

## Alert

### Federal Regulators Finalize Stress Testing Requirements for SIFIs and Mid- to Large-Sized Banking Organizations

October 19, 2012

Section 165(i) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) requires:

- The Board of Governors of the Federal Reserve System (“Board”) to conduct an annual stress test (“Supervisory Test”) on each systemically important bank holding company (“BHCs”) and systemically-important nonbank;
- All banking organizations with total consolidated assets of more than \$10 billion (on an average basis over the prior four quarters) to conduct an annual company-run stress test (“Annual Self-Test”); and
- Systemically important BHCs and nonbanks to conduct an additional mid-cycle company-run stress test each year (“Mid-Cycle Self-Test”).

Last week, the Board, the Office of the Comptroller of the Currency (“OCC”) and the Federal Deposit Insurance Corporation (“FDIC”) all issued final rules to effectuate these Dodd-Frank Act stress testing requirements.

The Board published two final rules.<sup>1</sup> One of the final rules (the “Covered Company Rule”) imposes all three stress testing requirements, and applies to the following:

- U.S. BHCs<sup>2</sup> with \$50 billion or more in consolidated assets;<sup>3</sup> and
- Nonbank financial companies (U.S. and non-U.S.) designated as “systemically important” by the Financial Stability Oversight Council (“Council”)

(collectively, “Covered Companies”).

<sup>1</sup> The final rules are available at <http://www.federalreserve.gov/newsevents/press/bcreg/20121009a.htm>.

<sup>2</sup> Neither of the Board’s stress testing rules apply to foreign banking organizations. The Board expects to issue a separate rulemaking applicable to foreign banking organizations at a later date. However, a U.S.-domiciled subsidiary of a foreign banking organization that has total consolidated assets above the applicable threshold is subject to the applicable rule. Institutions currently relying on Supervision and Regulation Letter SR 01–01 issued by the Board (as in effect on May 19, 2010) are not required to comply with the Rule until July 21, 2015.

<sup>3</sup> In all cases discussed in this *Alert*, the size of an entity’s total consolidated assets is based on average assets over the four most recent consecutive quarters.

The other final rule issued by the Board (the “Other Fed Regulatee Rule”) imposes only the Annual Self-Test, and applies to the following:

- BHCs with total consolidated assets of greater than \$10 billion but less than \$50 billion; and
- Savings and loan holding companies (“SLHCs”) and state member banks with total consolidated assets of greater than \$10 billion

(collectively, “Other Fed Regulatees”).

Concurrently with the Board’s action, the OCC and the FDIC also finalized stress testing requirements substantially similar to the Other Fed Regulatee Rule (respectively, the “OCC Rule” and the “FDIC Rule”).<sup>4</sup> The OCC Rule applies to national banks and federal savings associations with total consolidated assets of greater than \$10 billion, while the FDIC rule applies to similarly-sized state nonmember banks and state savings associations.

In each case, the agencies’ final stress testing rules largely mirror their earlier proposals. For a summary of the Board’s original proposal, please see our Jan. 11, 2012 [Memorandum](#); for a summary of the original FDIC proposal, please see our Jan. 19, 2012 [Alert](#); and for a summary of the original OCC proposal, please see our Jan. 25, 2012 [Alert](#).

This *Alert* highlights the differences between the final rules and those proposals.

## I. The Board Rules

### Effective Date

One of the most significant changes between the Board’s original proposal and the two final rules are the dates on which different types of entities must comply with the new stress testing requirements. In general, the final rules issued by the Board give Covered Companies and Other Fed Regulatees more time before the new requirements take effect.

Effective Date for	Original Proposal	Final Rules <sup>5</sup>
Existing Covered Companies	Immediately upon adoption of a final rule	BHCs that participated in the SCAP <sup>6</sup> are subject to both annual testing requirements in 2012 (with first Mid-Cycle Self-Test to be conducted in 2013); all others must begin annual testing in 2013 (with the first Mid-Cycle Self-Test to be conducted in 2014)
Existing Other Fed Regulatees	Immediately upon adoption of a final rule	BHCs and banks that qualify by end of 2012 must conduct first Annual Self-Test in 2013 (with no public reporting until their second test), except banks that are owned by BHCs that participated in the SCAP, which must start testing in 2012 (with no delay of public reporting)

<sup>4</sup> The OCC Rule is available at <http://www.occ.gov/news-issuances/news-releases/2012/nr-occ-2012-142.html> and the FDIC Rule at <http://www.fdic.gov/news/news/press/2012/pr12116.html>.

