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Federal Reserve Board Proposes Changes to DFAST/CCAR Rules

On September 26, 2016, the Board of Governors of the Federal Reserve System (Federal Reserve) issued a notice of proposed rulemaking (NPR) inviting public comment on specific changes to the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) rules, including the elimination of the qualitative assessment requirement for bank holding companies that are large, but are not complex.

Separately, in a speech delivered on September 26, 2016 at Yale University titled "Next Steps in the Evolution of Stress Testing", Federal Reserve Governor Daniel Tarullo outlined a series of planned and potential changes to the Board's DFAST/CCAR rules based upon the Board's evaluation of those rules.

This alert briefly summarizes key features of these two announcements, which are applicable to bank holding companies with more than US$50 billion in assets.

These announcements demonstrate the Federal Reserve's continued focus on the capital planning and stress testing process, which will have important practical implications for effected bank holding companies and, in some circumstances (as demonstrated by the changes set forth in the NPR as further described below), may provide additional flexibility.[1] The comment deadline on the NPR is November 25, 2016. Thus, it is likely that the changes proposed in the NPR will be finalized before the end of the year. Those with responsibility for an organization's DFAST/CCAR process should carefully consider these announcements as part of their ongoing stress testing and capital planning activities.

The Current DFAST/CCAR Rules

The current stress testing and capital planning process consists of two rules. One is the Federal Reserve's DFAST rule, which requires the Federal Reserve to conduct supervisory stress tests of bank holding companies with US$50 billion or more in assets and requires the bank holding companies to conduct annual and mid-cycle company-run stress tests. The other is the Federal Reserve's CCAR rule, through which the Federal Reserve assesses the internal capital planning processes of bank holding companies and the ability of those companies to maintain sufficient capital under expected and stressful conditions.

Under the CCAR rule, a bank holding company must submit an annual capital plan to the Federal Reserve. If the Federal Reserve does not approve the plan, the bank holding company may not make any capital distributions.

[1] The Federal Reserve's focus on capital adequacy and the evolution of its stress testing processes is further illustrated in recent statements made by Federal Reserve Chair Janet Yellen before the House of Representatives Committee on Financial Services on September 28, 2016, a transcript of which is available at the Federal Reserve's website.

Summary of Key NPR Changes

Changes for Large and Noncomplex Bank Holding Companies

In the NPR, the Federal Reserve is proposing to revise the standards that it uses to review capital plans for bank holding companies that have total consolidated assets of less than US$250 billion, foreign exposures of less than US$10 billion and nonbank assets of less than US$75 billion.

Starting in 2017, these bank holding companies will not be subject to provisions in the CCAR rule that allow the Federal Reserve to object to a plan based upon supervisory concerns related to assumptions, analysis and methodologies used in a plan (i.e., qualitative criteria). Instead, large, noncomplex bank holding companies would be subject to assessments conducted through the regular supervisory process and targeted, horizontal assessments. The NPR notes that the Federal Reserve would send a supervisory communication to each large and noncomplex firm describing the scope of these supervisory reviews, and that the reviews likely would occur in the quarter following the CCAR qualitative assessment for large and complex firms. Under the NPR, large and noncomplex bank holding companies will continue to be subject to the quantitative standards contained in the CCAR rule.

The NPR also proposes to relax some reporting requirements for large, noncomplex bank holding companies. Currently, all bank holding companies subject to the CCAR rule must file detailed reports on particular activities and exposures. For large, noncomplex bank holding companies, the Board is proposing to raise the materiality threshold on some reporting items, reduce some the supporting documentation requirements and eliminate some specific reporting schedules.

Proposed Transition Relief for Companies that Cross the US$50 Billion Threshold

To facilitate compliance with the DFAST/CCAR rules by bank holding companies that cross the US$50 billion threshold, the NPR includes a proposal to extend the period of time in which they need to meet applicable stress testing and capital planning requirements. Specifically, the cutoff date for compliance with the capital planning rule would be moved to September 30, so a firm that crosses the US$50 billion asset threshold in the fourth quarter of a calendar year would not have to submit a capital plan until April 5 of the second year after it crosses the threshold. Similarly, the firm would not become subject to the stress testing rules until the third calendar year after it crosses the threshold.

De Minimis Capital Distributions

Under the current CCAR rule, a bank holding company may make a capital distribution outside its capital plan and without Federal Reserve approval, if the distribution is less than 1% of the company's Tier 1 capital. In the NPR, the Federal Reserve is proposing to reduce this threshold to 0.25%, and to prohibit any such distribution during a "blackout period" while the Federal Reserve is conducting the CCAR process. This period would be the second quarter of each calendar year.

September 26 Tarullo Speech

Stress Capital Buffer

In his September 26 speech, Governor Tarullo signaled that the Federal Reserve is considering other changes to the DFAST/CCAR rules and procedures. These potential changes, however, would not be effective in 2017, and some would be subject to public notice and comment.

Most significantly, the Federal Reserve is considering the adoption of a "stress capital buffer" to setting post-stress capital requirements for the bank holding companies. This buffer would effectively add the GSIB surcharge to the Federal Reserve's estimates of the amount of capital a bank holding company needs under stress conditions. If adopted, this requirement would significantly increase the capital requirements applicable to GSIBs.

The imposition of a stress capital buffer also could have the effect of requiring a firm to hold capital to meets its stress losses and fund its planned dividends over the next year. This, according to Governor Tarullo, could permit the Federal Reserve to eliminate the 30% "soft limit" on dividend payouts that it adopted in 2010.

Governor Tarullo also noted that the Federal Reserve is considering several changes to its stress test model. Specifically, the Federal Reserve may adjust the model to assume that bank balance sheets and risk-weighted assets would remain constant over a severely adverse scenario. This assumption would attribute any decline in lending during a recession to the impact of the recession, not capital requirements. The Federal Reserve also may make the severity of the change in the unemployment rate less severe during downturns, and may tie the outlook for housing prices to disposable personal income. Furthermore, the Federal Reserve is considering disclosing descriptions of changes in the model well in advance of the stress test, and phasing in the most material model changes over two years. Finally, the Federal Reserve may publish data that represent a typical bank portfolio of loans and securities along with the losses that might be associated with that portfolio under different stress scenarios. On the other hand, the Federal Reserve is not planning to publish the full code for the model.

For further information regarding the impact of the final capital rules, or financial reform generally, please contact your principal Squire Patton Boggs lawyer or one of the individuals listed in this alert.

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