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Regulatory Practice Letter

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Capital Plan Requirement for Large Bank Holding Companies – Fed Final Rule

Executive Summary

The Federal Reserve Board ("Fed") approved a final rule on November 22 that requires U.S. bank holding companies with total consolidated assets of $50 billion or more ("BHCs" or "covered BHCs") to submit an annual capital plan to the Fed for review and to request prior approval in certain circumstances before making a capital distribution. BHCs that receive a notice of objection to their submitted capital plan will not be permitted to make a capital distribution until the objection is cleared. The final rule became effective December 30, 2011 and covered BHCs are required to submit their capital plans no later than January 5 of each calendar year, or other later date as set by the Fed. For 2012, the capital plans were due no later than January 9, 2012.

To supplement the requirements of the final rule, the Fed has provided Summary Instructions and Guidance ("Instructions") for the thirty-four (34) large BHCs currently covered by the final rule (based on September 30, 2011 data). Among other things, the Instructions outline the Fed's expectations for a BHC's capital policies, effective capital adequacy processes, and the macroeconomic scenarios to be incorporated in the BHC's capital plans. Separate Instructions have been given to the nineteen (19) BHC's that previously participated in the Fed's Comprehensive Capital Analysis and Review ("CCAR") in early 2011 ("CCAR firms") and to the 15 firms that are covered by the final rule but did not previously participate in the CCAR ("non-CCAR firms").

The CCAR firms will be required to submit data supporting their capital plans using two new data collection forms – FR-Y-14Q and FR-Y-14A. The first quarterly submission, FR-Y-14Q, was due December 15, 2011 for data reported generally as of the end of the third quarter. The first annual submission, FR-Y-14A, was due with the capital plan on January 9. 2011.

Background

The Fed's final rule closely follows the earlier proposed rule released in June 2011 (refer to Regulatory Practice Letter 2011-12) though with some modifications, including a requirement that a covered BHC may not make a capital distribution until it receives a notice of non-objection from the Fed.

The final rule also draws a distinction between the 19 CCAR firms and the 15 additional non-CCAR firms that now fall under the final rule. The CCAR followed the 2009 Supervisory Capital Assessment Program ("SCAP"), a standardized stress test, which was conducted for the 19 largest U.S. bank holding companies at that time. The SCAP focused on identifying whether those BHCs had capital sufficient to withstand a more-adverse-than anticipated economic environment while maintaining their capacity to lend. The CCAR involved a forward-looking analysis of the internal capital planning processes of the same 19 large BHCs and their anticipated capital actions in 2011 (such as dividend payments and stock redemptions). Because of their involvement in the SCAP and the CCAR, the 19 CCAR firms are deemed to have appropriate reporting and planning processes in place to provide data on the new FR-Y-14Q and FR-Y-14A. It is anticipated that the non-CCAR firms will need to build and implement internal systems to satisfy the data requirements for the stress scenarios set by the Fed, so they will not be required to submit the new forms but may be required to submit other supporting data.

The final rule is separate from provisions under Section 165 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act") that require BHCs with total consolidated assets of $50 billion or more to be subject to enhanced prudential standards, including capital requirements. However, going forward, BHCs will be required to incorporate into their capital plans any requirements related to capital that the Fed finalizes pursuant to the Dodd-Frank Act, such as the results of stress tests or early remediation requirements. Similarly, the new data collection forms are also expected to be used to accommodate reporting requirements under the Dodd-Frank Act related to stress testing for covered BHCs and nonbank financial companies supervised by the Fed.

Description

Scope

The final rule applies to:

- All U.S. BHCs with total consolidated assets of $50 billion or more, measured as the average of the previous four calendar quarters as reported on the BHC's consolidated financial statements.
  - BHCs that qualify for the first time after January 5 of any calendar year will not be subject to the requirements of the rule until January 1 of the next calendar year.
- Any institution that the Fed has determined, by order, to be subject to the final rule's requirements based on the institution's size, level of complexity, risk profile, scope of operations or financial condition.

