Federal Reserve Proposes Stress Capital Buffer Requirement

May 2, 2018

On April 10, 2018, the Federal Reserve Board (the "FRB") proposed changes to its capital, capital planning and stress testing frameworks to introduce a "stress capital buffer" to replace the fixed 2.5% portion of the capital conservation buffer and a new stress leverage buffer. The new buffers would be integrated with the FRB's regulatory capital, capital planning and stress testing regimes, as well as the recently proposed Stress Testing Policy Statement.[1] The comment period for the proposals ends June 25, 2018.

The proposed changes reflect one of the last regulatory reform initiatives championed by former FRB Governor Daniel Tarullo before he stepped down at the beginning of April 2017.[2]

The proposed changes would apply to firms subject to the FRB's capital plan rule: bank holding companies with $50 billion or more in total consolidated assets and U.S. intermediate holding companies of foreign banking organizations established pursuant to Regulation YY (together, "covered firms"). The proposal would take effect on December 31, 2018, with a covered firm's first stress buffer requirements effective on October 1, 2019.

IMPACT OF PROPOSED CHANGES

The FRB asserts that the proposed changes generally would maintain or somewhat increase the amount of capital required for global systemically important banks (GSIBs) and somewhat decrease the level of required capital for all other covered firms. Based on data from the Comprehensive Capital Analysis and Review ("CCAR") program from 2015, 2016 and 2017, the proposed rule would have increased the common equity tier 1

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1 Press Release, FRB, Federal Reserve Board requests comment on package of proposals that would increase the transparency of its stress testing program (Dec. 7, 2017). To access a copy of the proposed rule, see the FRB's website here. For more discussion about those rules, see this Client Update.

2 FRB Governor Daniel K. Tarullo, Departing Thoughts, Speech Before Woodrow Wilson School, Princeton (Apr. 4, 2017) ("The proposal for what our staff has called a "stress capital buffer" (SCB) would simplify our capital regime by replacing the existing 2.5 percent fixed capital conservation buffer applicable to all banks with a buffer requirement equal to the maximum decline in a firm's common equity ratio under the severely adverse scenario of the stress test.").

("CET1") capital requirements of GSIBs in the aggregate for those three years by anywhere from approximately $10 billion to $50 billion, due to the inclusion of the GSIB surcharge in the calculation of their capital conservation buffer requirement. Non-GSIBs, however, would have seen decreases in their CET1 capital requirements ranging from approximately $10 billion to $45 billion in the aggregate, due to the relaxed assumptions regarding balance sheet growth and capital distributions. Despite the estimated increases in capital requirements for GSIBs, the FRB asserts that if the proposed rule had been in effect during recent CCAR exercises, no firm would have needed to raise additional capital in order to avoid the proposal's limitations on capital distributions.

SUMMARY OF PROPOSED CHANGES

Modifications to Stress Capital and Leverage Buffer Requirements

Under the FRB's current capital rule, to avoid limitations on capital distributions and certain discretionary bonus payments, covered firms must maintain a capital conservation buffer of CET1 capital equal to the sum of: (a) 2.5%, (b) any capital countercyclical buffer that is in effect (applicable to banking organizations subject to the advanced approaches),[3] and (c) any applicable "GSIB surcharge."[4] Covered firms are also subject to capital distribution limitations under the FRB's capital plan rule, based on a firm's post-stress capital ratios and, for GSIBs, the enhanced supplementary leverage ratio (the "eSLR").

The proposed rule would replace the above-described capital conservation buffer with three new buffers as follows:

1. *a standardized approach capital conservation buffer* equal to the sum of (a) a stress capital buffer, (b) any countercyclical capital buffer that is in effect, and (c) any applicable GSIB surcharge;

2. an *advanced approaches capital conservation buffer* equal to (a) 2.5%, (b) any countercyclical capital buffer that is in effect, and (c) any applicable GSIB surcharge; and

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3 A banking organization is subject to the advanced approaches capital requirements if it has $250 billion or more total consolidated assets or $10 billion or more in on-balance sheet foreign exposures, or is a banking organization subsidiary of a depository institution, bank holding company, savings and loan holding company or intermediate holding company subject to the advanced approaches.

4 The GSIB surcharge requires bank holding companies identified by the FRB as GSIBs to hold additional common equity tier 1 capital based on the FRB's methodology estimating GSIBs' systemic risk profiles.

3. a *stress leverage buffer* requirement that would apply on top of the 4% minimum tier 1 leverage ratio, functioning in the same way as the capital conservation buffer.

The *stress capital buffer* used in the calculation of the standardized approach capital conservation buffer would be equal to the sum of:

- the difference between a covered firm's starting and lowest projected CET1 capital ratios under the severely adverse scenario in the supervisory stress tests, calculated under the standardized approach; and
- the sum of the ratios of: (a) a covered firm's planned common stock dividends; to (b) projected risk-weighted assets ("RWAs"), for *each* of the fourth through seventh quarters of the planning horizon.

