Simpson Thacher

Memorandum

Federal Reserve Governor Outlines Changes to Stress Testing Regime

Governor Tarullo's Speech Previews Revised Approaches to Both the Quantitative and Qualitative Aspects of CCAR, Including a New Stress Capital Buffer

Federal Reserve Proposes Changes to Capital Plan Rule

September 29, 2016

In a speech at the Yale University School of Management Leaders Forum on September 26, Federal Reserve Governor Daniel Tarullo announced the Federal Reserve's intent to implement a suite of revisions to the Comprehensive Capital Analysis and Review ("CCAR") processes and requirements. The anticipated revisions would seek to address the "imperfect alignment" of CCAR with the current regulatory capital requirements, the Federal Reserve's desire for additional macroprudential stress testing elements, the unnecessary burden placed on less complex banking organizations by the qualitative requirements of CCAR, and the industry's desire for improved transparency regarding the Federal Reserve's stress testing expectations.

Among other potential changes, Governor Tarullo's speech previewed the following significant revisions to the CCAR framework:

- the addition of a new "stress capital buffer" for purposes of determining a CCAR firm's minimum post-stress capital requirements;
- the elimination of the "qualitative" CCAR assessment for relatively smaller, less complex firms;
- adjusted stress test assumptions on both a microprudential and macroprudential basis; and
- additional Federal Reserve disclosures regarding stress test results and models to promote public transparency.

To implement several of the proposals highlighted in Governor Tarullo's speech, the Federal Reserve will need to undergo a formal rulemaking process, including the usual public notice-and-comment process. Notably, however, Governor Tarullo indicated that certain of the proposals may be implemented without changes in the current published regulations. Such statements may compound industry concerns that the Federal Reserve's implementation of certain key aspects of its CCAR stress tests has not complied with the Administrative Procedure Act of 1946.[1]

Introduction of a New "Stress Capital Buffer"

Under the quantitative requirements of the CCAR stress tests, the Federal Reserve may object to an institution's capital plan when stress tests reveal that the firm would not be able to maintain its post-stress capital ratios above the regulatory minimum levels over the planning horizon, taking into account its planned capital distributions. In addition to other minimum regulatory capital ratios, CCAR firms are currently required to maintain a Common Equity Tier 1 capital ("CET1") ratio of at least 4.5%, plus a uniform 2.5% "capital conservation buffer," plus potentially applicable additional buffers and surcharges (such as the "countercyclical buffer," applicable to banking organizations with more than $250 billion in assets or $10 billion in on-balance-sheet foreign exposures, and the "GSIB surcharge," applicable to the eight institutions designated as global systemically important banks).

The revised quantitative CCAR requirements, as previewed in Governor Tarullo's speech, would replace the 2.5% fixed capital conservation buffer with a new "stress capital buffer." The stress capital buffer would require a CCAR firm to hold a buffer of CET1 equal to the maximum decline in a firm's CET1 ratio under the "severely adverse" scenario of the supervisory stress test (without accounting for the firm's planned capital distributions), as reflected in the Federal Reserve's modelling calculations. Thus, for example, if a firm's CET1 ratio were to decline from 13% to 8% under CCAR's severely adverse scenario, that firm's required stress capital buffer would be 5%. To avoid any reduction in the stringency of the regulatory capital rules, all firms would be subject to a minimum stress capital buffer floor of 2.5% (the same as the prior capital conservation buffer), regardless of their CET1 reduction under the severely adverse stress scenario.

The stress capital buffer would be in addition to 4.5% CET1 minimum baseline amount, any applicable countercyclical buffer and any applicable GSIB surcharge. Accordingly, a firm subject to a 5% stress capital buffer and hypothetical 3% GSIB surcharge would be constrained in making any capital distributions that would bring its CET1 ratio under 12.5%. A firm's stress capital buffer requirement would be calculated by

[1] *See, e.g.*, Committee on Capital Markets Regulation, *The Administrative Procedure Act and Federal Reserve Stress Tests: Enhancing Transparency* (September 2016). The Administrative Procedure Act imposes a set of uniform procedural requirements on federal agency rulemakings, requiring that: (i) agencies provide the public notice of, and an opportunity to comment on, proposed rules, (ii) agencies publish their final rules; and (iii) agency actions be subject to judicial review and reversal if they fail to comply with the APA's procedural requirements or are otherwise arbitrary and capricious.

the Federal Reserve in connection with each year's stress test, and its capital plan would not be approved if the plan indicated that the firm would fall into the buffer under the stress test's baseline projections.

Reduced CCAR Burden for "Non-Complex" Firms

Under the qualitative requirements of the CCAR stress tests, the Federal Reserve may object to an institution's capital plan if it finds that the firm's capital planning processes (including its controls and governance processes) are not sufficiently reliable. Through prior iterations of the CCAR exercise, the Federal Reserve recognized that this qualitative assessment was unduly burdensome for relatively smaller, less complex firms, as it created pressure to develop complex processes, extensive documentation, and sophisticated stress test models that mirrored those used by the largest, most complex firms, in order to avoid the possibility of a public objection to their capital plan. Such qualitative grounds have been, in fact, the basis for most capital plan rejections to date.