The rule would not apply until July 21, 2015 to any BHC subsidiary of a foreign banking organization that has relied on the Fed's Supervision and Regulation Letter 01-01.

Capital Plans

The final rule requires a covered BHC to develop and maintain a capital plan, which is defined as a written presentation of a company's capital planning strategies and capital adequacy processes. The capital plan must be reviewed and approved by the BHC's board of directors prior to submission to the appropriate Federal Reserve Bank and the Fed (collectively hereinafter, the "Fed"). Capital plan submissions must be made no later than January 5 of each calendar year, or other later date as determined by the Fed. The Fed has set January 9, 2012 as the submission date for 2012.

Mandatory Elements of the Capital Plan

The capital plan must include:

- An assessment of the expected sources and uses of capital reflecting the covered BHC's size, complexity, risk profile, and scope of operations, assuming both expected and stressful conditions, including:
    - Estimates of projected revenues, losses, reserves, and pro forma capital levels, including any minimum regulatory capital ratios, over the planning horizon under expected conditions and under a range of stressed scenarios, including any scenarios provided by the Fed and at least one stressed scenario developed by the BHC appropriate to its business model and portfolios.
    - A calculation of the pro forma tier 1 common ratio over the planning horizon under expected conditions and under a range of stressed scenarios, and discussion of how the company will maintain a pro forma tier 1 common ratio above 5 percent under expected conditions and the stressed scenarios;
        - "Tier 1 common ratio" means the ratio of a BHC's tier 1 common capital to total risk-weighted assets. (This definition will remain in effect until the Fed adopts an alternative tier 1 common ratio definition as a minimum regulatory capital ratio pursuant to the implementation of Basel III.)
        - "Tier 1 common capital" means tier 1 capital less the non-common elements of tier 1 capital, including perpetual preferred stock and related surplus, minority interest in subsidiaries, trust preferred securities and mandatory convertible preferred securities.
    - A discussion of the results of any stress test required by law or regulation, and an explanation of how the capital plan takes these results into account; and
    - A description of all planned capital actions over the planning horizon.
- A detailed description of the BHC's process for assessing capital adequacy, including how, under expected and stressful conditions, the BHC will:
    - Maintain capital commensurate with its risks, maintain capital above the minimum regulatory capital ratios and above a tier 1 common ratio of 5 percent, and serve as a source of strength to its subsidiary depository institutions; and
    - Maintain sufficient capital to continue its operations by maintaining ready access to funding, meeting its obligations to creditors and other counterparties, and continuing to serve as a credit intermediary.
- The BHC's capital policy – defined as a written assessment of the principles and guidelines used for capital planning, capital issuance, usage and distributions, including: internal capital goals; the quantitative or qualitative guidelines for dividend and stock repurchases; the strategies for addressing potential capital shortfalls; and the internal governance procedures around capital policy principles and guidelines; and
- A discussion of any expected changes to the BHC's business plan that are likely to have a material impact on the firm's capital adequacy or liquidity.

Data Collection

Upon the request of the Fed, a covered BHC must provide information regarding its:

- Financial condition, including capital;
- Structure;
- Amount and risk characteristics of on- and off-balance sheet exposures, including exposures within its trading account, other trading-related exposures (such as counterparty-credit risk exposures) or other items sensitive to changes in market factors, including, as appropriate, information about the sensitivity of positions to changes in market rates and prices;
- Relevant policies and procedures, including risk management policies and procedures;
- Liquidity profile and management; and
- Other relevant qualitative or quantitative information requested by the Fed or the appropriate Reserve Bank to facilitate review of the capital plan.

The Fed has finalized two new forms, the FR Y-14Q (Quarterly) and the FR Y-14A (Annual), *Capital Assessments and Stress Testing,* which will fulfill the data collection requirements of the final rule. Covered BHCs must submit the FR-Y-14A with their capital plans on January 5 each calendar year or other date as specified by the Fed.

