
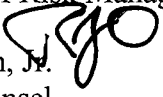


**DATE:** October 9, 2012

**MEMORANDUM TO:** Board of Directors

**FROM:** Sandra L. Thompson   
Director, Division of Risk Management Supervision

Richard J. Osterman, Jr.   
Acting General Counsel

**SUBJECT:** Stress Testing Requirements for Covered Banks: Final Rule to Implement Section 165(i)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act

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**Recommendation:** Staff recommends that the Board of Directors of the Federal Deposit Insurance Corporation (“Board”) approve this final rule (“final rule”) to implement section 165(i)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Act”). The final rule requires state nonmember banks and state savings associations supervised by the Federal Deposit Insurance Corporation (“FDIC” or “Corporation”) with total consolidated assets of more than \$10 billion to perform annual stress tests in accordance with the final rule, report the results of such stress tests to the Corporation and the Board of Governors of the Federal Reserve System (“FRB”) at such time and in a form required by the Corporation, and publish a summary of the results of the required stress tests. The Office of the Comptroller of the Currency (“OCC”) and the FRB will issue similar final rules. If approved, the final rule will be published in the *Federal Register*.

## **I. Introduction**

Section 165(i)(2) of the Act instructs the FDIC to issue regulations that require FDIC-insured state nonmember banks and FDIC-insured state-chartered savings associations with total consolidated assets of more than \$10 billion (“covered banks”) to conduct certain stress tests on an annual basis. Further, the Act requires that such regulations: (1) define the term “stress test”; (2) establish methodologies for the conduct of the stress tests that provide for at least three different sets of conditions, including baseline, adverse, and severely adverse conditions; (3)

establish the form and content of a required regulatory report on the stress tests; and (4) require covered banks to publish a summary of the results of their stress tests.

The FDIC originally proposed stress testing requirements implementing section 165(i)(2) of the Act through a Notice of Proposed Rulemaking (“NPR”) published in the *Federal Register* on January 23, 2012, titled “Annual Stress Test” (“proposed rule”).<sup>1</sup> The NPR solicited comment on all aspects of the proposed rule and the FDIC received 18 comments in response to the NPR. The final rule adopts the requirements proposed in the NPR with certain modifications, discussed further below, which take into consideration concerns and suggestions presented by commenters.

Section 165(i)(2) of the Act requires each primary Federal financial regulatory agency, including the FDIC, to issue consistent and comparable stress testing regulations in coordination with the FRB and the Federal Insurance Office. The final rule will be issued along with the OCC’s final stress testing requirements for covered national banks and Federal savings associations and the FRB’s final rules relating to stress testing for covered state member banks.

## **II. Summary of the Proposed Rule**

The proposed rule required covered banks to conduct annual stress tests. The proposed rule defined “covered bank” as any state nonmember bank or state-chartered savings association that has more than \$10 billion in total consolidated assets, as determined based on the average total consolidated assets as reported on the state nonmember bank’s four most recent Reports of Condition and Income (Call Reports) or on the state savings association’s four most recent Thrift Financial Reports (TFRs). Once an entity becomes a covered bank, it would remain a covered bank unless and until it has \$10 billion or less in total consolidated assets, as determined based on the average total consolidated assets as reported on either its four most recent Call Reports or its four most recent TFRs.

The proposed rule also defined the term “stress test” as a process to assess the potential impact on a covered bank of economic and financial conditions on the consolidated earnings, losses, and capital of a covered bank over a set nine-quarter planning horizon, taking into

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<sup>1</sup> 77 FR 3166 (January 23, 2012).

account the current condition of the covered bank and its risks, exposures, strategies, and activities.

Under the proposed rule, the FDIC would provide at least three scenarios (baseline, adverse, and severely adverse scenarios) that each covered bank must use to conduct its annual stress test, in advance of the annual stress tests required of all covered banks. Each covered bank would be required to use the applicable scenarios to calculate, for each quarter-end within the planning horizon: (i) potential losses, (ii) pre-provision net revenues, (iii) loan loss reserves, and (iv) *pro forma* capital positions over the planning horizon, including the impact on capital levels and ratios. Each covered bank would also be required to calculate, for each quarter-end within the planning horizon, the potential impact of the specific scenarios on its capital ratios. Each covered bank would be required to conduct annual stress tests using data as of September 30 for any given calendar year.

