Capital Planning and Stress Testing: Federal Reserve Board Policy Statement and Reporting

Executive Summary

The Federal Reserve Board (Federal Reserve) recently approved a final policy statement that establishes a framework to govern the agency’s approach to scenario design for the stress testing required in connection with its capital plan rule, more commonly referred to as the Comprehensive Capital Analysis and Review or CCAR, and to its Regulation YY requirements, which implement the supervisory and company run stress tests required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), more commonly referred to as DFAST. The policy statement became effective January 1, 2014.

On November 1, 2013 the Federal Reserve released the macroeconomic scenarios to be used in the 2014 stress testing exercises under the CCAR and DFAST. The Federal Reserve indicates these scenarios are consistent with the final policy.

Bank holding companies (BHCs) participating in the 2014 CCAR were required to submit their capital plans no later than January 6, 2014 along with Form FR-Y-14A, entitled Capital Assessments and Stress Testing, which also satisfies the reporting requirements for these BHCs under DFAST. The Form FR-Y-14A was also due by January 6, 2014.

On September 30, 2013 the Federal Reserve published a final notice of data collection activities for new Form FR-Y-16, entitled Annual Company Run Stress Test Projections, to be used by financial companies that are not covered by the CCAR but must conduct stress tests under DFAST. The Form FR-Y-16 is due to the Federal Reserve on March 31, 2014.

Background

The CCAR and DFAST stress tests are separate exercises that rely on similar processes, data, supervisory exercises, and requirements, although DFAST is far less intensive as it is designed for firms that were not included in the original CCAR regime (the CCAR followed the 2009 Supervisory Capital Assessment Program (SCAP), a standardized stress test that was conducted for the 19 largest U.S. BHCs at that time, and was originally conducted for those same 19 large BHCs). The Federal
Reserve states that it coordinates these processes to reduce duplicative requirements and to minimize burden. Accordingly, the Federal Reserve publishes annual stress test scenarios that are to be used in both the CCAR and DFAST exercises.

CCAR – Capital Plan

The CCAR stress tests were originally applicable to BHCs with $100 billion or more in assets, but expanded to include BHCs with $50 billion or more in total consolidated assets (CCAR BHCs) consistent with the $50 billion threshold established for the enhanced prudential standards by the Dodd-Frank Act. The Federal Reserve issued final rules in November 2011 that amended Regulation Y to require the BHCs meeting this threshold to submit an annual capital plan, including stress tests, to the Federal Reserve for review and to request prior approval in certain circumstances before making a capital distribution. The Federal Reserve publishes annually the macroeconomic scenarios to be incorporated in the BHC’s capital plan. These scenarios are the same scenarios used in the DFAST stress scenarios.

The CCAR BHCs are required to submit data supporting their capital plans using two new data collection forms – FR-Y-14Q and FR-Y-14A. The annual submission, FR-Y-14A is due with the capital plan in January of each reporting year using an "as of" date of September 30 of the previous year. (Please refer to Regulatory Practice Letter 12-03).

DFAST

The Federal Reserve issued two final rules in October 2012 that together implement the DFAST stress test requirements pursuant to the enhanced prudential standards provisions under Section 165 of the Dodd-Frank Act. In particular, the DFAST provisions require:

- The Federal Reserve to conduct an annual stress test of each BHC with total consolidated assets of $50 billion or more and each nonbank financial company that the Financial Stability Oversight Council has designated for supervision by the Federal Reserve (together, Covered Companies) to evaluate whether the Covered Company has sufficient capital, on a total consolidated basis, to absorb losses as a result of adverse economic conditions (supervisory stress tests). The supervisory stress tests provide for at least three different sets of conditions—baseline, adverse, and severely adverse conditions.
- Covered Companies to conduct their own company run stress tests semi-annually.
- “Other Financial Companies,” defined to include BHCs with more than $10 billion and less than $50 billion in total consolidated assets, savings and loan holding companies (SLHCs) with more than $10 billion in total consolidated assets and state member banks with more than $10 billion in total consolidated assets except for those that are consolidated subsidiaries of a Covered Company, to conduct annual company-run stress tests.

