Client Alert

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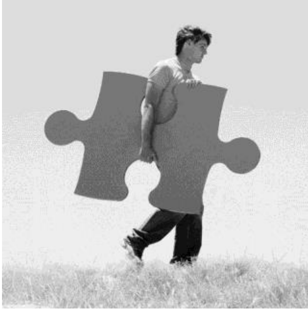

Tailoring More Stringent Prudential Standards Under Section 165 of Dodd-Frank: Fed Finalizes Stress Test Relief for Large and Noncomplex Firms

On January 30, 2017, the Board of Governors of the Federal Reserve System (the "Federal Reserve") adopted a final rule (the "Final CCAR Rule") that revises the capital plan and stress test rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The Final CCAR Rule establishes a new class of bank holding companies ("BHCs") with at least $50 billion in total consolidated assets—"large" and "noncomplex" firms that are subject to less stringent requirements than other BHCs subject to the annual Comprehensive Capital Analysis and Review ("CCAR"). The Final CCAR Rule also tightens certain requirements for all BHCs subject to CCAR testing. While it remains to be seen whether the new classification will be used to tailor other requirements under Section 165 of the Dodd-Frank Act, the Final CCAR Rule nonetheless represents a significant step towards establishing more tailored regulatory regimes for banking organizations.

The Federal Reserve initially invited for comment on a notice of proposed rulemaking to revise the capital plan and stress test rules for BHCs with at least $50 billion in total consolidated assets and U.S. intermediate holding companies ("IHCs") of foreign banking organizations in September 2016 (the "CCAR Proposal").[2] Largely consistent with the CCAR Proposal, the Final CCAR Rule nevertheless responds to some of the concerns raised by the twelve comment letters received by the Federal Reserve on the CCAR Proposal.

As described in greater detail below, BHCs that (i) maintain total consolidated assets of at least $50 billion but less than $250 billion, (ii) maintain nonbank assets of less than $75 billion and (iii) are not classified as a U.S. global systemically important bank ("G-SIB") (each, a "Large and Noncomplex Firm") will:

- No longer be subject to the qualitative component of CCAR, whereby the Federal Reserve may object to a capital plan on the basis of qualitative deficiencies in the firm's capital planning process; and
- Benefit from the modification of certain regulatory reporting requirements under the Federal Reserve's capital plan rule.

For all BHCs subject to the Federal Reserve's capital plan rule, the Final CCAR Rule:

- Simplifies the initial applicability provisions of both the capital plan and stress test rules;
- Reduces the amount of additional capital distributions that a BHC may make during a capital plan cycle (without necessitating the prior approval of the Federal Reserve); and

[1] Amendments to the Capital Plan and Stress Test Rules, Dock No. R-1548 RIN 7100 AE-59 (Jan. 30, 2017), *available at* https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20170130a1.pdf.
[2] *See* 81 Fed. Reg. 67239 (Sept. 30, 2016). *See also* Morrison & Foerster LLP, *The Fed Revisits CCAR and Proposes CCAR Relief for Large and Noncomplex Firms* (Sept. 28, 2016), *available at* https://media2.mofo.com/documents/160928-fed-revisits-ccar.pdf.

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- Extends the range of potential as-of dates the Federal Reserve may use for the trading and counterparty scenario component used in the stress test rules.

A. Federal Reserve's Existing Capital Plan and Stress Test Rules

Pursuant to Section 165 of the Dodd-Frank Act, the Federal Reserve conducts an annual assessment of the capital planning and post-stress capital adequacy of BHCs with total consolidated assets of at least $50 billion. This testing takes two forms: CCAR (conducted pursuant to the Federal Reserve's capital plan rule)[3] and the Dodd-Frank Act Stress Test ("D-FAST") (conducted pursuant to the Federal Reserve's stress test rules).[4] Under the capital plan rule, each BHC must submit a capital plan annually to the Federal Reserve that details its capital planning processes and capital adequacy assessment. The Federal Reserve may object to a BHC's capital plan on both qualitative and quantitative grounds.