<sup>5</sup> Under both the Covered Company Rule and the Other Fed Regulatee Rule, the Board has the power to extend (or, in some cases, accelerate) the various deadlines.

<sup>6</sup> Supervisory Capital Assessment Program.

Effective Date for	Original Proposal	Final Rules <sup>5</sup>
A BHC that becomes a Covered Company after adoption of the rule	<p>If threshold is crossed more than 90 days before Sept. 30 of a given year, then first Supervisory Test and Annual Self-Test is required that year</p> <p>If trigger date is also more than 90 days before March 31 of a given year, then Mid-Cycle Self-Test is also required that year</p>	Must start complying with all three testing requirements in the calendar year following the date it qualifies as a Covered Company
A nonbank that becomes a Covered Company after adoption of the rule	<p>If threshold is crossed more than 180 days before Sept. 30 of a given year, then first Supervisory Test and Annual Self-Test is required that year</p> <p>If trigger date is also more than 180 days before March 31 of a given year, then Mid-Cycle Self-Test is also required that year</p>	Must start complying with all three testing requirements in the calendar year following the date it qualifies as a Covered Company
An entity that becomes an Other Fed Regulatee after adoption of the rule	If threshold is crossed more than 90 days before Sept. 30 of a given year, then first Annual Self-Test is required that year (except that this trigger does not apply to SLHCs until they are subject to minimum capital requirements)	<p>BHCs and banks that qualify by end of 2012, must conduct first Annual Self-Test in 2013 (with no public reporting until their second test), except banks that are owned by BHCs that participated in the SCAP, which must start testing in 2012 (with no delay on public reporting)</p> <p>BHCs, SLHCs and banks that qualify after 2012, must conduct first Annual Self-Test in following calendar year (except that this trigger does not apply to SLHCs until they are subject to minimum capital requirements)</p>

### Stress Testing Cycles

While largely retaining the stress testing cycles contained in the original proposal, the final rules incorporated a few changes. Most importantly, all entities subject to the Other Fed Regulatee Rule (except (1) SLHCs with more than \$50 billion in total consolidated assets and (2) state member banks that are owned by Covered Companies) are given approximately three extra months each year to complete the Annual Self-Test and to submit the required regulatory report to the Board, as well as to publicly disclose a summary of the results. In addition, the original public disclosure deadlines (early April for the Supervisory Test and Annual Self-Test, and early October for the Mid-Cycle Self-Test) have been adjusted for all entities under both rules, so that they no longer interfere with the “quiet periods” preceding earnings announcements of publicly-traded entities.

## Final Testing Cycle Timeline

Stress Test Step	Timeframe
Board publishes scenarios for upcoming Supervisory Test and Annual Self-Test	By Nov. 15
Covered Companies and Other Fed Regulatees complete Annual Self-Test and submit report to the Board	By Jan. 5 for Covered Companies and their Other Fed Regulatee subsidiaries, as well as SLHCs with >\$50 billion in total consolidated assets By March 31 for Other Fed Regulatees not covered above
Covered Companies receive results of their Supervisory Test (followed by public disclosure of summary by the Board)	By March 31
Covered Companies and Other Fed Regulatees publicly disclose summary of results of Annual Self-Test	Between March 15 and 31 for Covered Companies and their Other Fed Regulatee subsidiaries, as well as SLHCs with >\$50 billion in total consolidated assets. Between June 15 and 30 for Other Fed Regulatees not covered above
Covered Companies complete Mid-Cycle Self-Test and submit report to the Board	By July 5
Covered Companies publicly disclose summary of results of Mid-Cycle Self-Test	Between Sept. 15 and 30

### Tailoring of Annual Self-Tests

The Board's original proposal would have applied consistent Annual Self-Test requirements on all Covered Companies and Other Fed Regulatees. However, recognizing that entities with less than \$50 billion in total consolidated assets are generally less complex and pose less risk to U.S. financial stability, the final rules incorporate a somewhat tailored approach, which modify the requirements for smaller institutions in several ways.

