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Ten key points from the Fed's stress buffer and leverage ratio proposals

Last week, the Federal Reserve (Fed) released two proposals detailing the first major changes to capital rules for bank holding companies (BHCs) under Fed Chair Jay Powell and Vice Chair for Supervision Randal Quarles. The first proposal, released on April 10, would add institution-specific stress buffers based on the most severe shock from the comprehensive capital analysis and review (CCAR) process to BHCs' ongoing capital requirements. Specifically, it introduces the stress capital buffer (SCB) and a companion stress leverage buffer (SLB) to incorporate Fed-modeled stress test results into ongoing capital requirements – formally raising regulatory day-to-day minimum capital ratios to levels the Fed otherwise expected prudently managed firms to maintain on their own. To reinforce this point, the Fed would also require BHCs to maintain projected ratios above the new minimums in the BHCs' own baseline economic scenario. In changing this process, the Fed would remove the threat of a public quantitative objection to BHCs' capital plans.

The Fed released a second proposal on April 11 to modify the enhanced supplementary leverage ratio (eSLR), a capital ratio surcharge that applies to the eight US global systemically important banks (GSIBs), in efforts to address the limitations a standard eSLR has in appropriately accounting for different risk levels among the GSIBs.[1] Taken together, the Fed expects that the two proposals will maintain or increase capital requirements for a few of the largest banks while reducing them for all others, particularly the custody banks.

1. **Capital relief for all but the largest GSIBs.** As originally floated in 2016,[2] the formally proposed SCB would be separately defined for each BHC as the BHC's most recent CCAR result's maximum projected decline in the common equity tier 1 (CET1) ratio under the Fed's severely adverse scenario. The Fed-modelled SCB plus four quarters of planned common stock dividends would then be applied to BHCs' ongoing capital thresholds, meaning that US GSIBs would for the first time have to hold capital for the combination of stress (via the SCB) and systemic footprint (via the GSIB surcharge).[3] The SCB would replace the existing fixed 2.5% capital conservation buffer (CCB), but would retain a floor of 2.5%. A companion stress leverage buffer (SLB), calculated in a similar fashion would be added to the Tier 1 leverage ratio minimum. On their own, the SCB and SLB would make no difference in capital requirements because BHCs were always required to hold enough capital to weather severe stress. In fact, with offsetting relief by relaxing assumptions for distributions and balance sheet growth (as discussed below), modeled stress will fall resulting in capital relief for all but the largest GSIBs. See **appendix** for illustration of these impacts.

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2. **Spotlight on the baseline scenario.** With the SCB and SLB included in the ongoing minimum thresholds, the relevant test of capital adequacy must be taken on a pre-stress basis. So, in a new twist, the Fed is requiring BHCs to demonstrate capital adequacy in expected, rather than stress, conditions. BHCs will do this immediately after receiving their SCB by incorporating all planned capital actions and projecting capital ratios using their own models under their own baseline economic scenario. Banks that project capital shortfalls in the new process will continue to have the option to 'take the mulligan' within two days of receiving their SCB by reducing their planned distributions to avoid capital requirement breaches. Given the newfound importance of the baseline scenario, banks that have not yet fully converged their budget forecast with their CCAR baseline will need to make this a priority.

   Moreover, with the emphasis taken off the annual test, the Fed will have its eyes laser focused on the differences between BHCs' actual quarterly performance and their baseline projections, taking note of any chronic underperformance as an indication of qualitative process weaknesses. Given this increase in scrutiny, BHCs will be motivated to further automate their projection processes so that they can efficiently update baseline projections as well as provide management and the Board with detailed quarterly analysis of deviations from projections.

3. **No longer front page news.** The stress buffer proposal takes the annual point-in-time post-stress requirement off the table, eliminating the risk of the high-profile surprise quantitative objection. Instead, it consolidates the pre-and post-stress requirements and creates a new, less direct mechanism to test for capital shortfalls. While this change would diminish the risk of being publicly named and shamed, the consequences of quantitative failure – restrictions on capital distributions – remain a risk in the retooled process. As before, the largest CCAR BHCs will still face the risk of a public objection on qualitative grounds – caused by Fed concerns about risk and capital planning governance, infrastructure or controls. However, given substantial improvements by the largest banks over the years, the newest entrants remain the most vulnerable to such an objection. The Fed already exempted "large and noncomplex" BHCs, generally those under $250b,[4] from the risk of a qualitative objection, so these BHCs will feel the most relief.

4. **Capital requirements will be (more) Fed scenario and model dependent.** Although the Fed's severely adverse scenario and model results are already the primary hurdle for most BHCs, the new SCB will make that explicit – with potentially worrisome implications. Because the SCB directly links capital buffers with the Fed's severely adverse scenario, the Fed can effectively increase ongoing capital requirements through its scenario design (to a point). For example, this year's severely adverse scenario was more severe than most banks expected[5] and likely will result in a higher SCB. Though the Fed has taken steps to signal its scenario design approach to address some of these concerns, it nevertheless retains much discretion in building scenarios. With BHCs living with the stress buffer results for more than a year, there may be even more concerns about the predictability and consistency of severely adverse supervisory scenarios, as well as the effectiveness of Fed models. As a result, expect even stronger calls for the Fed to increase transparency of their scenario design and modeling processes. One potential change would be public review-and-comment for the stress scenarios, which Governor Quarles endorsed in his Congressional testimony this week.