The Federal Reserve may object to a BHC's capital plan on qualitative grounds if the:

- BHC has material unresolved supervisory issues (e.g., issues associated with the BHC's capital adequacy processes);
- Assumptions and analysis underlying the BHC's capital plan are not reasonable or appropriate;
- BHC's methodologies for reviewing its capital adequacy process are not reasonable or appropriate; or
- BHC's capital planning process or proposed capital distributions otherwise constitute an unsafe or unsound practice, or would otherwise violate any law, regulation, Federal Reserve order, directive, or condition imposed by (or written agreement with) the Federal Reserve.

The Federal Reserve may object to a BHC's capital plan on quantitative grounds if the BHC has not demonstrated an ability to maintain capital above each minimum regulatory capital ratio on a pro forma basis under expected and stressful conditions throughout the planning horizon.

B. Elimination of CCAR Qualitative Assessment for Large and Noncomplex Firms

The Final CCAR Rule eliminates the Federal Reserve's qualitative assessment and objection for Large and Noncomplex Firms, while maintaining the quantitative assessment. In lieu of the qualitative criteria, the Final CCAR Rule specifies: (1) the manner in which the Federal Reserve will conduct supervisory review of capital plans; (2) the elements required for a capital plan submission; (3) model risk management expectations for Large and Noncomplex Firms and (4) the application of market shock and the large counterparty default components for BHCs.

Identifying Large and Noncomplex Firms

Under the CCAR Proposal, a Large and Noncomplex Firm would have included a BHC with (as of December 31 of the calendar year prior to the beginning of the capital plan cycle): (1) average total consolidated assets of at least $50 billion but less than $250 billion; (2) total on-balance sheet foreign exposure of less than $10 billion and (3) average total nonbank assets of less than $75 billion. While the Final CCAR Rule maintains prongs "1" and "3" above, the $10 billion foreign exposure threshold has been eliminated and, instead, replaced by the criterion that the firm not be a U.S. G-SIB. In making this modification, the Federal Reserve noted that foreign exposures may arise from business activities that are not complex.

In determining the applicability of the qualitative component of the CCAR assessment to large banking organizations, the Federal Reserve considered numerous factors, such as: (i) size; (ii) complexity of operations and (iii) interconnectedness with other financial institutions. First, banking organizations with greater than $250 billion in total consolidated assets generally have more significant systemic risk profiles and larger market shares

[3] *See* 12 C.F.R. § 225.8.
[4] *See* 12 C.F.R.§ 252, subparts E and F (Regulation YY).

in the financial industry. Second, a nonbank asset threshold of $75 billion effectively separates out BHCs that are significantly engaged in activities outside the business of banking. Additionally, nonbank entities are more vulnerable to funding runs, as they generally rely on less stable forms of funding than insured depository institutions. Given that the above thresholds are "based on the static measures of size and nonbank assets," the Federal Reserve explained that it will "periodically re-assess the appropriateness of the thresholds for purposes of the requirements of the capital plan and stress test rules to ensure they remain suitable indicators for measuring complexity and risk."[5]

Supervisory Review of Capital Plans

1. ***Removal of CCAR Qualitative Assessment***. Under the Final CCAR Rule, Large and Noncomplex Firms will no longer be subject to the provisions of the Federal Reserve's capital plan rule whereby the Federal Reserve may object to a capital plan on the basis of deficiencies in the firm's capital planning process or unresolved supervisory issues. However, the Federal Reserve retains the authority to take supervisory actions related to capital planning against Large and Noncomplex Firms (e.g., actions to address unsafe and unsound practices or conditions or violations of law).

