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Federal Reserve Releases 2018 CCAR Results

By Luigi L. De Ghenghi, Randall D. Guynn, Gabriel D. Rosenberg & Andrew Rohrkemper on July 3, 2018

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The Federal Reserve last week released the results of its **2018 Comprehensive Capital Analysis and Review** (CCAR). We have analyzed the 2018 CCAR results, along with the **Dodd-Frank Act Stress Test results** published the previous week, and have prepared a graphical summary available **here**. As our summary shows, on average the stress losses for the firms subject to CCAR in 2018—measured by impact on CET1 risk-based capital ratios—were 33% higher compared to the 2017 CCAR cycle, evidence of the increased severity of the Federal Reserve's severely adverse supervisory stress scenario.

A total of 35 firms were subject to the 2018 CCAR assessments: 13 advanced approaches U.S. bank holding companies (BHCs), 10 non-advanced approaches U.S. BHCs, and 12 U.S. intermediate holding companies (IHCs) of foreign banking organizations. For the first time, U.S. BHCs with $50 billion or more but less than $100 billion in total consolidated assets were excluded from the CCAR assessment, consistent with the statutory change in the threshold for enhanced prudential standards under the Economic Growth, Regulatory Relief, and Consumer Protection Act enacted in May of this year. This change excluded three BHCs—CIT Group, Comerica and Zions—from this year's assessment.

The Federal Reserve did not object to the capital plans of 34 of the 35 firms. The Federal Reserve objected to one firm's capital plan on qualitative grounds and issued a conditional non-objection on quantitative grounds for three firms—Goldman Sachs, Morgan Stanley and State Street. For Goldman Sachs and Morgan Stanley, the Federal Reserve announced that it would not object to each firm's planned capital distributions so long as they are limited to no more than a benchmark amount equal to the greater of the firm's actual distributions made over the previous four calendar quarters and the annualized average of actual distributions over the previous eight calendar quarters. For State Street, the Federal Reserve stated that it has required the firm to take certain steps regarding the management and analysis of its counterparty exposures under stress. Four other firms—American Express, JPMorgan, KeyCorp and M&T Bank—took advantage of the opportunity to adjust their planned capital actions (the so-called "mulligan") after receiving the Federal Reserve's preliminary estimates for their post-stress capital ratios.

The Federal Reserve noted that each of the three firms receiving a conditional non-objection was projected to have at least one minimum post-stress capital ratio lower than the corresponding minimum required capital ratio, attributable in part to the adverse one-time accounting impacts of the Tax Cuts and Jobs Act (TCJA) enacted in December 2017. The Federal Reserve cited, among other factors, the one-time negative impact on these firms' capital ratios stemming from an overall favorable tax change, which the Federal Reserve noted was not indicative of the firms' performances under stress, as well as "uncertainties" in firms' capital ratios resulting from the timing of the TCJA—likely a reference to the timing of deferred tax assets and deferred tax liabilities. The conditions to the Federal Reserve's non-objections for Goldman Sachs and Morgan Stanley effectively limit these firms' capital distributions for the next four quarters based on a backward-looking benchmark, an approach consistent with the limitations imposed in past cycles for firms that did not meet post-stress minimum requirements and received quantitative objections (see, e.g., the limitations imposed on Zions in the 2014 CCAR cycle). We also note that five out of the six capital shortfalls (two for each of the three firms) related to Tier 1 leverage or supplementary leverage ratios, suggesting potential structural or conceptual inconsistencies with the use of risk-insensitive capital measures, which are intended as back-stops to the primary risk-based capital requirements, as post-stress minimum requirements.

The Federal Reserve also publicly identified the following three trends it observed in the capital planning practices of the 35 CCAR firms:

- For certain areas, such as credit cards, auto loans and revenues from certain business lines, the Federal Reserve noted certain inherent difficulties, such as lack of relevant data, in estimating stress losses or revenues. The Federal Reserve noted that some firms more than others were able to use "appropriate techniques" to overcome these challenges, although it did not publicly elaborate on the nature of the difficulties or its preferred techniques to address them.

