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CCAR 2016

EY Regulatory Alert

February 2016

On Thursday, January 28, 2016, the Federal Reserve Board (FRB) published the Comprehensive Capital Analysis and Review (CCAR) 2016 instructions and the supervisory scenarios for the annual stress tests required under the Dodd-Frank Act stress test (DFAST) rules and the capital plan rule[1] that apply to the 33 bank holding companies (BHCs) participating in CCAR this year.[2] *While there are no significant surprises in the instructions, some new features in the CCAR 2016 scenarios warrant particular attention. Specifically, the supervisory severely adverse scenario introduces a period of negative short-term interest rates.*

Technical instructions reinforce the now-explicit and differentiated expectations of SR 15-18 and SR 15-19

The CCAR 2016 instructions are generally consistent with last year's CCAR exercise. However, they contain additional details on how BHCs should implement technical amendments to stress test and capital rules and reiterate changes from updated guidance published since CCAR 2015, including:

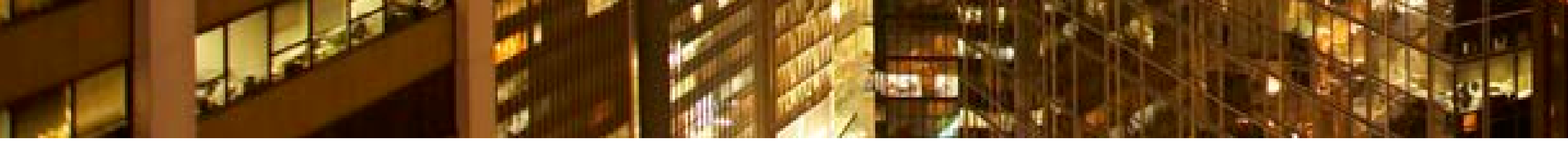
- November 25, 2015 amendments to the capital plan and stress testing rules
- December 21, 2015 supervisory letters SR 15-18 and SR 15-19[3]
- January 21, 2016 updates to the FR Y-14A/Q/M Instructions

While the scenarios may impact the ability for BHCs' to meet quantitative requirements under CCAR, SR 15-18 and SR 15-19 reinforce the high supervisory expectations that form the basis of the FRB's qualitative CCAR assessment.

[1] http://www.federalreserve.gov/newsevents/press/bcreg/20160128a.htm

[2] Applicability: 31 CCAR BHCs from last year plus two new participants: BancWest Corporation and TD Group US Holdings LLC. The same 6 US global systemically important banks (G-SIBs) as last year are subject to the FRB's Global Market Shock (GMS), and the same 8 G-SIBs as last year are subject to the FRB's Counterparty Default Scenario component.

[3] The new guidance supersedes SR 09-4 and SR 99-18 and provides "core" expectations for capital planning, which builds upon existing minimum expectations published in other regulatory guidance (i.e., CCAR Range of Current Practices (2013), Comprehensive Capital Analysis and Review 2015 Summary Instructions and Guidance, Instructions for the Capital Assessments and Stress Testing information collection, SR 11-7, SR letter 12-17/CA, and SR 13-1).



Key issues highlighted in the CCAR 2016 instructions that were previously communicated include:

Reiterated changes from November 25, 2015 Final Rule amending the capital plan and stress testing rules

- Removal of tier 1 common ratio, indefinite delay of stressed advanced approaches risk-weighted asset calculations, and one-year delay for incorporating supplementary leverage ratio into stress projections
- Modification of DFAST capital action assumptions to highlight the incorporation of planned mergers and acquisitions in capital projections
- Requirement to include Volcker Rule deductions from regulatory capital in FR Y-14A schedules, as appropriate, over the nine-quarter planning horizon

Highlighted key areas from SR 15-18 and SR15-19

The SR 15-18 and SR 15-19 guidance effectively subdivides the current 33 CCAR BHCs and future filers into two tiers, with higher expectations for the first tier of Large Institution Supervision Coordinating Committee (LISCC) and "Large and Complex" firms.[4]