Under the framework established by the proposed rule, the FDIC would collect a covered bank's stress test results in early January of each year on a confidential basis. The NPR provided that, before covered banks would be required to complete the stress tests, the FDIC would publish for notice and comment the specific requirements and instructions for reporting the results of the annual stress tests ("required report"). The proposed rule also required each covered bank to take into account the results of its annual stress test when making changes, if appropriate, to: the bank's capital structure (including the level and composition of capital); its exposures, concentrations, and risk positions; any plans of the covered bank for recovery and resolution; and improvement of the overall risk management of the firm. Within 90 days of submitting the report to the FDIC, each covered bank would also be required to publish a summary of its results.

The proposed rule also recognized that the stress test requirements of section 165(i)(2) would apply to the parent company and to each subsidiary financial company (including covered banks) that individually have more than \$10 billion in total consolidated assets. Accordingly, the NPR stated that the Corporation would coordinate with the other primary Federal financial regulatory agencies to avoid unnecessary complexity or duplication of effort associated with

these requirements, including by coordinating the development of economic scenarios, as appropriate.

### **III. The Final Rule**

The final rule adopts the proposed rule, as presented in the NPR, with certain modifications. Like the proposed rule, the final rule requires covered banks to conduct annual stress tests. The final rule defines a stress test as an assessment of the potential effect of scenarios, including adverse scenario, baseline scenario, and severely adverse scenario, on the consolidated earnings, losses, and capital of a covered bank over the planning horizon, taking into account the current condition of the covered bank and the covered bank's risks, exposures, strategies, and activities. The final rule notes that stress tests required by the rule would be one component of the broader stress testing activities conducted by covered banks.

Like the proposed rule, the final rule defines a "covered bank" as any state nonmember bank or state savings association that has more than \$10 billion in total consolidated assets, as determined based on the average total consolidated assets as reported on the state nonmember bank's or state saving association's four most recent Call Reports. However, to address commenters concerns regarding testing, reporting, and disclosure for certain covered banks, the final rule also separates "covered banks" into two categories: over \$50 billion covered banks and \$10 billion to \$50 billion covered banks. The final rule defines an "over \$50 billion covered bank" as any state nonmember bank or state savings association with average total consolidated assets that are not less than \$50 billion. The final rule defines a "\$10 billion to \$50 billion covered bank" as any state nonmember bank or state savings association with average total consolidated assets that are greater than \$10 billion but less than \$50 billion. Average consolidated assets is defined as the average of the total consolidated assets on the covered bank's Call Report for the four most recent quarters. If a covered bank has not filed the Call Report in the four most recent quarters, average total consolidated assets means the average of the covered bank's total consolidated assets as reported on the covered bank's Call Reports, for the most recent one or more consecutive quarters.

The final rule also provides that a covered bank would remain subject to the stress test requirements contained in the final rule based on the covered bank's applicable category (\$10

billion to \$50 billion or over \$50 billion), unless and until the total consolidated assets of the covered bank fall below the relevant size threshold for the applicable category for each of the four consecutive quarters as reported on the covered bank's four most recent Call Reports.

Most banks with consolidated assets of \$50 billion or more have been involved in previous stress testing, including the 2009 Supervisory Capital Assessment Program (SCAP) and the Board's Comprehensive Capital Analysis and Review (CCAR) stress tests, and consequently have in place a framework necessary to conduct the stress tests required by this rule. Given the size, complexity and importance of these covered banks to the safety and soundness of the United States banking system, staff believes it is appropriate for these covered banks to commence stress testing as soon as possible. Consequently, state nonmember banks and state savings associations with consolidated total assets equal to or exceeding \$50 billion will be required to conduct their first annual stress tests under this final rule using financial data as of September 30, 2012.

Staff is aware, however, that some state nonmember banks and state savings associations with assets of \$50 billion or more may not be able or ready to conduct the annual stress test this year in a manner that would yield meaningful results. For example, covered institutions that were not subject to SCAP and CCAR may need more time to develop and implement a robust stress testing framework. Therefore, the final rule includes the reservation of authority for the FDIC to permit these covered banks to delay the application of the requirements under this final rule on a case-by-case basis.