- The Federal Reserve observed that some firms had “purchased large trading positions to offset the losses arising from the instantaneous market shock,” which we presume is a reference to the global market shock (GMS) scenario component to which six of the largest CCAR firms are subject. The Federal Reserve noted that this practice could be cause for concern if firms have not sufficiently analyzed the risk of these hedging strategies and subjected them to appropriate governance procedures. As an example of the type of risks from these strategies, the Federal Reserve pointed to the possibility that counterparties could be unwilling to make such hedging positions available during periods of market stress.
- The Federal Reserve also observed that many firms’ internal controls for capital planning fall short of supervisory expectations in various areas, including information systems and data management, capital planning audits, and model risk management.

About CCAR

CCAR is the Federal Reserve’s annual assessment of the capital planning processes of the largest U.S. BHCs – those with more than $100 billion in total consolidated assets – and the U.S. IHCs of foreign banking organizations. CCAR includes a quantitative assessment under stressed conditions, which measures, over a forward-looking nine-quarter time horizon, whether the firm would meet minimum capital requirements (without capital buffers) under a hypothetical adverse and severely adverse economic scenarios assuming the implementation of the firm’s proposed capital action plan (i.e., its planned dividends, share buybacks and capital-raising actions over the nine-quarter horizon). In addition, CCAR includes for the 18 largest and most complex firms a qualitative assessment of the firm’s capital planning processes and management. If the Federal Reserve objects to a firm’s capital plan on either a quantitative or (if applicable) qualitative basis, the firm will not be permitted to distribute capital through dividends, share repurchases or other means, except as specifically approved by the Federal Reserve.

July 3, 2018

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Visuals of 2018 CCAR and DFAST Results

This document includes visuals of the Federal Reserve's 2018 Comprehensive Capital Analysis and Review ("**CCAR**") results as well as the supervisory Dodd-Frank Act stress test ("**DFAST**") results for the 35 firms subject to the 2018 CCAR assessment, which include 23 U.S. bank holding companies with $100 billion or more in total consolidated assets that are not controlled by a foreign banking organization ("**Large BHCs**") and 12 U.S. intermediate holding companies ("**IHCs**") of foreign banking organizations (together, the "**CCAR Firms**"). The statutory thresholds for DFAST and CCAR were amended by the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (the "**EGRRCPA**"), increasing the total consolidated asset threshold to $100 billion beginning May 2018 and to $250 billion beginning November 2019. The Federal Reserve is expected to propose new regulations addressing the applicability of DFAST and CCAR to firms with between $100 billion and $250 billion in total consolidated assets.

Background on DFAST: Pursuant to its DFAST regulations, the Federal Reserve conducts annual supervisory stress tests to assess the potential impact of various hypothetical economic scenarios on the consolidated earnings, losses and regulatory capital of each Large BHC over a nine-quarter planning horizon. As part of the supervisory DFAST, the Federal Reserve projects each CCAR Firm's balance sheet, net income, and resulting post-stress capital levels, and regulatory capital ratios under three scenarios (baseline, adverse and severely adverse) using data reported to the Federal Reserve by each of the CCAR Firms as of December 31 of the previous year. As the EGRRCPA requires the removal of the adverse scenario from DFAST, we expect the Federal Reserve will make a similar conforming change to CCAR.

The DFAST requirements, as amended by the EGRRCPA, also require CCAR Firms, as well as other U.S. banking organizations with $100 billion or more in total consolidated assets, to conduct company-run DFASTs.

