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ALERT MEMORANDUM

Significant Increase in Capital Requirements for U.S. GSIBs
Relief from Qualitative Stress Test Objections for Smaller Banking Organizations

Analysis of FRB Governor Tarullo Remarks and Accompanying Rulemaking Proposal

October 5, 2016

On September 26, 2016, Federal Reserve Board ("FRB") Governor Daniel Tarullo delivered a speech outlining significant planned changes to the FRB's supervisory stress testing regime. Many of these changes would continue to ratchet up effective capital requirements for the eight U.S. global systemically important banking organizations ("GSIBs"). These changes also appear intended to make *ongoing capital requirements* more dynamic by incorporating the effect of the stress tests into everyday capital adequacy.

Implementation of the concepts introduced by Governor Tarullo will require the FRB to propose revisions to its regulations implementing the Basel III capital framework (the "U.S. Basel III rules"), its capital planning rule and its regulations governing Dodd-Frank Act stress testing ("DFAST") and the Comprehensive Capital Analysis and Review ("CCAR"). Shortly following the speech, the FRB proposed to implement one of these changes by eliminating the CCAR *qualitative* review for firms deemed "large and noncomplex" (the "2017 CCAR Proposal" or the "Proposal"). The FRB proposes that this change be effective for the 2017 CCAR/DFAST cycle; other changes outlined in the speech would not apply to the immediately upcoming cycle.

The most significant proposed change would introduce a further departure from the international Basel capital framework by imposing a "stress capital buffer" ("SCB") to replace the capital conservation buffer ("CCB") for all firms subject to CCAR ("CCAR firms"). The annual recalibration of an individual CCAR firm's SCB, combined with the "black box" nature of the FRB CCAR models that would produce each firm's SCB, will add significant complexity to the capital planning process for CCAR firms. In addition, the SCB is designed to materially increase day-to-day capital requirements for these firms. Other discussed changes would increase even further the effective capital requirements for U.S. GSIBs, in particular, as well as other CCAR firms.

The key changes discussed in Governor Tarullo's speech, as well as those set forth in the 2017 CCAR Proposal, are outlined below. We have divided them into three categories: (A) changes that would affect all CCAR firms; (B) changes relevant particularly to the eight U.S. GSIBs; and (C) changes that would primarily affect smaller CCAR firms (highlighting specifically changes that would impact intermediate holding companies ("IHCs") of foreign banking organizations ("FBOs")).

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A. Key Considerations and Open Questions Relevant to All CCAR Firms

1. *Replacement of the Capital Conservation Buffer with the "Stress Capital Buffer" and its Incorporation into the CCAR Quantitative Assessment*

— ***Structure and Effects of the SCB.*** The FRB intends to replace the 2.5% CCB for all CCAR firms with the SCB, a bespoke buffer recalibrated annually and based on each firm's projected losses under the CCAR severely adverse stress scenario. The SCB would equal a CCAR firm's maximum decline in its common equity Tier 1 ("CET1") ratio over the CCAR cycle's 9-quarter severely adverse stress horizon, before taking into account a CCAR firm's planned capital actions. The existing CCB of 2.5% would become the floor for the new SCB.

- It appears from Governor Tarullo's speech[1] that the SCB would be used in two different ways:
  - First, Governor Tarullo suggests that each CCAR firm would be required to apply the SCB on an ongoing basis *in its ordinary course capital adequacy compliance*. Thus, like the CCB, a CCAR firm would continuously need to maintain capital levels above the minimum ratios *plus* the SCB in order to avoid restrictions on dividends, other capital distributions and executive discretionary bonuses.
  - Second, in order to obtain capital plan approval under CCAR, each CCAR firm would need to demonstrate not only that it can maintain the U.S. Basel III rule minimum requirements under a severely adverse stress scenario, but also that it can make all proposed distributions in its capital plan over the full planning horizon without dipping into the SCB *under the baseline scenario*. There is no indication in the speech, however, that CCAR firms would need to maintain capital above the minima plus the SCB under the severely adverse scenario (i.e., on a post-stress basis).
  - Combining these two approaches, even if a CCAR firm obtains approval of its capital plan, if its CET1, tier 1 or total risk-based capital ratios were to dip into the SCB range following approval, it would be restricted from making capital distributions and executive discretionary bonuses in the same manner that the CCB currently restricts such payouts.