2. ***Scope and Notice of Review***. The Federal Reserve will conduct the supervisory review of capital plans of Large and Noncomplex Firms in a manner similar to existing supervisory programs, including: (i) a distribution of a first day letter in advance of the start of review; (ii) standard communications during the exam; (iii) lead time to meet requests for additional information and (iv) sufficient time frames for addressing the findings. The Federal Reserve will provide Large and Noncomplex Firms with several months' notice of the areas of focus of the annual capital plan review. The review may encompass areas where the firm's practices are evolving and specific issues that have been previously raised in firm-specific supervisory communications.

   In line with comments received in response to the CCAR Proposal, the Federal Reserve will ensure that communications and standards are coordinated between any teams conducting targeted horizontal reviews and dedicated supervisory teams. As capital planning expectations will be tailored to the size and complexity of a firm, Large and Noncomplex Firms will continue to be subject to the standards set forth in SR Letter 15-19.[6]

3. ***Timing of Review***. Consistent with the CCAR Proposal, the supervisory review of capital plans will generally occur in the third quarter of each calendar year under the Final CCAR Rule. While several commenters requested that the review take place during the second quarter "to avoid coinciding with the D-FAST mid-cycle process, which occurs in the third quarter," the Federal Reserve noted that such a revision is unnecessary given that:

   - Moving the supervisory review to the second quarter would limit the amount of time that a firm would have to prepare supporting documentation;
   - The Federal Reserve intends to provide the first day letter to firms during the first quarter and firms will have additional time to provide supporting documentation after they submit their capital plans; and
   - The timing of supervisory review of Large and Noncomplex Firms will be separate from the comprehensive CCAR qualitative assessment in order to clarify the differences in the review to the public.

[5] Amendments to the Capital Plan and Stress Test Rules, *supra* note 1 at 24.
[6] *See* Federal Reserve Guidance on Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms, SR Letter 15-19 (Dec. 18, 2015), *available at* https://www.federalreserve.gov/bankinforeg/srletters/sr1519a1.pdf (outlining the Federal Reserve's capital planning expectations for Large and Noncomplex Firms in the following areas: (i) governance; (ii) risk management; (iii) internal controls; (iv) capital policy; (v) incorporating stressful conditions and events; and (vi) estimating impact on capital positions).

Elements Required for Capital Plan Submission

Under the Final CCAR Rule, firms' capital plans must contain the minimum elements of a capital plan, including the firm's capital policy and description of the firm's capital planning process. Such elements are necessary because they:

- Provide important inputs into the supervisory assessment of the firm's capital plan regardless of whether the assessment occurs through CCAR or through the regular supervisory process; and
- Enable the firm's board of directors to understand and approve of the firm's capital adequacy, capital planning processes and capital-related decisions.

However, like the CCAR Proposal, Large and Noncomplex Firms under the Final CCAR Rule will now benefit from reduced supporting documentation requirements in connection with the submission of their capital plans. Specifically, the Final CCAR Rule revises the instructions to Appendix A of the FR Y-14A to eliminate the requirement that a Large and Noncomplex Firm include in its capital plan submission certain documentation regarding its models, including: (i) any model inventory mapping document; (ii) methodology documentation; (iii) model technical documents and (iv) model validation. Large and Noncomplex Firms will not be expected to include such supporting documentation in their capital plans to the extent that they have been vetted by senior management and approved by the Large and Noncomplex Firm's board of directors.

Model Risk Management Expectations for Large and Noncomplex Firms

The Federal Reserve clarified in the Final CCAR Rule that Large and Noncomplex Firms must maintain documentation regarding the (i) loss, (ii) revenue and (iii) expense estimation models used for stress scenario analysis, as well as update such documentation to reflect any revisions to the models. As provided in SR Letter 15-19, the expectations for models are reduced for Large and Noncomplex Firms.

