FS Regulatory Brief

Dodd-Frank stress testing requirements for mid-sized financial firms:

Highlights and insights

February 2013

Executive summary

The recently published stress testing final rule and supervisory guidance[1] issued by the federal banking regulators – Board of Governors of the Federal Reserve (FRB), Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC) – contain a number of notable features requiring domestic banks and bank holding companies, savings and loans banks and bank holding companies with total assets between $10 billion and $50 billion to evaluate, report to regulators and publicly disclose the impact of stressed market conditions on the firm's financial condition and regulatory capital levels.

A key feature of the new regulation is its application of the supervisor-developed scenarios for institutions with assets in the $10B to $50B range. Similar to CCAR and CapPR, the banking regulators through their review of stressed capital results are evaluating whether financial companies would have sufficient capital to undertake planned capital actions (e.g., dividends or stock repurchases) and lend to households and businesses in times of severe economic and financial stress. Further, the banking regulators are also evaluating the quality and comprehensiveness of the firm's stress testing and capital planning processes.

While the stress testing final rule and supervisory guidance is not as comprehensive as Comprehensive Capital Analysis and Review (CCAR), the supervisory expectations are similar for mid-sized banks. Regulators expect capital planning supported by effective stress testing will be an ongoing process integrated into the business and the internal control framework of banks. CCAR was designed to push executives to enhance their management of the bank as they work to upgrade their risk management and capital assessment reporting and controls. Larger banks have already restructured their management and oversight of the business as a result of the significant number of regulatory questions and findings raised in the CCAR and CapPR reviews including issues designated by the FRB as Matters Requiring Immediate Attention (MRIAs) and Matters Requiring Attention (MRAs).

Executive management teams with assets in the $10B to $50B range are currently looking for a cost-efficient approach to minimize disruptions and fully integrate the stress tests into their business operations and strategic planning as they:

- Deploy a strong project management office (PMO) to govern their implementation efforts.
- Broaden their modeling efforts to effectively challenge and identify limitations for new or existing models and tools.
- Improve their governance framework.
- Enhance their existing process and control framework.
- Improve their reference technology architecture and vendor analyses.

[1] See appendix for specific references.

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Based on our experience, there is a great deal for impacted firms to do in a short period of time. They will need to adopt a structured approach that has been tested with the FRB to facilitate a simpler implementation than was experienced by banks that are already under CCAR and CapPR requirements.

In this **FS Regulatory Brief**, we highlight the business implications of meeting regulatory expectations for stress testing and capital planning and delve into the large-bank regulatory expectations that are now being applied to other financial companies.

What are the key elements that firms need to consider?

The final rules provide reporting dates for covered financial firms with total assets between $10 billion and $50 billion are as follows:

Description	**Date**
Financial information cut-off date	September 30, 2013
Cut-off date for regulators to provide scenarios for annual stress tests	November 15, 2013
Deadline for submission of the stress test results to banking regulators	March 31, 2014
Public disclosure of the stress test results	June 2015*

* The final rule requires bank holding companies, savings and loan holding companies, and state member banks with less than $50 billion in total consolidated assets to begin publicly disclosing their stress test results in 2015 with respect to stress tests conducted in the fall of 2014.

As part of their capital planning exercise, financial companies should develop comprehensive capital plans on, at least, an annual basis. This includes *pro forma* capital analyses and supporting projections based on the multiple supervisor-provided scenarios tested during annual company-run stress tests, using data as of September 30th of each year. These scenarios include, at a minimum, baseline, adverse, and severely adverse scenarios. Additional scenarios might be administered based on the company's financial condition, size, complexity, risk profile, scope of operations or activities, or risks to the US economy.

The objective of the stress testing rules is to ensure that financial companies have (i) robust, forward-looking capital planning processes that account for their unique risks, and (ii) sufficient capital to continue operations throughout times of economic and financial distress.

