nonbank assets would be determined by reference to the FR Y-9LP, which would be amended to include a new line item 17 of PC-B Memoranda (total nonbank assets of a holding company that is subject to the capital plan rule). For purposes of determining nonbank assets, certain intercompany transactions are excluded while others are included. Generally, intercompany transactions between nonbank companies are excluded from this calculation, while transactions between nonbank companies, on the one hand, and banks and regulated holding companies, on the other, are included. For a table setting out which transactions are included versus excluded for purposes of this calculation, see Appendix A.

### Removal of Qualitative Assessment

In the FRB's view, large and noncomplex banking organizations present less systemic risk than large and complex banking organizations, including those that are subject to the Large Institution Supervision Coordinating Committee supervisory framework ("LISCC firms"). The Proposed Rule would revise the FRB's standards for reviewing the capital plans of large and noncomplex firms. In particular, under the Proposed Rule, large and noncomplex firms would no longer be subject to the qualitative assessment in CCAR beginning with the 2017 CCAR cycle, meaning that: (1) the FRB capital plan rule would no longer provide

<sup>5</sup> Average total nonbank assets would equal: (i) total combined nonbank assets of nonbank subsidiaries, as reported on line 15a of Schedule PC-B of the FR Y-9LP plus (ii) the total amount of equity investments in nonbank subsidiaries and associated companies as reported on line 2a of Schedule PC-A of the FR Y-9LP; plus (iii) assets of each Edge and Agreement Corporation, as reported on the FR 2886b, to the extent such corporation is designated as "nonbanking" in the box on the front page of the FR 2886b; minus (iv) assets of each federal savings association, federal savings bank, or thrift subsidiary, as reported on the Call Report. In each case, the amounts are as of December 31, 2016.

that the FRB may object to a large and noncomplex firm's capital plan based on unresolved supervisory issues or concerns with the assumptions, analysis and methodologies used in the capital plan, and (2) the FRB instead would conduct its supervisory assessment of a large and noncomplex firm's risk-management and capital planning practices through the regular supervisory process and target, horizontal assessments of particular aspects of capital planning. Large and noncomplex firms would continue to be subject to the quantitative assessment in CCAR.

Further, the proposed review process for large and noncomplex firms, which will be conducted on a supervisory basis outside of CCAR, is expected to be more limited in scope, include targeted horizontal evaluations of specific areas of the capital planning process, and focus on the standards set forth in the capital plan rule and SR 15-19. Before the start of the supervisory review process, the FRB would send a supervisory communication to each large and noncomplex firm describing the scope of the year's review. The review likely would occur in the quarter following the CCAR qualitative assessment for LISCC banking organizations and large and complex banking organizations.

Large and complex banking organizations and LISCC firms would remain subject to the qualitative objection criteria, the CCAR qualitative review process and current reporting requirements.

### **Reduction in Reporting Requirements**

The Proposed Rule would modify associated regulatory reporting requirements for large and noncomplex firms by reducing burdens associated with the FR Y-14 series of reports, which collect data used to support supervisory stress test models and continuous monitoring efforts for Covered Holding Companies. This reduction in reporting is a result of the FRB's desire to reduce reporting burdens in response to requests and feedback from banking organizations. In particular, the Proposed Rule would:

- change FR Y-14's definition of a "material portfolio" for large and noncomplex firms to mean a portfolio with asset balances greater than either (1) \$5 billion or (2) 10 percent of tier 1 capital, both measured as an average for the four quarters preceding the reporting quarter. This change would exclude certain portfolios from reporting and is coupled with the FRB stating that it intends to apply the median, rather than the 75<sup>th</sup> percentile, loss rate from supervisory projections in modeling losses on these portfolios;
- revise the FR Y-14A Appendix A instructions by removing the requirement for large and noncomplex firms to include certain documentation in their

capital plan submissions related to its models, including any model inventory mapping document, methodology documentation, model technical documents and model validation documentation, though large and noncomplex firms would still be required to be able to produce all of these materials upon request by the FRB; and

- remove the requirement for large and noncomplex firms to complete certain portions of the FR Y-14A Schedule A (Summary), including the Securities OTTI methodology sub-schedule, Securities Market Value source sub-schedule, Securities OTTI by security sub-schedule, the Retail repurchase sub-schedule, the Trading sub-schedule, Counterparty sub-schedule, and Advanced RWA sub-schedule.

The Proposed Rule's amendments to FR Y-14A would be adopted by Covered Holding Companies as of December 31, 2016 or as of June 30, 2017 at the discretion of the firm. Because the FRB expects firms to be able to produce data on request, although there might be some relief in terms of the length of reports, large and noncomplex firms likely will still need to prepare all of the documents outlined above and thus this may not result in a reduction of burdens to a material degree.

### **Streamlining Initial Applicability**

The Proposed Rule would streamline the initial applicability of CCAR and DFAST by providing additional time before the application of these requirements to new Covered Holding Companies. For an illustrative timeline of the proposed capital and stress test rules initial applicability changes and blackout periods see Appendix B.