However, Large Complex Firms[7] and LISCC Firms[8] must continue to satisfy more stringent model requirements, including with respect to: (i) the granularity of projections; (ii) variable selection process; (iii) controls for the use of vendor models and (iv) measures for assessing model performance. Likewise, expectations for model documentation are also lowered for Large and Noncomplex Firms as compared to LISCC and Large Complex Firms. Accordingly, given the tailored evaluation of model risk management at Large and Noncomplex Firms, the Federal Reserve explained in the Final CCAR Rule that it does not expect these firms to maintain the "same level of sophistication and intensity of model risk management . . . compared to LISCC and [Large Complex Firms]."[9]

Measuring and Reporting of Average Total Nonbank Assets

The Final CCAR Rule specifies the manner and frequency in which nonbank assets should be measured for purposes of evaluating whether a firm maintains nonbank assets of less than $75 billion.

1. ***Definition of Nonbank Assets***. Under the Final CCAR Rule, "nonbank assets" includes all assets held by nonbank entities, regardless of the type of asset.
2. ***Measuring Nonbank Assets for the 2017 Capital Plan Cycle***. In order to limit double counting of certain nonbank assets, a firm is permitted under the Final CCAR Rule to net intercompany exposures among nonbank subsidiaries for purposes of assessing nonbank assets for the 2017 capital plan cycle. However, the Final CCAR Rule does not permit a firm to net intercompany assets between a nonbank company and an affiliate whose assets are not included in the nonbank asset measure.
3. ***Frequency of Measuring Nonbank Assets on FR Y-9LP***. Like the CCAR Proposal, firms must under the Final CCAR Rule report their nonbank assets on the FR Y-9LP on new line item 17 of PC-B Memoranda to

[7] Firms with (a) $250 billion or more in total consolidated assets or (b) $10 billion or more in foreign exposures (hereinafter, "Large Complex Firms").
[8] Firms subject to the Large Institution Supervision Coordinating Committee supervisory framework (hereinafter, "LISCC Firms").
[9] Amendments to the Capital Plan and Stress Test Rules, *supra* note 1 at 16.

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determine their average total nonbank assets (for the capital plan cycle beginning January 1, 2017). In response to commenters who requested clarification as to the frequency of the calculation of the nonbank asset measure on FR Y-9LP, the Federal Reserve explained that firms should perform the calculation on a monthly basis. Accordingly, new line item 17 will be reported quarterly on the FR Y-9LP and reflect the average nonbank assets measure for that particular quarter. However, the initial filing of line item 17 should constitute the actual amount as of December 2016 as opposed to a four-quarter average.

Changes Regarding the *De Minimis* Exception

The *de minimis* exception provided under the capital plan rule permits a well-capitalized BHC to distribute small, additional amounts of capital above those approved on its capital plan without the need for a re-assessment of the BHC's capital plan. The Final CCAR Rule tightens the CCAR requirements by: (1) lowering the *de minimis* exception amount for all BHCs and (2) establishing a "blackout period" during which a BHC is (i) prohibited from submitting a notice to use the *de minimis* exception or (ii) submitting a request for prior approval for additional capital distributions that do not qualify for the *de minimis* exception.

1. ***Lowering of the De Minimis Exception Amount for all BHCs***. Consistent with the CCAR Proposal, the Final CCAR Rule modifies the *de minimis* amount from 1.00% to 0.25% of tier 1 capital. Firms may, however, still execute capital distributions consistent with meeting their targeted capital ratios as part of the next planning cycle.

   Moreover, firms retain the ability to submit requests for larger amounts of capital distributions beyond those included in the firm's capital plan with the prior approval of the Federal Reserve. The Federal Reserve will consider several factors when evaluating a capital distribution request, including, but not limited to, the size and complexity of the BHC making the request. Accordingly, a request from an LISCC or Large Complex Firm would require stronger justification for a capital distribution request when compared to a request made by a Large and Noncomplex Firm.

