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Federal Regulators Issue Joint Guidance on Company-Run Stress Tests for Mid-sized Banks

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The authors discuss the final supervisory guidance on Mid-size Bank company-run stress tests recently issued by federal regulators.

The Board of Governors of the Federal Reserve System ("Federal Reserve") recently announced the results of the annual company-run stress tests for the 30 largest banking institutions, concluding that the institutions have improved their capital positions and are now better positioned to endure conditions of extremely severe stress than they were five years ago.[1] For Mid-sized Banks,[2] this announcement offers a glimpse into the implementation of the stress-test public disclosure requirements, which such institutions are required to meet in 2015.

This article summarizes the long-awaited final supervisory guidance on Mid-size Bank company-run stress tests (the "Guidance"), which was recently issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (collectively, the "Federal Regulators").[3] The Guidance sets general supervisory expectations for how to conduct company-run stress tests,

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and provides examples of practices that supervisors would consider consistent with those expectations.

BACKGROUND

Section 165(i) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") requires financial companies with more than US$10 billion in total consolidated assets to conduct stress tests. Bank holding companies with at least US$50 billion in total consolidated assets and systemically important nonbank financial companies are subject to annual supervisory stress tests and must also conduct semi-annual company-run stress tests. Mid-sized Banks must conduct annual company-run stress tests.

In May 2012, after publishing a proposed regulation to implement the Dodd-Frank Act stress test requirements, the Federal Regulators issued initial supervisory guidance applicable to banking organizations subject to these requirements.[4] The May 2012 guidance set forth five principles for creating satisfactory stress testing frameworks. Under the principles, stress tests should:

- Include activities and exercises tailored to the institution's exposures, activities, and risks;
- Employ multiple stress testing activities and approaches;
- Be forward-looking and flexible;
- Be clear, actionable, well supported, and inform decision-making; and
- Include strong governance and effective internal controls.

In October 2012, the Federal Regulators finalized the stress test rules implementing the Dodd-Frank Act requirements.[5] Recognizing that Mid-sized Banks are less complex than Large Banks and that size and complexity should be taken into account in implementing the stress test rules, the Federal Regulators simultaneously indicated that they would publish supplemental guidance specifically for Mid-sized Banks to assist in the development of stress test programs. Accordingly, the Federal Regulators issued the current

Guidance to supplement the May 2012 guidance, which continues to apply to both Mid-sized Banks and Large Banks. The Guidance is intended to clarify supervisory expectations with respect to each requirement of the stress test rules.

SUPERVISORY EXPECTATIONS FOR STRESS TEST PRACTICES

Stress Test Timing and Scope

Mid-sized Banks must conduct annual company-run stress tests using three macroeconomic scenarios (baseline, adverse, and severely adverse) provided no later than November 15 by their primary federal regulator. The stress test projections are based on exposures as of September 30 and must cover a nine-quarter planning horizon that begins with the quarter ending on December 31 of the current year, and ends with the quarter ending on December 31 two years later. Mid-sized Banks must project losses, pre-provision net revenues ("PPNR"), the balance sheet, risk-weighted assets, and capital for each quarter. Additionally, Mid-sized Banks must estimate adequate levels of allowance for loan and lease losses ("ALLL") to cover credit risk that remains at the end of each quarter.

The stress test should cover all business lines and risk areas in order to assess the effect of each scenario on the entire enterprise. Since Mid-sized Banks vary in activities, they need not use those variables defined by the regulators that are not relevant to the company's business. Likewise, Mid-sized Banks may incorporate additional variables in order to administer the stress tests more accurately. Mid-sized Banks may use additional variables supplied by third-party vendors, but they should meet supervisory expectations for using third-party vendors. Stress tests should evolve to match a Mid-sized Bank's growing size, complexity, and sophistication.

Core Principles

Generally, stress test policies and practices should be transparent and critical, consist of well-documented methods and assumptions, and be based on models that are commensurate with the size, complexity, and sophistication of the institution. Mid-sized Banks are not required to use any one method in particular to estimate and project the effects of the variables, but the choice of method or methods should accurately represent a Mid-sized Bank's products and business lines, and be appropriately sensitive to the scenarios. The methodologies chosen must be consistent, repeatable, transparent, and well documented. Additionally, estimates and projections should be consistent with each other across the stress test so that one element accurately responds to the behavior of corresponding elements. Lastly, appropriately competent staff and senior management must oversee the stress test process.

Areas of Focus

The Guidance specifically identifies and elaborates on nine areas of focus: data sources, data segmentation, model risk management, loss estimation, PPNR, balance sheet and risk-weighted asset projections, immaterial portfolios, quarterly provisions for loan and lease losses ("PLLL") and quarter-end ALLL, and quarterly net income. In each of these nine areas, the Guidance emphasizes the core principles that apply across the stress test.

Data Sources. Mid-sized Banks must have appropriate management information systems and data processes to collect data for stress tests. Data on which projections are based must be reliable and generally consistent across time. If a Mid-sized Bank lacks historical internal data or data with sufficient granularity, it may use data from similar organizations, but it must also develop mechanisms to gather requisite data for future use. Mid-sized Banks should apply conservative assumptions to bridge gaps in relevant data.

Data Segmentation. Mid-sized Banks should segment data on their portfolios and business activities into categories based upon common risk characteristics. The goal is to separate exposures with varying degrees of sensitivity to the stress test scenarios.

