Dodd-Frank Act Mid-Cycle Stress Tests 2013: Summary Instructions

May 2013

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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Introduction

Under the Board's rule implementing Dodd-Frank Act stress test requirements for bank holding companies (BHCs) with total consolidated assets of $50 billion or more and nonbank financial companies supervised by the Board (Dodd-Frank Act stress test rule for covered companies, or covered company rule), BHCs that participated in the 2009 Supervisory Capital Assessment Program are required to conduct a mid-cycle company-run stress test in 2013.[1]

The mid-cycle stress test must be conducted using data as of March 31, 2013, and be based on scenarios developed by the BHC. BHCs must report the stress test results to the Board no later than **July 5, 2013.** In addition, BHCs must publicly disclose a summary of the results in the period between September 15 and September 30, 2013.

Each BHC is required to publish a summary of the results of its stress tests conducted under its severely adverse scenario, which is intended to promote market discipline and facilitate an understanding of the financial conditions and risks of the companies. The mid-cycle stress tests are conducted by BHCs, and their public disclosure should reflect the BHCs' own views of their capital adequacy under the scenarios that they develop and employ.[2] The Federal Reserve will incorporate information from the companies' mid-cycle stress tests into its ongoing assessment of covered companies through the normal supervisory process. However, it is important to note that the mid-cycle company-run stress test is not being conducted under the Board's capital plan rule and is not part of the annual Comprehensive Capital Analysis and Review. Accordingly, the Board will not provide an objection or non-objection to a company's mid-cycle stress test. Furthermore, the Federal Reserve does not conduct a supervisory stress test to coincide with the mid-cycle company-run stress tests.

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1 The 18 BHCs participating in the 2013 mid-cycle company-run stress tests are Ally Financial Inc.; American Express Company; Bank of America Corporation; The Bank of New York Mellon Corporation; BB&T Corporation; Capital One Financial Corporation; Citigroup Inc.; Fifth Third Bancorp; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; KeyCorp; Morgan Stanley; The PNC Financial Services Group, Inc.; Regions Financial Corporation; State Street Corporation; SunTrust Banks, Inc.; U.S. Bancorp; and Wells Fargo & Company. For additional information on the covered company rule, see "Company-Run Stress Test Requirements for Covered Companies" at 12 CFR part 252, subpart G.

2 Companies should conduct their stress tests in accordance with the expectations and principles set forth in the "Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets," 77 *Fed. Reg.* 29458 (May 17, 2012).

Report Submitted to Supervisors

BHCs must submit their mid-cycle company-run stress test results to the Federal Reserve no later than July 5 of each calendar year, in accordance with the Board's covered company rule. BHCs must use the FR Y-14A Summary schedule to report the results of their company-run stress tests and the FR Y-14A Scenario schedule to report the scenarios they develop to use in the mid-cycle stress test.[3] Each BHC must submit its FR Y-14A and any supporting information to the Federal Reserve through a secure collaboration site.

BHCs should reference the instructions associated with each schedule to determine how to complete that schedule. BHCs will report on the FR Y-14A Summary schedule their estimates of losses, resources available to absorb those losses, balance sheet positions, and capital composition on a quarterly basis over the nine-quarter planning horizon, beginning with the second quarter of the current calendar year. BHCs should complete the "Capital Worksheet—DFAST" tab of the FR Y-14A Summary schedule, but should leave the "Capital Worksheet—CCAR" tab blank.[4] Each BHC must also submit the FR Y-14A Scenario schedule to report the paths of the variables used in its baseline, adverse, and severely adverse scenarios.

