CCAR 2017

EY Regulatory Alert

February 2017

On Friday, February 3, 2017, the Federal Reserve Board (FRB) published the 2017 Comprehensive Capital Analysis and Review (CCAR) instructions and the related supervisory scenarios for the annual stress tests required under the Dodd-Frank Act Stress Testing (DFAST) rules and the capital plan rule. Additionally, the FRB issued letters describing reduced CCAR requirements for large and noncomplex firms, enhancements to certain supervisory stress testing models, and an overview of expectations for the intermediate holding companies (IHCs) of foreign banks that are required to file a capital plan in 2017 but are not subject to full CCAR and DFAST requirements until CCAR 2018.

Instructions continue to stratify expectations between 15-18 and 15-19 firms, and reinforce the heightened expectations for risk management, controls and governance

As compared to prior years, the CCAR 2017 instructions now provide clear and separate expectations for large and complex (15-18) and large and noncomplex (15-19) firms. This year's instructions also reinforce the heightened expectations that form the basis for the FRB's qualitative assessment of firms' capital planning processes, including strong risk management, controls, governance, and for certain firms a required CFO attestation as to data accuracy and completeness. Additionally, the FRB is focused on how firms have addressed outstanding regulatory issues on the final capital forecast.

The instructions also provide details on how firms should reflect recent phase-in of certain regulatory requirements and amendments to capital and stress test rules, including the final rule, Amendments to the capital plan and stress test rules, published on January 30, 2017. The final rule removed large and noncomplex firms from the qualitative assessment under CCAR, modified the definition of large and noncomplex firms, provided clarity on the exam process for these firms, and for all firms affirmed the proposal around de minimis capital actions that may be executed without preapproval of the FRB.

The CCAR 2017 instructions and additional letters provide guidance to the 34 CCAR banks submitting capital plans this year. This includes 13 large and complex firms and 21 large and noncomplex firms. This year there is one additional public filer (large and noncomplex) as well as six new IHCs who will submit a non-public filing. Highlights include:

- The FRB published a baseline and two stressful economic scenarios with features that are generally consistent with last year. Of note, this year's supervisory severely adverse scenario assumes a slightly more severe downturn in the US economy, peaking unemployment at 10%, and incorporates a large decline in commercial real estate prices and euro area recession.
- The CCAR 2017 supervisory severely adverse scenario did not include negative interest rates. Negative short-term interest rates were included in CCAR 2016, which tested both stress impacts and firms' operational capabilities to model negative rates. In CCAR 2017, short-term interest rates decline but do not fall to zero. Also, a marginally less elevated path for US market volatility index (VIX) and more severe path for commercial real estate (CRE) were notable differences in the variable paths compared to last year.
- The FRB's CCAR quantitative assessment is generally in line with the approach and assessment from last year, with revisions to three FRB models. Firms should be especially mindful of their forecasts around CRE given the more stressful severely adverse scenario combined with the change to the FRB's CRE loss model.
- The qualitative assessment will be informed by a firm's ability to meet regulatory expectations in six areas: governance, risk management, internal control, capital policies, incorporating stressful conditions and events and estimating the impact on capital positions.
- The FRB emphasized that material unresolved supervisory issues, unreasonable or inappropriate assumptions and analyses underlying the capital plan, or an unsafe/unsound capital planning process could support a qualitative objection. Firms should examine how these unresolved issues are considered in their capital projections and assumptions, limitations and weaknesses framework.
- The 2017 global market shock (GMS) scenarios were published requiring an as-of date of January 3. There were no changes in the GMS instructions. For the severely adverse scenario, risk factor spot and volatility shocks are generally smaller than 2016 for certain asset classes (e.g., equities, rates, foreign exchange (FX) and commodities) and there is less widening in agency mortgage-backed securities (MBS) and to-be-announced (TBA) forward spreads. The shocks for other asset classes are the same as (e.g., securitized products, private equity) or greater than last year (e.g., CDS-cash basis, certain emerging market (EM) sovereign spreads).
- Large and noncomplex firms are no longer subject to the CCAR qualitative assessment but remain subject to supervisory assessments that examine their capital planning processes. These firms will be examined through the FRB's year-round supervision inspection process starting in the third quarter of 2017. Additionally, these firms are now subject to less stringent reporting requirements. These include certain FR Y-14 reports and certain supporting documentation, which is now due upon request, rather than as part of the April 5 submission.
- A separate letter with instructions was provided for new IHCs describing the requirements for the FRB's qualitative assessment and confirming the non-applicability of a quantitative assessment this year. These requirements are outlined below.
- De minimis exception threshold was reduced as per the January 30, 2017, final rule, which set a blackout period for exception notices and incremental capital distribution requests.