Background on CCAR: CCAR is an annual capital planning exercise conducted by the Federal Reserve that, like DFAST, involves hypothetical stressed economic scenarios over a nine-quarter planning horizon. Under CCAR, the Federal Reserve assesses for each CCAR Firm (i) whether it has sufficient capital to continue operations over a nine-quarter planning horizon, taking into account certain hypothetical economic and financial stress conditions and (ii) whether it has implemented robust, forward-looking capital planning processes that account for the company's risks and are supported by the CCAR Firm's risk measurement and management practices. As part of CCAR, the Federal Reserve quantitatively evaluates each CCAR Firm's plans to make capital distributions, such as dividend payments, stock repurchases or planned acquisitions. In past CCAR cycles, the Federal Reserve also subjected each CCAR Firm to a qualitative assessment with the possibility of a qualitative objection to its capital plan. Beginning with the 2017 CCAR cycle, only the largest firms (referred to as Large and Complex Firms) are subject to the possibility of a qualitative objection; in 2018, 18 of the 35 CCAR Firms are Large and Complex Firms subject to the qualitative assessment. For other CCAR Firms (Large and Noncomplex Firms), the Federal Reserve will assess the qualitative aspects of their capital planning processes as part of its normal supervisory process, without the possibility of a qualitative objection, through a targeted **Horizontal Capital Review**.

Differences Between Supervisory DFAST and CCAR Post-Stress Capital Analysis: While closely related, there are some important differences between the Federal Reserve's supervisory DFAST and the CCAR post-stress capital analysis. While the supervisory DFAST and CCAR quantitative assessments incorporate the same projections of pre-tax net income, the primary difference is the capital action assumptions that are combined with these projections to estimate a CCAR Firm's post-stress capital levels and ratios.

To project post-stress capital ratios for the supervisory DFAST, the Federal Reserve uses a standardized set of capital action assumptions that are specified in its DFAST regulations. Common stock dividend payments are generally assumed to continue at the same level as the previous year. Scheduled dividend, interest, or principal payments on any other capital instrument eligible for inclusion in the numerator of a regulatory capital ratio are assumed to be paid. No repurchases of common stock are assumed. The capital action assumptions do not include the issuance of any new common stock, preferred stock, or other instruments that would be included in regulatory capital, except for common stock issuance associated with expensed employee compensation or in connection with a planned merger or acquisition.

In contrast, for the CCAR post-stress capital analysis, the Federal Reserve uses a CCAR Firm's planned capital actions, and assesses whether the CCAR Firm would be capable of meeting supervisory expectations for minimum capital ratios even if stressful conditions emerged and the CCAR Firm did not reduce planned capital distributions.

As a result, post-stress capital ratios projected for the supervisory DFAST may differ significantly from those for the CCAR post-stress capital analysis.

Projections of Capital Ratios: Both CCAR and DFAST rely on projections of each firm's balance sheet, risk-weighted assets ("**RWAs**"), net income, and resulting regulatory capital ratios, all of which are projected for each quarter of the nine-quarter planning horizon in accordance with the regulatory capital requirements that will be effective for the firm in that quarter. Accordingly, each CCAR Firm's stressed capital projections reflect the applicable U.S. Basel III capital rules. Because the Federal Reserve has indefinitely delayed use of the advanced approaches risk-based capital framework for DFAST and CCAR, the RWAs for the projections are based on the standardized approach ("**SA**") for all firms (including advanced approaches firms).

	Periods Applicable	Required Minimum Ratio	Numerator (Capital) Methodology	Denominator (RWA) Methodology
Common Equity Tier 1 risk-based capital ratio ("**CET1 RBC ratio**")	2018:Q1 to 2020:Q1	4.5%	Basel III	Basel III SA
Tier 1 risk-based capital ratio ("**Tier 1 RBC ratio**")		6%	Basel III	Basel III SA
Total risk-based capital ratio ("**Total RBC ratio**")		8%	Basel III	Basel III SA
Tier 1 leverage ratio		4%	Basel III	Avg. Assets
Supplementary Leverage Ratio ("**SLR**") (advanced approaches firms only)		3%	Basel III (Tier 1 capital)	Total Leverage Exposure