In accordance with the FR Y-14A Summary schedule instructions, each BHC must submit information supporting its projections. In addition to the quantitative projections collected on the FR Y-14A, each BHC is required to submit qualitative information supporting its projections. For the mid-cycle company-run stress test, a BHC is not required to resubmit the full set of documentation that it provided for the annual company-run stress. The BHC should submit information on any material changes to its stress testing methodologies or processes that have occurred since the company submitted documentation supporting its annual company-run stress test, including any changes in response to feedback from the Federal Reserve. The supporting information that was included in the BHC's previously submitted capital plan does not need to be resubmitted, *provided that information is still an accurate description of the methodologies and processes the BHC used to conduct its mid-cycle company-run stress test.*

3 The FR Y-14 schedules are available at www.federalreserve.gov/apps/reportforms/default.aspx.

4 As discussed below, in conducting its mid-cycle company-run stress test, a company must incorporate the capital action assumptions set forth in the covered company rule. The "Capital Worksheet—CCAR" tab of the FR Y-14A Summary schedule relates to stress tests that are conducted under the Board's capital plan rule (12 CFR 225.8), which incorporate a company's planned capital actions.

Requirements for Mid-Cycle Stress Tests

Stress Testing Scenarios

For the mid-cycle company-run stress tests, each BHC is required to develop three scenarios—baseline, adverse, and severely adverse—that are appropriate for its own risk profile and operations.

The Board's covered company rule defines each of the three scenarios as follows:

1. *Baseline scenario* means a set of conditions that affect the U.S. economy or the financial condition of a covered company, and that reflect the consensus view of the economic and financial outlook.
2. *Adverse scenario* means a set of conditions that affect the U.S. economy or the financial condition of a covered company that are more adverse than those associated with the baseline scenario and may include trading or other additional components.
3. *Severely adverse scenario* means a set of conditions that affect the U.S. economy or the financial condition of a covered company, and that overall are more severe than those associated with the adverse scenario and may include trading or other additional components.

A BHC may use a variety of quantitative and qualitative approaches to develop its scenarios. The adverse and severely adverse scenarios should reflect a company's unique vulnerabilities to factors that affect its firm-wide activities and risk exposures, including macroeconomic, market-wide, and firm-specific events. BHCs should consider their own risk profiles and operations in designing specific elements of the adverse and severely adverse scenarios.

Estimates of Projected Revenues, Losses, Reserves, and Pro Forma Capital Levels

Similar to the annual company-run stress test, each BHC must calculate, for each quarter-end within the planning horizon, potential losses, pre-provision net revenue, provision for loan and lease losses, and capital levels under each of the scenarios. Each BHC must also calculate, for each quarter in the planning horizon, the potential effect of the specific scenarios on its regulatory capital ratios and tier 1 common ratio.

A BHC's submissions for each scenario should be based on its own processes and analyses. The format the Federal Reserve uses to collect the FR Y-14A report on the mid-cycle company-run stress tests does not imply that a BHC should use any specific methodology to project its losses and revenues for its stress test. Similar to the annual company-run stress test, it is the responsibility of each BHC to capture all potential sources of losses from all on- and off-balance sheet positions, as well as any other events that have the potential to impact capital in baseline and stress environments. In all cases, each BHC should demonstrate that its results are consistent with the macroeconomic and financial environments—and any other conditions—specified in the scenarios being used, and that the various components of its results are internally consistent.

Similar to the requirements of the covered company rule that apply to annual company-run stress tests, a BHC is required to calculate for the mid-cycle company-run test its pro forma capital ratios using a set of capital action assumptions based on historical distributions, contracted payments, and a general assumption of no redemptions, repurchases, or issuances of capital instruments.[5] A BHC should also assume it will not issue any new common stock, preferred stock, or other instrument that would count in regulatory capital in the second through ninth quarters of the planning horizon, except for any common issuances related to expensed employee compensation.

Public Disclosure by Companies

Similar to its annual company-run test, a BHC must publicly disclose quantitative and qualitative information about its mid-cycle company-run stress test conducted under the severely adverse scenario.[6] The Federal Reserve believes that disclosure is a key element of company-run stress tests. Therefore, to allow market participants and the public to better understand a BHC's stress test results, the Federal Reserve expects BHCs to disclose information that is *at minimum* as detailed as that described below.