Note: one final rule governs Covered Companies and the second final rule governs Other Financial Companies.

The data submitted by Covered Companies on the Form FR Y 14A under the CCAR/capital plan rule also satisfies the data collection requirements applicable to
these entities under DFAST. Nonbank financial companies supervised by the Federal Reserve must also file Form FR Y 14A as part of the DFAST requirements.

Other Financial Companies that met the asset thresholds as of December 31, 2012, are required to comply with the DFAST requirements beginning with the 2014 exercises. As such, they must submit data supporting their annual company-run stress test to the Federal Reserve on new Form, FR Y-16 (discussed below), by March 31, 2014 based on data as of September 30, 2013.

The Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) each released final rules in October 2012 that are substantially similar to the Federal Reserve’s DFAST rules and are applicable to institutions under their supervisory authority (national banks, Federal savings associations, state nonmember banks and state-chartered savings associations). The agencies’ rules require OCC- and FDIC-supervised institutions with more than $10 billion in total consolidated assets to conduct annual company run stress tests.

Description
Policy Statement – Scenario Design Framework

Overview and Scope

The Federal Reserve’s final Policy Statement on the Scenario Design Framework for Stress Testing will apply to the stress tests required under the agency’s capital plan rule (i.e., the CCAR stress tests) and its DFAST rules.

The Federal Reserve will provide for at least three different sets of conditions (each set, a scenario), including baseline, adverse, and severely adverse scenarios for both supervisory and company-run stress tests. In general, the Federal Reserve anticipates that it will not issue additional scenarios; however, to the extent the Federal Reserve determines specific circumstances or vulnerabilities require particular vigilance to ensure the resilience of the banking sector, they will be captured in either the adverse or severely adverse scenarios.

The stress test scenarios are not intended to be forecasts but rather as hypothetical paths of economic variables that will be used to assess the strength and resilience of the companies’ capital in various economic and financial environments. The Federal Reserve expects to develop the scenarios beginning in July and August of each year based on “the collection and consideration of information from academics, professional forecasters, international organizations, domestic and foreign supervisors, and other private-sector analysts that regularly conduct stress tests based on U.S. and global economic and financial scenarios,” including analysts at the Covered Companies. The information will be updated through the end of October using “incoming macroeconomic data releases and other information” and the scenarios will be published no later than November 15 of each year.

The Federal Reserve will use the stress tests to assess the effect of different scenarios on the consolidated capital of each company over a forward-looking planning horizon of at least nine quarters.

The Federal Reserve generally expects to use the same scenarios for all companies subject to the final rules though it may require a subset of companies— depending on
a company’s financial condition, size, complexity, risk profile, scope of operations, or activities, or risks to the U.S. economy—to include additional scenario components or additional scenarios that are designed to capture different effects of adverse events on revenue, losses, and capital. An example of such an additional component is the market shock that applies to companies with significant trading activity. Any additional components or scenarios will be published no later than December 1 of each year.

**Scenarios**

The economic and financial variables included in the scenarios will likely incorporate the follow types of variables over a 13 quarter period:

- Multiple measure of economic activity and prices, such as the real and nominal gross domestic product (GDP) growth and the Consumer Price Index (CPI) inflation rate
- Multiple measures of developments in equity and property markets, such as the Core Logic National House Price Index and the Dow Jones Total Stock Market Index
- Multiple measures of interest rates, such as the rate on the three-month Treasury bill and the prime rate
- Similar measures for international variables for specific areas, such as the euro area, the United Kingdom, developing Asia, and Japan.

The market shocks for companies with significant trading activity will include shocks to a broad range of risk factors that are similar in granularity to those risk factors trading companies use internally to produce profit and loss estimates, under stressful market scenarios, for all asset classes that are considered trading assets, including equities, credit, interest rates, foreign exchange rates, and commodities. In contrast to the economic and financial variables, the market shock component consists of an instantaneous “shock” and will be applied only in the adverse and severely adverse scenarios.