*Initial Capital Plan Submission.* Currently, if a BHC or IHC becomes a Covered Holding Company on or before December 31 of a calendar year, the Covered Holding Companies must submit a capital plan by April 5 of the following year. Under the Proposed Rule, the cut-off date would be moved back to September 30: that is, a BHC or IHC that becomes a Covered Holding Company after September 30 of a given calendar year would not be required to submit a capital plan until April 5 of the second year.

*DFAST Requirement.* Currently, a BHC or IHC that becomes a Covered Holding Company on or before March 31 of a given year becomes subject to DFAST beginning in the following year. The Proposed Rule would require a Covered Holding Company to become subject to DFAST in the year following the first year in which the Covered Holding Company submitted a capital plan.

*Onboarding to Regulatory Reporting.* Currently, a BHC or IHC that becomes a Covered Holding Company must prepare FR Y-14M reports as of the end of the month in which it becomes a Covered Holding Company and must submit its first FR Y-14M within 90 days after the end of the first reporting month. Under the Proposed Rule, new Covered Holding Companies would have an extended onboarding period for regulatory reporting requirements. Specifically, the Proposed Rule would require a Covered Holding Company to begin preparing its initial FR Y-14M as of the end of the third month after becoming a Covered Holding Company and submit its first FR Y-14M within 90 days after the end of that month.

### **Higher Threshold for Additional Capital Distributions**

Although reporting requirements will be streamlined and reduced in various ways, the Proposed Rule restricts a Covered Holding Company's ability to distribute capital. Under the current capital plan rule, a Covered Holding Company may make additional capital distributions above the amount listed in a capital plan to which the FRB did not object if: (1) the Covered Holding Company remains well capitalized after the distribution, (2) the Covered Holding Company's performance and capital levels following the distribution are consistent with its projections under the expected conditions in its capital plan, (3) the Covered Holding Company provides 15 days' notice prior to execution and the FRB does not object within that time period, and (4) the aggregate dollar amount of all capital distributions during the capital planning cycle would not exceed the total amount described in the Covered Holding Company's capital plan by more than 1.00 percent of the Covered Holding Company's tier 1 capital as reported in its first quarter FR Y-9C (the "*de minimis* exception"). The Proposed Rule would (1) establish a one-quarter "blackout period" (the second quarter of a calendar year) during which a Covered Holding Company would not be able to submit a notice of its intended reliance on the *de minimis* exception or otherwise submit a request for prior approval for additional capital distributions, and (2) lower the *de minimis* limit from 1.00 percent to 0.25 percent of a Covered Holding Company's tier 1 capital.

### **Other Changes**

Under the current stress test rules, the FRB is required to select a date in the calendar year between January 1 and March 1 of the current stress test cycle to be the "as-of" date for the data used as part of the global market shock<sup>6</sup>

<sup>6</sup> Global market shock is a set of instantaneous, hypothetical shocks to a large set of risk factors. These shocks are components in the supervisory adverse and severely adverse scenarios of DFAST and generally involve large and sudden changes in asset prices, interest rates and spreads, reflecting general market distress and heightened uncertainty.

components of the Covered Holding Company's adverse and severely adverse scenarios. The Proposed Rule would amend this practice by allowing the FRB to select an "as-of" for the global market shock from October 1 of the calendar year preceding the year of the stress cycle to March 1 of the calendar year of the stress test cycle. This change would take effect for the 2018 stress test cycle.

\* \* \*

Please do not hesitate to contact us with any questions.

---

The FRB requires Covered Holding Companies with significant trading activity to incorporate the global market shock in its company-run stress tests.