Changes Between 2017 and 2018 CCAR and DFAST: The 2018 CCAR and DFAST exercises were structurally similar to the 2017 exercises, with only two technical changes, each affecting the scope of CCAR Firms. First, certain Large and Complex Firms that were recently formed U.S. IHCs and therefore did not participate in CCAR 2017 (and which were instead subject to a confidential review in 2017) became subject to the CCAR process in 2018. These firms were the U.S. IHCs of Barclays, Credit Suisse, Deutsche Bank, RBC and UBS. (Deutsche Bank Trust Corporation, which is a subsidiary of DB USA Corporation, Deutsche Bank's U.S. IHC, participated in prior years' CCAR exercises as a U.S. BHC.) Second, three firms with between $50 billion and $100 billion in total consolidated assets—Comerica, CIT Group and Zions—were exempt from 2018 CCAR and DFAST due to the statutory threshold changes of the EGRRCPA. Apart from these scoping changes, the severely adverse supervisory scenario was significantly more severe for 2018 CCAR than the 2017 scenario, resulting in approximately 33% higher stress losses on average, based on changes in aggregated CET1 risk-based capital ratios under supervisory DFAST as reported by the Federal Reserve.

Quantitative and Qualitative Results: For 2018 CCAR, the Federal Reserve did not object to the capital plans of 34 of the 35 CCAR Firms. The Federal Reserve objected to one firm's capital plan on qualitative grounds and issued a conditional non-objection on quantitative grounds for three firms—Goldman Sachs, Morgan Stanley and State Street. The Federal Reserve projected each of the three firms for which it issued a conditional non-objection to have at least one minimum post-stress capital ratio lower than the corresponding minimum required capital ratio. For two of these firms, the conditions to Federal Reserve's non-objection effectively limit these firm's capital distributions based on a backward-looking benchmark, an approach consistent with the limitations imposed in past CCAR cycles for firms that did not meet post-stress minimum requirements. As in previous years, the Federal Reserve provided each CCAR Firm with an opportunity to make a downward adjustment to its original planned capital distributions after receiving the Federal Reserve's preliminary estimates of the firm's stressed capital ratios. Six firms took advantage of this opportunity to adjust their planned capital actions in the 2018 CCAR exercise.

Visuals of 2018 CCAR and DFAST Results

Actual = Each BHC's reported capital ratio for Q4 2017, if available. Actual SLR ratios are reflected for advanced approaches BHCs based on the amounts the BHC reported under its company-run DFAST exercise (where available); where unavailable, amounts reflect data sourced from SNL Financial.

BHC DFAST = Lowest stressed capital ratio projected over the planning horizon under the **BHC's company-run DFAST** exercise, if available, which reflects the BHC's internal models as applied to the Supervisory Severely Adverse Stress Scenario and the DFAST capital action assumptions.