5. **Efficiency, simplicity, transparency…and due process.** Consistent with the principles Governor Quarles has espoused, the Fed also took the stress buffer proposal as an opportunity to simplify CCAR capital requirements. While the proposal highlights the reduction in total number of capital requirements from 24 to 14, many of those eliminated, including the post-stress requirement for the less stressful adverse scenario, were unlikely to be constraining as a practical matter. As before, the CET1 and Tier 1 leverage ratios will most likely remain the binding capital ratios for most banks. Notably, the Fed's new construct totally removes the requirement that supplementary leverage ratios exceed minimums on a post-stress basis, a test that might have constrained some firms. In addition, the Fed made some real concessions to the banks in terms of transparency and due process. Most notably, banks can request reconsideration of the SCB calculated by the Fed within 15 days from receipt of their SCB. The Fed will then have 30 days to respond in writing and will be required to provide an explanation of its rationale for its final decision. Banks may use this new process, which is also available to appeal qualitative objections, to press a more receptive Fed to explain supervisory stress results.

6. **Fed meets banks halfway on balance sheet assumptions.** Under the current CCAR requirements, the Fed assumes that banks' assets will grow throughout the nine-quarter horizon. This has long been a point of contention for the banks, which argue that some business lines would significantly contract during periods of stress, reducing expected losses and shrinking balance sheets and risk weighted assets (RWAs), with lower decline in capital ratios. The Fed has agreed to meet banks halfway by assuming that banks will maintain a constant level of assets, including risk-weighted assets, over the planning horizon. While this goes some way to appeasing the banks, we expect that the industry will continue to push the Fed to allow for some reduction in banks' balance sheets, especially for lines of business that are particularly sensitive to changes in market levels, such as trading and prime brokerage.

7. **Simplified capital actions assumptions are a gain for some banks.** The Fed currently assumes that banks will make all of their planned capital actions - including dividends, repurchases, and issuances of regulatory capital instruments - even under severe stress over the nine-quarter planning horizon. Under the stress buffer proposal, this assumption will be narrowed significantly to include only four quarters of planned common stock dividends and no repurchases. Additionally, the Fed has removed the implied expectation that BHCs will keep dividends to 30% of baseline earnings or else face "heightened scrutiny," Fed code for "best not to go there." While this frees BHCs to raise their dividend payout ratios, they also must recognize that higher dividends directly translate to higher capital requirements under the new proposal.

8. **Buffer for eSLR calibrated in line with systemic risk.** The Fed's second proposal would recalibrate the eSLR buffer at half of each firm's GSIB surcharge to provide some risk sensitivity to the different business focuses among the GSIBs. Currently, the eSLR buffer is a flat two percent for all GSIBs, which is particularly binding for GSIBs with moderate credit and market risk profiles, such as the two GSIBs that operate primarily as custody banks. The supervisory rationale for calibrating the buffers for leverage based ratios is to ensure that they operate as prudent backstops to the risk-based capital ratios rather than as a binding constraint, a position long held internally by the Fed. Under the proposal, all GSIBs would see a reduction in their eSLR and those with the smallest GSIB surcharges, including the custody banks, would see the greatest benefit. Of course, this only matters to banks for which the eSLR was the binding constraint in the first place.

9. **Questions for Congress.** As the Fed receives and considers comments on these proposals, Congress will continue its push forward on its Dodd-Frank reform bill that would raise the threshold for many Dodd-Frank requirements – including the statutory stress tests – but would not directly impact the thresholds for CCAR.[6] We believe the Fed would take these new thresholds into account but will retain some flexibility to keep CCAR for banks with between $100b and $250b in assets. The Fed is still considering a framework for supervising these banks, but one option could be to differentiate between traditional banks with lower risk profiles who will be at the 2.5% SCB floor and those who have SCB buffers greater than 2.5% floor. The former group could get some relief from the annual supervisory stress tests until they materially change their risk profile. However, there will still be an expectation that they perform their own stress testing as a foundational component of internal risk management in line with SR 12-7. We expect that the latter group, on the other hand, would likely remain subject to an annual supervisory stress test to ensure that their SCB does not get out of sync with their risk taking.