2. ***Blackout Period for the De Minimis Exception***. The Final CCAR Rule, like the CCAR Proposal, establishes a one-quarter "blackout period" during the second quarter of the calendar year (i.e., when each firm submits its updated capital plan and the Federal Reserve conducts CCAR to review such capital plans). During the blackout period, BHCs are prohibited from submitting a notice to use the *de minimis* exception or submitting a request for prior approval for additional capital distributions that do not qualify for the *de minimis* exception. BHCs seeking to make capital distributions in the second quarter (when the CCAR exercise is already underway) in excess of the amount described in a capital plan (for which a non-objection was issued pursuant to the *de minimis* exception or prior approval process) will be required to submit a:

   - Notice to use the *de minimis* exception by March 15; or
   - Request for prior approval for incremental capital distributions that do not qualify for the *de minimis* exception by March 1 and reflect the additional distributions in the capital plan.

Modification of Reporting Requirements

As part of the stress testing framework, BHCs must submit to the Federal Reserve the FR Y-14 series of reports, which consists of the: (i) semi-annual FR Y-14A; (ii) quarterly FR Y-14Q and (iii) monthly FR Y-14M. The Final CCAR Rule increases the materiality thresholds for filing schedules on the FR Y-14Q report and the FR Y-14M report for Large and Noncomplex Firms, reduces the supporting documentation required to be submitted in connection with a Large and Noncomplex Firm's capital plan and reduces the information that must be provided in connection with the FR Y-14A.

1. ***Increased Materiality Threshold for FR Y-14Q and FR Y-14M Reports***. Consistent with the CCAR Proposal, the materiality thresholds for filing schedules on FR Y-14Q and FR Y-14M reports for Large and Noncomplex Firms increase under the Final CCAR Rule. The FR Y-14 instructions currently define "material

portfolios" as those with asset balances greater than $5 billion or asset balances greater than 5% of tier 1 capital on average for the four quarters preceding the reporting quarter. However, the Final CCAR Rule revises the definition of "material portfolio" for Large and Noncomplex Firms to include a portfolio with asset balances greater than either: (i) $5 billion or (ii) 10% of tier 1 capital (both measured as an average for the four quarters preceding the reporting quarter). To avoid discouraging firms from reporting a portfolio as immaterial, the Final CCAR Rule applies the median loss rate on immaterial portfolios held at all firms subject to the supervisory stress test. The revised definition will become effective beginning with the first "as-of" date after the effectiveness of the Final CCAR Rule.

2. ***Reductions in Supporting Documentation Required in Connection with Capital Plan***. The Final CCAR Rule reduces the supporting documentation that a Large and Noncomplex Firm will be required to submit with its capital plan. Specifically, the Final CCAR Rule revises Appendix A to FR Y-14A to remove the requirement that a Large and Noncomplex Firm include in its capital plan submission certain documentation regarding its: (i) models, including any model inventory mapping document; (ii) methodology documentation; (iii) model technical documents and (iv) model validation documentation. However, Large and Noncomplex Firms are still expected to be able to produce such documentation upon request by the Federal Reserve.
3. ***Removal of Requirement to Complete Certain Sections of FR Y-14A Schedule A***. Under the Final CCAR Rule, Large and Noncomplex Firms are no longer required to complete several portions of the FR Y-14A Schedule A, including the: (i) Securities Other-Than-Temporary Impairment ("OTTI") methodology sub-schedule; (ii) Securities Market Value source sub-schedule; (iii) Securities OTTI by security sub-schedule; (iv) Retail repurchase sub-schedule; (v) Trading sub-schedule; (vi) Counterparty sub-schedule and (vii) Advanced risk-weighted assets sub-schedule.

Simplification of Initial Capital Plan Application, Stress Test Rules and Regulatory Reporting

For BHCs with greater than $50 billion in total consolidated assets, the Final CCAR Rule simplifies the initial applicability provisions for the capital plan and stress test rules (i.e., subparts E and F of Regulation YY), as well as provides additional time before those requirements apply to BHCs that cross the $50 billion threshold near the April 5 capital plan submission and stress test date.

