First take

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Ten key points from Governor Tarullo's speech on stress testing and the Fed's NPR

The Federal Reserve (Fed) is tilting the balance of its supervisory stress testing program to drive capital requirements higher for large, systemically important Bank Holding Companies (BHCs),[1] while providing some relief for less complex institutions. In an important speech last Monday, Fed Governor Daniel Tarullo suggested several significant changes to the Fed's annual Comprehensive Capital Analysis and Review (CCAR), which will more fully align ongoing capital requirements with stress-based capital requirements and generally raise regulatory minimum capital ratios to levels the Fed otherwise expected prudently managed firms to maintain on their own.[2] See the **Appendix** for a graphic depiction of this point.

Most significantly, Governor Tarullo's proposals, still subject to rulemaking, will embed the G-SIB capital surcharge[3] into CCAR'S post-stress minimum thresholds and, for ongoing capital requirements, substitute more severe institution-specific stress capital buffers in place of the existing 2.5% capital conservation buffer (CCB). However, Governor Tarullo also discussed several changes to the Fed's economic scenario assumptions which would mitigate some of the capital impact to the largest BHCs. These increases to BHCs' capital requirements could be implemented as early as 2018, following a rulemaking proposal and comment process.

Separately, but critically for less-complex BHCs, the Fed also issued a Notice of Proposed Rulemaking (NPR) that provides smaller traditional banking organizations subject to CCAR with relief from intensive CCAR qualitative assessments (including relief from the potential for their capital plans to be publically rejected for qualitative reasons). This beneficial change would take effect in the next CCAR cycle.

1. **BHCs subject to CCAR will have ongoing capital requirements that directly incorporate the Fed's modelled post-stress capital calculations.** Governor Tarullo's speech introduced a new Stress Capital Buffer (SCB), which all CCAR BHCs would add to their minimum ongoing capital ratio thresholds. The SCB would be separately defined for each BHC as the BHC's most recent CCAR result's maximum projected decline in the common equity tier 1 (CET1) ratio under the severely adverse scenario.[4] This variable, risk-sensitive, Fed-modelled SCB would replace the existing fixed 2.5% capital conservation buffer (CCB).[5] The application of the SCB to BHCs' ongoing capital thresholds would mean that BHCs would for the first time be forced to manage to their stressed CCAR results throughout the year. To reinforce this point, the Fed would also require each BHC to maintain projected ratios above the new minimums in its baseline economic scenario under CCAR. Because the Fed has long expressed an expectation that BHCs maintain sufficient capital to weather a severe downturn, this new formulation for ongoing requirements should be manageable.