State nonmember banks and state savings associations that would be \$10 billion to \$50 billion covered banks on the rule's effective date would be required to conduct their first stress tests using financial statement data as of September 30, 2013. Institutions that become covered banks after the effective date of the final rule would conduct their first stress test in the calendar year after they become a covered bank. This is a change from the proposed rule, which required stress tests to begin in the same calendar year if the institution became a covered bank no less than 90 days before September 30 of that year. This change was made in response to comments stating the proposed timeline was impractical for certain institutions. In the final rule, for example, a bank for which the four-quarter average of total consolidated assets exceeded \$10

billion on its June 2013 Call Report (based on the average from its September 2012, December 2012, March 2013, and June 2013 Call Reports) would become a covered bank on June 30, 2013 and would conduct its first stress test beginning in 2014. The rule would also allow the Corporation to accelerate or extend any specified deadline for stress testing if it determines that such modification is appropriate in light of the institution's activities, operations, risk profile, or regulatory capital.

After the initial tests and in subsequent years, the final rule would require each covered bank to conduct annual stress tests using the covered bank's financial data as of September 30th to assess the potential impact of different economic and financial scenarios on the consolidated earnings and capital of that bank and certain related items over at least a nine-quarter forward-looking planning horizon, taking into account all relevant exposures and activities. Under the rule, the Corporation would provide annually to covered banks, no later than November 15th, at least three scenarios, including baseline, adverse, and severely adverse, that each covered bank would use to conduct its annual stress test. The FDIC may require a covered bank to include one or more additional scenarios in its stress test based on the institutions activities, level of complexity, risk profiles, scope of operations and regulatory capital, in addition to any other relevant factors. The FDIC will notify the institution in writing no later than September 30 that the covered bank will be required to include one or more additional scenarios in its stress test, and the notification will include a description of the scenario and the basis for requiring the institution to include the scenario in its stress test.

The FDIC has also established provisions within the final rule that apply to covered banks having significant trading activities. For those covered banks, an additional trading and counterparty risk scenario may be included in their stress tests. The FDIC will select an as-of date between October 1 and December 1 of that calendar year for the trading and counterparty risk scenario which will be communicated to the covered bank no later than December 1. This provision is necessary to allow the FDIC to tailor the scenarios and other stress test requirements for those covered banks to ensure that the stress tests provide a meaningful identification of downside risks and assessment of the potential impact of adverse outcomes on the covered bank's capital. Typically, the scenarios would include market price and rate "shocks" consistent with historical or hypothetical adverse market events.

The final rule would require each covered bank to use the applicable scenarios in conducting stress tests to calculate, for each quarter-end within the planning horizon, the impact on its pre-provision revenues, market and credit losses, loan loss reserves, and *pro forma* capital positions throughout the planning horizon, including the impact on capital levels and ratios.

In accordance with the requirements of the final rule, each year each covered bank would be required to report to the Corporation, in the manner and form prescribed in the final rule, the results of the stress tests conducted by the bank during the immediately preceding year (“required report”). Over \$50 billion covered banks are required to submit the required report on or before January 5<sup>th</sup> of each year; \$10 billion to \$50 billion covered banks are required to submit the required report on or before March 31<sup>st</sup> of each year. These institutions would be permitted to use their parent holding company’s reporting timeline.

The Corporation has published for comment a description of items to be included in the required report to the Corporation for over \$50 billion covered institutions.<sup>2</sup> OMB is expected to act on this notice in the fourth quarter of 2012. The Corporation plans to separately publish for comment a description of the items to be included in the required report for \$10 billion to \$50 billion covered banks. It is anticipated that the required report for these covered banks would include description of the types of risks being included in the stress test, a description of the assumptions regarding the covered bank’s capital actions over the planning horizon, aggregate losses, aggregate net income, and changes in each of the covered bank’s regulatory capital ratios, as well as any other information required by the Corporation.

Consistent with the requirements of the Dodd-Frank Act, the final rule would require each covered bank to publish a summary of the results of its annual stress tests. An over \$50 billion covered bank must publish a summary of the results of its annual stress tests in the period starting March 15 and ending March 31 of the next calendar year and a \$10 billion to \$50 billion covered bank must publish a summary of the results of its annual stress test in the period starting June 15 and ending June 30 of the next calendar year. These institutions would be permitted to use their parent holding company’s disclosure timeline. For \$10 billion to \$50 billion covered

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<sup>2</sup> 77 FR 52718 (August 30, 2012).

banks, the requirement for public disclosure commences with the 2014 stress test (the period starting June 15 and ending June 30 of 2015). Covered banks must disclose information regarding the severely adverse scenario such as a description of the types of risks being included in the stress test and estimates of aggregate losses, pre-provision net revenue, provision for loan and lease losses, net income, and regulatory capital ratios.