Phase-in of certain regulatory requirements for CCAR 2017:

- Required supplementary leverage ratio (SLR) minimum of 3% for advanced approach bank holding companies (BHCs) beginning in projection periods Q1 2018 to Q1 2019. Covered firms may be required to evidence sound approaches for projecting off-balance sheet exposures when calculating pro-forma SLR under both baseline and stress scenarios.
- CFO attestation for LISCC firms for FR Y-14 instructions compliance, material accuracy of the actuals data, and effectiveness of internal controls for the submitted reports with an as-of date of December 31, 2016. Implied in a firm's attestation is the ability to connect identified data and control issues to its overall assessment of capital adequacy.
- Unless effective by December 31, 2016, new accounting standards, including changes to the current expected credit loss impairment standard, should not be reflected in projections unless a firm is an early adopter of a particular standard.

Potential future changes not included in CCAR 2017 instructions:

- The FRB has communicated additional changes to the CCAR framework in future exercises. These include the implementation of a stress capital buffer, changes to the treatment of planned distributions, adjustments to certain balance sheet and risk-weighted asset assumptions, and the removal of heightened scrutiny of capital plans that imply dividend payout ratios above 30%.

Final rule observations

- Final definition of large and noncomplex firms includes BHCs and US IHCs of foreign banking organizations with total consolidated assets between $50 billion and $250 billion, total nonbank assets of less than $75 billion, and that are not identified as global systemically important banks (defined as US GSIBs). Notably, the FRB removed the proposed criterion that large and noncomplex firms must have less than $10 billion in foreign exposure.
- The FRB removed the qualitative component from the annual CCAR process for large and noncomplex firms. These firms, however, remain subject to existing quantitative standards and measures and supervisory assessment of capital planning processes.
- Introduced a horizontal capital review (HCR) for large and noncomplex firms and shifts the assessment process from April of each year to the third quarter. This will likely shorten the window for regulatory issue remediation prior to the next CCAR cycle.
- Large and noncomplex firms still have to submit a capital plan; however, CCAR supporting documentation for models and methodologies, technical documents, and validation reports will be submitted as part of the large and noncomplex exam process, and not part of the April submission.
- Relaxed reporting requirements on certain FR Y-14A templates and provided updated materiality thresholds where immaterial portfolios will be defined as less than $5 billion or 10% of tier 1 capital, measured as an average for the four quarters preceding the reporting quarter.
- Affirmed de minimis addition capital actions may be executed without preapproval of the FRB if under 0.25% of tier 1 capital and during any period except the second quarter of each year.
- Large and complex banks remain subject to the quantitative and qualitative components of the annual CCAR process.

The CCAR 2017 macro scenarios highlight sensitivities to corporate loan markets and CRE exposures

The FRB published a baseline and two stressful economic scenarios with features generally consistent with last year, excluding the forecast of negative interest rates. As in prior years, the FRB provided the same 28 measures of economic and market conditions to describe the 2017 CCAR scenarios.

Following a first quarter peak, the VIX follows an incrementally less elevated path compared to last year. The downward deterioration in the CRE index appears more severe than last year, largely due to a higher starting point but with a similar trough. This is consistent with the FRB's description of heightened stress in commercial real estate markets.

