Client Update

FRB Finalizes Capital Plan and Stress Testing Changes; Recent Developments Suggest More Changes Possible

NEW YORK
Gregory J. Lyons
gjlyons@debevoise.com

David L. Portilla
dlportilla@debevoise.com

David Aman
daman@debevoise.com

Lee A. Schneider
lschneider@debevoise.com

J. Michael Coburn
jmcoburn@debevoise.com

Chen Xu
cxu@debevoise.com

WASHINGTON, D.C.
Satish M. Kini
smkini@debevoise.com

LONDON
Aatif Ahmad
aahmad@debevoise.com

On January 30, 2017, the Board of Governors of the Federal Reserve System (the "FRB") finalized revisions to its capital plan and stress test rules (the "Rule") 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").[1] The Rule relaxes requirements for smaller banking organizations, while the standards for larger and more complex organizations largely remain the same. The Rule went into effect for the 2017 capital plan cycle, which began on January 1, 2017. The recently announced departure of FRB Governor Tarullo, the principal FRB proponent of these rules, as well as actions by certain members of Congress and the ability of the new administration to fill vacancies at the FRB and other banking agencies all suggest that further review of this and other banking frameworks imposed since Dodd-Frank may be forthcoming.

BACKGROUND TO THE RULE

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 Dodd-Frank. The FRB conducts CCAR in order to assess Covered Holding Companies' capital planning processes and their ability to maintain sufficient levels of capital under expected and stressful conditions.

[1] Press Release, FRB, Federal Reserve Board finalizes rule to modify its capital plan and stress test rules for 2017 cycle (Jan. 30, 2017). To access a copy of the finalized rule, see the FRB's website here. To access a copy of the draft report forms, see the FRB's website here.

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.[2] These SR letters describe the differing 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 Rule represents a further tailoring of the FRB's capital planning and stress test expectations for banking organizations covered by SR 15-19 and adopts a new framework for identifying large and noncomplex banking organizations.

The overall framework for capital planning is broadly similar for SR 15-18 and SR15-19, but SR 15-18 imposes more formality, granularity and comprehensiveness on the larger and more complex firms that it addresses, which can impose significant additional burdens upon management. Board oversight responsibilities, however, do not fundamentally differ between SR 15-18 and SR 15-19.

The Rule was first proposed on September 26, 2016, with a two-month comment period. The Rule closely follows the proposed rule but has replaced the requirement that a large and noncomplex banking organization have less than $10 billion in foreign exposure with a requirement that the entity cannot be designated a global systemically important bank ("G-SIB").

SUMMARY OF CHANGES

The Rule:

- revises the framework for identifying certain "large and noncomplex firms" (*i.e.*, those subject to the relatively more lenient requirements of SR 15-19, rather than SR 15-18);
- removes the qualitative assessment basis for objection in CCAR for large and noncomplex firms;
- reduces certain reporting requirements for large and noncomplex firms;

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[2] 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.

- streamlines the initial applicability of the capital plan and stress test rules for new Covered Holding Companies; and
- decreases the *de minimis* threshold for capital distributions under the capital plan rule and imposes a one-quarter "blackout period" on any such distribution.

Identifying Large and Noncomplex Firms

The 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;
- is not identified as a G-SIB; and
- had average total nonbank assets of less than $75 billion.

The G-SIB criteria in the Rule replaces the requirement in the proposed rule that a Covered Holding Company have foreign exposures of less than $10 billion to qualify as "large and noncomplex."

For the purposes of the 2017 capital plan cycle, average total nonbank assets are determined by reference to line items on various reporting forms.[3] 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.

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[3] Average total nonbank assets will 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) 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 bank or thrift subsidiary, as reported on the Call Report. In each case, the amounts are as of December 31, 2016.

As to the impact of the changes in the Rule on designations, one Covered Holding Company became subject to SR 15-18 rather than SR 15-19, with 13 Covered Holding Companies in total now reportedly subject to SR 15-18.[4] On the other hand, these new criteria in the rule resulted in other Covered Holding Companies being moved from SR 15-18 to SR 15-19, with 21 Covered Holding Companies reportedly now being subject to SR 15-19.[5] Foreign banking organizations that are not bank holding companies but had to establish intermediate holding companies because of the FRB's Regulation YY generally remain subject to SR 15-18 because their U.S. broker-dealers and other subsidiaries have over $75 billion of U.S. assets.

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 complex firms that are subject to the Large Institution Supervision Coordinating Committee supervisory framework ("LISCC firms"). The Rule revises and makes more lenient the FRB's standards for reviewing the capital plans of large and noncomplex firms.