Referenced changes from January 21, 2016 update of FR Y-14A/Q/M schedules

- Requirement to populate new Schedule F (Business Plan Changes) with planned "material" business changes (e.g., merger, acquisition, divestiture) for the 2016 CCAR cycle, formalizing information that had been captured in prior CCAR cycles on an ad-hoc basis.
- CFO attestation (which will start December 31, 2016, for FR Y-14A/Q/Ms as of that date) for nine current and seven future LISCC firms focusing on attestation that:
  - Projections and actuals data is prepared in conformance with FRB instructions
  - Data is materially accurate and supported by effective internal controls and reviews by senior management, and that material weaknesses and errors in data are promptly reported to the FRB as they are identified

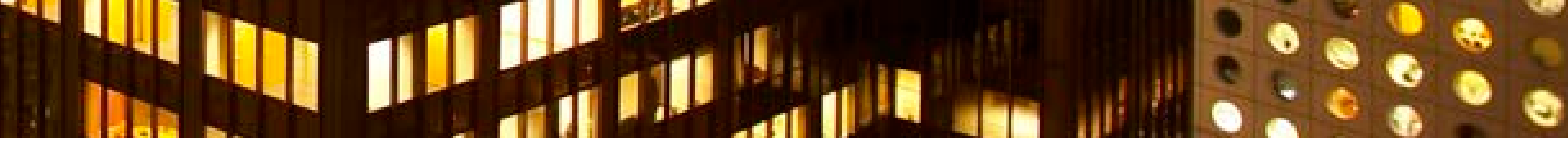
SR 15-18 has enhanced emphasis and relatively higher expectations for LISCC and Large and Complex firms in the areas of modeling, risk identification, data management and governance. Highlights include:

- Higher expectations toward **usage of models and quantitative methods** for losses, balance sheet and pre-provision net revenue including increased scrutiny on **assumptions** in balance sheet forecasting
- Expectation to evaluate risk identification and assessment at least **quarterly**
- Expectation to use **multiple internal scenarios** across material risks in ongoing capital planning
- Elevated expectations on controls related to **qualitative approaches and overlays**
- Elevated expectations on **model performance assessment** (potential additional **sensitivity testing**)
- Enhanced standards for the use of **benchmark models** in capital planning
- Increased engagement of the RWA production function in the projections of **standardized RWA**
- Specific requirement for senior management to review the capital planning process **quarterly**
- Re-emphasis on **internal audit's** role in evaluating the firm's capital planning process and supporting risk-management and internal control practices
- More emphasis on use of scenarios for **operational risk loss projections**
- Elevated expectations on use of **internal data**

SR 15-19 includes differentiated expectations for "Large and Noncomplex" firms primarily in the following areas:

- Use of quantitative approaches
- Use of internal data
- Use of benchmark models
- Operational risk loss projections
- Trading exposures
- Validation of vendor models
- RWA projections

[4] "LISCC Firms and "Large and Complex Firms" are defined as US BHCs and intermediate holding companies (IHCs) of FBOs that have total consolidated assets greater than $250 billion, have consolidated total on-balance sheet foreign exposure greater than $10 billion and/or are subject to the Federal Reserve's LISCC. "Large and Complex" applies to slightly less than half of the current 33 CCAR firms. "Large and Noncomplex Firms" are defined as US BHCs and IHCs of FBOs that have total consolidated assets greater than $10 billion but less than $250 billion, have consolidated total on-balance sheet foreign exposure less than $10 billion and are not subject to the Federal Reserve's LISCC. The remaining CCAR firms are designated "Large and Noncomplex."



Other noteworthy items in the instructions

- CCAR will be integrated into the FRB's ongoing supervisory activities conducted throughout the year, and ongoing reviews will be focused specifically on risk management, internal controls, audit and corporate governance.
- The qualitative assessment for CCAR 2016 will focus on areas highlighted in SR 15-18 and SR 15-19, including governance, risk management, internal controls, capital policies, scenario design and projection methodologies.
- Related to bank holding company (BHC) baseline planned capital actions, BHCs may include lower distributions in the second quarter of the planning cycle but cannot, without FRB approval, include or execute a larger amount of capital distributions than in the prior year's capital plan.
- BHCs are expected to reflect conservative common dividend payout ratios in their capital plans. Payout ratios above 30% will receive higher scrutiny and will be reviewed against a BHC's ability to meet its baseline earnings projections.
- Unless effective December 31, 2015, new accounting standards should not be reflected in projections.
- BHC subsidiaries of foreign banking organizations (FBOs) that will be designated as the US intermediate holding company (IHC) must include in their capital plan an assessment of how the transfers of subsidiary assets and liabilities would affect the BHC's capital adequacy.