2. **The G-SIB capital surcharge will be incorporated into CCAR's post-stress requirements.** With the introduction of the SCB closing one gap between ongoing and post-stress capital requirements, the Fed introduced another change to further tighten the link. Governor Tarullo suggested that, as previously signaled, the G-SIB capital surcharge, which is a new core component of ongoing capital requirement for G-SIBs, would also be included in BHCs' post-stress capital minimums under CCAR. As a result, G-SIBs, especially those with large trading activities, must maintain a higher capital ratio after consideration of the Fed's projected losses under the severely adverse scenario in order to pass CCAR's annual quantitative test. (Note that the CCB was never part of CCAR's post-stress minimum ratios; likewise the SCB will not be part of that calculation for the severely adverse scenario, but it *will* be included under the baseline scenario.)
3. **To mitigate these challenges, BHCs' planned capital distributions would not be fully factored-in under CCAR's severely adverse scenario.** Currently under CCAR, the Fed deducts the full nine quarters of BHCs' planned dividends and buybacks from the Fed's projected capital losses to assess whether post-stress capital ratios remain above minimum capital ratio thresholds. However, Governor Tarullo suggested limiting this deduction to only four quarters of dividends (i.e., leaving out all buybacks and the remaining dividends) when applying CCAR's severely adverse scenario. This would make the incorporation of the G-SIB surcharge into CCAR more manageable because buybacks and the remaining five quarters of dividends often make up the bulk of planned capital distributions. The change also addresses BHCs' long-standing observation that if severely adverse conditions were to occur, BHCs would be compelled by regulation to curtail distributions so would not maintain planned capital distributions for the entire nine-quarter planning horizon.
4. **Could the baseline economic scenario become BHCs' new binding constraint?** Governor Tarullo made clear that under CCAR, BHCs would have to maintain regulatory minimum capital ratios under all scenarios. With the SCB included in this minimum threshold for CCAR's baseline economic scenario, and the inclusion of all planned dividends and buybacks in the baseline scenario (unlike the severely adverse scenario), the Fed's modelled baseline projections could become BHCs' new binding constraint. The Fed's baseline projections, and the projections' comparison with the BHCs' own modelled baseline projections, have been inconsequential to this point, so the Fed has never emphasized or published these results. However, since BHCs will need to be more concerned about how the Fed will project their performance under the baseline scenario, the Fed may have to consider disclosing the baseline results alongside the severely adverse and adverse results which the Fed has published. The Fed has thus far avoided disclosing baseline results in order to avoid the market confusing the Fed's projections with BHC earnings forecasts.
5. **The Fed will no longer project growth in BHCs' balance sheets, which provides some additional relief.** Beginning in CCAR 2014, the Fed began making its own projections of BHCs' balance sheets and risk-weighted assets (RWA) over the stressed time horizon, rather than using BHCs' projections. The Fed's projections have predictably proven to be more conservative than the BHCs', but Governor Tarullo's speech indicated that the Fed is taking into consideration industry arguments that some business lines could significantly shrink during periods of stress, and therefore reduce expected losses and shrink balance sheets and RWAs (i.e., the capital ratios' denominators). Therefore, rather than making a projection, the Fed would make a simplifying assumption of constant asset and RWA balances during the stressed time horizon (based on BHCs' starting assets and RWA). This change would offer BHCs more certainty and make it somewhat easier for BHCs to meet their stressed minimum ratios, because the capital ratios' denominators would be smaller. The Fed would not need to issue a rulemaking in order to make this change, so it could occur as soon as CCAR 2017 given its simplicity to implement.
6. **Integration of funding and liquidity stress into CCAR?** Governor Tarullo's remarks indicated that the Fed is considering the introduction of funding and liquidity shocks into future CCAR scenarios. Most notably, Governor Tarullo noted that "direct" funding shocks (i.e., increased funding costs as a result of losses and demands from creditors) could be included in stress testing models in the relatively near future because of their direct ties to BHCs' capital levels, projected losses, and reliance on short-term wholesale funding. However, the integration of liquidity shocks would prove to be more challenging due to the highly interrelated nature of liquidity shortages. The Fed plans to continue research on the linkages between capital and liquidity stress testing, and in particular may try to use stress testing results as a starting point for its less well-known, non-public, liquidity stress-testing program, called Comprehensive Liquidity

Analysis and Review (CLAR), or vice versa. Although Governor Tarullo noted that most of the new features still need further study before they are ready to be incorporated into supervisory models, his comments should highlight to BHCs the importance of integrating capital, funding, and liquidity stress considerations.

7. **The Fed will increase transparency, but stop short of full disclosure**. Governor Tarullo remarked that the Fed plans to continue increasing stress testing transparency, particularly for supervisory modeling updates, pre-provision net revenue (PPNR) projections, and the Fed's qualitative assessment results. Currently, a high-level summary of changes to supervisory models is released publicly with the results, thus giving BHCs insufficient time to react. Governor Tarullo indicated that the Fed is considering releasing changes to the models "well in advance" of the April 5th submission deadline, and phasing in the most significant changes over two years in order to reduce potential stress testing result volatility. The latter consideration would be particularly important for the stability of the SCB.