— ***Calibration of the SCB.*** The SCB would vary among CCAR firms based on individual CCAR results, would be set anew each year and would be set in the manner described above.

- Governor Tarullo indicates that the SCB would be based on a firm's maximum CET1 ratio decline under the severely adverse stress scenario "before the inclusion of the firm's planned capital distributions".
  - However, later in the speech, Governor Tarullo notes that the FRB also plans to assume a CCAR firm will maintain its planned dividends for one year while reducing its repurchases. Therefore, it appears that a CCAR firm's planned dividends for the first four quarters of its capital plan will be effectively added to the projected post-stress losses to determine the buffer amount. Governor Tarullo says that the combination of the SCB and a one-year dividend maintenance assumption would effectively require a firm to hold capital *on an ongoing basis* to meet any stress losses *and* to "pre-fund" its planned dividends for the following year.
- The SCB would never be lower than 2.5%. Accordingly, the CCB effectively remains in place as a "floor" on the SCB, much the way

[1] Governor Daniel K. Tarullo, "Next Steps in the Evolution of Stress Testing", Remarks at Yale University School of Management Leaders Forum, Sept. 26, 2016.

the standardized approach serves as a floor, pursuant only to the U.S. Basel III rules, on the advanced approaches to determining total risk-weighted assets ("RWA").

- The SCB would be recalculated during each CCAR cycle and thus would vary from year to year based on a CCAR firm's stress test performance.
  - This methodology would introduce significant uncertainty into the capital planning process, since a CCAR firm would be unable to predict accurately the maximum decline of its CET1 ratio under the severely adverse stress scenario without access to the FRB's supervisory models, which Governor Tarullo reiterated will remain a "black box".
  - The bespoke nature of the SCB would mean that minimum capital and buffer requirements, on both an ongoing capital compliance basis and for purposes of CCAR testing, will differ for each CCAR firm. This raises questions as to how the SCB will figure into the FRB's plans for revising the definition of "well capitalized" for bank holding companies ("BHCs"), which to-date has not been revised to reflect the adoption of the U.S. Basel III rules or the CCAR. It is also unclear whether or to what extent the SCB, which represents a significant gold-plating of the international Basel capital framework's CCB, will figure into comparability and equivalency determinations for FBOs seeking to establish branches or agencies in the United States, to acquire banking subsidiaries in the United States or to obtain or maintain financial holding company status.
- One of the speech's hypothetical illustrations of the SCB focused on the CET1 ratio requirement. However, as a replacement for the CCB, the SCB would sit atop the tier 1 and total minimum capital requirements as well. As a result, a shortfall of additional tier 1 or tier 2 capital could cause a GSIB to fall into the buffer range and become subject to restrictions on distributions.

— ***Flexibility.*** Governor Tarullo envisions that as part of the SCB approach, CCAR firms will have the opportunity, once they are preliminarily informed of their SCB, but prior to public disclosure of the results of the CCAR stress test, to scale back their planned capital distributions in order to avoid falling into the SCB buffer zone under baseline projections.

- This opportunity for adjustment would be incorporated into the "mulligan" CCAR firms may now take to adjust their capital distributions following receipt of their DFAST and preliminary CCAR results in order to ensure they pass the CCAR stress tests before final public disclosure.

— ***Key Takeaways.*** The goal of the SCB appears to be full integration of the CCAR stress testing regime into day-to-day compliance with the U.S. Basel III rules.

- The SCB proposal further confirms that CCAR and capital plan rules will operate as the effective binding constraint on most CCAR firms. While the U.S. Basel III rules purport to establish the minimum requirements and buffers for all U.S. banking organizations, CCAR in fact establishes an opaque parallel capital regime that imposes effective capital requirements for large banking organizations that are much higher than the Basel III minimum and buffer requirements. The SCB and the one-year dividend "pre-funding" assumption make this "effective" requirement for elevated pre-stress capital levels into a mandatory requirement to maintain capital above the SCB and pre-funded dividend amounts on an ongoing compliance basis.
- The SCB and the proposed simplifications to the CCAR assumptions seek to address the inherent contradictions in the CCAR process

regarding planned capital distributions. The current CCAR process actually requires CCAR firms to assume that they will continue to make all planned capital distributions during periods of adverse stress despite the CCB's self-executing restrictions on such distributions when a firm's capital levels fall into the CCB buffer zone. The SCB and the proposed simplifications attempt not only to resolve this inherent contradiction but to transform the once-a-year CCAR review into an ongoing elevated buffer requirement above the U.S. Basel III rule's minimum capital requirements.