The supervisory expectations and related focal points for annual capital plans are as follows:

Comprehensiveness of the capital plan

- Strategic planning, risk appetite, evaluation of new products, and merger/acquisition decisions all informed by stress testing results.
- Stress testing fully integrated with the firm's operations, business decisions, and risk management processes.
- Contingency planning, and integrated capital and liquidity adequacy analysis informed by insights from stress testing.
- All firm-wide risks captured under baseline, adverse, and severely adverse conditions.

Reasonableness of assumptions and robustness of capital planning process

- Thorough data analysis and supporting sound risk measurement methodologies and systems.
- Credible and consistent set of business and financial assumptions (e.g., revenue, cost, loss estimates, balance sheet, etc.), under various scenarios.
- Good data quality and reconciliation to regulatory filings.
- Quality of capital and financial planning and capital adequacy processes.

Inclusion of policy governing distributions and capital actions

- Capital management governance.
- Contingency planning, and integrated capital and liquidity adequacy analysis informed by insights from stress testing.

Ability to meet regulatory capital ratio requirements under stressed market conditions throughout the planning horizon and inclusive of planned capital actions

- Impact of results in key capital decisions (e.g., dividend and capital buyback programs).
- Communication with board of directors so they understand impact in stressed conditions.

The regulators expect a financial company's board of directors to be responsible for reviewing and approving policies and procedures governing stress testing processes. The review and approval process should take place as frequently as economic conditions or the condition of the financial company may warrant, but no less than annually. Regulators also expect the board of directors and executive management to receive a summary of the stress test results.

Regulators also require the board of directors and executive management to consider the results of the stress tests in the normal course of business, including but not limited to the financial company's capital planning, assessment of capital adequacy, and risk management practices.

Sizing up the impact to your business

These supervisory requirements come in the context of a significant change in expectations of firms' capital policies and capital planning processes.

Overall, the evolution in regulatory expectations has caused banks to create a more comprehensive risk operating model in order to assess the current state and frame the target operating model for the board of directors and executive management team. Among other actions, this focus on a more effective risk management operating model has led banks to:

- Restructure risk management so it is more aligned with the business.
- Develop a more robust bank risk appetite framework, along with limits to better control business activities.
- Refine incentive compensation policies.
- Realign committee structures to promote accountability, responsible decision making, and proper escalation of issues.

Increased reporting and regulator expectations could have additional substantial implications, with executive management responding by right-sizing company staff and making changes to the availability and quality of data and the formality of processes and governance. We expect there could also be a substantial impact on the overall business and the ability to enhance shareholder value. Because the impact could prove great, executive teams are working to better integrate themselves with the finance team so they are comfortable with utilizing stress testing and capital planning results to inform significant decisions, such as evaluating the amount of capital to devote to capital-intensive segments.

Drawing upon lessons learned from the larger banks

CCAR was designed to push bank boards and executives toward enhanced management and upgraded risk management and capital assessment processes. And as noted above, capital planning and stress testing are not one-time events. The regulators expect it will instead be an ongoing process that is integrated into the business and the internal control framework at affected financial institutions. Our experience with the larger firms and interaction with banking supervisors suggests the following:

- The approach needs to be credible with the regulators.
- The analysis must be undertaken at a sufficiently granular level so that banking supervisors and outside analysts can make their own independent assessment.
- Management needs to have governance and capital management processes that are robust and able to operate in a stress environment.

With less than a one-year window to implement the new stress testing reporting, financial companies must plan well and start early. Companies need to make upfront investments in the capital reporting framework and process, in order to reap rewards in the long term. Key executives and board members must get involved with the capital plan to help reassure the appropriate firm-wide focus, particularly given it will be assessed by banking supervisors both for its completeness and robustness.

While each company will face its own unique challenges, the following are some key lessons that will help accelerate the implementation process:

Planning and mobilization

- Identify a team of executives to own and champion the effort, to assure that stress tests be forward looking and utilized in decision making throughout the business cycle.
- Conduct ongoing education sessions for both the board of directors and management so they understand their fiduciary obligations and regulators' expectations for the capital plan's completeness and robustness.
- Create a strong PMO function for a well-controlled process.
- Engage IT and finance early in the process to facilitate a short production process for supervisor-provided scenarios.