   Additionally, we expect that the Fed's PPNR disclosures will include increasing granularity over the next several CCAR cycles, including a breakdown of net interest income, non-interest income, non-interest expense, and operational risk losses. Governor Tarullo's speech further noted that the Fed is considering ways to increase the information released in relation to the qualitative feedback it delivers to specific BHCs. However, Governor Tarullo rejected industry requests for the Fed to fully disclose its supervisory models due to the potential that it would incentivize firms to simply copy and optimize the characteristics assessed by the Fed.

8. **Scenario design revisions are under consideration.** Governor Tarullo indicated that the Fed is taking another look at some of its core macroeconomic scenario variables, namely the unemployment rate and housing prices. As we pointed out in February,[6] the magnitude of CCAR 2016's employment shock was larger than prior years because the unemployment rate started at a lower level and grew at a faster rate to still reach prior peaks. Governor Tarullo suggested that the Fed would incorporate less severe shocks to employment in downturns, with the goal of making the severely adverse scenario less pro-cyclical. To further reduce pro-cyclicality, Governor Tarullo remarked that the Fed would connect projected changes in housing prices to changes in disposable personal income.

9. **Smaller BHCs will receive relief from qualitative requirements.** As we predicted,[7] the Fed's NPR excludes certain smaller and less complex BHCs from the qualitative portion of CCAR. BHCs must meet three measures (averaged over the prior four quarters) to be included in this relief: have (a) less than $250 billion in total assets, (b) less than $10 billion in foreign exposures on their balance sheets, and (c) less than $75 billion in nonbank assets (collectively defined as "large and noncomplex" BHCs). The third criterion related to nonbank assets is different from the Fed's earlier definition of "large and noncomplex" BHCs[8] and was included to ensure that the Fed provides relief only to BHCs that are primarily engaged in traditional banking activities, as opposed to capital markets activities that could have a greater systemic impact. We expect there are a couple firms considered large and noncomplex under the Fed's previous definition that remain caught in CCAR's qualitative review and may want to consider strategies to untie themselves.

   The affected large and noncomplex BHCs have largely met or exceeded the Fed's expectations for capital planning processes, and will no longer be at risk of receiving an objection to their capital plans on qualitative grounds or the associated reputational effects of public criticism. However, they will receive reviews as part of the normal supervisory process and additional horizontal reviews related to specific capital planning topics. Accordingly, we recommend that they stay focused on the Fed's qualitative expectations in order to avoid critical feedback during annual reviews. Furthermore, other BHCs should note that the shift will allow the Fed to dedicate even more supervisory resources to the larger BHCs remaining in CCAR.

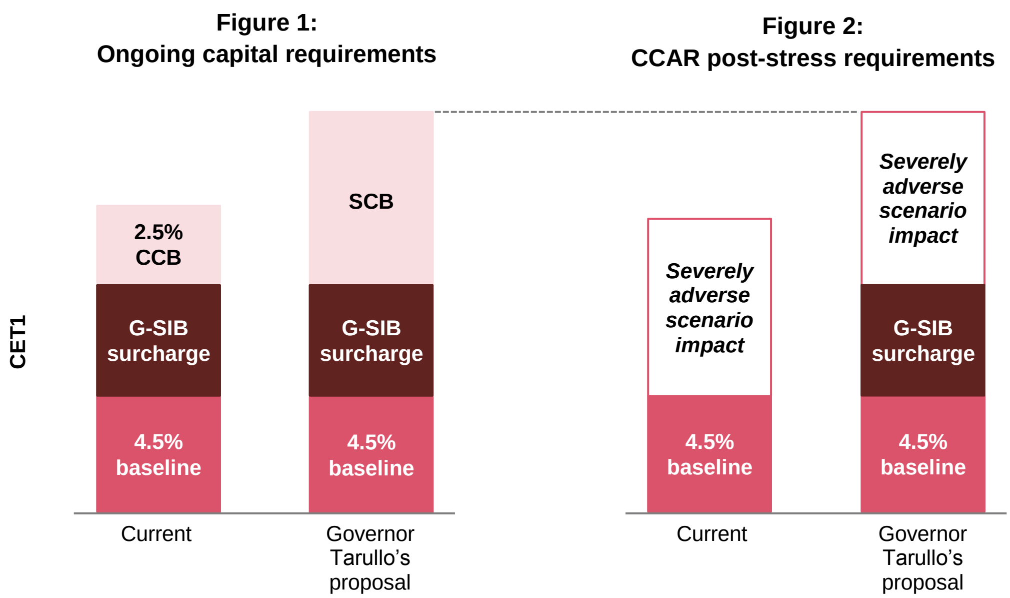
10. **The Global Market Shock will likely have more impact in future CCAR rounds.** In CCAR 2016, the effect of the Global Market Shock (GMS) was limited because the Fed chose an "as-of date" in early January, a time when trading activity is subdued and BHCs tend to have less trading and counterparty risk, so would be less affected by a shock.[9] In order to account for this limitation, the NPR extends the starting point of the Fed's range of potential GMS as-of dates to October 1st of the prior calendar year, starting in CCAR 2018. This range includes more typical positions for the six G-SIBs affected by the GMS, and raises the likelihood that resulting losses, and thus needed post-stress capital, will be higher. In a related point, Governor Tarullo said that the Fed has yet to determine whether foreign-owned CCAR filers with larger trading operations would be subject the GMS trading and counterparty components.[10]

