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FINANCIAL SERVICES FLASH REPORT

Federal Reserve Modifies its Capital Planning And Stress Testing Regulations

July 23, 2015

On Friday, July 17, 2015, the Federal Reserve surprised the market with a proposal to modify its capital planning and stress testing regulations, which would take effect for the 2016 capital plan and stress testing cycles.[1]

The notice of proposed rulemaking (NPR) proposes to remove the tier 1 common capital ratio requirement for all banking organizations. For large bank holding companies, the proposal would modify the stress test capital action assumptions. For banking organizations subject to the advanced approaches, the proposal would delay the incorporation of the supplementary leverage ratio for one year and indefinitely defer the use of the advanced approaches risk-based capital framework in the capital plan and stress test rules. All banking organizations will therefore continue to use standardized risk-weighted assets.

For bank holding companies with total consolidated assets of more than $10 billion but less than $50 billion and savings and loan holding companies with total consolidated assets of more than $10 billion, the proposal would eliminate the fixed assumptions regarding dividend payments for company-run stress tests and delay the application of stress testing for these savings and loan holding companies for one year.

The proposal would also make certain technical amendments to the capital plan and stress test rules to incorporate changes related to other rulemakings.

Under the new proposals, banks that are subject to the supplementary leverage ratio will need to incorporate the ratio into their 2017 stress tests.

The Federal Reserve has also stated that it is considering a broad range of issues relating to the capital plan and stress test rules, including how the rules interact with other elements of the regulatory capital rules and whether any modification may be appropriate. But these issues will be addressed in a separate rulemaking. However, the regulator stated that it does not anticipate proposing another rulemaking that would affect the 2016 capital plan and stress test cycle beyond what is contained in this new proposal.

The NPR is out for comment until September 24, 2015.

[1] www.federalreserve.gov/newsevents/press/bcreg/bcreg20150717a1.pdf.

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Changes impacting banks

Proposed revisions to the capital plan and stress test rules for all banking organizations

The proposal would remove the requirement that a banking organization demonstrate its ability to maintain a pro forma tier 1 common capital ratio of five percent of risk-weighted assets under expected and stressed scenarios. When the Federal Reserve adopted the tier 1 common requirement as part of the capital plan and stress test rules, it expected the tier 1 common ratio to remain in force until the Board adopted a minimum common equity capital requirement. In 2013, the Federal Reserve revised its regulatory capital rules to strengthen the quantity and quality of regulatory capital held by banking organizations. These revisions included a new minimum common equity tier 1 capital requirement of 4.5 percent of risk-weighted assets, which was fully phased-in on January 1, 2015.

The 2016 capital plan and stress test cycle is the first cycle in which banking organizations will be subject to the 4.5 percent common equity tier 1 capital ratio for each quarter of the planning horizon. The common equity tier 1 capital ratio generally is expected to be more binding than the tier 1 common ratio under the severely adverse scenario because of the regulatory capital rule's stringent capital deductions, most of which will be fully phased-in by the end of the next planning horizon. Removing the tier 1 common ratio requirement will further reduce the burden of maintaining legacy systems and processes necessary for calculating the tier 1 common ratio.

Delaying the inclusion of the supplementary leverage ratio

The proposed revisions to the capital plan and stress test rules for banking organizations subject to the advanced approaches requires those firms to delay the inclusion of the supplementary leverage ratio in the capital plan and stress test rules for one year. These banking organizations would therefore not be required to include an estimate of the supplementary leverage ratio for the capital plan and stress test cycles beginning on January 1, 2016.

The Federal Reserve states that this proposed change is in light of the October 2014 revisions, which changed the commencement date of the capital plan and stress test cycles. Due to this timing change, the new proposals seek to provide adequate time for organizations to develop the required systems necessary to project the supplementary leverage ratio.

Deferral of the introduction of the advanced approaches

In response to concerns raised by several banking organizations that the use of advanced approaches in the capital plan and stress test rules would require significant resources and would introduce complexity and opacity, the Federal Reserve has proposed deferring the use of the advanced approaches to calculate banks' minimum regulatory capital requirements. Instead, the proposed rules state that organizations must project their risk-weighted assets using the standardized approach, and have delayed until further notice the use of the advanced approaches for calculating risk-based capital requirements for purposes of the capital plan and stress test rules.

The elimination of fixed dividend assumptions

For bank holding companies with total consolidated assets of more than $10 billion but less than $50 billion, and savings and loan holding companies with total consolidated assets of more than $10 billion, the proposal would eliminate the fixed dividend assumptions for company-run stress tests.

These organizations would instead be required to incorporate their own dividend payment assumptions consistent with internal capital needs and projections.

Currently, the stress test rules require these companies to make the same capital action assumptions in their stress tests that apply to large bank holding companies. These capital action assumptions require them to assume they maintain their common stock dividend at a steady rate over the planning horizon, continue payments on other regulatory capital instruments at their stated dividend rate, and assume no repurchases or issuance of shares for each of the second through ninth quarters of the planning horizon. The proposal would maintain the assumptions of no repurchases, redemptions, or issuance of regulatory capital instruments in the stress tests.

These changes have been prompted by concerns raised by banking organizations that dividends made at the holding company level are often funded directly through a subsidiary bank's distributions to its holding company, but that subsidiary banks may be subject to dividend restrictions that would not permit the bank to upstream capital to its holding company.

The proposed change would also better align the stress test rules with the rules applicable to state member banks and the rules of the other banking agencies.

Delaying stress test cycles

The proposal would delay for one stress test cycle the application of the company-run stress test rules to savings and loan holding companies (SLHCs) with total consolidated assets of more than $10 billion. SLHCs will therefore become subject to the stress test rules for the first time beginning on January 1, 2017.

The original stress test rules provided a two-year transition period for these savings and loan holding companies to comply with the stress test requirements once they became subject to regulatory capital requirements on January 1, 2015. However, the October 2014 revisions to the stress test rules resulted in a shortening of this initial transition period to one year. The proposal would reinstate the previous transition period.

Savings and loan holding companies with total consolidated assets of more than $50 billion would report results by April 5, 2017, and those with total consolidated assets of less than $50 billion would report results by July 31, 2017.

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