As previewed in Governor Tarullo's speech, the Federal Reserve issued proposed rules to address this undue burden by eliminating the qualitative CCAR assessment for CCAR firms that have total consolidated assets of less than $250 billion, on-balance sheet foreign exposure of less than $10 billion, and nonbank assets of less than $75 billion ("non-complex firms"). Additionally, the proposal would modify associated regulatory reporting requirements for non-complex firms to collect less detailed information on the firms' stress test results, and raise the materiality threshold for reporting on specific portfolios. The elimination of the qualitative CCAR assessment for non-complex firms would be effective beginning with the 2017 CCAR cycle, and a non-complex firm would be able to implement the modified reporting requirements either immediately or after a six-month delay. Governor Tarullo's speech did note, however, that the Federal Reserve would continue to assess the qualitative aspects of non-complex firms' capital planning "through the normal supervisory process, supplemented with targeted horizontal reviews of discrete aspects of capital planning."

30% Dividend Payout Ratio Guidance

In light of the new approach, described below, of adding one year's planned dividends to a firm's capital buffer, Governor Tarullo suggested that the Federal Reserve may revisit its current policy of subjecting dividend payout ratios above 30% of projected post-tax net income to heightened scrutiny. To date, most CCAR firms have kept their proposed dividend payout ratios below this 30% threshold in light of this policy. Governor Tarullo also indicated that the Federal Reserve does not expect to issue any specific higher payout ratio as updated guidance, but noted that the new stress capital buffer may require a firm that is planning a higher dividend to cut its dividend if the firm were to face unexpected adversity.

Reduction of 1% "De Minimis" Basket for Capital Actions

The Federal Reserve's proposed changes to the capital plan rule would also limit the availability of the "de minimis" exception for capital distributions. The de minimis exception currently allows any CCAR firm to make additional capital distributions above the amounts described in its approved capital plan if the total amount of such distributions for the one-year period following the Federal Reserve's approval of the firm's capital plan does not exceed 1.0% of the firm's Tier 1 capital. The proposal would amend the de minimis exception in two ways. First, the proposal would establish a one-quarter "blackout period" while the Federal Reserve is conducting CCAR (i.e., the second calendar quarter of each year), during which CCAR firms would not be able to submit the required notification to the Federal Reserve of their proposed use of the de minimis exception. Second, the proposal would lower the de minimis exception limitation from 1.0% to 0.25% of a firm's Tier 1 capital. These changes would be effective for the 2017 CCAR cycle.

Adjusted Microprudential and Macroprudential Stress Test Assumptions

Governor Tarullo's speech outlined the following revised assumptions that the Federal Reserve would incorporate in CCAR stress testing and scenario design to better account for observed trends, industry responses and macroprudential goals:

- *Treatment of Planned Dividends and Share Repurchases*: The Federal Reserve currently assumes that a CCAR firm would proceed with all planned dividends and share repurchases during the two-year planning horizon, regardless of the stress level facing the firm. Under the revised approach, the Federal Reserve would assume that a CCAR firm will maintain its dividends for one year while reducing its repurchases, effectively requiring a firm to hold capital to meet its stress losses and fund its planned dividends over the next year.
- *Balance Sheet and Risk-Weighted Asset Assumptions*: To counter the risk of a credit crunch caused by banks reducing their balance sheets through asset sales or reductions in new lending in order to maintain their capital ratios under stress, the Federal Reserve has required that banks' capital plans for the severely adverse CCAR scenario not be based on restricting the bank's supply of loans. With this requirement, the Federal Reserve's model actually operated to project an increase in the balance sheets of CCAR firms during the severely adverse scenario. In response to industry concerns that loan portfolios would not be increasing under any reasonable assumptions during a severely adverse scenario, the Federal Reserve is considering replacing this aspect of its model with a simple assumption that balance sheets and risk-weighted assets would remain constant over the severely adverse scenario horizon.
- *Expansion of Global Market Shock and Counterparty Default Shock in Models*: Currently, only GSIBs are required to include the scenario components of global market shock and counterparty default shock in their stress test modeling. In his speech, Governor Tarullo not only rebuffed suggestions that these should be dropped as duplicative of the GSIB surcharge, but also noted that as the U.S. trading operations of more foreign banks become subject to CCAR (through the creation of U.S. intermediate holding

companies), the Federal Reserve intends to revisit whether these shock elements should be applied to firms beyond the U.S. GSIBs.

- *Macroprudential Assumptions*: The Federal Reserve is considering two additional revisions to its stress test scenario design framework that are motivated by the macroprudential consideration of reducing procyclicality: reducing the assumed severity of the change in the unemployment rate during downturns, and tying the assumed path of housing prices during a downturn to disposable personal income.
- *Research Program to Inform Further Adjustments*: Governor Tarullo announced that the Federal Reserve would be undertaking a research program to analyze other potential risks, especially those related to funding shocks, liquidity shocks and spillovers from the default of common counterparties, with the goal of ultimately informing stress test scenario design.

Promoting Transparency

In his speech, Governor Tarullo indicated that the Federal Reserve plans to make several changes to its disclosure policies in the interest of promoting transparency in the stress testing process. First, while the Federal Reserve has since 2009 published post-stress capital ratio results for each participating firm, the Federal Reserve plans to make more granular disclosures of results in the next cycle or two of stress tests, such as more detailed information on the components of projected net revenues.

Second, the Federal Reserve is considering providing additional information regarding its supervisory models used in the stress tests. In particular, it is considering disclosing descriptions of changes "well in advance" of the stress test, phasing in the most material model changes over two years, and publishing projected losses under various stress scenarios for a hypothetical set of data representing typical bank portfolios of loans and securities. Nevertheless, Governor Tarullo noted that the Federal Reserve has no plans to "publish the full computer code" in the supervisory model used to project revenues and losses, out of concern for permitting firms to "game the system."

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