The stress capital buffer would be subject to a floor of 2.5%. The FRB believes that such a floor would prevent the proposed changes from providing benefits to covered firms compared to firms below $50 billion in total consolidated assets, which would still be subject to the existing baseline, fixed 2.5% capital conservation buffer. (An example of how the stress capital buffer would operate is included as Appendix 1.)

The stress leverage buffer would be equal to the sum of:

- the difference between the covered firm's starting and lowest projected tier 1 leverage ratio under the severely adverse scenario in the supervisory stress tests; and
- the sum of the ratios of: (a) the covered firm's planned common stock dividends; to (b) its projected leverage ratio denominator, for *each* of the fourth through seventh quarters of the planning horizon.

The proposal would not extend the stress buffer concept to the supplementary leverage ratio applicable to bank holding companies subject to the advanced approaches or the eSLR applicable to GSIBs.

A covered firm would be bound by the most stringent capital standard among: (a) the standardized approach capital conservation buffer; (b) the stress leverage buffer; and (c) if applicable, the advanced approaches capital conservation buffer and the eSLR.

Modifications to Stress Test Assumptions

Currently, the FRB's supervisory stress test scenarios assume that a firm makes all capital actions (dividends, repurchases and issuances) contemplated by its capital plan.

The proposals make a number of changes to these assumptions, which also would apply to company-run stress tests:

- *Repurchases and Redemptions*. The FRB would no longer assume that a covered firm makes all planned repurchases and redemptions of capital instruments. Instead, the proposal narrows the assumptions to assume that a company *does not* make a repurchase or redemption of a capital instrument that is eligible for inclusion in the numerator of a regulatory capital ratio. The FRB would continue to assume that a covered firm makes payments on any instrument that qualifies as additional tier 1 capital or tier 1 capital equal to the stated dividend, interest or principal due on those instruments during the quarter.

- *Capital Issuances*. The FRB would assume that a firm *does not* make any planned capital issuances, except those issuances contemplated in connection with a planned merger or acquisition to the extent that such a transaction is reflected in the firm's pro forma balance sheet estimates.

- *Dividends*. The FRB would assume that a covered firm *does not* pay dividends on any instruments that qualify as CET1. Because the stress capital buffer requires a covered firm to pre-fund one year of common stock dividends, these dividends would not need to be included in the assumptions used for stress testing purposes.

The FRB also proposed to amend its Stress Testing Policy Statement to relax certain assumptions about asset growth under its supervisory stress tests.[5] In particular, under the proposal:

- The FRB would assume that a covered firm takes actions to maintain, rather than grow, its current level of assets (the "no-growth" assumption).

- Similarly, the FRB would assume that a covered firm's RWAs and leverage ratio denominator generally remain unchanged.

Modifications to CCAR

The FRB would modify certain elements of CCAR in parallel with the introduction of the stress capital buffer requirement. At present, under CCAR, the FRB may issue a quantitative objection to a covered firm's capital plan if the firm does not demonstrate an ability to maintain capital ratios above the minimum requirements under the

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[5] These assumptions would not apply to the FRB's company-run stress tests. As is currently the case, the FRB expects each covered firm's projected balance sheet under the company-run stress test to be consistent with the applicable scenario (baseline, adverse, severely adverse) and the firm's business strategy. *See* 83 Fed. Reg. 18160, 18166 n. 34 (Apr. 25, 2018).

supervisory stress test scenarios. The FRB also subjects covered firms' capital plans to heightened scrutiny if the capital plan includes dividend payout ratios above 30%.

The proposal would replace the quantitative objection with the stress capital buffer and eliminate the 30% dividend payout ratio criterion, as the FRB believes the pre-funding requirement would incentivize prudent dividend payouts. In addition, the proposal would require a covered firm to limit planned capital distributions for the fourth through seventh quarters of the planning horizon to be consistent with any effective capital distribution limitations that would apply under the firm's own baseline scenario projections. The planned capital distributions also would have to be consistent with any applicable GSIB surcharge or countercyclical buffer and with any known changes to these items during the planning horizon; a covered firm would assume its GSIB surcharge in the eighth and ninth quarters of the planning horizon are the same.[6]

The proposal would also make a number of procedural changes to the capital plan rule:

- *Assessment of Planned Capital Distributions*. A covered firm would have two business days after receipt of initial notice of its stress buffer requirements to determine whether its planned capital distributions are consistent with the effective capital distribution limitations that would apply to the firm's baseline scenario throughout the fourth through seventh quarters of the planning horizon. If not, the firm would be required to reduce the capital distributions described in its capital plan.

- *Requests for Reconsideration*. A covered firm would have 15 calendar days after receipt of the FRB's qualitative objection to its capital plan or any of its stress buffer requirements to submit to the FRB a request for reconsideration. The FRB would respond to the firm within 30 calendar days with its decision to affirm or modify any of the stress buffer requirements or would withdraw its objection to the firm's capital plan. While a request for consideration is pending, the stress buffer requirement or qualitative objection, as applicable, would not be effective. The firm generally would be able to continue to make capital distributions that were included in the last capital plan for which the firm received a non-objection.