The CCAR 2016 scenarios have some key differences in features and severity, including negative US short-term interest rates ...

The FRB provided the same 28 indicators of economic and market conditions to describe the 2016 CCAR scenarios as in 2015. The global market shock (GMS) risk factor shock templates were not released and are expected by March 1, 2016 as per Regulation YY.[5]

Supervisory severely adverse (severely adverse) scenario

The Severely Adverse Scenario assumes negative US short-term interest rates and a more severe downturn in the US economy as compared to last year. The scenario includes a global recession, with a severe recession in three of the four country blocks (US, EU, UK, Japan) and a mild recession in developing Asia, and a heightened period of corporate financial stress. [*See more detail on the severely adverse scenario in Tables 1-9 on pages 5 and 6*]

Supervisory adverse (adverse) scenario

The Adverse Scenario assumes mild deflation with consumer prices falling and lower paths of US Treasury yields relative to last year. It also assumes a moderate recession in the US, broadly consistent with last year's adverse scenario, and moderate recessions in the euro area, the United Kingdom, and Japan, as well as below-trend growth in developing Asia.

Supervisory baseline (baseline) scenario

The Baseline Scenario has a moderate economic expansion in the US and internationally at growth rates and levels similar to last year's baseline scenario.

GMS and counterparty default severely adverse scenario[6]

The 2016 GMS severely adverse scenario is qualitatively described in the overall scenario release, with highlights including:

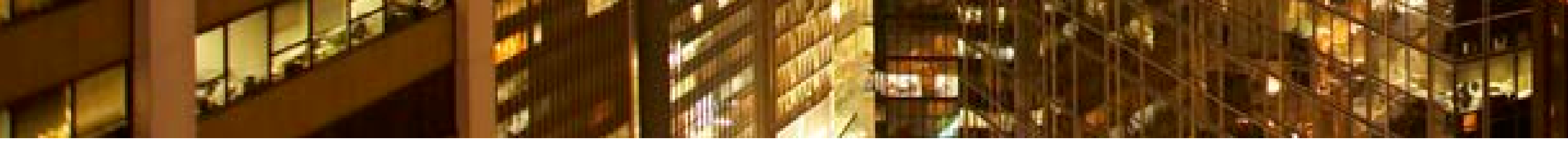
- A sudden sharp increase in general risk premiums and credit risk, significant market illiquidity and the distress of one or more large entities that rapidly sell a variety of assets into a fragile market
- General decline in US Treasury rates, resulting in negative short-term rates
- Peak-to-trough asset value changes that are generally comparable to 2007–2009, with declines in markets less affected by deteriorating liquidity generally comparable to the second half of 2008
- Breakdowns in historical basis spreads, with spread widening between cash and to-be-announced (TBA) forward markets and corporate bonds and credit default swaps
- Larger widening of credit spreads for municipal, sovereign and advanced economies' corporate products and greater declines in the value of private equity investments, recently issued securitized products and non-agency residential mortgage-backed securities as compared to 2015

GMS and counterparty default adverse scenario

- The adverse scenario simulates an extended low growth environment and muted volatility across most asset classes and term structures. Key changes from the 2015 adverse scenario include new elements that are distinct from and not mechanically linked to the severely adverse scenarios.

[5] http://www.ecfr.gov/cgi-bin/retrieveECFR?gp=&SID=cf69eb924cea74aac02264a0ea36596d&r=PART&n=12y4.0.1.1.17#se12.4.252_154

[6] Note: the GMS "as-of" date is January 4, 2016, and similar to prior year, banks may use an alternate as-of date that corresponds to their weekly internal risk reporting between January 4-8, 2016.



