BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

OFFICE OF BOARD MEMBERS

December 16, 2013

BY ELECTRONIC MAIL

Subject: Federal Reserve Independent Balance Sheet and RWA Projections

Dear Sir or Madam,

In the instructions for the Comprehensive Capital Analysis and Review for 2014, the Federal Reserve noted that it will independently project bank holding company (BHC) balance sheets and risk-weighted assets under the supervisory scenarios. In past reviews, the Federal Reserve used the projections of asset and liability balances and risk-weighted assets provided by each BHC.[1] The purpose of this letter is to provide additional information on this important change. In the 2014 CCAR, the Federal Reserve will independently project balances and use these projections to produce its projections of pre-provision net revenue, loan losses, risk-weighted assets and other relevant items. These projections will be used to compute pro forma regulatory capital ratios under the supervisory baseline, supervisory adverse, and supervisory severely adverse scenarios.[2]

Independent balance projections permit a more consistent horizontal analysis, one that features common assumptions regarding total borrowing by households and businesses and firms' market shares. In addition to enhancing the comparability of results across BHCs, the independence of the supervisory models—including those relating to balance projections—supports the credibility of the results. Each BHC's independent projection of balances reflects its own projection for total borrowing as well as its share of that market, and therefore use of these projections by the Federal Reserve reduces the horizontal comparability of the stress tests. However, BHCs will continue to use their own projections of asset balances and risk-weighted assets to calculate capital ratios for their company-run stress tests under both supervisory scenarios and the BHC stress scenario, and the Federal Reserve will continue to evaluate BHCs' own processes for projecting these items.

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[1] These projections are supplied by BHCs in the FR Y-14 report.
[2] See 12 CFR 252.134(a)(2).

Historical Experiences of Banking Assets in Recessions

Table 1 shows the changes in loans and total assets at the median of the 50 largest banks in the nine quarters beginning in the first quarter of each of the three most recent recessions.[3] As shown, the median bank saw total assets grow in each of the past three recessions; in the most recent two recessions, loans also grew. Projections in which most banks see major contractions in loans or total assets over nine quarters, even in severe recessions, would thus be at odds with historical experience.

Table 1. Change in Banking Assets Over Nine Quarters of the Median Bank Among the Top 50

Recession (NBER peak)	Change in loans (percent)	Change in total assets (percent)
July 1990	-3.1	2.8
March 2001	18.7	18.9
Dec. 2007	4.3	9.9

The Federal Reserve's Procedure for Projecting BHCs' Balances

The Federal Reserve has developed a set of models to project the aggregate volume of total assets, loans, and securities held by the banking system as a function of broad economic conditions based on the historical correlation of these variables. Some of these conditions proxy for loan supply, defined as the willingness of a bank to extend a loan conditional on the state of the macroeconomy. The Federal Reserve's projections will assume that these proxies for loan supply remain fixed over the nine-quarter horizon of the stress test at their historical average levels. This assumption is consistent with the Federal Reserve's expectation that large, complex BHCs have sufficient capital to continue to serve as credit intermediaries even in a severely adverse operating environment and do not simultaneously contract loan supply.

The Federal Reserve's models project industry-wide total assets, loans, securities, and total liabilities. They do not separately project individual asset categories such as first-lien mortgages, C&I loans, or mortgage-backed securities. As a result, the models will tend to capture the shift in bank assets away from loans and toward securities that occurs naturally under stress, but they won't capture shifts within loans.

The Federal Reserve will translate its projection of total banking industry growth rates into firm-specific projections of individual items by assuming firms' portfolio mixes and market shares are constant

[3] Calculations are based on information from the Consolidated Reports of Condition and Income (Call Reports). Total assets and total loans were obtained for the 50 largest Call Report filers (by total assets) that were in existence both at the beginning of each recession period and nine quarters thereafter. The nine-quarter change in total assets (or loans) was then calculated for each of the 50 firms and the overall median of the sample was then determined. Alternative calculations, including using data on bank holding companies rather than commercial banks, give similar results.

over time.[4] This process ensures that firms' risk profiles throughout the stress test horizon are primarily driven by their outstanding business mix on the stress test as-of date. It also improves the horizontal comparability of stress test outcomes due to the consistent application of the growth rates to each firm.

Implications for Independent Supervisory Projections

The new procedure will affect the independent supervisory projections of both the numerator and denominator of BHCs' pro forma capital ratios. The denominator will be affected directly because the Federal Reserve will use its independent balance projections in computing risk-weighted assets throughout the planning horizon. If the Federal Reserve's balance projections are materially higher than those of the BHC, all else equal, the associated pro forma capital ratios will be lower than those of the BHC.

However, the numerator will be also be affected by the use of independently projected—and, as we will explain further, likely higher—balances. The Federal Reserve will use these estimates of balances when computing PPNR and credit losses. This process introduces an additional source of difference between the independent supervisory estimates of credit losses, PPNR, and other components of net income relative to those of the BHCs.

Projections from CCAR 2013

In order to give concrete examples of the Federal Reserve's procedures and to highlight the potential difference between the projections of the Federal Reserve and of BHCs, this section compares BHC projections of asset balances from CCAR 2013 to supervisory projections of asset balances that would have been obtained if the Federal Reserve's models had been used in the review last year.

Table 2 shows the cumulative change in total assets submitted by firms in the 2013 CCAR and Dodd-Frank Act stress test exercises under the supervisory severely adverse scenario as well as the Federal Reserve's projections of the cumulative change in total assets through the same scenario. (Total assets comprise loans, securities, trading assets, and other assets.) It is instructive to compare the median BHC projections from Table 2 with the actual experience of bank assets in recessions, shown in Table 1.

Note that the Federal Reserve's projections assume that the credit supply proxies take on their long-run average values during the planning horizon. As shown, the median firm projected assets to have shrunk 3.8 percent during the scenario; even the BHC at the top quartile projected assets to have shrunk 1.5 percent. By contrast, the Federal Reserve's projection would have projected total asset growth of 2 to 3 percent during the scenario, depending on exact specification.

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[4] The Federal Reserve will, however, account for any planned mergers, divestitures, or any other expected changes to a BHC's business plan that are likely to have a material impact on the BHC's capital adequacy and funding profile and are included in the BHC's capital plan, based on the information provided by the BHC.

Table 2. Asset Growth Projections in CCAR/DFAST 2013

	Cumulative change in total assets over nine quarters (percent)
BHC Projections	
25th percentile	-1.5
50th percentile	-3.8
75th percentile	-9.5
Federal Reserve model	2.0 to 3.0

Table 3 shows the same statistics for total loans. Again, as in the previous table, the Federal Reserve's projections assume that the credit supply proxies take on their long-run average values during the projection horizon. By the end of the scenario horizon, the median firm projected loans to have shrunk by about 7.8 percent relative to the jumping off point. By contrast, the Federal Reserve's model projects that total loans grew slightly, approximately 1 to 2 percent, depending on exact specification. Thus, the Federal Reserve's projection would have substantially exceeded that of the median BHC submission.

Table 3. Loan Growth Projections in CCAR/DFAST 2013

	Cumulative change in total loans over nine quarters (percent)
BHC Projections	
25th percentile	-0.5
50th percentile	-7.8
75th percentile	-9.4
Federal Reserve model	1.0 to 2.0