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Memorandum

Federal Reserve Adopts Changes to Capital Buffers and Stress Testing Standards

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The federal banking agencies recently issued a final rulemaking to revise the capital rules applicable to banking organizations, especially global systemically important banking organizations ("GSIBs") and other banking organizations subject to the Federal Reserve's Comprehensive Capital Analysis and Review ("CCAR") process. In particular, the final rules replace the static capital conservation buffer with a dynamic "stress capital buffer" tied to the results of a banking organization's CCAR modeling, and adjust certain CCAR stress test assumptions and review standards.

The final rules, which are largely consistent with the Federal Reserve's proposal issued in April 2018, generally seek to further the long-stated goal of the U.S. banking agencies to streamline and tailor the regulatory framework. According to Federal Reserve staff, the stress capital buffer is expected to decrease the required levels of capital for non-GSIBs subject Categories II through IV of the Federal Reserve's recently adopted enhanced prudential standards tailoring rule ("EPS Tailoring Rule") relative to currently required levels, and would increase the required levels of capital required for GSIBs.

Introduction of New Stress Capital Buffer

Under the current 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 final rules integrate the CCAR quantitative requirements with the existing regulatory capital regime by replacing the 2.5% fixed capital conservation buffer with a new "stress capital buffer" for banking organizations subject to CCAR. The stress capital buffer will 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, *plus* the sum of the ratios of the firm's planned common stock dividends for each of the fourth through seventh quarters of the planning horizon (as a percentage of risk-weighted assets from the quarter in which the firm's projected CET1 ratio reaches its minimum in the stress test). Thus, for example, if a firm's CET1 ratio were to decline from 13% to 9% under CCAR's severely adverse scenario, and the firm had planned to issue common stock dividends equal to, in aggregate, 1% of risk-weighted assets in the fourth through seventh quarters of its planning horizon, that firm's required stress capital buffer will be 5%. To avoid any reduction in the stringency of the regulatory capital rules, all firms will 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 will 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%.[1]

While the proposed rules would have required CCAR firms to also comply with a new "stress leverage buffer" requirement (determined in a manner similar to that used to determine a CCAR firm's stress capital buffer), the Federal Reserve did not retain this requirement in the final rules.

A CCAR firm's stress capital buffer will be calculated by the Federal Reserve in connection with each year's stress test, and will be made public by June 30 of each year. Each CCAR firm's updated annual stress capital buffer requirement will then become effective on October 1 of each year (beginning October 1, 2020), with the resulting restrictions on capital distributions effective from October 1 through September 30 of the following year. To provide a transition between the 2019 CCAR cycle and the first stress capital buffer requirement, for the period from July 1 through September 30, 2020, a firm will generally be authorized to make capital distributions that do not exceed the four-quarter average of capital distributions approved by the Federal Reserve in the previous capital plan cycle.

Within two business days of being notified of its stress capital buffer requirement, a CCAR firm will be required to assess whether its planned capital distributions in the fourth through seventh quarters of the planning horizon, under the baseline CCAR scenario, would be consistent with capital distribution limitations (taking into account its stress capital buffer and any other applicable buffers). If its planned capital distributions are inconsistent with its minimum capital and leverage requirements under the baseline scenario, a firm will be required to adjust its planned capital distributions for those quarters and notify the Federal Reserve of any such adjustments. Unlike the proposed rules, the final rules permit a firm to increase its planned distributions through this adjustment process to allow additional flexibility in its capital planning. Any increases in planned dividends in quarters four through seven of the planning horizon would be reflected in a firm's stress capital buffer requirement.

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[1] This analysis assumes a countercyclical capital buffer amount of 0%, consistent with the current level as affirmed by the Federal Reserve on March 6, 2019: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190306c.htm.

Adjusted CCAR Stress Test Assumptions and Review Standards

The final rules include the following revised assumptions that the Federal Reserve will incorporate in its CCAR stress testing process 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 of the final rules, the Federal Reserve will assume that a CCAR firm would not pay any dividends on common stock or make any share repurchases or redemptions over the stress test planning horizon. However, the inclusion of four quarters of planned dividends in the calculation a CCAR firm's stress capital buffer will maintain an incentive to engage in disciplined dividend planning, effectively requiring a firm to hold capital to meet its stress losses and pre-fund one year of planned dividends. Notably, this buffer would not reflect share repurchases. As the Federal Reserve has recognized, many large bank holding companies were able to reduce their repurchases early on in the last financial crisis.
- **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 (by holding loan supply constant while allowing credit demand to respond to conditions in the stress scenario). In response to industry concerns that loan portfolios would not be increasing under any reasonable assumptions during a severely adverse scenario, the final rules replace this aspect of the Federal Reserve's CCAR model with a simple assumption that balance sheets and risk-weighted assets would remain constant over the severely adverse scenario horizon.
- **Business Plan Changes Not Incorporated.** The final rules do not incorporate material business plan changes in a firm's stress capital buffer requirement. For example, planned issuances of common or preferred stock in connection with a planned merger or acquisition will not be included in the stress capital buffer requirement calculation. In addition, any planned common stock dividends attributable to issuances that would be made in connection with a planned merger or acquisition will also not be included in the stress capital buffer requirement calculation. However, in the event that a change to a firm's business plan results (or could result) in a material change in the firm's risk profile, the Federal Reserve will retain authority to require the firm to submit an updated CCAR capital plan and to update the firm's stress capital buffer based on that plan.

In addition to the above revised assumptions, the final rules revise several aspects of the Federal Reserve's review of capital plans under the CCAR process. For instance, the final rules revise the definition of eligible retained income in its capital to make the automatic limitations on a firm's distributions more gradual as the firm's capital ratios decline. In addition, the final rules eliminate the Federal Reserve's current policy of subjecting dividend payout ratios above 30% of projected post-tax net income to heightened scrutiny, in light of the proposed inclusion of four quarters of planned dividends in the calculation a CCAR firm's stress capital buffer (which the Federal Reserve views as sufficient incentive for prudent dividend payouts). To date, most CCAR firms have kept their proposed dividend payout ratios below this 30% threshold in light of this policy.

In addition, under the final rules, the Federal Reserve will no longer object to a CCAR firm's capital plan based on a quantitative assessment of the firm's capital adequacy, since the firm's distributions will be subject to ongoing limitations that would be automatically triggered if a firm breaches its stress capital buffer requirement.[2]

Further, while the proposal would have retained the requirement that a CCAR firm generally seek prior approval from the Federal Reserve to make a capital distribution in excess of the amount described in the firm's CCAR capital plan, the final rules permit a CCAR firm to make capital distributions in excess of the planned capital distributions included in its capital plan without prior approval by the Federal Reserve so long as the firm is in compliance with the final rule's automatic distribution limitations (including the stress capital buffer requirement) and other limited circumstances. A firm would be required to notify the Federal Reserve and appropriate Reserve Bank of changes to its planned capital actions within 15 days of executing such an action.

[2] The Federal Reserve also eliminated the qualitative review process for most CCAR firms in March 2019. Specifically, a firm that participates in four assessments and successfully passes the qualitative evaluation in the fourth year is no longer subject to a potential qualitative objection. 84 FR 8953 (March 13, 2019).

For more information regarding these final rules, please contact any member of the Firm's Financial Institutions Group, including those listed below.

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