More specifically, under the Rule, large and noncomplex firms are no longer subject to the qualitative assessment in CCAR, beginning with the 2017 CCAR cycle, while large and complex firms continue to be subject to the assessment. Thus, the FRB may not object to the plans of large and noncomplex firms based on unresolved supervisory issues or concerns with the assumptions, analysis and methodologies used in the capital plan.

However, the qualitative process remains important for large and noncomplex firms because the FRB now evaluates the process as part of a new supervisory process referred to as the Horizontal Capital Review ("HCR"). HCR, and other supervisory processes, may result in, among other things, MRAs (Matters Requiring Attention) and MRIAs (Matters Requiring Immediate Attention), as part of an organization's standard exam processes.

Further, the HCR, 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 the FRB will continue to enforce the supervisory expectations of the capital planning process

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[4] "Chart Watch 2017 CCAR, stress test scenarios," SNL (Feb. 3, 2017).

[5] *Id.*

set forth in SR 15-19. Large and complex firms, as well as LISCC firms, are subject to the heightened expectations in SR 15-18. Before the start of the supervisory review process, the FRB will 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. At a process level, the review is likely to be guided more by local examiners than the FRB in Washington D.C., which should afford affected banking institutions more involvement in the review.

Large and complex banking organizations and LISCC firms remain subject to the qualitative objection criteria, the CCAR qualitative review process and current reporting requirements and less interactive, more D.C.-directed review processes.

Reduction in Reporting Requirements

The Rule modifies 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 Rule:

- changes 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 excludes certain portfolios from reporting and is coupled with the FRB stating that it intends to apply the median, rather than the 75th percentile, loss rate from supervisory projections in modeling losses on these portfolios;[6]
- revises 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

[6] Under the proposed Rule, the FRB would only apply the median loss rate to large and noncomplex firms. Under the final Rule, the FRB would apply the median loss rate to all firms subject to the supervisory stress test.

noncomplex firms would still be required to be able to produce all of these materials upon request by the FRB; and

- removes 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, the Securities Market Value source sub-schedule, the Securities OTTI by security sub-schedule, the Retail repurchase sub-schedule, the Trading sub-schedule, the Counterparty sub-schedule and the Advanced RWA sub-schedule.

The 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 Rule streamlines 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 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 Company must submit a capital plan by April 5 of the following year. Under the 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 Rule requires that a Covered Holding Company 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 Rule, new Covered Holding Companies have an extended onboarding period for regulatory reporting requirements. Specifically, the Rule requires 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.

Tightening of Threshold for Additional Capital Distributions

Although reporting requirements will be streamlined and reduced in various ways for large and noncomplex firms, the Rule further tightens all Covered Holding Companies' ability to distribute capital. Under the historical capital plan rule, a Covered Holding Company could 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 Rule makes such distributions more strict in two ways. One, it establishes 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. Two, it lowers 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[7]

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

components of the Covered Holding Company's adverse and severely adverse scenarios. The Rule amends 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.

DEVELOPMENTS SUGGESTING FURTHER CHANGES

The Rule represents a material change in the capital placing processes for large and noncomplex firms. However, while further change is not certain, post-election developments at the Executive, Congressional and Regulatory levels may result in further changes to capital planning processes, as well as other elements of the heightened bank regulation since Dodd-Frank.

Executive Action. Among other actions, President Trump signed an Executive Order on February 3, 2017 instructing the Treasury Secretary to work with the Financial Stability Oversight Council ("FSOC") to examine existing financial laws, regulations and treaties and to report within 120 days as to what extent such rules comply with seven core principles, including ensuring and enabling American companies to be more competitive and ensuring regulations are efficient, effective and appropriately tailored.[8] Although somewhat "coded," this Executive Order suggests that the administration could seek to use FSOC as a means to pursuing a deregulatory agenda, which could include revising CCAR.[9]

Congressional Action. Senior members of Congress also have proposed reducing the requirements of CCAR specifically, and banking burdens more generally. Senator Patrick Toomey, Chairman of the Subcommittee on Financial Institutions and Consumer Protection of the Senate Committee on Banking, Housing, and Urban Affairs, sent a letter, dated February 9, 2017, to FRB Chair Yellen requesting that the FRB examine ending CCAR altogether and instead monitor the stress testing procedures performed internally by regulated institutions.[10] Similarly, House Financial Services Chairman Jeb Hensarling reportedly released a memorandum last week calling for, among other things, moving stress testing to a two-year cycle.[11] Moreover, addressing financial

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[8] Presidential Executive Order on Core Principles for Regulating the United States Financial System (Feb. 3, 2017), available here.