For 2012, only the CCAR firms will be required to submit the new forms. An FR-Y-14Q for the third quarter of 2011 must have been submitted by December 15, 2011 and an FR-Y-14Q for the fourth quarter of 2011 must be submitted by February 14, 2012. The CCAR firms were expected to file an FR-Y-14A with their capital plan by January 9, 2012. A separate FR-Y-14A is expected to be submitted for each of the scenarios included in the capital plan.

Non-CCAR firms will not be required to complete the forms for the 2012 capital plan submission but may be required to provide additional information as requested by the Fed over time.

Reviews, Resubmissions and Requests

The BHC's board of directors (or designated committee) is required to review at least annually the effectiveness of the BHC's processes for assessing capital adequacy and ensuring deficiencies in assessment processes are remediated, as well as to approve the capital plan. The board-approved plan would be required to be submitted to the Fed by January 5 of each year (or later date as directed by the Fed).

Following timely submission of the capital plan, the Fed would provide the BHC with a notice of objection or notice of non-objection by March 31. (The Fed has committed to provide notice by March 15 for the 2012 submission in order to give BHCs adequate opportunity to adjust capital distributions in the first quarter.) For BHCs that receive a notice of non-objection, the approval would extend through the first quarter of the subsequent year. BHCs that receive an objection would not be able to make a capital distribution while the objection remains outstanding, except for distributions for which the Fed has provided its non-objection in writing.

The Fed may object to a capital plan, in whole or in part, if the:

- Fed determines that the BHC has material unresolved supervisory issues, including but not limited to issues associated with its capital adequacy processes;

- Assumptions and analyses underlying the BHC's capital plan or methodologies for reviewing the effectiveness of its capital adequacy processes, are not reasonable or appropriate;
- BHC has not demonstrated an ability to maintain capital above each minimum regulatory capital ratio and above a tier 1 common ratio of 5 percent, on a pro forma basis under expected and stressful conditions throughout the planning horizon; or
- BHC's capital planning processes or proposed capital distributions constitute an unsafe or unsound practice, or would violate any law, regulation, Fed order, directive, or any condition imposed by, or written agreement with, the Fed.

Where the Fed has objected to a BHC's capital plan, the BHC may, within ten days of the notice of objection, submit a written request for reconsideration of the objection. The Fed would respond to such a request within 10 days.

Additional Submissions

A BHC would be required to revise and resubmit its capital plan within 30 calendar days of one of the following events:

- The Fed objects to the capital plan;
- The BHC determines there has been or will be a material change in the BHC's risk profile, financial condition or corporate structure since adopting the capital plan; or
- The BHC is directed to update its capital plan by the Fed for any of the following reasons:
    - The capital plan is incomplete or the capital plan or the BHC's internal capital adequacy processes contain weaknesses;
    - There has been or will likely be a material change in the BHC's risk profile (including a material change in its business strategy or any risk exposure), financial condition, or corporate structure;
    - The BHC-developed stressed scenario(s) in the capital plan are not sufficiently stressed, or changes in the macro-economic outlook that could have a material impact on a BHC's risk profile require the use of updated scenarios; or
    - The capital plan or the condition of the BHC raise any issues to which the Fed could object to in its review of a capital plan.

The Fed will provide notice of objection or notice of non-objection within 75 days of the resubmission date.

Request for Approval for Certain Capital Distributions

Notwithstanding a notice of non-objection, a covered BHC may not make a capital distribution without first receiving approval from the Fed if:

- After giving effect to the capital distribution, the BHC would not meet a minimum regulatory capital ratio or, a tier 1 common ratio of 5 percent;
- The Fed determines that the capital distribution would result in a material adverse change to the organization's capital or liquidity structure or that earnings were materially underperforming projections;
- The dollar amount of the capital distribution would exceed the amount described in the capital plan approved by the Fed; or

- The capital distribution would occur after an event occurred that required resubmission of the capital plan and prior to the Fed acting on the resubmitted plan.