Appendix A

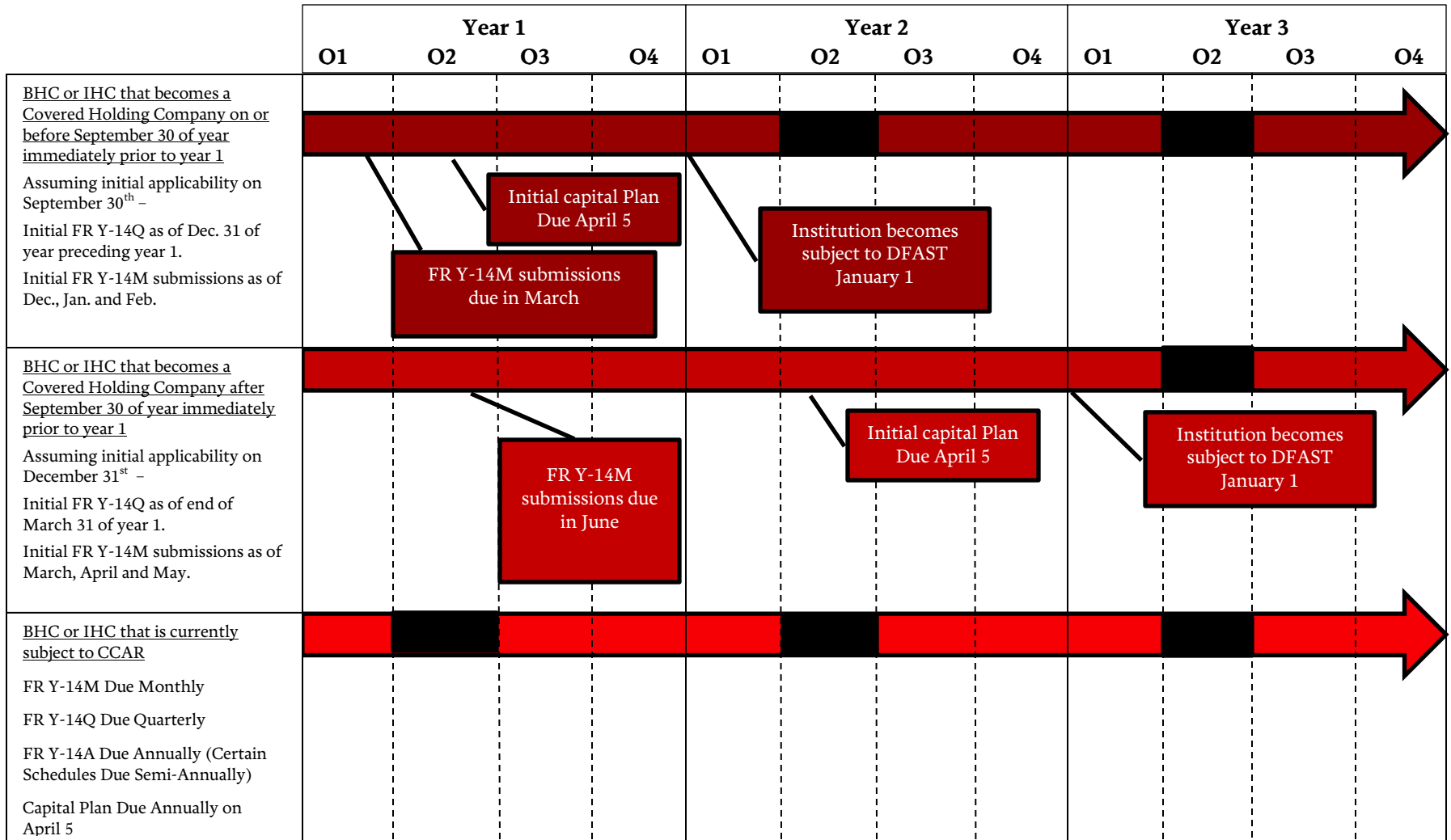
Summary of Treatment of Intercompany Transactions and Nonbank Companies for Purposes of Calculating Nonbank Assets		
	Included	Excluded
<b>Intercompany Assets and Operating Revenue</b>	<ul style="list-style-type: none"> <li>Assets and operating revenue between a nonbank company and: (1) reporting Covered Holding Companies, (2) any depository institution and (3) any depository institution subsidiary.</li> </ul> <p>For Covered Holding Companies that are subsidiaries of foreign banking organizations:</p> <ul style="list-style-type: none"> <li>Assets and operating revenue between a nonbank company and: (1) the reporting Covered Holding Company, (2) any branch or agency of the foreign banking organization or (3) any non-U.S. subsidiary, non-U.S. associated company, or non-U.S. corporate joint venture of the foreign banking organization that is not held through the reporting Covered Holding Company.</li> </ul>	Assets and operating revenue among nonbank companies
<b>Nonbank Companies</b>	<ul style="list-style-type: none"> <li>Nonbank assets held at nonbank subsidiaries, including nonbank assets of each Edge or Agreement Corporation designated as “nonbanking” in FR 2886b.</li> <li>Equity investments in unconsolidated nonbank subsidiaries, associated nonbank companies and nonbank corporate joint ventures over which the Covered Holding Company exercises significant influence.<sup>7</sup></li> </ul>	<p>Assets held at:</p> <ul style="list-style-type: none"> <li>National banks</li> <li>State member banks</li> <li>State nonmember insured banks, including industrial banks</li> <li>Federal savings associations</li> <li>Federal savings banks</li> <li>Thrift institutions</li> <li>Any subsidiary of a depository institution, except for Edge or Agreement Corporation designated as “nonbanking” in FR 2886b</li> </ul>


<sup>7</sup> For purposes of the FR Y-9LP, (i) a subsidiary is a company in which the reporting bank holding company directly or indirectly owns more than 50% of the outstanding voting stock; (ii) an associated company is a corporation in which the reporting bank holding company, directly or indirectly, owns 20-50% of the outstanding voting stock and over which the reporting bank holding company exercises significant influence; and (iii) a corporate joint venture is a corporation owned and operated by a group of companies, no one of which has a majority interest, as a separate and specific business or project for the mutual benefit of that group of companies.



Appendix B

Illustrative Timeline of Proposed Capital and Stress Test Rules Initial Applicability and Blackout Periods




 During Blackout Periods, which occur during the second quarter of the year, an institution may not submit a notice specifying its intended reliance on the *de minimis* exception or otherwise submit a request for prior approval for additional capital distributions. If institutions would like to use the *de minimis* exception in the second quarter, notices are due by **March 15**. If institutions would like to request prior approval for incremental capital distributions that do not qualify for the *de minimis* exception they must submit such requests by **March 1**.