Model Risk Management. Model risk management involves developing practices for validating a Mid-sized Bank's models. Mid-sized Banks should subject models to appropriate standards for development, implementation, use, and governance. They should document each model's assumptions, limitations, and uncertainties, and have in place a process by which to challenge methodologies and results.

Loss Estimation. Loss estimation practices must capture risks associated with portfolios, business lines, and activities. The Federal Regulators expect loss estimation methods for credit risk to be more sophisticated than those for other types of risks because credit risk typically presents the largest risk to capital for Mid-sized Banks. Additionally, a bank may use a different method of estimation for each scenario. Mid-sized Banks must estimate credit losses from loan portfolios and securities holdings directly and separately, while incorporating other losses into PPNR. Mid-sized Banks may estimate loan losses at an aggregate level, loan-segment level, or loan-by-loan level using appropriate techniques such as net charge-off models, roll-rate models, and transition matrices.

Pre-Provision Net Revenues. The Federal Regulators caution Mid-sized Banks not to assume revenue streams will remain constant or come from the same sources across all stress scenarios. PPNR estimates should consider the effects of higher nonaccruals, increased collection costs, and changes in funding sources, and be consistent with loss projections, the balance sheet, and risk-weighted assets. Mid-sized Banks may estimate PPNR on an aggregate level for the entire company or by business line. They may base their PPNR estimates on internal or industry historical experience or use a model-based approach. Operating losses and losses other than credit losses associated with loan portfolios and securities holdings should be included in projecting PPNR.

Balance Sheet and Risk-weighted Assets. Balance sheet and risk-weighted asset projections should take into consideration a Mid-sized Bank's business decisions and actions during past stressful periods. For example, when making balance sheet and risk-weighted asset projections, Mid-sized Banks should consider whether they reduced their activities and the overall size of the balance sheet during past stressful periods. Mid-sized Banks must justify major changes to the composition of their risk-weighted assets in stress scenarios, such as material purchase or sale of assets. They must also consider the effect of changes in balance sheet and risk-weighted asset projections on PPNR. Any assumptions about reductions in risk-weighted assets and thus capital requirements should be well supported.

Estimates for Immaterial Portfolios. Mid-sized Banks need not apply the same rigor and analysis to lower-risk and immaterial portfolios. Immaterial portfolios are those that would not have a consequential effect on capital adequacy under the stress test scenarios.

Quarterly Provisions and Ending Allowance for Loan and Lease Losses. Estimated PLLL should incorporate a Mid-sized Bank's need for higher reserve levels under stressed conditions due to poor loan performance. Mid-sized Banks should ensure that ALLL covers remaining losses at the end of each quarter, and that ALLL at the end of the last quarter of the stress test horizon covers losses projected beyond the planning horizon.

Quarterly Net Income. Mid-sized Banks should base projected net income on its loss, revenue, and expense projections. Tax estimates should reflect relevant assumptions made in other projections.

Additional Areas of Guidance

As part of the stress test, Mid-sized Banks are required to estimate the impact of each scenario on the bank's capital levels and ratios. The Office of the Comptroller of the Currency expects that under the various scenarios, a bank's capital levels and ratios would decrease as the severity of the scenario increases. Any case in which the resulting capital levels and ratios increase should be well supported and documented. Unlike holding companies, which are required to make specific assumptions about capital actions (such as dividend payments), banks need only use ones that are consistent with their internal practices.

The guidance also elaborates on the supervisory expectations for controls, oversight, and documentation; regulatory reporting; and public disclosures.

CONCLUSION

The Guidance emphasizes that a Mid-sized Bank should develop sophisticated, well-documented methodologies for its stress tests to accurately represent the effect each scenario will have on the institution. At the same time, the Guidance allows for flexibility in developing and implementing methodologies appropriate to each bank's unique circumstances.

Stress tests have significant regulatory and reputational implications for banks. In addition to ensuring satisfactory stress test methodologies and practices, a Mid-sized Bank may consider stress testing an important component of its risk management program. In implementing such a program, the bank may decide to adjust its balance sheet to increase capital, improve liquidity, decrease leverage, enhance interest rate risk management, and/or reduce dependence on short-term funding. Such adjustments may help the bank become more resilient and meet regulatory expectations.

NOTES

[1] Board of Governors of the Federal Reserve System, Press Release (Mar. 20, 2014), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20140320a.htm.

[2] Mid-sized Banks are banks, savings associations, bank holding companies, and savings and loan holding companies with total consolidated assets of more than US$10 billion, but less than US$50 billion.

[3] Supervisory Guidance on Implementing Dodd-frank Act Company-Run Stress Tests for Banking Organizations with Total Consolidated Assets of More Than $10 Billion but Less Than $50 Billion, 79 Fed. Reg. 14153 (Mar. 13, 2014).

[4] *See* Supervisory Guidance on Stress Testing for Banking Organizations With More Than $10 Billion in Total Consolidated Assets, 77 Fed. Reg. 29458 (May 17, 2012).

[5] *See* Annual Stress Test, 77 Fed. Reg. 61238 (Oct. 9, 2012) (12 C.F.R. § 46); Supervisory and Company-Run Stress Test Requirements for Covered Companies, 77 Fed. Reg. 62378 (Oct. 12, 2012) (12 C.F.R. § 252); Annual Company-Run Stress Test Requirements for Banking Organizations With Total Consolidated Assets Over $10 Billion Other Than Covered Companies, 77 Fed. Reg. 62396 (Oct. 12, 2012) (12 C.F.R. § 252); Annual Stress Test, 77 Fed. Reg. 62417 (Oct. 15, 2012) (12 C.F.R. § 325).