- The supervisory severely adverse scenario assumes an incrementally more severe downturn in the US economy, as compared to last year, particularly a larger decline in commercial real estate prices. The unemployment rate peaks at 10%, commercial real estate prices plunge, and yields on investment-grade corporate bonds widen significantly. Yields on US treasuries are bound at zero this year, as compared to negative yields in last year's scenario. The global recession is evidenced by more severe recessionary episodes in the euro area and UK and less severe in Asia.
- The supervisory adverse scenario assumes a global aversion to long-term fixed-income assets despite lower short-term rates, bringing about a near-term rise in long-term rates and steepening yield curves in the US and four global concentrations. The widespread deflation in 2016 was changed to represent more regional deflation in the 2017 scenario (i.e., Japan is more pronounced, less severe in euro area and developing Asia, and absent in the UK and US).
- The supervisory baseline scenario has a moderate economic expansion in the US and expansion in international activities similar to last year's baseline scenario.

The CCAR 2017 GMS[1] severely adverse scenario may highlight sensitivities to portfolios with hedge protection

For the six BHCs subject to GMS and the eight BHCs subject to the counterparty default scenario component, there was no change in the instructions.

For GMS severely adverse scenario, while the spot and volatility shocks for certain asset classes (e.g., equity, rates, FX and commodities) are less severe than in prior years, these could limit gains in hedged portfolios given that deep out-of-the-money options may not trigger. For portfolios that may be more subject to directional risk (such as securitized products, private equities or EM sovereign bonds), the application of similar or greater shocks may result in similar or greater losses for those portfolios, subject to the changes in the composition of a firm's portfolio.

[1]Note: The GMS as-of date is January 3, 2017, and the six global market shock (GMS) firms include Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley and Wells Fargo.

FRB has enhanced three new models …

- The operational risk loss model was enhanced, and the mortgage repurchase model was retired. The operational risk loss model will now forecast losses using an average of the historical simulation model, consistent with last year, and an enhanced industry-level regression-based model that will distribute losses to each firm based on its asset size.
- The pre-provision net revenue (PPNR) model has added components increasing the sensitivity to macroeconomic conditions and decreasing the sensitivity to a firm's most recent historical firm data. Moreover, the enhanced model is expected to better account for firm-specific differences through results that converge to the firm's post-crisis average experience.
- The commercial real estate model was enhanced to streamline data and estimation processes and leverage updated macroeconomic variables.

… which may differentially impact firms

Changes in the FRB models may result in lower supervisory estimates of firms' post stress capital ratios. Firms operating closer to post-stress minimum regulatory capital levels under the FRB's quantitative assessment should consider the following when assessing their capital buffers:

- The pre-provision net revenue (PPNR) model has added components increasing the sensitivity to macroeconomic conditions and decreasing the sensitivity to a firm's most recent historical firm data. Moreover, the enhanced model is expected to better account for firm-specific differences through results that converge to the firm's post-crisis average experience.
- The commercial real estate model was enhanced to streamline data and estimation processes and leverage updated macroeconomic variables.

Horizontal capital review for large and noncomplex firms has enhanced emphasis on risk management, process and controls, data management, and governance. Highlights include:

- **Qualitative assessment occurs during the year-round supervision process in the third quarter.**
- **Strong challenge during the assessment process is expected for unresolved supervisory issues, unreasonable or inappropriate assumptions and analyses underlying the capital plan, or unsafe/unsound capital planning processes.**
- **Large and noncomplex firms continue to have the opportunity for a one-time adjustment to planned capital distributions.**
- **Firms that meet expectations may make certain capital distributions, with prior notice to the Federal Reserve, in excess of the amount listed in their capital plan as long as the firm is considered to be "well capitalized" and its performance is consistent with expected conditions.**
- **Supporting documentation for a firm's capital plan is now due in response to a first day letter, rather than as part of the April 5 submission.**
- **Large and noncomplex firms are no longer required to submit certain sub-schedules of the FR Y-14 reports or immaterial portfolios as part of the FR Y-14Q and FR Y-14M reporting.**
- **For such immaterial portfolios, where data is not submitted, the FRB will use median loss rates, rather than historical, more punitive losses.**

- RE model considerations — The FRB's previous CRE model was parameterized based on commercial mortgage-backed securities (CMBS) data and now may be shifting the inputs to rely more on collected FR Y-14Q data. This change will likely reduce certain data translations and may produce a more tailored model. This change comes with limited years of historical data and could produce different loss estimates as compared to the previous model. Given the FRB's CRE loss rates were significantly higher than firms' projections last year, the impact of model changes and the lack of a phased-in approach introduce uncertainty around the FRB's CRE projections in CCAR 2017.