[9] Debevoise Client Update, "Executive Order and DOL Memo Signal Shift in Federal Financial Regulatory Agenda" (Feb. 5, 2017), available here.

[10] Senator Toomey Letter to Chair Yellen (Feb. 9, 2017).

[11] "New GOP Memo Targets Stress Tests, CFPB in Dodd-Frank Changes," Bloomberg (Feb. 9, 2017).

regulation more broadly, in a letter dated January 31, 2017, Representative Patrick McHenry, the Vice Chairman of the House Financial Services Committee, declared "unacceptable" the continued participation in international forums such as the Basel Committee by the FRB.[12] Citing Representative McHenry's letter specifically, Valdis Dombrovskis, leader of financial services regulation for the EU, stated on February 10, 2017 that U.S. departure from international frameworks may force the EU to "reassess" whether U.S. financial services regulation is equivalent to that of the EU.[13] A determination of non-equivalence could impair the ability of U.S. financial firms to operate in Europe.

Regulatory Changes. Expected changes to the constitution of the FRB also could bring further reforms to CCAR. There are currently two vacant seats on the FRB (including the Dodd-Frank-created Vice Chair for Bank Supervision) and there will be three open seats out of seven total seats when Governor Tarullo steps down on or about April 5, 2017, as announced last Friday.[14] Tarullo has been the FRB Governor most focused on CCAR. In addition, Scott Alvarez has announced that he will step down as General Counsel to the FRB later this year.[15] Given the significant discretion the banking agencies have in both formulating and evaluating capital plans, a difference in approach by the FRB personnel could have a significant impact on the process.

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Please do not hesitate to contact us with any questions.

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[12] Representative McHenry Letter to Chair Yellen (Jan. 31, 2017).

[13] "EU financial service chief warns U.S. against nitpicking bank rules," Reuters (Feb. 10, 2017).

[14] Press Release, FRB, Daniel Tarullo submitted his resignation (Feb. 10, 2017), available here.

[15] Press Release, FRB, Scott Alvarez, General Counsel will retire this year(Feb. 8, 2017), available here.

Appendix A

Summary of Treatment of Intercompany Transactions and Nonbank Companies for Purposes of Calculating Nonbank Assets		
	Included	**Excluded**
Intercompany Assets and Operating Revenue	• Assets and operating revenue between a nonbank company and: (1) reporting Covered Holding Companies, (2) any depository institution and (3) any depository institution subsidiary. For Covered Holding Companies that are subsidiaries of foreign banking organizations: • 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.	Assets and operating revenue among nonbank companies
Nonbank Companies	• Nonbank assets held at nonbank subsidiaries, including nonbank assets of each Edge or Agreement Corporation designated as "nonbanking" in FR 2886b. • Equity investments in unconsolidated nonbank subsidiaries, associated nonbank companies and nonbank corporate joint ventures over which the Covered Holding Company exercises significant influence.[16]	Assets held at: • National banks • State member banks • State nonmember insured banks, including industrial banks • Federal savings associations • Federal savings banks • Thrift institutions • Any subsidiary of a depository institution, except for an Edge or Agreement Corporation designated as "nonbanking" in FR 2886b

[16] 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 Capital and Stress Test Rules Initial Applicability and Blackout Periods

	Year 1				Year 2				Year 3			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
<u>BHC or IHC that becomes Covered Holding Company on or before September 30 of year immediately prior to year 1</u> Assuming initial applicability on September 30th – Initial FR Y-14Q as of Dec. 31 of year preceding year 1. Initial FR Y-14M submissions as of Dec., Jan. and Feb.		FR Y-14M submissions due in March Initial Capital Plan due April 5			Institution becomes subject to DFAST January 1							
<u>BHC or IHC that becomes Covered Holding Company after September 30 of year immediately prior to year 1</u> Assuming initial applicability on December 31st – Initial FR Y-14Q as of Mar. 31st of year 1. Initial FR Y-14M submissions as of Mar., Apr. and May.		FR Y-14M submissions due in June				Initial Capital Plan Due April 5			Institution becomes subject to DFAST January 1	[Blackout Period]		
<u>BHC or IHC that is currently subject to CCAR</u> FR Y-14M due monthly FR Y-14Q due quarterly FR Y-14A due annually (certain schedules due semi-annually). Capital plan due annually on Apr. 5.		[Blackout Period]				[Blackout Period]				[Blackout Period]