First take

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Ten key points from the 2015 Comprehensive Capital Analysis and Review ("CCAR")

The 2015 stress test results published on March 11th as part of the Federal Reserve's ("Fed") CCAR follow last week's release of Dodd-Frank Act Stress Test ("DFAST") results.[1] CCAR differs from DFAST by incorporating the 31 participating bank holding companies' ("BHC" or "bank") proposed capital actions and the Fed's qualitative assessment of BHCs' capital planning processes. The Fed objected to two foreign BHCs' capital plans and one US BHC received a "conditional non-objection," all due to qualitative issues.

1. **Capital planning process enhancements pay off:** The fact that only two plans were rejected indicates that BHCs' investments in quality processes have been worthwhile, most recently at Citi.[2] Banks now have more room to make the CCAR exercise more sustainable by reducing costs and integrating with financial planning for better strategic decision making.

2. **No amount of capital can make up for deficient processes:** In objecting to the capital plans, the Fed cited foundational risk management issues such as risk identification and modeling quality. The press leak of this year's rejections could have been an intentional effort to avoid an overreaction to last week's positive quantitative-only DFAST results (avoiding confusion from prior years).

3. **Return of the "conditional non-objection":** The Fed reintroduced the conditional non-objection in CCAR 2015 for one US BHC, Bank of America, after a one-year hiatus. Under this qualified pass, the Fed is requiring the bank to fix issues related to its loss and revenue modeling and internal controls, and to resubmit its capital plan by the end of the third quarter of 2015. Although matters requiring immediate attention ("MRIAs") generally must be remediated within one CCAR cycle, conditional passes seem to operate as super-MRIAs by giving the Fed teeth to require remediation within six months (which may be particularly important this year, given the three month extended CCAR cycle for 2016).[3] However, BHCs receiving this pass have ultimately been able to follow through on their proposed capital distributions, so the return of the conditional pass may be more of a broad message from the Fed: even though all US BHCs passed this year, their CCAR processes must continue to improve.

4. **Large banks see little downside to taking the mulligan, so are being more aggressive with planned capital actions:** Three of the largest US BHCs exercised the option to adjust their planned capital distributions downward, after receiving last week's DFAST results indicating their initial plans distributed too much capital. The use of this "mulligan" continues to be limited to the largest institutions with the most sophisticated capital planning processes, and

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[1] See PwC's *First take: Federal Reserve's 2015 Dodd-Frank Act Stress Test* (March 6, 2015).

[2] Notably, Wells Fargo remains the only one of the top six US banks to have never received an objection or "conditional non-objection" to its capital plan.

[3] See PwC's *First take: CCAR guidance and final revised capital plan rule* (October 22, 2014).

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is increasingly being taken as they attempt to pay out more to shareholders. However, the Fed may look unfavorably on this development if viewed as a sign of weak capital planning capabilities (and may rethink stress testing guidelines in the future).

5. **Fed and BHC loan loss modeling differences are converging, but the gap remains wide:** Continuing the previous two years' trend, the gap between Fed and BHC loan loss rate projections has again shrank this year – by about 30% across loan-types driven mostly by residential loan loss projections. This convergence will likely help management better align its proposed capital actions with the Fed's views and more precisely assess the risk of taking the mulligan. However, the gap remains wide, at over 140 basis points across loan categories, including about 440 basis points for CRE loans. While the Fed's projected loan loss rates have been declining rapidly under the severely adverse scenario (reaching a 6.1% average this year, down from 6.9% in 2014 and 7.5% in 2013), BHCs' projections have been declining more slowly.

6. **Fed asset growth projections continue to exert downward pressure on stressed Tier 1 common ratios:** CCAR 2014 marked the first time that the Fed projected banks' growth in risk-weighted assets, which significantly reduced stressed Tier 1 common ratios. This year Fed projections again exceed BHC projections, this time by about 10% under Basel I (versus about 12% last year) under the severely adverse scenario. As a result, banks' stressed Tier 1 common ratios are about 90 basis points lower on average than they would have been under the Fed's 2013 approach.

7. **Caution signs line the road ahead for new CCAR entrants:** As part of last year's CCAR, the Fed noted that the 12 then-new CCAR entrants would not be held to the same high standards applicable to the largest BHCs.[4] This year, in contrast, the Fed made clear that this grading curve does not apply to new entrants that are supervised by the Fed's Large Institution Supervision Coordinating Committee ("LISCC"). Therefore, large intermediate holding companies and certain nonbanks deemed systemically important should take notice that the Fed's heightened standard for LISCC firms will likely apply to them when they enter CCAR down the road.[5]

8. **Proving comprehensive risk identification will be one of the biggest challenges for CCAR 2016:** A new expectation for 2015 required banks to prove (rather than simply describe) the comprehensiveness of their risk identification process and its linkage to capital planning and scenario generation. Given the experienced challenges in doing so this year, expect this area to be an important Fed focus for CCAR 2016.

9. **Binding constraints on capital will evolve:** The Tier 1 leverage ratio continues to be a binding constraint, especially among the BHCs with the largest capital markets businesses. However, as the proposed G-SIB capital surcharge is implemented,[6] these banks will further increase their common equity which will lessen the impact of the leverage ratio. The binding constraint will remain a moving target as banks seek to optimize their capital holdings given the phase-in of the G-SIB capital surcharge (along with expected short-term funding capital penalties and long-term debt requirements) and the upcoming implementation of the supplementary leverage ratio ("SLR").[7]

10. **CCAR is bigger than stress testing:** The Fed explicitly stated this year that outstanding supervisory issues, beyond capital planning, may result in a qualitative objection to a BHC's capital plan. This statement clarifies that matters outside of capital planning, such as regulatory reporting (beyond the FR Y-14 and FR Y-9C series), enterprise risk management, and governance may lead to the Fed halting additional capital distributions to shareholders.

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[4] See PwC's *First take: Federal Reserve's 2014 Comprehensive Capital Analysis and Review* (March 27, 2014).

[5] See PwC's *Regulatory brief, Foreign banks: US admission price rising* (July 2014). These new entrants will include Barclays, Credit Suisse, UBS, and likely GE Capital.

[6] See PwC's *Regulatory brief, G-SIB capital: A look to 2015* (December 2014).

[7] See PwC's *First take: Supplementary leverage ratio* (September 2014).

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