Federal Banking Agencies Issue Final Stress Testing Rules

This week, the U.S. federal banking regulators each issued final rules (the "Stress Testing Rules") that impose stress-testing requirements on all insured depository institutions and insured depository institution holding companies over a $10 billion total consolidated asset threshold ("Covered Institutions"), as required by Section 165(i) of the Dodd-Frank Act.[1] Covered Institutions will be required to conduct annual stress tests under baseline and multiple adverse macroeconomic scenarios according to parameters established by the respective Agencies.

Concurrently, the Federal Reserve issued a final rule implementing supervisory and company-run stress testing (the "SIFI Stress Testing Rule" and, together with the Stress Testing Rules, the "Final Rules") for BHCs with over $50 billion in total consolidated assets ("Large BHCs") and nonbank financial companies designated by the Financial Stability Oversight Council under Section 165 of the Dodd-Frank Act ("Nonbank SIFIs" and, together with Large BHCs, "Covered SIFIs").[2] Covered SIFIs will be required to undergo annual stress tests conducted by the Federal Reserve, and will be required to conduct their own "company-run" stress tests twice a year.

The SIFI Stress Testing Rule finalizes regulations first proposed on January 5, 2012, as part of the Federal Reserve's package of proposed regulations to implement Sections 165 and 166 of Dodd-Frank (the "Proposed SIFI Rules").[3] The SIFI Stress Testing Rule is the first component of the Proposed SIFI Rules to be issued in final

1 77 Fed. Reg. 61,238 (Oct. 9, 2012) (Office of the Comptroller of the Currency (the "OCC")); 77 Fed. Reg. 62,396 (Oct. 12, 2012) (Federal Reserve Board (the "Federal Reserve")). The rule issued by the Federal Deposit Insurance Corporation (the "FDIC" and, together with the OCC and the Federal Reserve, the "Agencies") has not yet been published. Links to the FDIC's final prepublication draft and the Federal Register are provided at the end of this Memorandum. For the purposes of this Memorandum, "Covered Institutions" include the following institutions, to the extent that such institutions cross the $10 billion consolidated asset threshold: national banks and federal savings banks regulated by the OCC; state nonmember banks and savings associations regulated by the FDIC; savings and loan holding companies ("SLHCs") and state member banks regulated by the Federal Reserve; and bank holding companies ("BHCs") with average total consolidated assets between $10 and $50 billion regulated by the Federal Reserve (larger BHCs are covered under the SIFI Stress Testing Rule, described below).

2 77 Fed. Reg. 62,378 (Oct. 12, 2012).

3 77 Fed. Reg. 594 (Jan. 5, 2012).

form. The Federal Reserve indicated that the SIFI Stress Testing Rules were completed ahead of the other Proposed SIFI Rules in order to provide clarity about when stress testing requirements will apply to various banking organizations and to require those Large BHCs that are required to conduct stress tests this year to publicly disclose the results of their company-run stress tests.

The release of the Final Rules is another step towards establishing stress testing as a central component of the Agencies' supervisory toolbox for a broader range of institutions, not just the largest banks. They build on the Supervisory Capital Assessment Program ("SCAP") stress tests conducted in 2009 during the financial crisis, the Federal Reserve's subsequent steps to formalize the capital planning process for Large BHCs through the Comprehensive Capital Analysis and Review ("CCAR") stress tests in 2010 and 2011, the Federal Reserve's 2011 capital planning rule, and the high-level internal stress testing principles applicable to Covered Institutions that the Agencies released in May 2012.[4] Results of both supervisory and company-run stress tests help to inform regulatory evaluations of a Covered Institution's capital adequacy and capital planning, including whether the Agencies will permit a Covered Institution to pay dividends or make other capital distributions. The Final Rules will significantly expand the number of institutions required to conduct some form of regulatory stress testing—either supervisory or "company-run"—over the next two to three years.