- This latest push for "superequivalency" of the CCB also defies the growing consensus outside the United States that capital levels need not significantly increase above the current levels mandated in the Basel capital framework. Three days after Governor Tarullo's remarks, European Commission Vice President Vladis Dombrovskis gave a speech declaring that the European Union will not require member states to implement the revisions to the Basel capital framework that would lead to increased capital requirements.[2]

2. Revisions to Modeling Assumptions

— ***Changes to treatment of planned dividends and share repurchases.*** CCAR currently assumes that, during the 9-quarter stress scenario, CCAR firms would not reduce their dividend and share buybacks plans—an unrealistic assumption that has the effect of lowering banks' projected capital.

- As discussed above, Governor Tarullo indicated the FRB would relax this assumption, allowing CCAR firms to assume they would reduce repurchases while maintaining their dividend for one year instead of two.
- More significantly, while this change is expected to affect ongoing capital compliance through its implied dividend "pre-funding", it is also expected to materially improve the ability of CCAR firms to "pass" CCAR, as it would reduce the post-stress capital levels that a firm would need to maintain in order to have its planned capital distributions approved.

— ***Simplification of balance sheet and RWA assumptions.*** The FRB's models currently include an unrealistic assumption that balance sheets would increase during the severely adverse stress scenario as institutions presumably assist clients, through lending or other customer products, in weathering the economic downturn.

- Governor Tarullo indicated that the FRB is considering replacing this assumption with a simplified parameter that balance sheets and RWAs remain constant over the severely adverse stress scenario.
- This change should have a beneficial impact for CCAR firms, especially those subject to the supplementary leverage ratio which will be integrated into CCAR in the 2017 cycle.

— ***Additional potential simplifications to model assumptions.*** The FRB also expects to propose revisions to the FRB's "Policy Statement on the Scenario Design Framework for Stress Testing" to reduce procyclicality. The proposed changes would make unemployment rate changes less severe during downturns and would replace the current judgmental approach to setting the hypothesized path of house prices by tying this variable to disposable personal income.

— ***Inclusion of additional macroprudential elements that could drive up post-stress losses and thus increase the SCB as well as elevate required pre-stress capital levels.***

- Governor Tarullo noted that the FRB is undertaking research to potentially incorporate additional macroprudential features into the stress tests, including a systemic funding shock,

[2] EC VP Dombrovskis, "Embracing Disruption", Speech before the European Banking Federation Conference, Sept. 29, 2016. See also Contiguglia, "Regulatory Fragmentation Drives Basel RWA Impasse", Risk (Sept. 29, 2016).

a liquidity shock (with attendant incorporation of fire sale asset value discounts) and an expanded counterparty default shock that may incorporate "second-round effects" of multiple counterparty defaults.

- Currently, only GSIBs or a subset thereof are subject to these "add-on" stress scenarios which generally increase losses over the stress horizon, and therefore increase effective capital requirements for subject firms. However, the speech signaled that the FRB intends to revisit whether the global market shock and counterparty default component should be limited to the U.S. GSIBs, and that the IHCs of FBOs may be required to include these "add-on" stress scenarios in future CCAR cycles.
- Governor Tarullo also indicated that the FRB is exploring the possibility of integrating capital and liquidity stress testing, which could lead to changes in the FRB's liquidity regulations and the Comprehensive Liquidity Analysis and Review ("CLAR"). The CLAR applies to firms currently in the FRB's Large Institution Supervision Coordinating Committee ("LISCC") portfolio.
- CCAR currently includes a counterparty default stress scenario for each of the GSIBs. However, this exercise does not now consider the potential impact of a large financial firm's default on central counterparties ("CCPs"). While the push toward clearing through CCPs may mitigate the systemic impact of a default of a member, a CCP's actions could also amplify stress in the system if the CCP calls on non-defaulting members for additional resources once their prefunded contributions have been exhausted.

