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ALERT MEMORANDUM

Federal Reserve Curtails Stock Buybacks and Caps Large Bank Dividends

Uncertainty Surrounds Future Capital Planning for CCAR Firms

June 26, 2020

On June 25, the Federal Reserve released firm-specific results from the Dodd-Frank Act Stress Tests and the Comprehensive Capital Analysis and Review, along with aggregate results of a "sensitivity analysis" aimed at gauging the ongoing economic impact of the COVID-19 pandemic on CCAR firms. These are the first results under the Federal Reserve's revised stress testing framework, which integrates supervisory stress testing results into CCAR firms' day-to-day capital requirements through the introduction of a "stress capital buffer" requirement intended to take effect October 1, 2020.

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The DFAST and CCAR results indicated that the U.S. banking industry is still strongly capitalized. But the combination of the Federal Reserve's sensitivity analysis (which yielded greater losses generally for the banking industry over near-term, pandemic-induced economic challenges) and the significant uncertainty in the probable future path of the economy, appears to have convinced the Federal Reserve to impose additional restrictions and requirements on CCAR firms. In particular, until further notice (or at least through the third quarter of 2020):

- Stock buybacks by CCAR firms are prohibited, except in relation to common stock issuances for employee stock ownership plans; and
- Common stock dividends may not exceed the lesser of (a) the amount of the firm's common stock dividends last quarter, and (b) an amount equal to the average of the firm's net income for the four preceding calendar quarters. CCAR firms may continue to make scheduled payments on additional Tier 1 and Tier 2 instruments without restrictions.

In addition, each CCAR firm is required to resubmit its capital plan "later this year", and is urged to reconsider long-term capital plans. The resubmission will be based economic scenarios that the Federal Reserve has not yet released.

This resubmission requirement and the accompanying restrictions on capital distributions are not discussed in detail in the materials released yesterday, leading to significant uncertainty regarding both future planning and the timing of any forthcoming Federal Reserve guidance.

This Memorandum highlights several of the key considerations and ambiguities for CCAR firms.

Capital Distribution Restrictions

- The Federal Reserve specifically applied the restrictions through the end of the third quarter of 2020, but left itself room to extend or modify the restrictions on a quarter-by-quarter basis – an approach that provides little certainty for banks and investors.
- For the third quarter of 2020, the Federal Reserve will permit common stock dividends, provided that the dividend does not represent an increase from the prior quarter and does not exceed an amount equal to the average of a firm's *net income* for the four preceding calendar quarters.
    - Yet, under the final stress capital buffer ("SCB") rule's transition provision for 2020, CCAR firms are authorized to issue dividends in the third quarter of 2020 not greater than the four-quarter average of capital distributions for which the Federal Reserve indicated its non-objection in the previous capital plan cycle.[1]
    - Yesterday's release does not specifically invalidate this transition provision although it appears the Federal Reserve's intent is to replace this general authorization with the potentially more circumscribed net-income based limitation on dividends.
    - Federal Reserve Governor Brainard objected to the dividend permissions granted to the CCAR firms, expressing concerns about uncertain economic conditions and about reliance on past net income that may have already been distributed by CCAR firms.
- The Federal Reserve does not address potential differences related to those CCAR firms that are intermediate holding companies ("IHCs") of foreign banks. IHCs do not usually have a set dividend schedule and IHC capital planning is often dependent upon the foreign bank's enterprise-wide capital planning and capital allocation needs.
    - Most IHCs generally maintain substantial capital in excess of their required minimums and buffers, but the new dividend limit could potentially and significantly impact an IHC's ability to return excess capital to its parent. During the COVID-19 pandemic, enterprise-wide capital allocation has taken on critical importance, as global geographies exhibit differing rates of reopening and recovery.

Capital Plan Resubmission and the Stress Capital Buffer

- The process for and timing of the capital plan resubmission are quite ambiguous.
    - The Federal Reserve will require firms to use updated scenarios to prepare revised capital plans, but does not indicate when or how many scenarios will be provided.
    - CCAR firms will have 45 days from the receipt of the updated scenarios to resubmit their capital plans.