Qualitative assessment expectations of capital plans for new US IHCs of foreign banking organizations

- New IHCs are required to produce a capital plan, supporting documentation, and estimates of losses and revenues under two internal scenarios and three supervisory scenarios by April 5, similar to ongoing CCAR filers.
- These first time submissions will be subject to a qualitative assessment only (i.e., not subject to a quantitative assessment) in alignment with the capital plan rule.

Qualitative assessment expectations of capital plans for new US IHCs of foreign banking organizations (continued)

- Similar to large and noncomplex firms, the qualitative assessment will be informed by supervisory activities conducted throughout the year that focus on risk management, internal controls, audit and governance. The assessment will also consider material unresolved supervisory issues, unreasonable or inappropriate assumptions and analyses underlying the capital plan, or an unsafe/unsound capital planning process.
- Market and counterparty default risks will receive particular attention in the FRB's assessment, given broker-dealer activities of new IHCs.
- The FRB's objection or non-objection to these IHCs' capital plans will not be made public this year.
- The FRB will inform the IHCs of the results of the qualitative assessment by June 30, 2017.

Comparison of select FRB variables CCAR 2017 vs. 2016 — severely adverse

Table 1: Real GDP growth

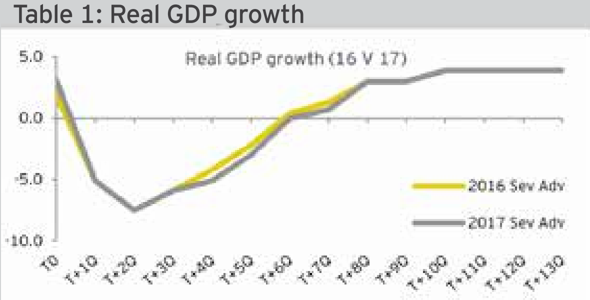


Table 2: Unemployment

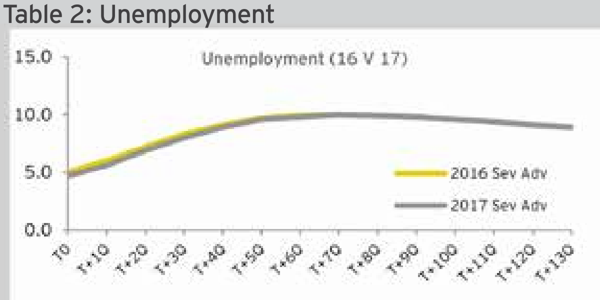


Table 3: CRE index

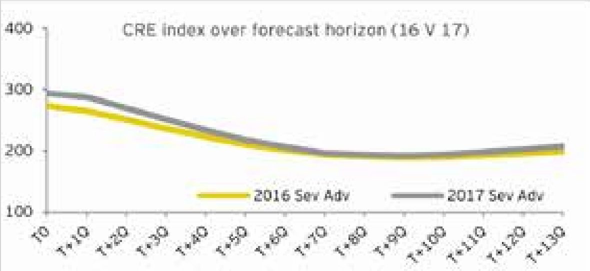


Table 4: Three-month treasury yield

Table 5: BBB corporate yield

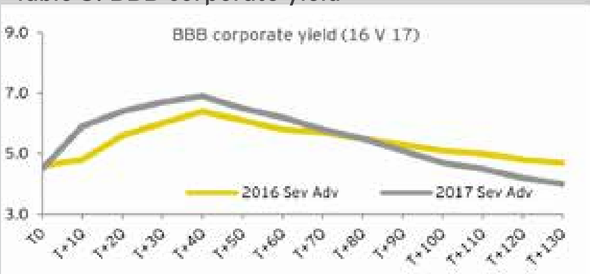


Table 6: Fixed-rate 30-year mortgage