3. *Modestly Increased Transparency*

— In response to calls for increased transparency, over the next few DFAST/CCAR cycles, the FRB intends to:

- Release more granular data on different components of projected net revenues as part of its disclosure of annual stress test results;
- "Tentatively" consider the feasibility of publishing data that represent typical bank portfolios of loans and securities with the losses the FRB's models would project under its stress scenarios; and
- Consider further disclosure about the reasons for qualitative objections and conditional non-objections.

— However, Governor Tarullo holds fast to the FRB position that the supervisory models themselves will not be disclosed due to concerns that banks would "game" the models to optimize their portfolios and thereby lower their capital requirements.

4. *Criticism of Layering of Additional Capital Requirements*

— Proposed changes that increase U.S. bank capital requirements above the internationally agreed Basel III standards run the risk of adversely affecting the competitiveness of U.S. banks, not just internationally, but also with respect to other entities that perform similar functions but that are not subject to increased capital requirements. Governor Tarullo's speech was delivered amidst reportedly increased boldness of non-U.S. regulators, many of which have begun to push back on or reject further capital increases beyond the initial Basel III framework.[3]

[3] See Taniguchi et. al., "Bank-Capital Battle Makes Japan, EU Allies Against U.S. Push", Bloomberg (July 26, 2016) (citing (i) Vice Minister Shirakawa of Japan's Financial Services Agency, a Basel Committee member, as claiming that Fed Governor Tarullo's call for a discard of banks' internal-model approach would hamper effective risk management and (ii) Daniele

— Furthermore, the CCAR stress tests continue to be a magnet for criticism, primarily because of the lack of transparency into the FRB's determinations.[4] The almost complete uncertainty about an individual firm's SCB would only serve to exacerbate the opacity of the process, notwithstanding certain accompanying changes that appear designed to temper unrealistic assumptions employed in the CCAR.

In this context, some have suggested that the CCAR process may violate the Administrative Procedure Act. An industry group paper noted that the Dodd-Frank Act did not explicitly grant authority to the FRB to veto a bank's capital distributions based on a failed stress test, and that the assumptions the FRB uses under the stress tests are not subject to public notice-and-comment procedures despite looking more like rulemakings than adjudications.[5]

B. <u>Specific Considerations for GSIBs</u>

— ***Extent of Incorporation of GSIB Surcharge Unclear.***

- It is quite clear that the SCB is intended to make *ongoing capital requirements* more dynamic by incorporating the effect of the stress tests into everyday capital adequacy. As a matter of ongoing capital adequacy compliance under the proposals outlined in Governor Tarullo's speech, U.S. GSIBs would be required to maintain capital levels above the regulatory minima, plus the SCB, plus the GSIB surcharge and plus the countercyclical buffer (if any).
- Governor Tarullo's speech is less clear, however, on how or whether the GSIB surcharge would be incorporated into the minimum ratios required to be maintained to "pass" the quantitative prong of CCAR.
  - The speech implies that capital plan approval requires that planned capital distributions not cause a CCAR firm's capital levels to dip below the sum of the regulatory minima, plus the SCB and—presumably by extension—the GSIB surcharge, but solely under the *baseline* scenario.
- The GSIB surcharge as implemented in the U.S. Basel III rules requires firms to calculate the surcharge under both Method 1 (which mirrors the Basel framework approach) and Method 2 (which incorporates a short-term wholesale funding factor generally resulting in a higher surcharge), and apply the larger of the two. The differential between the two methods is significant for most U.S. GSIBs, and they are required to apply much higher GSIB surcharges than would otherwise result under international GSIB surcharge standards. However, Governor Tarullo's speech gives no reason to expect that the Method 1 surcharge (rather than the higher of the two methods) could have a role in the CCAR process.
  - The future rulemaking to implement the SCB could provide commenters an opportunity to renew objections to this dual-method approach to the GSIB surcharge, since its "superequivalence" will be amplified by the further "superequivalent" proposal to require the SCB in lieu of the internationally agreed 2.5% CCB.