… and negative interest rates introduce some new analytical considerations

A key analytical challenge for CCAR 2016 will come from the negative 3-month Treasury rate that emerges in the second quarter of the nine-quarter severely adverse scenario and will also be a feature for the GMS severely adverse scenario. Negative short-term interest rates are a phenomenon which has not yet occurred in the US but are occurring at the moment in several markets around the world (e.g., interbank markets for CHF, DKK, EUR, JPY and SEK). Negative US short-term interest rates may require firms to challenge and enhance the output from certain projection and valuation models.

- **Scenario expansion model adjustments.** Scenario expansion models used to translate the core macroeconomic variables or market risk factors to the full suite of revaluation or projection model input parameters may have to be examined to assess if the use of "floors" or "lower boundaries" in such expansion models will need modification to accommodate the projection of negative interest rates.
- **PPNR (pre-provision net revenue) projection adjustments.** Models or other approaches to project income using variables that are directly or closely related to the 3-month Treasury rate may need additional review and analysis, and potential overlays to results. As negative US rates would not have featured in model historical developmental data sets banks may want to look closely at the calibration of their models, and challenge results in the context of potential customer/counterparty behavior and product pricing in the negative rate scenario.
- **Valuation model adjustments.** Certain valuation models for products such as interest rate caps/floors and swaptions may rely on traditional log-normal models, which do not allow for negative interest rate parameters. Depending on which (if any) rate shocks result in negative interest rates, some banks may still need to assess all products that are impacted by negative interest rate parameters and test their valuation models from both a methodology and implementation perspective to provide that these models can function properly under negative rate scenarios.
- **Credit loss models.** These models may be impacted to a lesser extent because the majority of credit models typically do not use interest rates as a material direct input, relying instead on House Price Index (HPI), unemployment, GDP and so on.

What is next?

Upcoming dates:

- **March 1, 2016**: global market shock factors due (will likely be released earlier)
- **April 5, 2016**: 2016 capital plan and FR Y-14A submissions due
- **Early June**: FRB to provide BHCs with an opportunity for a one-time reduction of planned capital distributions based on initial post-stress results, which may include reduction in all types of capital distributions, not just common stock distributions
- **June 30, 2016**: communication deadline for decisions by the FRB
- BHCs to disclose company-run stress test results within 15 days of the release of final FRB results

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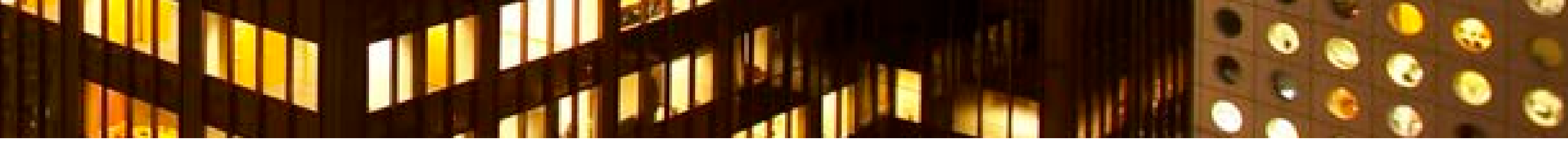