This Memorandum summarizes the key issues raised by the Final Rules and highlights certain changes between the Final Rules and the notices of proposed rulemaking the Agencies published in January 2012.[5] Although the Final Rules are substantively similar to the proposals, there were some significant changes to the procedural requirements in the Final Rules, particularly with respect to the timing of stress testing requirements applicable to Covered Institutions with $10 billion to $50 billion in total consolidated assets ("Smaller Covered Institutions").

- *Timing of Stress Tests*. In January, the Agencies had proposed to require Covered Institutions to begin conducting their annual stress tests this year, with reporting beginning in early 2013. In response to numerous comments, however, the Stress Testing Rules delay for one year implementation of stress testing requirements for Smaller Covered Institutions. As a result, Smaller Covered Institutions generally must complete their first round of company-run stress tests in early 2014, based on September 30, 2013 data, while Covered Institutions with over $50 billion in total consolidated assets

4 See, e.g., 77 Fed. Reg. 29,458 (May 17, 2012) ("Stress Testing for Banking Organizations with More than $10 Billion in Total Consolidated Assets"); 76 Fed. Reg. 74,631 (Dec. 1, 2011) ("Capital Plans", codified at 12 C.F.R. § 225.8).

5 See Proposed SIFI Rules; 77 Fed. Reg. 3166 (Jan 23, 2012) (FDIC); 77 Fed. Reg. 3408 (Jan. 24, 2012) (OCC).

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("Larger Covered Institutions") must complete stress tests using September 30, 2012 financial data by January 2013. This change reflects the fact that most Larger Covered Institutions already have been involved in regulatory stress testing, as part of SCAP and/or CCAR, while stress tests will generally be a new exercise for Smaller Covered Institutions. The FDIC and OCC indicated that they will be willing to consider extensions on a case-by-case basis for Larger Covered Institutions that need additional time to develop a robust stress testing framework.

Similarly, under the Federal Reserve's SIFI Stress Testing Rule, only the 19 Large BHCs that participated in SCAP (or their successors) ("SCAP BHCs") will be required to submit September 30, 2012 data for supervisory stress tests, and to conduct and report the results of their 2012 company-run stress tests in January 2013. Other Covered SIFIs will begin stress testing in the fourth quarter of 2013—based on September 30, 2013 data—for submission to the Federal Reserve in January 2014. The Federal Reserve has also reserved the right to extend, or in some cases accelerate, the timing of compliance obligations.

SLHCs will not be subject to the Stress Testing Rules until the year after they become subject to the Federal Reserve's minimum regulatory capital requirements.

Annual supervisory and company-run stress tests will be conducted based on financial information dated as of September 30 of each year, with projections over at least a nine-quarter forward-looking planning horizon (e.g., company-run stress tests for 2012 will use September 30, 2012 data and make projections through the end of 2014, and will be reported to the Agencies in early 2013). Submission of company-run stress test results to the Agencies is due by January 5 each year for Larger Covered Institutions, and March 31 for Smaller Covered Institutions. Covered SIFIs must also submit the data necessary to support the Federal Reserve's annual supervisory stress tests by January 5, and must complete and submit their second, "mid-cycle" company-run stress tests (based on March 31 data) by July 5 of each year.

A chart showing the initial and ongoing timing requirements is attached as an appendix to this Memorandum.

- *Scenarios and Methodologies*. Stress tests must be performed based on September 30 data under a minimum of three macroeconomic scenarios—baseline, adverse and severely adverse—which will be provided to Covered Institutions by November 15 of each year. The Final Rules suggest that the scenarios used by each Agency will be identical or substantially similar to those used by the other Agencies, although divergences are not precluded, and the Agencies have retained discretion to require Covered Institutions to run stress tests under other scenarios and conditions as they deem appropriate. For example, Covered Institutions with significant trading activities may be required to include a trading and counterparty component in the scenarios used for the stress tests. The Federal Reserve's rules specifically state that it may impose more or less stringent requirements on firms depending on the extent of their systemic importance, and that it may require some Covered Institutions to include additional stress assumptions in their stress scenarios, or to apply additional scenarios beyond the minimum three. The other Agencies' rules have similar reservations of authority.