Appendix

Each of the below graphics compare current required minimum CET1 levels (once the CCB and G-SIB surcharge fully phase-in) with Governor Tarullo's proposed minimum levels. Figure 1 does so for ongoing capital requirements and Figure 2 does so for CCAR's post-stress requirements.

Figure 1 demonstrates that Governor Tarullo's proposal to replace the CCB with the SCB will increase ongoing CET1 requirements. Figure 2 shows the proposal's addition of the G-SIB surcharge in the post-stress minimum, partially offset with a severely adverse scenario impact that is somewhat smaller under the proposal because of reductions in distribution and balance sheet growth assumptions.

Therefore, Governor Tarullo's proposal has the effect of aligning ongoing capital requirements with CCAR post-stress requirements, as depicted by the equal heights of the right-side bars of each Figure.



Endnotes

1. We use “BHC” to refer to all banking organizations that are subject to CCAR, including intermediate holding companies established by July 1, 2016, and any nonbank financial company that becomes subject to CCAR requirements in the future (there are currently none).
2. Although this publication focuses on CCAR, Governor Tarullo’s speech also has implications for Dodd-Frank Act Stress Testing (DFAST). For more information on DFAST, see PwC’s *First take, Five key points from the Fed’s 2016 DFAST* (June 2016).
3. See PwC’s *First take, Key points from the Fed’s final G-SIB surcharge rule* (July 2015).
4. Governor Tarullo described the SCB using the CET1 ratio as an example. It is unclear whether the SCB would be calculated separately for other risk-based capital ratios or apply to the leverage ratio. The Fed will also need to clarify the impact of dividend payouts on the SCB.
5. The CCB started to be phased into the Fed’s ongoing capital review this year, and is set to reach 2.5% of CET1 when fully phased-in in 2019. The CCB would remain a floor to the SCB.
6. See PwC’s *First take, Ten key points from the Fed’s 2016 CCAR instructions and supervisory scenarios* (February 2016).
7. See PwC’s *First take, Five key points from the Fed’s Comprehensive Capital Analysis and Review* (June 2016).
8. See PwC’s *First take, Fed's supervisory assessment of capital planning and positions* (December 2015).
9. This limited selection of the GMS as-of date was a side effect of the Fed’s change of the capital plan submission date from January to April, and the associated shift of the potential as-of date range from January to March. See *First take* cited in note 5 for more detail.
10. Furthermore, Governor Tarullo mentioned central clearing parties and brought up the topic of second order effects from counterparty default. This could be a sign of a substantial changes in the counterparty default shock.

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