Comparison of select FRB variables (CCAR 2015 vs. 2016) — severely adverse

Table 1: Real GDP growth

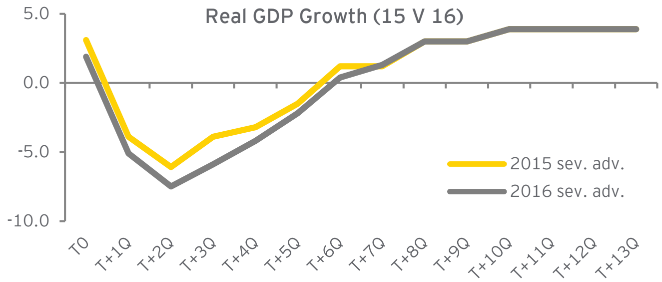


Table 2: Unemployment

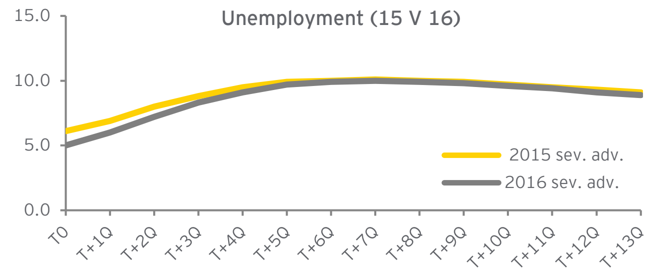


Table 3: CPI

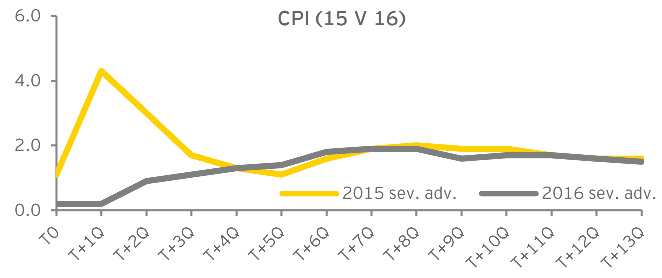


Table 4: 3-Month Treasury yield

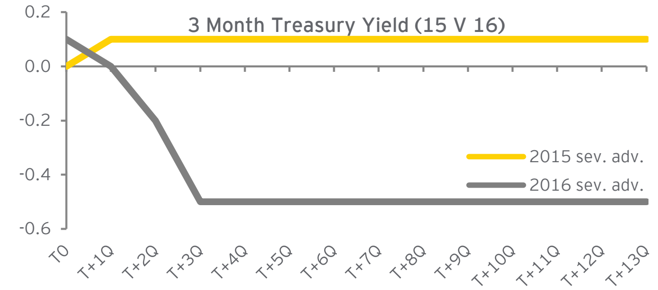


Table 5: BBB corporate yield

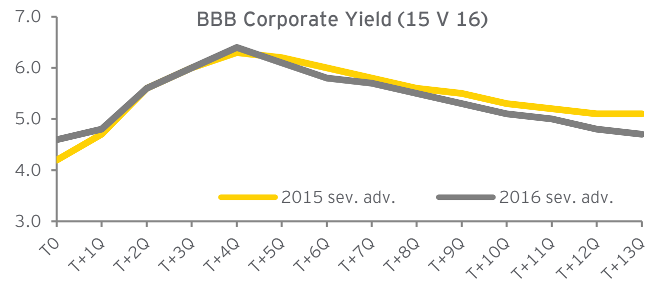


Table 6: Fixed-rate 30-year mortgage

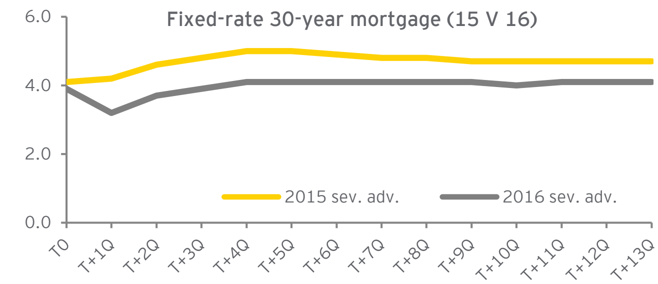


Table 7: House Price Index

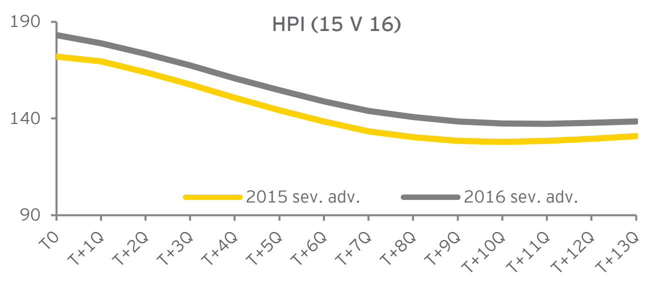
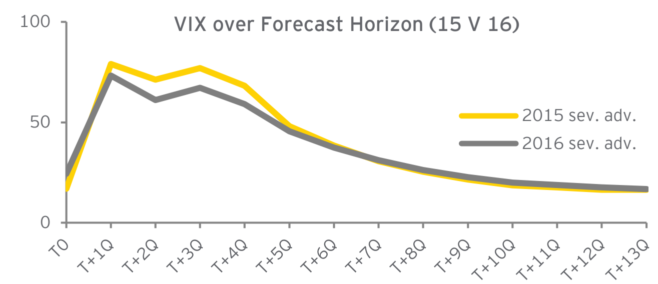