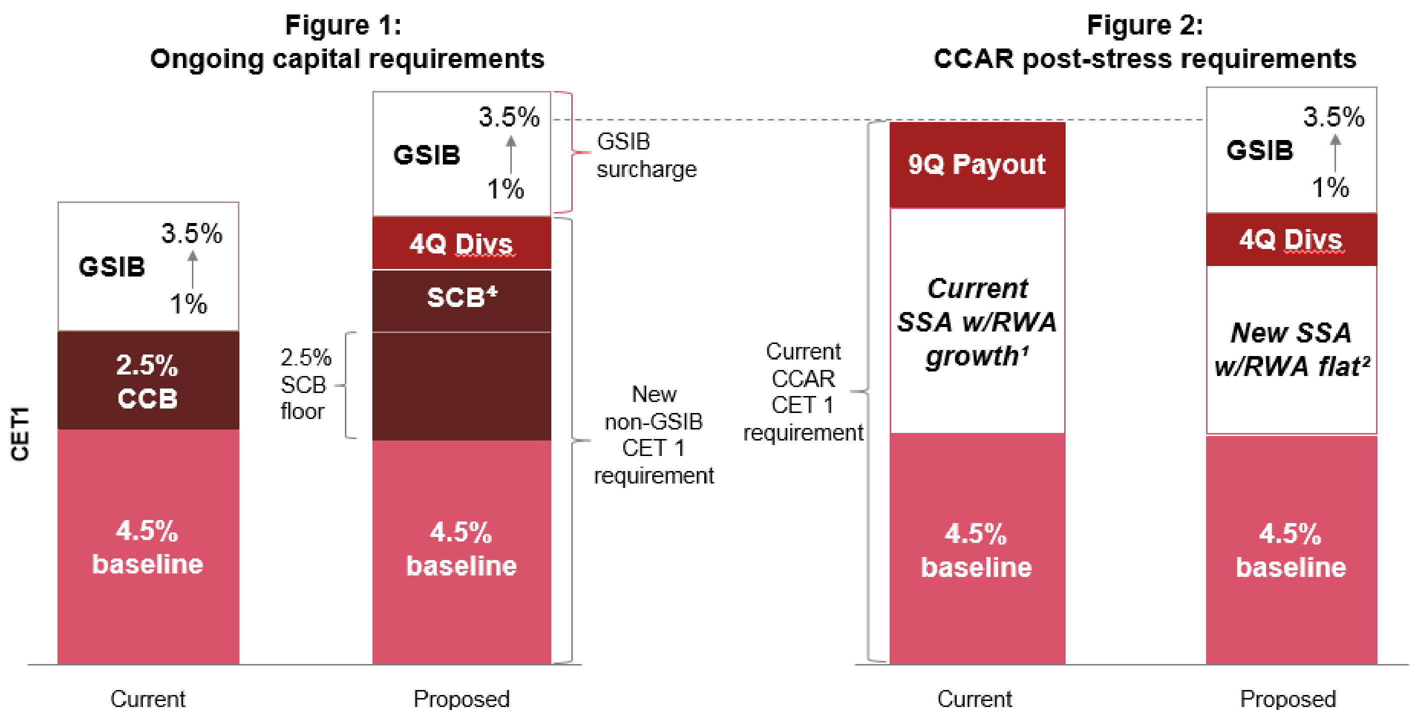
10. **Double relief for custody banks?** The Dodd-Frank reform bill includes a different strategy for reducing the leverage ratio burden on custody banks - removing low-risk deposits held at central banks from the denominator of the ratio. Former Governor Tarullo previously rejected this approach and Fed Chair Jay Powell said in his most recent Congressional testimony that he preferred the Fed's approach of recalibrating the eSLR. The House, which is currently considering the bill, may consider changing this provision in light of the Fed's proposal, but Senators supporting the bill have stated that they will not accept modifications. As such, Governor Quarles acknowledged in testimony this week that the Fed will likely need to amend its proposal if Congress passes the bill as-is.

Appendix

Each of the below graphics compare current required minimum CET1 levels (once the CCB and G-SIB surcharge fully phase-in) with the Fed's proposed minimum levels. Figure 1 does so for ongoing capital requirements and Figure 2 does so for CCAR's post-stress requirements.

Figure 1 demonstrates that the Fed's proposal to replace 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.

Therefore, the Fed's proposal has the effect of aligning ongoing capital requirements with CCAR post-stress requirements, as depicted by the equal heights of the right-side bars of each Figure.



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

Endnotes

1. See PwC's *First take, Ten key points from Governor Tarullo's speech on stress testing and the Fed's NPR* (October 2016).
2. See PwC's *First take, Five key points from Governor Tarullo's farewell speech* (April 2017).
3. US intermediate holding companies of foreign GSIBs do not have a GSIB surcharge.
4. The Fed defined "large and noncomplex" firms as those that (a) have less than $250 billion in total assets, (b) have less than $75 billion in nonbank assets, and (c) are not GSIBs. See PwC's *First take, Ten key points from the Fed's 2017 CCAR instructions and supervisory scenarios* (February 2017).
5. See PwC's *First take, Ten key points from the Fed's 2018 CCAR instructions and supervisory scenarios* (February 2018).
6. Under the Economic Growth, Regulatory Relief, and Consumer Protection Act: (a) US BHCs with $250b or more in total global assets would still face enhanced prudential standards (EPS); (b) mid-sized firms holding $100-249b total global assets would wait for 18 months for EPS relief under a Fed adopted risk-based framework; and (c) firms below the $100b threshold would be freed from the EPS regime upon enactment.

Additional information

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