Under the SIFI Stress Testing Rule, Covered SIFIs are expected to tailor their company-run stress tests to their own idiosyncratic operations and risks. While the Federal Reserve will provide economic scenarios for the annual company-run stress tests conducted based on September 30 data, Covered SIFIs will be required to design their own baseline, adverse and severely adverse scenarios for the "mid-cycle" company-run stress tests based on March 31 data, and are expected to consider other idiosyncratic scenarios and vulnerabilities during their ongoing internal analyses of capital adequacy.

- *Further Guidance Expected*. Despite the broad scope of these releases, many steps remain to be completed. The Agencies have indicated that they intend to invite public comment on proposed guidance that will detail their framework and procedures for developing the annual stress test scenarios, and may publish further guidance clarifying supervisory expectations for how Covered Institutions should conduct their company-run stress tests. The Agencies have also begun to develop and release for public comment the forms that they will use to collect information on stress test data and results.[6]

  Despite the controversial lack of transparency regarding the models used by the Federal Reserve in the SCAP and CCAR stress tests and requests for clarity regarding what models the Federal Reserve intends to use going forward, the Federal Reserve did not disclose, or commit to disclose, the models it will employ in running its supervisory stress tests. However, it indicated that it was considering how much additional transparency it could provide, and that, at a minimum, it would publish an overview of its stress testing methodologies each year. The Federal Reserve expects to publish

6 See, e.g., 77 Fed. Reg. 52,718 (Aug. 30, 2012) (FDIC); 77 Fed. Reg. 49,485 (Aug. 16, 2012) (OCC); 77 Fed. Reg. 60,695 (Oct. 4, 2012) (Federal Reserve). The Federal Reserve's Form FR Y-14A, which is currently used to collect data from the SCAP BHCs, is the model for the proposed OCC and FDIC forms. See http://www.federalreserve.gov/reportforms/.

additional information regarding the extent and timing of disclosures regarding supervisory models at a later date.

- *Public Disclosures*. The Agencies made two changes to the Final Rules to address concerns regarding public disclosures. First, to address concerns that disclosure of baseline scenario results could be viewed as earnings guidance by the market, the Agencies have decided to require release only of the severely adverse scenario results from the Federal Reserve's supervisory stress tests and from initial company-run stress tests. However, the Federal Reserve indicated it would continue to evaluate whether public release of results from the adverse and baseline scenarios would be helpful to the public, and could choose to release such results for future rounds of stress tests. Second, the Agencies adjusted the required disclosure dates for company-run stress tests to avoid overlap with the "quiet periods" some firms enforce prior to the release of their earnings announcements. Public releases are now required during a fifteen-day window approximately 90 days after the date a stress test report is due to the relevant Agency.

  The Final Rules now specifically provide that such publication can be made on a Covered Institution's website or "any other forum reasonably accessible to the public." In addition, the Agencies have provided that a subsidiary depository institution can generally release its stress test data as part of, and on the same schedule as, its parent holding company, thereby relieving Covered Institutions of the potential for duplicative or overlapping publication requirements.

- *Governance and Use Requirements*. In response to requests for clarity on the role of senior management and boards of directors in company-run stress tests, the Final Rules provide that senior management is responsible for establishing and maintaining a system of controls, oversight, and documentation, including policies and procedures, designed to ensure that the stress testing processes used by the company are effective in meeting the requirements of the Final Rules. The board of directors, or an appropriate committee thereof, is responsible for approving and reviewing the policies and procedures of the stress testing processes as "frequently as economic conditions or the condition of the company may warrant, but not less than annually." In addition, the board of directors and senior management of the company are required to take into account both supervisory and company-run stress tests as part of assessing the firm's capital planning process—under the SIFI Stress Testing Proposal, the rule text specifically requires stress tests to be considered in capital plans; assessments of the firm's risks, exposures and concentrations; and in developing resolution and recovery plans.