Each BHC must disclose the required information regarding its stress tests on its website or in any other forum that is reasonably accessible to the public. The BHC's quantitative and qualitative information should be included in a single release to assist market participants and the public in interpreting the stress test results.

Quantitative Disclosure

A BHC must disclose, at a minimum, the following quantitative information about its mid-cycle company-run stress test conducted under the severely adverse scenario:

1. Cumulative estimates of
    a. pre-provision net revenue and other revenue;
    b. provision for loan and lease losses, realized losses/gains on available-for-sale and held-to-maturity securities, trading and counterparty losses, and other losses or gains;
    c. net income before taxes;
    d. loan losses (dollar amount and as a percentage of average portfolio balance) in the aggregate and by subportfolio, including domestic closed-end first-lien mortgages; domestic junior-lien mortgages and home equity lines of credit; commercial and industrial loans; commercial real estate loans; credit card exposures; other consumer loans; and all other loans.
2. The beginning value, ending value, and minimum value of pro forma regulatory capital ratios and the tier 1 common ratio.

Qualitative Information

BHCs are also required to disclose qualitative information that supports the summary of their stress test results. This information must include, at a minimum, a description of the types of risks included in the stress test; a general description of the methodologies used in the stress test, including those employed to estimate losses, revenues, provision for loan and lease losses, and changes in capital positions over the planning horizon; and an explanation of the most significant causes for the changes in regulatory capital ratios and the tier 1 common ratio.

Description of the Types of Risks Included in the Stress Test

A BHC is required to disclose a description of the types of risks included in the stress test. Each BHC should disclose information that clearly describes the types of risks and exposures captured in its severely adverse scenario for all lines of business and activities. This includes information about risks that may threaten or adversely affect the company's capital position through increased losses, reduced revenues, and changes in the balance sheet or risk-weighted assets. A BHC should tie the risks to specific portfolios and business activities and describe how the stress test incorporates those risks in those portfolios and lines of business. The information should discuss the extent to which risks are wholly or only partially covered by the stress tests (for example, if not all aspects of interest-rate risk are captured by the stress test in the BHC's severely adverse scenario).

General Description of the Methodologies Used in the Stress Test

A BHC is required to disclose a general description of the methodologies used in the stress test, including

[5] For an explanation of the capital action assumptions, see 77 *Fed. Reg.* 62378, 62394–95 (October 12, 2012), codified at 12 CFR 252.146(b).

[6] BHCs are not required to disclose the results of their stress tests conducted under the baseline or adverse scenarios.

those employed to estimate losses, revenues, provision for loan and lease losses, and changes in capital positions over the planning horizon. A BHC should disclose information that clearly describes the methodology used to produce its projections for losses, revenues, provision for loan and lease losses, and changes in capital positions under the severely adversely scenario. Information should be provided for all elements of the stress tests, including loss estimation, revenue estimation, projections of the balance sheet and risk-weighted assets, and capital levels and ratios. Where judgment is an essential part of the BHC's projections, the BHC should describe the rationale and magnitude of the judgment, as well as the process it used to ensure consistency of projections with the conditions of the severely adverse scenario.

A BHC should describe key assumptions used to derive loss and revenue estimates. If a BHC's models rely upon historical relationships, the BHC should describe why these relationships are expected to be maintained in the severely adverse scenario. A BHC should also include any other information and documentation necessary to support or explain its capital calculations.

Notably, disclosures for the mid-cycle stress test should also include information about a BHC's severely adverse scenario, such as a description of the scenario, the rationale for variable selection, process for projecting variables, and the paths of key variables.

Explanation of the Most Significant Causes for Changes in Regulatory Capital Ratios

In its disclosure, A BHC should provide a clear explanation of the changes in regulatory capital ratios over the planning horizon. For instance, if a major component of the reduction in a BHC's regulatory capital ratios resulted from deterioration in the quality of its retail credit exposures over the planning horizon, the BHC should describe this in the explanation. The explanation should take into account the risks identified and describe the changes in capital by material income statement and balance sheet line items affected by the severely adverse scenario.