First, as discussed above, most entities with \$50 billion or less in total consolidated assets will have more time to complete and disclose the results of their Annual Self-Test. Second, such smaller entities are also generally not required to provide as detailed a public disclosure of the results as larger entities and Covered Companies.<sup>7</sup> Third, in the Other Fed Regulatee Rule, the Board indicated that it expects the forms used to report the Annual Self-Test results to the Board will be tailored according to entity size, with smaller entities using a "significantly more limited" form than larger entities and Covered Companies.

Finally, depending on the systemic footprint and span of operations and activities of a Covered Company or Other Fed Regulatee, the Board may require that entity to include additional components in its adverse or severely adverse scenarios, or to use additional scenarios designed to capture particular risks to specific lines of business. In particular, the Board may require:

- A trading and counterparty component in the "adverse" and "severely adverse" scenarios for an entity with significant trading activity (as determined by the Board and specified in the Capital Assessments and Stress Testing report (FR Y-14));

<sup>7</sup> While the disclosure requirements were particularly reduced for smaller entities, in general, the final rules decreased the amount of information all entities are required to publicly disclose.

- One or more additional components in the adverse and severely adverse scenarios based on a particular entity's financial condition, size, complexity, risk profile, scope of operations, or activities, or risks to the U.S. economy; and
- One or more additional scenarios (in addition to the "baseline," "adverse," and "severely adverse" scenarios to be used by all Covered Companies and Other Fed Regulatees) based on a particular entity's financial condition, size, complexity, risk profile, scope of operations, or activities, or risks to the U.S. economy.<sup>8</sup>

### **Assumptions Regarding Capital Ratios**

In response to requests to the Board to adopt the disclosure approach used for CCAR<sup>9</sup> in 2012 (which included some common assumptions of capital actions across bank holding companies) and to enable comparisons across firms and between the company-run and supervisory stress tests, the final rules require Covered Companies and Other Fed Regulatees to make the following assumptions regarding their capital actions over the planning horizon:

- For the first quarter of the planning horizon, the entity must take into account its actual capital actions as of the end of that quarter; and
- For each of the second through ninth quarters of the planning horizon, the entity must include in the projections of capital:
  - Common stock dividends equal to the quarterly average dollar amount of common stock dividends paid in the previous year (that is, the first quarter of the planning horizon and the preceding three calendar quarters);
  - Payments on any other instrument that is eligible for inclusion in the numerator of a regulatory capital ratio equal to the stated dividend, interest, or principal due on such instrument during the quarter; and
  - An assumption of no redemption or repurchase of any capital instrument that is eligible for inclusion in the numerator of a regulatory capital ratio.

### **Public Reporting**

Another important change between the Board's original proposal and the final rules is that only the results from the "severely adverse" scenario will be included when the Board publishes the results of a Covered Company's Supervisory Test or when a Covered Company or Other Fed Regulatee reposts the results of its Self-Tests.

## **II. The OCC Rule**

### **Effective Date**

As discussed above, the OCC Rule applies to national banks and federal savings associations with total consolidated assets of greater than \$10 billion.<sup>10</sup> The final OCC Rule divides such depository institutions into two categories: (1) those with total assets between \$10 and \$50 billion ("Mid-Sized OCC Regulatees") and (2) those with total consolidated assets over \$50 billion ("Large OCC Regulatees"). Under the OCC's original proposal all covered institutions would have been required to conduct their first Annual Self-Test in 2012. Under the OCC Rule, however, only Large OCC Regulatees are required to begin stress testing in 2012.<sup>11</sup> Mid-Sized OCC Regulatees are given until 2013, and the public disclosure requirement is further delayed until their second Annual Self-Test. Under both the original proposal and the OCC Rule, depository institutions that

<sup>8</sup> If the Board requires the use of additional components or scenarios, it will provide written notification to the relevant entity no later than Sept. 30. Within 14 calendar days thereafter, the entity may request in writing that the Board reconsider. The Board must then respond in writing within 14 calendar days of receipt of the company's request, and must provide a final description of any additional components or scenarios required by Dec. 1. For purposes of the Mid-Cycle Stress Tests, the process is the same, except that the Board must provide the initial notification no later than March 31 and a final decision by June 1.