1. ***Capital Plan Submission Date***. Any BHC that crosses the $50 billion asset threshold on or before December 31 of a calendar year must, under the current capital plan rule, submit a capital plan by April 5 of the following year. However, the Final CCAR Rule moves the cutoff date for the capital plan submission to September 30. A firm that crosses the $50 billion asset threshold in the fourth quarter of a calendar year will, therefore, not have to submit a capital plan until April 5 of the second year after it has crossed the threshold.
2. ***Initial Stress Test Date***. Under the current stress test rules, a BHC that crosses the $50 billion asset threshold before March 31 of a given year would be subject to the stress test rules under subparts E and F of Regulation YY beginning in the following year. The Final CCAR Rule aligns the cutoff date for initial application of the stress test rules in subparts E and F of Regulation YY with that of the capital plan rule so that a BHC becomes subject to the stress test rules in subparts E and F in the year following the first year in which the BHC submitted a capital plan. Accordingly, a firm will have at least a year before it is subjected to its initial stress test under subparts E and F. This change will provide a more orderly onboarding process for new FR Y-14 filers, as well as simplify the application of the capital plan and stress test rules.
3. ***Extended Onboarding Period for Regulatory Reporting***. Currently, any BHC that crosses the $50 billion asset threshold must prepare FR Y-14M reports as of the end of the month in which it crossed the threshold. The BHC's first FR Y-14M must be submitted within 90 days after the end of the month.

   However, the Final CCAR Rule extends the onboarding period of regulatory reporting requirements, requiring a BHC to (i) begin preparing its initial FR Y-14M as of the end of the third month after the BHC first crossed the $50 billion asset threshold (as opposed to as of the month in which the BHC crosses the threshold) and

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(ii) submit its first FR Y-14M within 90 days after the end of that month. The extended onboarding period will enable BHCs to more easily comply with their FR Y-14 reporting obligations when they take effect and, consequently, alleviate the burden for reporting BHCs.

Continued Application of CCAR for LISCC Firms and Large Complex Firms

The Final CCAR Rule does not amend the application of CCAR's qualitative assessment for LISCC Firms and Large Complex Firms. However, the Final CCAR Rule, like the CCAR Proposal, contains a modification to the capital plan rule's qualitative objection criteria for LISCC Firms and Large Complex Firms. Under the Final CCAR Rule, the Federal Reserve may object to a capital plan of an LISCC Firm or Large Complex Firm if, among other factors, the methodologies and practices that support the BHC's capital planning process are not reasonable or appropriate.

Market Shock Component

1. ***Revisions to the Time Period for the Market Shock "As-Of" Date***. Under the current stress test rules, the Federal Reserve may require a BHC with significant trading activity to include a trading and counterparty component ("Global Market Shock") in its "adverse" and "severely adverse" scenarios for its company-run stress tests. While the Federal Reserve must currently select a date between January 1 and March 1 of the calendar year of the stress test cycle, the Final CCAR Rule enables the Federal Reserve, for the 2018 stress test cycle, to select any date between October 1 of the prior year and March 1 of the year of the stress test cycle for the as-of date of the Global Market Shock. The Federal Reserve has additionally clarified that the Final CCAR Rule will not change the Federal Reserve's practice of permitting firms to use the data from weekly internal risk reporting (for the week of the chosen as-of date) and does not alter the reporting deadlines for the reporting schedules related to the market shock.
2. ***Application of Market Shock and Large Counterparty Default Component***. While commenters to the CCAR Proposal requested that the Federal Reserve clarify that Large and Noncomplex Firms would not be subject to the Global Market Shock and large counterparty default components of the supervisory stress test, the Federal Reserve noted in the Final CCAR Rule that only firms with greater than $500 billion in total consolidated assets (that are subject to the market risk rule) are subject to the Global Market Shock component. Accordingly, Large and Noncomplex Firms could not qualify for inclusion in the Global Market Shock component of the supervisory stress test.

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