- *Foreign Banking Organizations*. Foreign banking organizations ("FBOs") and their U.S. branches and agencies are not covered by the Final Rules, although the U.S. bank and U.S. intermediate BHC subsidiaries of an FBO would be covered if they cross the relevant asset thresholds of $10 billion or $50 billion. Intermediate U.S. BHC subsidiaries of FBOs that rely on their foreign bank parent's capital under Federal Reserve Letter SR 01-01 will be exempt until July 21, 2015. The Federal Reserve has indicated that it will address the application of Section 165 of Dodd-Frank to FBOs in a later rulemaking.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Banking and Financial Institutions" under the "Practices" section of our website at http://www.clearygottlieb.com.

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Links to the Final Rules

Federal Reserve:

Supervisory and Company-Run Stress Test Requirements for Covered Companies:

http://www.gpo.gov/fdsys/pkg/FR-2012-10-12/pdf/2012-24987.pdf

Annual Company-Run Stress Test Requirements for Banking Organizations with Total Consolidated Assets:

http://www.gpo.gov/fdsys/pkg/FR-2012-10-12/pdf/2012-24988.pdf

FDIC:

http://www.fdic.gov/news/board/2012/2012-10-09_notice_dis-a_res.pdf

OCC:

http://www.gpo.gov/fdsys/pkg/FR-2012-10-09/pdf/2012-24608.pdf

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Appendix: Initial Timing of Company-run Stress Testing Requirements for Covered Institutions [7]

Financial Institution	Data Date(s)	Reporting Date(s)	Publication Date(s)
Smaller Covered Institutions, as of the effective date[8]	As of September 30, 2013	By March 31, 2014	Between June 15 and June 30, 2015 with respect to 2014 stress test (using data as of September 30, 2014). The results of the 2013 stress test are not required to be made public.
Smaller Covered Institutions reaching the $10 billion threshold after the effective date	Such Covered Institutions must comply with the Stress Testing Rules commencing the calendar year after they reach the threshold.		
Smaller Covered Institutions that cross the $50 billion threshold after the effective date	Such Covered Institutions must comply with the Stress Testing Rules applicable to Larger Covered Institutions in the calendar year they become a Larger Covered Institution.		
Larger Covered Institutions, as of the effective date	As of September 30, 2012	By January 5, 2013	Between March 15 and March 31, 2013
Covered Institution that is a consolidated subsidiary of a BHC or SHLC subject to annual stress tests	Such Covered Institutions may elect to conduct their stress tests and report their results in accordance with the timeline of their parent companies. However, once a Covered Institution opts to do so, it remains subject to that requirement unless it obtains the approval of its primary federal regulator to do otherwise. The Stress Testing Rules do not specifically address the publication requirements for such Covered Institutions, but we would anticipate that they would follow the requirements of the parent.		
SCAP BHCs, as of the effective date	As of September 30, 2012, and March 31, 2013	By January 5, 2013, and July 5, 2013	Between March 15 and March 31, 2013, and between September 15 and September 30, 2013
Large BHCs (other than SCAP BHCs), as of the effective date	As of September 30, 2013, and March 31, 2014	By January 5, 2014, and July 5, 2014	Between March 15 and March 31, 2014, and between September 15 and September 30, 2014
Nonbank SIFIs	Such Covered Institutions must comply with the SIFI Stress Testing Rules commencing the calendar year after the year they first become subject to the Federal Reserve's minimum regulatory capital requirements.		

7 SLHCs will not be subject to the Stress Testing Rules until the year after they become subject to the Federal Reserve's minimum regulatory capital requirements.

8 For the OCC, the effective date is October 9, 2012; for the FDIC, it will be the date the FDIC rule is published in the Federal Register; for the Federal Reserve, it is November 15, 2012.

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