<sup>9</sup> Comprehensive Capital Analysis and Review.

<sup>10</sup> The OCC Rule will not apply to federal branches or agencies of a foreign bank, regardless of size.

<sup>11</sup> However, the OCC reserved the right to delay this deadline on a case-by-case basis.

later grow above the \$10 billion threshold are required to conduct their first Annual Self-Test in the following calendar year.

### Stress Testing Cycle

The OCC originally proposed distributing the scenarios to be used for the Annual Self-Test on Oct. 15 of each year. However, the OCC Rule moves that date to Nov. 15, to be consistent with the Fed. In addition, like the Other Fed Regulatee Rule, the OCC Rule gives Mid-Sized OCC Regulatees approximately three extra months each year to complete the Annual Self-Test and submit the required regulatory report to the OCC, as well as to publicly disclose a summary of the results.

### Final Testing Cycle Timeline

Stress Test Step	Timeframe
OCC publishes scenarios for upcoming Annual Self-Test.	By Nov. 15
Annual Self-Test completed and report submitted to the OCC.	By Jan. 5 for Large OCC Regulatees By March 31 for Mid-Sized OCC Regulatees
Publicly disclose of summary of results of Annual Self-Test.	Between March 15 and 31 for Large OCC Regulatees Between June 15 and 30 for Mid-Sized OCC Regulatees.

### Tailoring of Annual Self-Tests

The OCC Rule incorporates certain methods for tailoring the Annual Self-Tests that are similar some of the methods used in the Fed’s final rules. Like the Fed, the OCC may require the use of additional components or scenarios, including the use of a trading and counterparty component in the “adverse” and “severely adverse” scenarios for an entity with significant trading activity.<sup>12</sup> In addition, as in the Other Fed Regulatee Rule, the OCC Rule suggests that the form used by Mid-Sized OCC Regulatees to report the Annual Self-Test results to the OCC will be more limited than the form used by Large OCC Regulatees.

### Public Reporting

The OCC Rule also adopts the change made in the Fed’s final rules to only require public disclosure of the results of the “severely adverse” scenario.

## III. The FDIC Rule

### Effective Date

As discussed above, the FDIC Rule applies to state nonmember banks and state savings associations with total consolidated assets of greater than \$10 billion. Like the OCC Rule, the FDIC Rule divides such depository institutions into two categories: (1) those with total assets between \$10 and \$50 billion (“Mid-Sized FDIC Regulatees”) and (2) those with total consolidated assets over \$50 billion (“Large FDIC Regulatees”). Moreover, the FDIC Rule incorporates all of the same revised effective dates for testing and disclosure as the OCC Rule (applying in the same manner to Mid-Sized and Large FDIC Regulatees, as they apply to Mid-Sized and Large OCC Regulatees).<sup>13</sup>

<sup>12</sup> Any decision by the OCC to require an additional component, assumption or scenario will be subject to a similar notice and comment procedure as the one required when increasing a bank’s minimum capital requirements under 12 C.F.R. § 3.12. If the OCC requires the use of the additional trading and counterparty component, it will select an “as-of” date between Oct. 1 and Dec. 1 for the data to be used in the component, which it will communicate to the regulatee by Dec. 1.

<sup>13</sup> Like the OCC, the FDIC reserved the right to delay the implementation date for a Large FDIC Regulatee on a case-by-case basis.

## Stress Testing Cycle

The FDIC Rule adopts the same revised Annual Self-Test cycle as the OCC Rule (with the Mid-Sized FDIC Regulatees afforded the same more relaxed timeframes as Mid-Sized OCC Regulatees).

## Tailoring of Annual Self-Tests

The FDIC Rule incorporates the same methods for tailoring the Annual Self-Tests that were adopted in the OCC Rule.<sup>14</sup>

## Public Reporting

Like the Fed's final rules and the OCC Rule, the FDIC Rule also limits the public disclosure requirements to the results of only the "severely adverse" scenario.

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<sup>14</sup> Any decision by the FDIC to require an additional component, assumption or scenario will be subject to a similar notice and comment procedure as the one required when issuing a capital directive under 12 C.F.R. § 325.6. If the FDIC requires the use of the additional trading and counterparty component, it will do so in the same manner as described above for the OCC.