[1] 12 CFR 225.8(k)(1)(ii). Under the SCB rule, CCAR firms may request permission to issue larger dividends in the 2020 transition period.

- The combination of the capital distribution restrictions with the mandate to resubmit capital plans creates some uncertainty with regard to the timeline associated with the SCB rule.
  - Under the SCB rule, a CCAR firm would have two business days after the release of the CCAR results to consider its SCB against its own baseline scenario and then consider (or reconsider) its planned capital actions for the next five quarters. It is expected that CCAR firms would then announce their capital actions based on an analysis of maintenance of their capital minima plus SCB. As a formal matter, CCAR firms are required to notify the Federal Reserve of any adjustments by resubmitting the Form FR Y-14A summary schedule reflecting the SCB requirement and its reduced planned capital distributions. Some firms may choose to appeal their SCB within 15 days of receipt of the CCAR results.
  - After yesterday's release, however, CCAR firms are faced with significant uncertainty in relation to how far into the future they may be able to forecast their capital planning. Considerations include:
    - The SCB is a combination of (i) the peak-to-trough decline in a CCAR firm's CET1 ratio over the 9-quarter CCAR horizon and (ii) its planned common stock dividends for the fourth through seventh quarters (essentially December through next September, just before the next year's SCB would be effective on October 1) of that horizon. Yet, with the possibility of resubmission of capital plans and the uncertainty regarding timing of lifting of the capital distribution restrictions, firms may not be able to predict their four-quarter dividend component with a high degree of certainty (in particular IHCs that have greater variability in their planned dividends). Thus, it would appear that the utility of the SCB may be greatly diminished this year.
    - The Federal Reserve could also choose to require recalculation of a firm's SCB based on its review of resubmitted capital plans under the updated scenarios.[2] Federal Reserve Governor Brainard noted yesterday that the "next round of stress tests could include a more complete picture of the credit quality of banks' [CRE portfolios]… over the first half of 2020." This appears to leave open the possibility that the Federal Reserve could conduct new stress tests that could form the basis for CCAR firms' SCBs for the next year.
  - The proximate cause of this uncertainty is the absence of any material discussion in yesterday's materials of the SCB or the process the Federal Reserve intends to follow with respect to finalizing each firm's SCB by the August 31st deadline for publishing firms' SCBs or by the October 1st effective date of the SCB.[3]
- Furthermore, the Federal Reserve did not publish the three economic scenarios it used in its COVID-19 sensitivity analysis, and as expected it only released aggregate industry data rather than

[2] 12 CFR 225.8(h)(2)(ii).
[3] 12 CFR 225.8(h)(4).

firm-by-firm analyses. It is highly likely, however, that the "additional scenarios" the Federal Reserve will provide to CCAR firms as the basis for their capital plan resubmission will be modeled on these sensitivity analyses. The aggregate data released indicated the three scenarios were generally more severe than those applied in the DFAST and CCAR stress tests, and therefore CCAR firms should expect deeper projected losses (and a potentially higher SCB requirement) after resubmission.

The Results

- DFAST / CCAR Results
  - The 2020 DFAST/CCAR is the first stress test since the implementation of changes required by the 2018 Economic Growth, Regulatory Relief and Consumer Protection Act, including the Federal Reserve's final tailoring framework promulgated in November 2019. For example,
    - CCAR 2020 is the first stress test where firms under $100 billion in total assets were excluded (in contrast to the previous $50 billion threshold).
    - Category IV firms which are subject to CCAR on a two-year cycle under the tailoring framework were included this year, after having been excluded from the CCAR stress tests last year.
    - This was the first CCAR stress test where only baseline and severely adverse scenarios were used, and the adverse scenario was eliminated.
  - The assumptions incorporated from the SCB rule were also used for the first time:
    - Generally no expected change in balance sheet, risk-weighted assets or leverage ratio denominator over the stress test horizon.
    - Common stock dividend payments were assumed to be zero over the stress test horizon, in order to isolate the SCB from planned capital actions.
    - Scheduled dividend, interest, or principal payments that qualify as additional tier 1 capital or tier 2 capital were assumed to be paid.
    - Repurchase of capital instruments were assumed to be zero. Conversely, the capital action assumptions did not include issuances of new common or preferred stock, nor did they include any impact of business plan changes.
  - With regard to the controversial Current Expected Credit Loss ("CECL") model for loan loss provisioning, the Federal Reserve stated: "To reduce uncertainty, allow for better capital planning at affected firms, and gather additional information on the impact of [CECL], the Federal Reserve maintained the framework used prior to the adoption of CECL for calculating allowances on loans in the 2020 supervisory stress test, and plans to do so for 2021."