The Fed will respond to a request for capital distribution within 30 days of receipt. The request must contain:

- The BHC's previously approved capital plan or an attestation that there have been no changes to its capital plan;
- The purpose of the transaction;
- A description of the capital distribution, including for redemptions or repurchases of securities, the gross consideration to be paid and the terms and sources of funding for the transaction, and for dividends, the amount of the dividend(s); and
- Any additional information requested by the Fed.

Exception

A covered BHC may make a capital distribution for which the dollar amount exceeds the amount described in the capital plan for which a non-objection was issued if:

- The BHC is, and after the capital distribution would remain, well capitalized;
- The BHC's performance and capital levels are, and after the capital distribution would remain, consistent with its projections under expected conditions;
- The annual aggregate dollar amount of all capital distributions (beginning on April 1 of a calendar year and ending on March 31 of the following calendar year) would not exceed the total amounts described in the company's capital plan for which the BHC received a notice of non-objection by more than 1.00 percent multiplied by the BHC's tier 1 capital, as reported to the Federal Reserve on the BHC's first quarter FR Y-9C;
- The BHC provides notice to the Fed 15 calendar days prior to a capital distribution, and that notice includes all information required as part of a request for capital distribution; and
- The Fed does not object to the transaction.

Summary Instructions and Guidance

To supplement the release of the final rule, the Fed provided two sets of Summary Instructions and Guidance that outline the agency's requirements and expectations. One set is directed to the 19 CCAR firms and one set is directed to the 15 non-CCAR firms that are covered by the final rule.

The Instructions provide: 1) general logistics for BHCs' capital plan submissions, 2) guidelines surrounding the mandatory elements of a comprehensive capital plan, 3) information on what the Fed will assess during the capital plan reviews, and a description of how the Fed will assess the planned capital distributions, 4) information on the Fed's response to capital plans and planned actions, 5) information for BHCs requesting incremental capital requests following the capital plan reviews, and 6) a discussion of planned disclosure at the end of CCAR firms reviews. In addition, Appendix I describes supervisory expectations for BHCs' capital policies, Appendix II outlines expectations for effective capital adequacy processes, and Appendix III describes the macroeconomic scenarios to be used.

The Instructions indicate that each BHC must include at least four scenarios in its capital plan:

- *BHC Baseline* – a BHC-defined baseline scenario;

- *Supervisory Baseline* – a baseline scenario provided by the Fed;
- *BHC Stress* – at least one BHC-defined adverse scenario; and
- *Supervisory Stress* – an adverse scenario provided by the Fed.

The six BHCs with large trading operations will also be expected to "run a global market shock" scenario provided by the Fed.

The capital plans were required to begin with data as of September 30, 2011 and span the 9 quarter period beginning in the fourth quarter of 2011 and concluding at the end of the fourth quarter of 2013.

Data Submissions – Forms FR-Y 14Q and FR-Y-14A

At the same time the Fed released its final rule requiring large BHCs to submit annual capital plans, the Fed released a final notice of data collection activities for two new forms, FR-Y-14Q and FR-Y-14A, entitled *Capital Assessments and Stress Testing*, which are to be filed quarterly and annually, respectively, by large BHCs. The forms are also expected to be used to accommodate reporting requirements under Section 165 of the Dodd-Frank Act, which relate to stress testing for large BHCs and nonbank financial companies supervised by the Fed when those rules are finalized.

The FR-Y-14A will collect annually a BHC's quantitative projections of balance sheet assets and liabilities, income, losses, and capital across a range of macroeconomic scenarios and qualitative information on methodologies used to develop internal projections of capital across scenarios. One or more of the scenarios would include a market shock that the BHCs would assume when making trading and counterparty loss projections. The FR-Y-14A consists of five primary schedules with supporting worksheets. The schedules are:

- Summary;
- Macro Scenario;
- CCR (Counterparty Credit Risk);
- Basel III; and
- Regulatory Capital Instruments.