Nouy, chair of the supervisory board of the European Central Bank as stating that an "overwhelming majority around the table" in Basel support "minimizing any increase in capital charges"); Kroner et. al., "EU May Refuse to Sign Up to New Banking Rules," Reuters (Sept. 26, 2016) (noting push back from EU officials regarding calls for higher capital requirements, and further noting that the standardized floor approach proposed by the U.S. undermines core objectives of the Basel rules). <u>See also</u> footnote 2 above.

[4] <u>See</u> Scott, "The Fed's Stress Tests Need to Be Transparent", <u>Wall St. J.</u> (Sept. 16, 2016).

[5] <u>See</u> Committee on Capital Markets Regulation, <u>The Administrative Procedure Act and Federal Reserve Stress Tests</u>, Sept. 2016.

— ***Interplay with the TLAC Buffer Unclear***. Under the FRB's proposal to implement the FSB's standard for total loss absorbing capacity ("TLAC"), the eight U.S. GSIBs and the IHCs of FBOs designated as GSIBs would be required to maintain a TLAC buffer, composed solely of CET1, on top of the minimum external TLAC risk-based ratio, in order to avoid restrictions on distributions and discretionary bonus payments. As proposed, the TLAC buffer would equal the CCB plus the Method 1 GSIB surcharge plus the countercyclical buffer (when in effect).

- If the CCB component of the TLAC buffers would be replaced with the SCB, this change would also increase TLAC requirements for these firms. Unfortunately, Governor Tarullo does not address the relationship between the proposed SCB and the TLAC standards.

C. The 2017 CCAR Proposal[6] Would Eliminate Qualitative Review for "Large and Noncomplex" Firms

— The CCAR and DFAST stress tests have led to significant expansion of the compliance function at large banking organizations given the adverse market impact that may result from public disclosure of an FRB objection to a CCAR firm's capital plan. The FRB acknowledges that many smaller, less complex CCAR firms have made significant investments to keep their capital planning and stress testing functions on par with the most complex firms and such firms may be "over-invest[ing] in stress testing and capital planning processes that are unnecessary to adequately capture the risks of these firms."

— ***Relief for "Large and Noncomplex" Firms.*** The 2017 CCAR Proposal would accordingly exempt a "large and noncomplex" firm from the annual *qualitative* review of its capital planning and processes, although such a firm would remain subject to the *quantitative* portion of the CCAR test and to the to-be-proposed SCB.

- The relief is designed to reduce the risks of a public objection to such a firm's capital plan, since CCAR firms have far greater control over their ability to pass the quantitative aspects of the exam by scaling back planned capital actions after reviewing DFAST results.

- Firms deemed "large and noncomplex" would still be expected to conform to the guidance in SR Letter 15-19, which sets out the FRB's supervisory expectations for capital planning at large noncomplex CCAR firms. However, deficiencies in their capital planning processes would generally be addressed through the supervisory process, instead of the CCAR process, primarily through exam ratings and examiner feedback or through nonpublic enforcement actions. The full scope of enforcement actions, including publicly disclosed capital directives, would remain available to the FRB in its role as supervisor.

— ***Scope of Relief.*** "Large and noncomplex firms" would include BHCs and IHCs with total consolidated assets of at least \$50 billion but less than \$250 billion (average over the preceding four quarters), on-balance sheet foreign exposure of less than \$10 billion (measured as of the most recent year-end), and nonbank assets of less than \$75 billion (measured as described below).

- This definition incorporates the thresholds for mandatory application of the advanced approaches in the U.S. Basel III rules, but adds a new threshold of \$75 billion in nonbank assets.
  - The preamble notes that this additional threshold was chosen based on "historical failures and bankruptcies of large financial firms and the risk profile of the current population of BHCs." Although a higher threshold of \$125 billion was considered, the lower threshold was chosen specifically to exclude from the definition of "large and noncomplex" certain IHCs that engage in significant capital markets activities but are

[6] 81 Fed. Reg. 67239 (Sept. 30, 2016).

not otherwise mandatorily subject to the advanced approaches. There is a clear bias in the FRB's Proposal toward ensuring that any firms with significant derivatives or capital markets activities—which the FRB states (without citing specific empirical support) have a "greater complexity of structure or activities and therefore greater risk"—are included in the "large and complex" category.

