

First take

A publication of PwC's financial services regulatory practice

Five key points from the Fed's 2020 CCAR and DFAST results

On June 25, the Federal Reserve (Fed) released the results of its 2020 Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Act stress tests (DFAST). Given the economic turbulence of the last several months, it also conducted additional sensitivity analyses of how banks would fare under three different recession and recovery scenarios from least to most severe: V-shaped, U-shaped, and a W-shaped double-dip.¹ It did not report bank-specific results under the additional scenarios but showed that aggregate loan losses ranged from \$560b to \$700b and aggregate capital ratios fell from 12% in Q4 2019 to between 9.5% and 7.7%. The Fed also did not issue any qualitative objections this year, fully removing CCAR "passes and failures" from the headlines. However, it did make news this year by suspending share repurchases, limiting dividends, and requiring capital plan resubmissions for all CCAR participants.

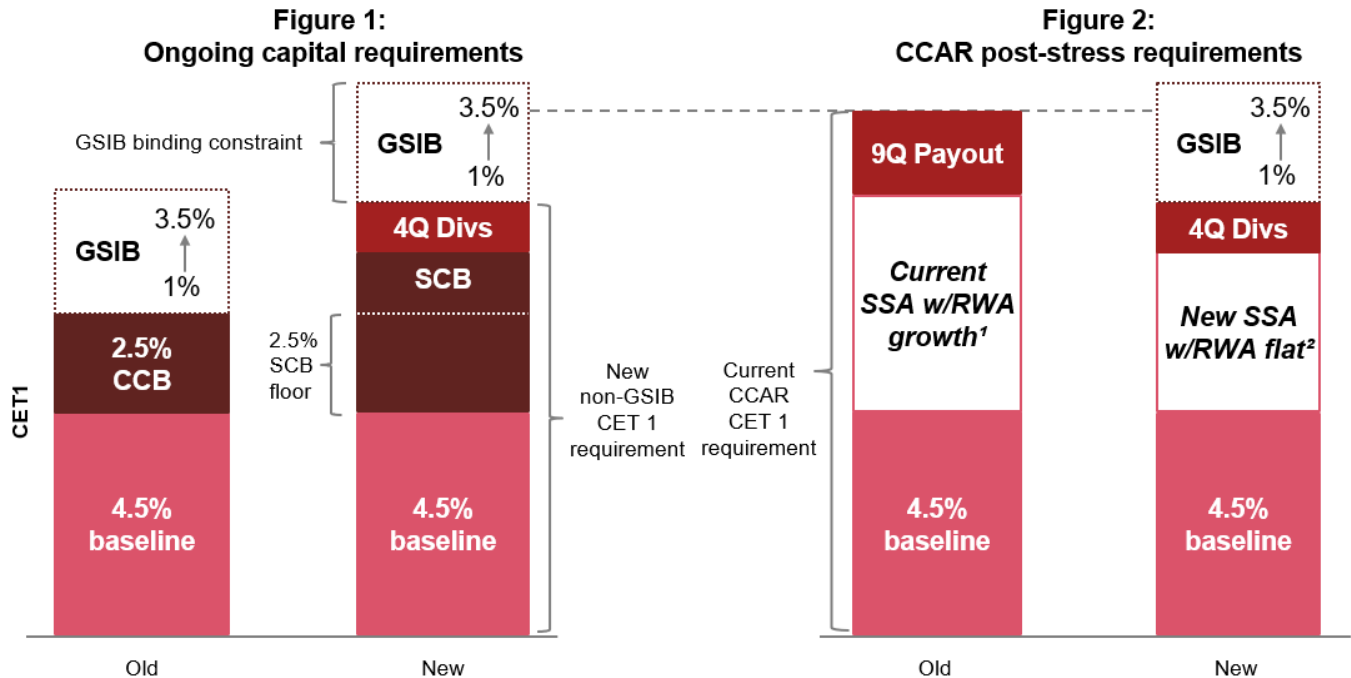
- 1. Balancing confidence and caution.** The Fed's response to an unprecedented situation reflects a balance between recognizing that banks are well-capitalized enough to weather the immediate crisis and that the current substantial economic uncertainty warrants caution. It reported that while several banks would approach their capital minimums under the U- and W-shaped scenarios, all would remain above them. As a result, it did not go so far as to require them to shelve dividends entirely. However, it is requiring the 34 banks that participated in CCAR to (1) suspend share repurchases in Q3 and (2) cap Q3 dividends.² Although share repurchases will be completely suspended for Q3, the eight US global systemically important banks (GSIBs) had already suspended share repurchases for Q2 and may have extended that decision for another quarter even without the Fed's mandate. Given the uncertainty around the economic outlook and the fact that the sensitivity analyses reflected plausible scenarios rather than specific forecasts, it is not surprising that the Fed is requiring banks to resubmit capital plans later this year and conducting additional analysis each quarter. Although the restrictions only apply to Q3 2020, we expect the Fed to increase scrutiny as the economic outlook becomes more clear and it is able to develop new scenarios with its usual rigor.