Covered banks that are subsidiaries of a bank or savings and loan holding company, would be permitted to publish abbreviated disclosures with the parent’s summary including changes in regulatory capital ratios of the depository institution subsidiary at the end of the planning horizon, and including an explanation of the most significant causes for the changes in regulatory capital ratios, such as the amount of losses attributable to a particular activity or lending portfolio.

A summary of the timeline is included in the table below:

<b>Process Overview of Annual Stress Test Cycle (using data as of September 30th)</b>		
<b>Step</b>	<b>Timeframe for Over \$50 Billion Covered Banks</b>	<b>Timeframe for \$10 Billion to \$50 Billion Covered Banks</b>
1 FDIC provides covered banks with scenarios for annual stress tests	No later than November 15 <sup>th</sup>	No later than November 15 <sup>th</sup>
2 Covered banks submit required reports to the FDIC on their stress tests	No later than January 5 <sup>th</sup>	No later than March 31 <sup>st3</sup>
3 Covered banks make required public disclosures	Between March 15 <sup>th</sup> and March 31 <sup>st</sup>	Between June 15 <sup>th</sup> and June 30 <sup>th</sup>



The final rule would also require each covered bank to establish and maintain a system of controls, oversight, and documentation, including policies and procedures, designed to ensure that the stress testing processes used by the bank are effective in meeting the requirements of the proposed rule and, at a minimum, outline the bank's stress testing practices and methodologies, validation, use of stress test results, and processes for updating the bank's stress testing practices consistent with relevant supervisory guidance. The rule would require the board of directors and senior management of each covered bank to approve and review the covered bank's controls, oversight, and documentation, including policies and procedures, as frequently as economic conditions or the condition of the bank warrant, but no less than annually.

The final rule would also require each covered bank to take the results of the annual stress test, in conjunction with the Corporation's analyses of those results, into account in making changes, as appropriate, to: the bank's capital structure (including the level and composition of capital); its exposures, concentrations, and risk positions; any plans of the covered bank for recovery and resolution; and to improve the overall risk management of the bank.

The staff has developed the final rule in close coordination with staff of the OCC and the Federal Reserve. Staff believes the final rules of the three agencies are consistent and comparable. Staff intends to coordinate with the Federal Reserve and the OCC in the development of scenarios to avoid duplication of effort and undue complexity in the application of the final rule.

#### **IV. Good Cause Waivers**

Staff proposes that the final rule become effective immediately upon publication in the Federal Register. This requires that the Board make findings of good cause to forgo the Administrative Procedure Act's 30-day delayed effective date requirements<sup>4</sup> and the publication requirements of section 302 of the Riegle Community Development and Regulatory Improvement Act.<sup>5</sup> Four state nonmember banks currently would be considered "over \$50 billion covered companies," and would fall within the scope of the final rule's requirement to conduct a company run stress test in 2012.

Staff believes that a finding of good cause for both requirements is warranted because the final rule is necessary to address the continuing exposure of the banking industry to potentially adverse economic factors. The staff believes that stress tests serve as an ongoing risk management tool that supports a covered bank's forward-looking assessment of its risks and better equips the organization to address a range of adverse conditions. As has been the case in the recent past, adverse economic conditions can arise suddenly. Therefore, the staff recommends that the process of stress testing begin promptly to ensure covered banks are prepared for various adverse economic situations that may threaten their health and the overall financial stability of the economy. Accordingly, we recommend that the Board find that good cause exists for an immediate effective date for the final rule.

## **V. Conclusion**

Staff recommends that the Board approve for publication in the *Federal Register* the attached final rule. The final rule establishes stress testing requirements for covered banks to provide the FDIC with forward-looking information to assist in assessments of a covered bank's capital adequacy, help to better identify potential downside risks and the potential impact of adverse outcomes on the covered bank's capital adequacy, and to assist in ensuring the institution's financial stability. Staff further recommends that the Board find that good cause exists for an immediate effective date for the final rule.

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