Table 8: VIX



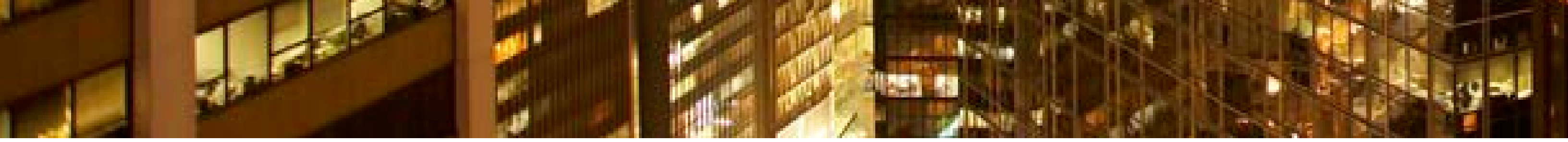
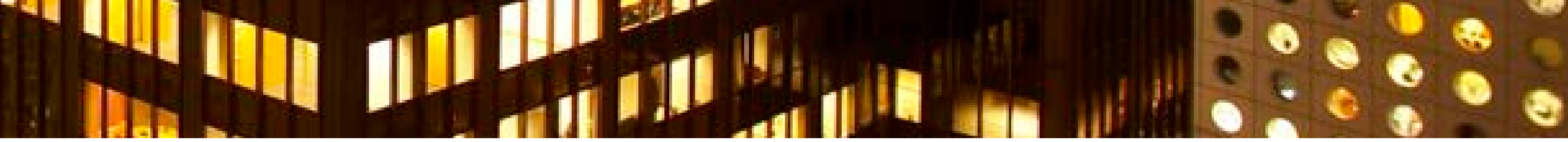


Table 9: Comparison of select FRB variables (CCAR 2015 vs. 2016) – severely adverse scenario

Macroeconomic factor	CCAR 2015				CCAR 2016				CCAR 2016 trough vs. CCAR 2015 trough	Relative Severity Indicator[8] 2016 vs. 2015
	3Q'14 jump-off	9Q trough[7]	Δ from 3Q'14 to trough	4Q'16 ending value	4Q'15 jump-off	9Q trough[7]	Δ from 4Q'15 to trough	1Q'18 ending value		
Real GDP growth (%)	3.1	-6.1	-9.2	3.0	1.9	-7.5	-9.4	3.0	-1.4	▲
Unemployment rate (%)	6.1	10.1	4.0	9.9	5.0	10.0	5.0	9.8	-0.1	▲
CPI inflation rate (%)	1.1	1.1	-	1.9	0.2	0.2	-	1.6	-0.9	▼
3-month Treasury yield (%)	0.0	0.1	0.1	0.1	0.1	-0.5	-0.6	-0.5	-0.6	▲
10-year Treasury yield (%)	2.5	0.9	-1.6	1.9	2.2	0.2	-2.0	1.2	-0.7	▲
BBB corporate yield (%)	4.2	6.3	2.1	5.5	4.6	6.4	1.8	5.3	0.1	▼
Fixed-rate 30-year mortgage (%)	4.1	4.2	0.1	4.7	3.9	3.2	-0.7	4.1	-1.0	▲
Prime Rate (%)	3.3	3.2	-0.1	3.2	3.3	2.6	-0.7	2.6	-0.6	▲
Dow Jones Total Stock Market Index	20,459	8,606.3	-11,852.5	11,521	21,101	10,395.5	-10,705.4	16,180	1,789	▼
House Price Index	172.1	128.4	-43.7	128.4	183.1	138.5	-44.6	138.5	10.1	▼
CRE Price Index	236.0	154.4	-81.6	154.6	273.4	190.1	-83.3	190.1	35.7	▼
Market Volatility Index	17.0	79.0	62.0	21.6	24.4	73.3	48.9	22.8	-5.7	▼

[7] Trough is an indicator of severity and as a result values for unemployment, BBB corporate yield and VIX represent the peak value over the nine projection quarters.

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



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