- The preamble further notes that this definition would exclude any firm subject to the LISCC supervisory framework, which currently includes the eight GSIBs, and the IHCs of Barclays, Credit Suisse, Deutsche Bank and UBS.
- The Proposal does not indicate whether the FRB intends to expand the scope of SR Letter 15-18, which sets out the FRB's expectations for large and *complex* CCAR firms (defined as those firms meeting the advanced approaches thresholds or subject to the LISCC framework) to incorporate the new $75 billion threshold for nonbank assets. The preamble discusses the qualitative review for large and complex firms, including those with over $75 billion in nonbank assets, as though a uniform set of elevated standards are to be applied to such firms, and therefore it would appear that the FRB intends to apply the elevated standards in SR Letter 15-18 to all CCAR firms that do not meet the definition of "large and noncomplex."

— ***Determining average total nonbank assets.***

- The proposal would define average total nonbank assets as the sum of:
  - Combined total nonbank assets of nonbank subsidiaries (excluding the assets of each federal savings association, federal savings bank, or thrift subsidiary);
  - Assets of each Edge and Agreement corporation, if the corporation is designated as "nonbanking"; and
  - Total equity investments in nonbank subsidiaries and associated companies, each as defined for purposes of the Form FR Y-9LP (excluding subsidiaries of depository institutions, except for Edge and Agreement corporation subsidiaries).
- The Proposal would also amend the parent company only financial statements for large holding companies (Form FR Y-9LP) to include a new line item for "average total nonbank assets" to identify large noncomplex firms. This new line item would first be effective for the March 31, 2017 reporting period.
- All intercompany assets of nonbank entities would be excluded, except for assets with (i) the reporting parent BHC, (ii) any depository institution affiliate, (iii) any affiliate that is a subsidiary of a depository institution, and (iv) for IHCs, (x) any branch or agency of the FBO parent, or (y) any non-U.S. subsidiary, non-U.S. associated company or non-U.S. joint venture (each as defined for purposes of the Form FR Y-9LP) that is not held by the IHC.
- In addition, so as not to allow quarter-end asset manipulation, the FRB intends to have nonbank assets calculated as an average over a quarter, but has asked for comment on whether the calculation should be a daily, weekly or monthly average.
- Given that the FRB does not currently require firms to report their average total nonbank assets, it will be difficult to assess which firms would be deemed "complex" solely due to the total nonbank asset prong of the "large and noncomplex" definition. It would be expected, however, that the FRB would disclose the tiering of the CCAR firms at the time of public disclosure of the annual CCAR results.

— ***Other Proposed Changes to the Stress Testing Framework***

- ***De Minimis Exception Tightened.*** The Proposal would scale back the *de minimis* exemption threshold for capital distributions under the capital plan rule.
  - Currently, a well capitalized CCAR firm may make additional capital distributions above the amount described in its approved capital plan without prior Board approval if the total distribution amount does not exceed 1% of the firm's tier 1 capital in the year following the FRB's action on the capital plan.
  - The Proposal would significantly lower the threshold for the *de minimis* exception from 1% to 0.25% beginning April 1, 2017.
- ***Blackout Period.*** The Proposal would also introduce a one-quarter blackout period while CCAR is ongoing (second quarter of each calendar year), within which CCAR firms would not be able to submit either a notice to use the *de minimis* exception or an application for prior approval of additional capital distributions.
- ***Extended Transition Periods.*** The Proposal would extend the transition period to comply with CCAR and DFAST for firms that cross the $50 billion total assets threshold. BHCs and IHCs that become CCAR firms before September 30 would be required to participate in the following year's CCAR/DFAST cycle, while firms that cross the threshold after September 30 would not need to comply until the second subsequent CCAR/DFAST cycle.
- ***Reduced Reporting Requirements.*** The Proposal would modify the Form FR Y-14 for large and noncomplex firms by raising materiality thresholds and reducing supporting documentation requirements.
- ***Modifications to "Add-on" Stress Scenarios.*** The Proposal would also give the FRB more flexibility with respect to the global market shock and counterparty default "add-on" scenarios by allowing the FRB to select an "as-of" date from October of the preceding year through March 1 of the current year of the CCAR cycle.

— ***Effective Date and Comment Period.*** Each of these amendments would be effective for the 2017 CCAR and DFAST cycles. Comments are requested on the Proposal before November 25, 2016.

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