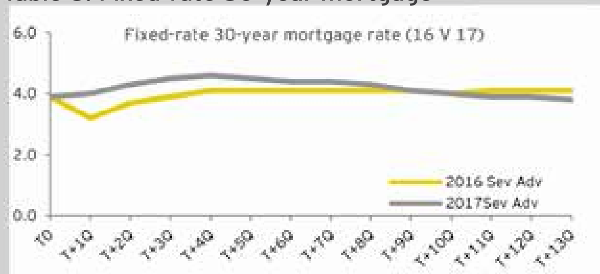


Table 7: House price index

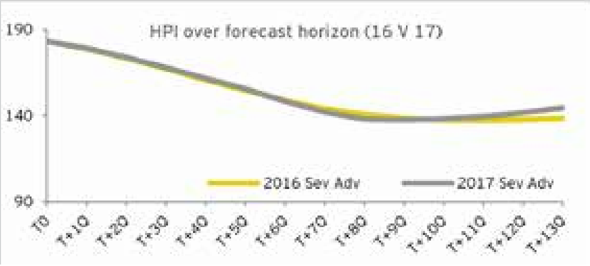


Table 8: VIX

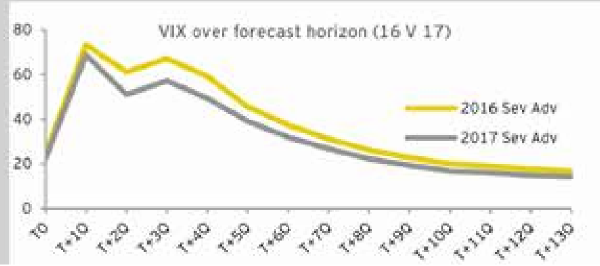
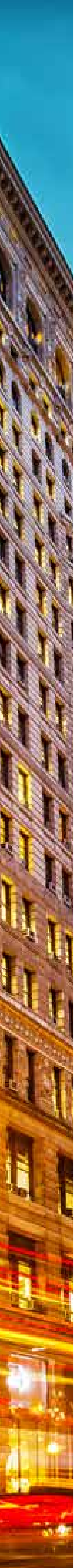


Table 9: Comparison of select FRB variables CCAR 2017 vs. 2016 — severely adverse scenario

Macroeconomic Factor	CCAR 2017				CCAR 2016				The difference between CCAR 2017 trough as compared to the CCAR 2016 trough
	4Q'16 jump-off	Δ from 3Q'14 to trough (absolute Δ % or amount)	9Q trough[2]	1Q'19 ending value	4Q'15 jump-off	Δ from 4Q'15 to trough (absolute Δ % or amount)	9Q trough	1Q'18 ending value	
Real GDP growth (%)	3.1	10.6	-7.5	3.0	1.9	9.4	-7.5	3.0	0
Unemployment rate (%)	4.7	5.3	10	9.8	5	5	10	9.8	0
CPI inflation rate (%)	3.4	62%	1.3	1.8	0.2	0%	0.2	1.6	1.1
3-month Treasury yield (%)	0.4	0.3	0.1	0.1	0.1	0.6	-0.5	-0.5	0.6
10-year Treasury yield (%)	2.2	64%	0.8	1.5	2.2	91%	0.2	1.2	0.6
BBB corporate yield (%)	4.5	13%	5.1	5.1	4.6	4%	4.8	5.3	0.3
Mortgage rate (%)	3.9	3%	4	4.1	3.9	18%	3.2	4.1	0.8
Prime Rate (%)	3.5	9%	3.2	3.2	3.3	21%	2.6	2.6	0.6
Dow Jones Total Stock Market Index	23276.7	50%	11704.3	17069.7	21100.9	51%	10395.5	16180.1	1308.8
House Price Index	183.3	25%	137.5	137.5	183.1	24%	138.5	138.5	-1
Commercial real estate price index	293.9	35%	192.1	192.1	273.4	30%	190.1	190.1	2
Market Volatility Index (VIX)	22.5	14%	19.3	19.3	24.4	7%	22.8	22.8	-3.5

[2] Actual scenario severity is based on each BHC's specific exposure, and the relative assessment is a general indicator of expected severity across BHCs.



Upcoming dates

- April 5, 2017 — 2017 capital plan and FR Y-14A submissions
- June 30, 2017 — Deadline for FRB to disclose DFAST results and CCAR 2017 quantitative and qualitative assessments for large and complex firms

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