Execution

- Focus on the board of directors submission date and then reverse engineer the due dates. This is critical when identifying areas such as model validation and capital planning, which require long lead times.
- Empower senior-level business unit and functional personnel to drive their assigned sections of the plan.
- Assure that significant senior executive time is devoted to the implementation.
- Create a "regulatory database" integrated into the data hub so that consistent assumptions and methodologies are used across all related processes.
- Develop benchmarking and process verification techniques to explicitly evidence "effective challenge" of complex modeling for stress scenarios with limited data.

Operationalizing the plan

- Determine how the existing business strategy should be influenced by the results from the stress test models.
- Address requirements for each material legal entity or business line to ensure the plan captures situations where the infrastructure may not be as complete and robust.
- Develop intra-company agreements to establish performance expectations and standards.
- Leverage IT and operations to drive efficiencies.

Strategic next steps

In response to the stress testing and capital planning expectations, financial companies should consider their next steps in advancing their overall capital management programs. Considerations for strategic next steps include the following:

1. **Implementation strategy:** Financial companies must create an implementation strategy, with an initial focus on educating executives and the board, designing tools/templates to facilitate strong governance by executive management, and identifying gaps with the regulatory expectations.
2. **Stress testing and capital planning framework:** Given the emphasis on process and documentation requirements inferred by the final rule and supervisory guidance, financial companies should take this opportunity to design a robust stress testing process and capital adequacy plan up-front. Financial companies should ensure that their capital plan incorporates considerations of all material risks, contemplates missing risks, quantifies model uncertainty, and identifies and plans remediation steps for process and documentation gaps. PMO protocols should be strong to facilitate coordination and integration across different functions, processes, and systems.
3. **Risk and capital management program strategy:** Financial companies should develop a plan to allow consistent assumptions and methodologies across all related processes, prioritizing models to be built and focusing on documenting modeling assumptions, model limitations, stress testing, and associated controls. Financial companies should also ensure their models have flexibility to allow for timely assessment and changes in assumptions and scenario severity.
4. **Scenario selection:** Financial companies should embrace the supervisory scenarios (baseline, adverse, and severely adverse) in the design of their company-specific scenarios. Internal "severely adverse" scenarios should incorporate add-ons to account for idiosyncratic factors and risks facing the firm, while resulting in a level of stress comparable to that represented in the supervisory "severely adverse" scenario for the banking industry as a whole.

Appendix: Key regulatory guidance references

Regulatory guidance	Link
Annual Company-Run Stress Requirements for Banking Organizations with Total Consolidated Assets over $10 Billion Other Than Covered Companies, Board of Governors of the Federal Reserve (October 12 2012)	http://www.gpo.gov/fdsys/pkg/FR-2012-10-12/pdf/2012-24988.pdf
Annual Stress Test Final Rule, Office of the Comptroller of the Currency (October 9, 2012)	http://www.occ.treas.gov/news-issuances/bulletins/2012/bulletin-2012-41.html
Annual Stress Test Final Rule, Federal Deposit Insurance Corporation (October 9, 2012)	http://www.fdic.gov/news/news/press/2012/pr12116.html
2013 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule, November 2012	http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20121115a1.pdf
"Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, Joint Notice of Proposed Rulemaking," *Federal Register* 77 (August 30, 2012): 52792-886	http://www.gpo.gov/fdsys/pkg/FR-2012-08-30/pdf/2012-16757.pdf
Supervisory and Regulatory Letter 12-7, *Supervisory Guidance on Stress Testing for Banking Organizations with Total Consolidated Assets of More than $10 Billion,* Board of Governors of the Federal Reserve (May 12 2012)	http://www.federalreserve.gov/bankinforeg/srletters/sr1207.htm

Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

Dan Ryan
Financial Services Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

Alison Gilmore
Financial Services Regulatory Practice Marketing Leader
646 471 0588
alison.gilmore@us.pwc.com

Contributors: Christophe Cadiou, Kevin J. Clarke, Fernando De La Mora, Kenneth Evola and Doug Summa.

www.pwcregulatory.com

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