- *Recalculation of Stress Buffer Requirements*. The FRB may recalculate a covered firm's stress buffer requirements whenever the firm chooses or is required to resubmit its capital plan due to a material change in the firm's risk profile, financial condition, or corporate structure; if the stress scenarios are no longer appropriate for the firm's business model and portfolios; or if changes in the market or macro-economic

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6 The FRB states that it intends to "monitor and evaluate a firm's quarterly performance relative to its baseline projections to help ensure that the firm adopts processes that realistically project performance and capital levels." 83 Fed. Reg. 18160, 18168 (Apr. 25, 2018).

outlook that could have a material impact on risk profile and financial condition require updated scenarios. The FRB would review the resubmitted capital plan within 75 calendar days after receipt. The FRB may conduct an updated supervisory stress test and recalculate the firm's stress buffer requirements based on the resubmitted capital plan.

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Please do not hesitate to contact us with any questions.

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APPENDIX 1

- Figure 1 below illustrates how the minimum CET1 capital ratio requirement would be affected under the proposed stress capital buffer requirement for a banking organization with the following characteristics:

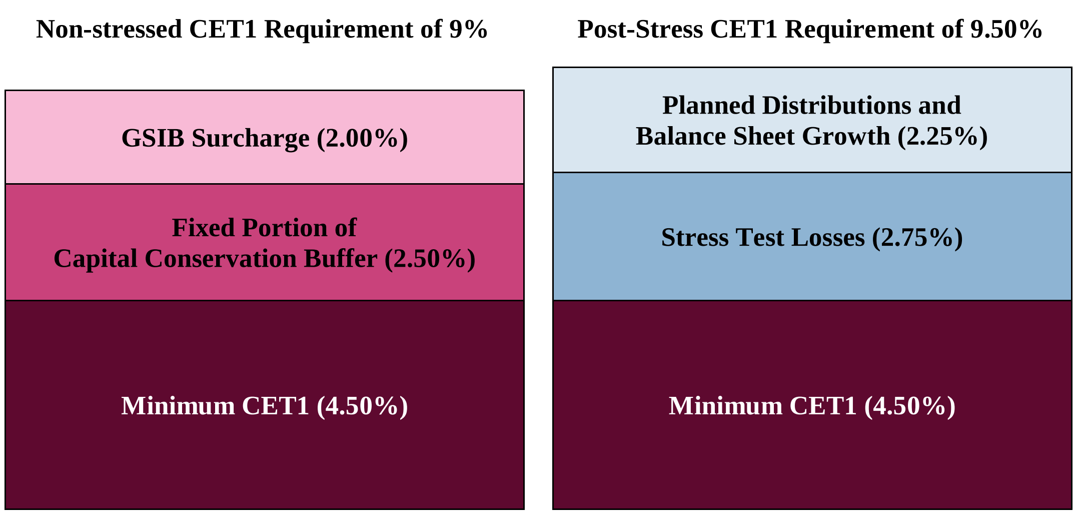
  - a GSIB surcharge of 2%;

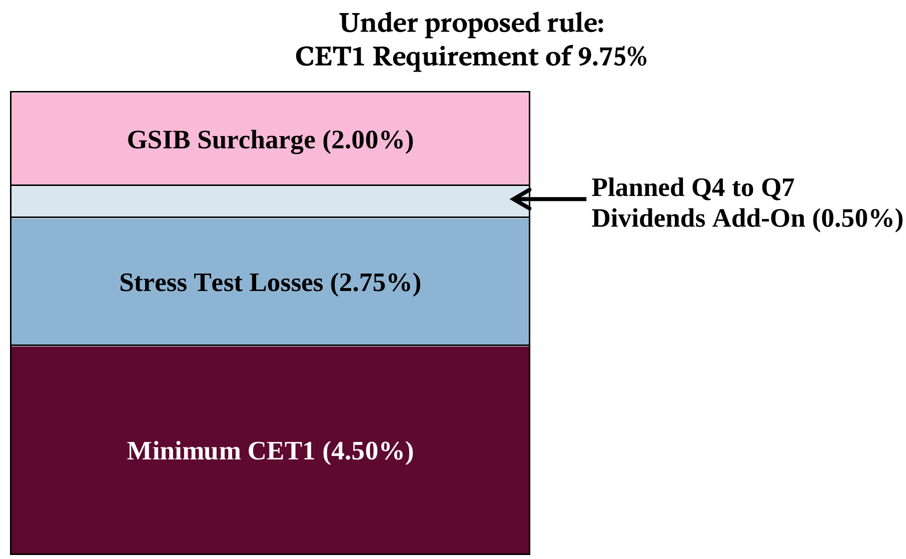
  - decreases in the firm's CET1 ratio under the severely adverse scenario of the FRB's supervisory stress test of 2.75% due to stress test losses and 2.25% as a result of planned distributions and balance sheet growth; and

  - planned dividend distributions from the fourth through seventh quarter of 0.125% of the firm's projected RWA for each such quarter for an aggregate amount of 0.5%.

Figure 1

Under current capital rule:




Under proposed rule:
CET1 Requirement of 9.75%
GSIB Surcharge (2.00%)
Planned Q4 to Q7
Dividends Add-On (0.50%)
Stress Test Losses (2.75%)
Minimum CET1 (4.50%)