In general, the baseline scenario will reflect the most recently available consensus views of the macroeconomic outlook expressed by professional forecasters, government agencies, and other public-sector organizations as of the beginning of the annual stress-test cycle (October 1 of each year). The severely adverse scenario will consist of a set of economic and financial conditions that reflect the conditions of post-war U.S. recessions. The adverse scenario will consist of a set of economic and financial conditions that are more adverse than those associated with the baseline scenario but less severe than those associated with the severely adverse scenario.

**OCC and FDIC**

The OCC issued a final “Policy Statement on the Principles for Development and Distribution of Annual Stress Test Scenarios” on October 21, 2013. The guidance outlines the processes the OCC intends to use to gather information on “material vulnerabilities or salient risks” and to coordinate with the Federal Reserve and the FDIC to develop the annual scenarios. The OCC’s guidance is substantially similar the Federal Reserve’s policy statement.
Data Submissions – Form FR-Y-16

Other Financial Companies that met the DFAST asset thresholds on December 31, 2012 are required to comply with the DFAST annual company-run stress testing requirements beginning October 1, 2013, (i.e., the 2014 DFAST exercise) using the stress scenarios provided by the Federal Reserve. On September 30, 2013, the Federal Reserve published new Form FR-Y-16, Annual Company Run Stress Test Projections, for use by Other Financial Companies to report the results of their annual company-run stress tests. It collects quantitative projections of balance sheet, income, losses, and capital across three scenarios (baseline, adverse, and severely adverse) and qualitative information on methodologies used to develop internal projections of capital across these scenarios. Form FR-Y-16 is due to the Federal Reserve by March 31 of each reporting year based on financial data as of September 30 of the previous year. The Federal Reserve may also request supplemental information, as needed, including conducting follow up discussions with or request responses to follow up questions from respondents.

Information received in the FR Y-16 report is expected to be used by the Federal Reserve “to form supervisory assessments of how effectively these banking organizations internally plan for their capital needs, identify risk, and measure and assess their own capital adequacy.”

Data is collected on Form FR Y-16 through three primary schedules:

- **Results Schedule.** For each of the three scenarios (baseline, adverse, and severely adverse), data would be reported for the income statement and balance sheet and capital (which includes the quantitative results of the stress tests under the three scenarios for each quarter of the planning horizon: i.e.; aggregate losses, pre-provision net revenue, provision for loan and lease losses, net income, and pro forma capital ratios (including regulatory and any other capital ratios specified by the Federal Reserve)),

  - Supplemental qualitative information for each of the three scenarios would cover:
    - A description of the types of risks included in the stress test
    - A summary description of the methodologies used in the stress test
    - An explanation of the most significant causes for the changes in regulatory capital ratios
    - Any other information required by the Board

- **Scenario Variables Schedule.** An institution may choose to project additional economic and financial variables, beyond the mandatory supervisory scenarios provided, to estimate losses or revenues for some or all of its portfolios. In such cases, the institution would be required to complete the Scenario Variables Schedule for each scenario where the institution chooses to use additional variables.

- **Contact Information Schedule.**

**OCC and FDIC**

Commentary

As stated in the guidance, stress testing is a tool that helps both bank supervisors and a financial company measure the sufficiency of capital available to support the financial company’s operations throughout periods of stress. The capital planning and stress testing exercises (CCAR and DFAST) do not address every risk an institution faces and do not provide full insight into all effects on an institution’s capital. The regulatory stress testing activities provide a collection of meaningful data around which companies can build their capital adequacy policies and activities. However, it should be noted that the regulators expect CCAR and DFAST to be just a component, although a significant component, of a company’s overall capital stress testing program. While CCAR and DFAST must be performed according to regulatory guidelines, as applicable; companies should also engage in other stress testing activities, as appropriate, as part of the capital planning process to ensure a thorough assessment of measured risks on the company’s balance sheet, earnings profile, and capital adequacy.