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- 2. Less payout flexibility than anticipated.** This is the first CCAR cycle with the stress capital buffer (SCB) in place,³ but it is most likely not the debut the Fed or the banks had in mind. The SCB, which was finalized in March and will take effect in Q4, replaces the static 2.5% capital conservation buffer and formally incorporates Fed-modeled start-to-trough stressed capital depletions into ongoing capital requirements. A primary objective of the SCB was to move capital decisions back to banks and remove the Fed's quantitative objection. Instead of the Fed mandating new capital plan submissions with lower payouts, distributions would be automatically reduced according to a set schedule if a bank falls below its all-in capital requirements, including the SCB, during the normal course of business (see **appendix** for an illustrative graphic and the automatic payout reduction schedule). Despite these intentions of separation and automation, the Fed has decided to reassert itself in the capital planning process by mandating limits on capital actions and undermining the perceived autonomy that had been given back to banks.
 - 3. Initial SCB disclosures indicate few surprises.** Banks were able to disclose their SCBs as of June 29 and the initial releases indicate that they were able to estimate their approximate buffers and have sufficient capital to meet their full requirements. Moreover, none are expected to be restricted in their dividends based on their SCB as any shortfall would fall within the least restrictive tiers of the payout reduction schedule (see **appendix**). That said, the Fed has the option to re-size banks' SCBs as part of the fall resubmission. Increasing SCBs would raise capital requirements, which Vice Chair for Supervision Randal Quarles has said that he is reluctant to do in the midst of pronounced economic stress given that it could result in reduced lending and support of markets. If the Fed is concerned about capital levels but does not want to raise capital requirements, we would expect it to continue to mandate further restrictions on buybacks and dividends.
 - 4. Robust and efficient processes are now mandatory.** During this CCAR cycle, the Fed shifted focus away from the traditional severely adverse scenarios and focused instead on banks' ability to assess their financial performance and capital needs in the current crisis. In particular, its qualitative review focused on how frequently banks could produce revised macro and market scenarios and whether they could credibly translate those scenarios into actionable forecasts of financial performance in a timely manner. This year's live stress event indicated that a number of banks' processes were insufficiently automated and unable to adapt to this changing environment in a timely manner with some relying too heavily on management judgment, assumptions and manual overlays. As such, both banks and the Fed will need to assess how to streamline these processes, including by reducing layers of governance and increasing automation, so that stress testing can be efficient, timely and sufficiently controlled. Banks that have not effectively adapted their capital planning processes to the new environment can expect supervisory feedback.
 - 5. The future of stress testing.** The Fed has already been on a path of updating the stress testing regime to reflect advances banks have made, but the recent crisis raises new questions about how CCAR and capital requirements in general should look in the future. For example, although this year's severely adverse scenario had a larger decline in unemployment than any preceding year - criticized by some as excessive - it was quickly overtaken by reality in March and April. As such, future Fed scenarios are likely to contemplate larger, sharper moves, making the test even more difficult. In addition, the Fed may consider expanding its scenarios to sources of stress beyond what has been observed historically. However, as the Fed's scenarios will now directly contribute to ongoing capital requirements via the SCB, scenario innovation will need to be balanced with the disruptions that would be caused by highly volatile capital requirements. In the near term, the Fed's analysis and requirements will be based on the up-to-date economic outlook, but it's not too early to think about the new normal after the economy has recovered. One option, raised by Vice Chair Quarles even before this crisis, is creating a positive baseline for the countercyclical capital buffer (CCyB). The CCyB, which was finalized by the Fed in 2016 but has never been raised above zero, would require banks to hold additional capital during periods of excessive credit growth and increased market risk. Quarles suggested that maintaining a non-zero CCyB would allow the Fed to dynamically adjust capital requirements according to risk conditions and reduce it in a downturn. Just as the last major crisis prompted the CCAR regime, this crisis may drive it into a new phase.

Appendix

Illustrative SCB impact

Each of the below graphics compare current required minimum CET1 levels (once the CCB and GSIB surcharge fully phase-in) with the minimum levels once the SCB takes effect. Figure 1 does so for ongoing capital requirements and Figure 2 does so for CCAR's post-stress requirements. Figure 1 demonstrates that replacing the CCB with the SCB will increase ongoing CET1 requirements. However, Figure 2 demonstrates that the current post stress capital requirements already force consideration of stress loss. The figures further demonstrate that only the largest GSIBs could see a capital increase depending on the size of their surcharge, whereas the more relaxed payout and balance sheet assumptions by the Fed will provide capital relief for all non-GSIBs and GSIBs with lower surcharges.



1. Supervisory Severely Adverse (SSA) impact excluding planned capital distributions with growth in RWA and Assets
2. Excludes all capital actions and holds RWA and assets flat

Calculation of maximum payout ratio

Capital buffer ³	Payout ratio
Greater than the Board-regulated institution's buffer requirement ⁴	None
Less than or equal to 100% of the bank's buffer requirement, and greater than 75% of the Board-regulated institution's buffer requirement	60%
Less than or equal to 75% of the bank's buffer requirement, and greater than 50% of the bank's buffer requirement	40%
Less than or equal to 50% of the bank's buffer requirement, and greater than 25% of the bank's buffer requirement	20%
Less than or equal to 25% of the bank's buffer requirement	0%

3. "Capital buffer" means each of, as applicable, the standardized approach capital conservation buffer, advanced approaches capital conservation buffer, and leverage buffer.
4. "Buffer requirement" means each of, as applicable, the standardized approach capital conservation buffer requirement, advanced approaches capital conservation buffer requirement, and leverage buffer requirement.

Source: Federal Reserve Table 2 to § 217.11

Endnotes

1. The Fed emphasized that these scenarios “are not predictions or forecasts” and noted that they do not include potential effects of government stimulus payments and expanded unemployment insurance.
2. Specifically, the Fed will cap dividends at the lower of Q2 levels or an amount equal to the average of the bank’s net income for the four preceding calendar quarters.
3. See PwC’s *First take, Ten key points from the Fed’s final stress capital buffer and 2020 CCAR instructions* (March 2020).

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