- Overall, in the aggregate, the CCAR firms exhibited strong capital and indicated the ability to withstand stress (at least under the Federal Reserve's February 2020, pre-pandemic scenarios) through the cycle.
- Nevertheless, there were a few firms that were hit particularly hard by the severely adverse scenario, and in particular projected credit card and auto loan losses. Under criteria applied in previous CCAR exercises, it appears certain firms may have been required to modify their capital actions given how close their projected ratios are to the minimum requirements in the stress scenarios. Under the current CCAR (subject to the uncertainties described above), these firms will likely have the largest SCBs—several perhaps in the range of 5% or higher.
- By contrast, several firms maintained strong capital ratios throughout the 9-quarter stress horizon, with projected declines in CET1 significantly below the 2.5% floor on the SCB.
  - Because the SCB is composed of (i) a firm's largest projected decline in CET1 *plus* (ii) its planned common stock distributions for quarters four through seven of the planning horizon, CCAR firms with relatively small projected declines in CET1 would likely have been able to comfortably make significant planned capital distributions (such as share repurchases and/or increased dividends) if the Federal Reserve had not curtailed share repurchases and limited dividends in connection with the release.

- <u>COVID-19 Sensitivity Analysis Results</u>
  - Extreme uncertainty exists with respect to the longer term effects of COVID-19 on the economy. Given this uncertainty, the Federal Reserve's sensitivity analysis considered three distinct downside risk paths for the economy:
    - a rapid V-shaped recovery that regains much of the output and employment lost by the end of 2020;
    - a slower, more U-shaped recovery in which only a small share of lost output and employment is regained in 2020; and
    - a W-shaped double dip recession with a short-lived recovery followed by another significant drop in activity later in 2020 due to a second wave of containment measures related to COVID-19.
  - The Federal Reserve attempted to tailor these scenarios as close as possible to what is occurring in the real economy. While the scenarios did not incorporate the unprecedented levels of support to borrowers from the Federal government, all three alternative downside scenarios did incorporate:
    - additional stress in the commercial real estate sector, such as higher commercial, retail and hotel vacancy rates;

- acute stress in energy and municipal bond markets and in currency, equity and bond markets in foreign countries most affected by the virus, and greater volatility and basis shocks;
- substantial growth in corporate loan balances and increased financial market volatility, each of which led to higher risk-weighted assets;
- financial stress on corporate borrowers in certain industry sectors that experienced an unparalleled decline in demand; and
- temporary amendments to the tax code under the Coronavirus Aid, Relief, and Economic Security ("CARES") Act to permit corporate tax loss carrybacks and remove certain limitations on tax loss carryforwards.

o The Federal Reserve provided only aggregate, not bank-specific, results comparing how the banking system as a whole would fare under the three economic paths.

- The sensitivity analysis provided projected losses only with respect to risk-based ratios and did not project losses under the supplementary or Tier 1 leverage ratios, consistent with Vice Chair Quarles recent statements indicating the Federal Reserve intends for the leverage ratio to serve as a backstop rather than a binding constraint.

o As previously indicated, declines in firms' risk-based capital ratios under each of the sensitivity analysis scenarios were deeper than under the February 2020 DFAST/CCAR scenarios.

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