The annual form is to be filed with the capital plan in early January each year with data reported as of September 30, except for the trading and counterparty collections data that would be reported as of a date designated by the Fed. For the 2012 FR-Y-14A, trading and counterparty positions are to be based on balances as of the close of business, November 17, 2011.

The FR Y-14Q will collect detailed data on a BHCs' various asset classes and pre-provision net revenue ("PPNR") for the reporting period, which would be used to support supervisory stress test models and for continuous monitoring efforts, on a quarterly basis. The Fed will use this data to assess the capital adequacy of covered BHCs using forward-looking projections of revenue and losses. The FR-Y-14Q schedules include:

- Securities Risk;
- Retail Risk;
- PPNR Risk;
- Wholesale Risk;
- Trading Risk;
- Basel III; and

- Regulatory Capital Instruments.

The quarterly reports are due at the same time as the FR-Y-9C filings. For the first, second and fourth quarters, the reporting date would be the same for all schedules. For the third quarter, the BHC's would be required to report data as part of a market shock exercise and the Fed would determine the as of date for trading data.

Commentary

The final capital plan rules adopted by the Fed, while reflecting some modifications, retained the broad framework of the proposed rule. Specifically, the Fed will evaluate covered BHCs capital adequacy, their internal processes for evaluating capital adequacy, and proposed capital distributions at least annually.

In issuing the final rule, the Fed made a distinction between the 19 CCAR firms and the 15 additional non-CCAR firms that now meet the applicable asset threshold under the final rule. Due to their involvement in the SCAP and the CCAR, the 19 CCAR firms are deemed to have appropriate reporting and planning processes in place to provide data on the new FR-Y-14Q and FR-Y-14A collection forms. The15 additional affected firms should begin to develop and implement internal systems to satisfy the data requirements for the stress scenarios set by the Fed.

As the final rule reflects the increasing supervisory emphasis on and scrutiny of covered BHC's capital plans and processes, and the potential supervisory consequences for objections to a capital plan, covered BHCs will need to continue to increase their own emphasis on their capital planning processes. Specifically, covered BHCs should give consideration to:

- Ensuring that the board of directors, or a designated committee, is able to satisfactorily demonstrate to supervisors their approach to measuring "robustness" of the processes and that identified weaknesses are remediated, as well as having approved the plan;
- The comprehensiveness of the plan, including the internal processes for ensuring that potential stress losses are captured, measured, and estimated for all of the covered BHC's activities;
- Developing BHC defined baseline and stress scenarios that are sufficiently robust and adequately supported by the underlying analysis to withstand supervisory scrutiny by the Fed, including from Fed economists;
- Ensuring that systems, data, and resources are sufficient to meet current data submissions requirements, as well as support the internal analysis; and
- Developing appropriate communication strategies as the Fed will publicly release its estimates of revenues and losses, as well as pro forma, post stress test capital ratios, and to handle potential disruptions in a covered BHC's planned capital distributions.

In addition, as the level and type of reporting is essentially being implemented for the first time it is expected that there will be subsequent iterations of the new reporting forms. It is likely the Fed will collect additional information, which could include macroeconomic and global economic data along with information pertaining to Basel III framework readiness. Similarly, with experience, the reporting forms and data collection could forseeably be expanded beyond the CCAR and non-CCAR firms to include those bank holding companies and other firms subject to stress testing under Section 165 of the Dodd-Frank Act that are not already covered by the Fed's capital plan rule. Even absent an expansion of reporting requirements, the capital planning principles outlined in the final capital rule will likely influence or be applied by Fed examiners reviewing capital planning processes at non-covered BHC's, particularly those in the $10 to $50 billion range.

In closing, it is worth noting that the overall tone of the final rule and the instructions would appear to imply that the Fed is seeking to strengthen current capital positions in large BHCs, perhaps in advance of the Basel III requirements, and to generally restrict capital distributions in the near term.

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