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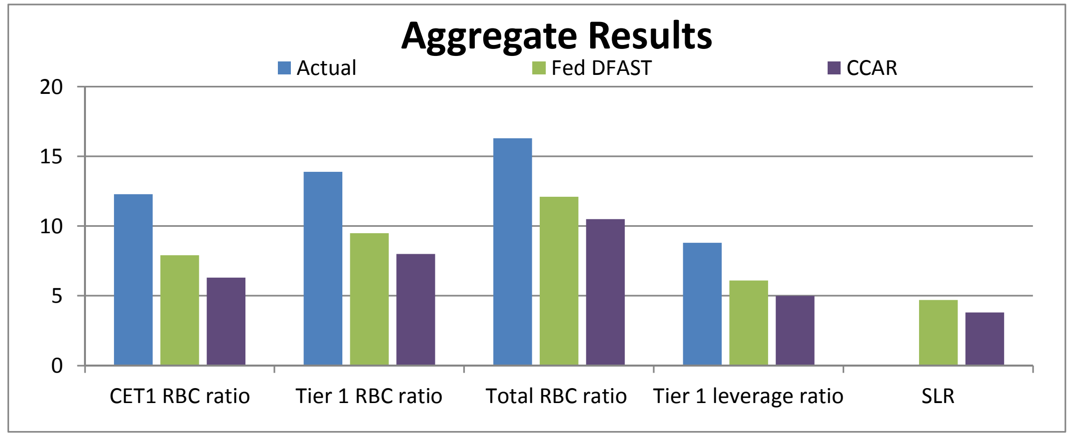
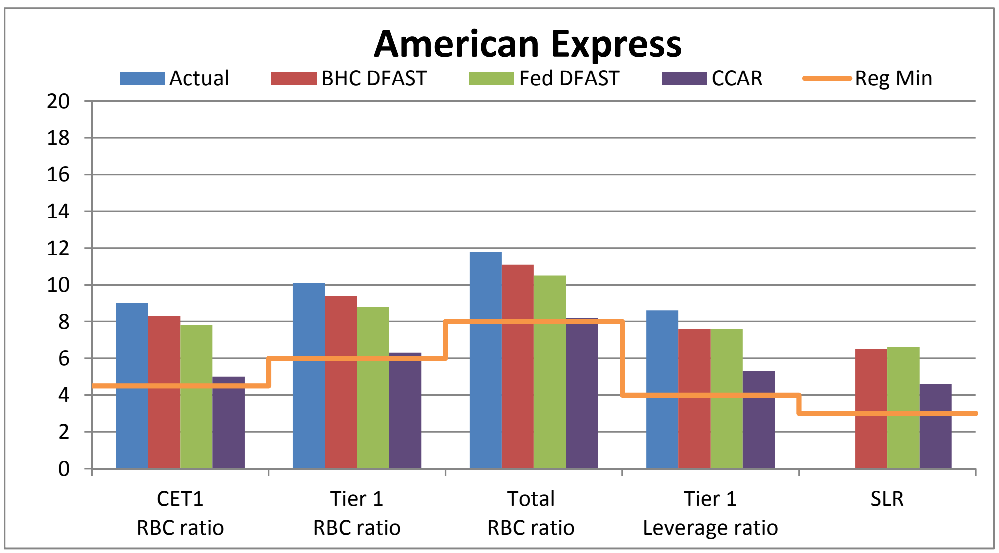
Reg Min = The required minimum capital ratios for each quarter of the planning horizon (2018:Q1 to 2020:Q1). All required minimum capital ratios exclude applicable capital buffers, including the enhanced SLR.

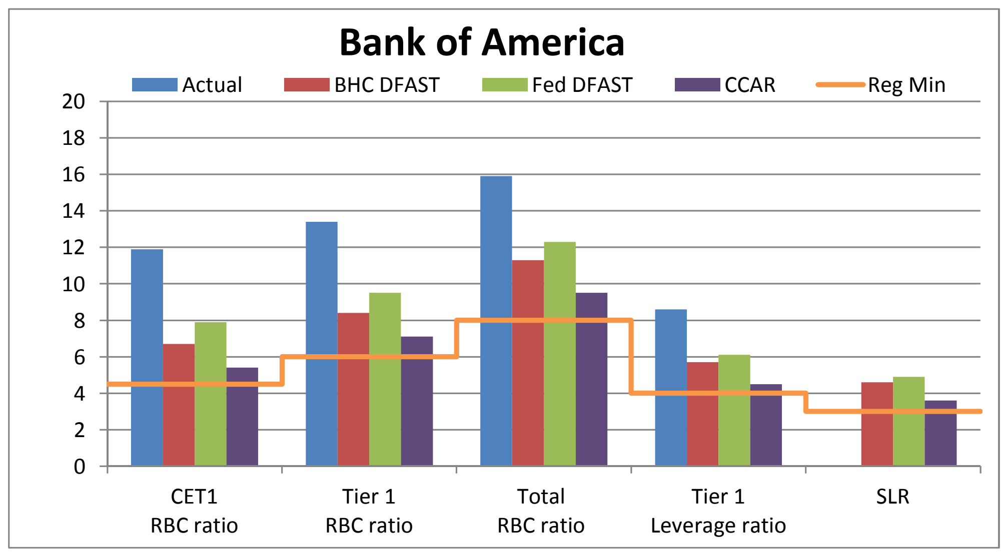
Snapshot: Change in Severity	2018	2017	Change
Avg. Starting CET1 Ratio	12.3%	12.5%	
Avg. Stressed Minimum CET1	7.9%	9.2%	
Average Peak-to-Trough CET1 Losses	4.4%	3.3%	33%

The 2018 severely adverse supervisory scenario was 33% more severe on average than the 2017 scenario.



Advanced Approaches BHCs





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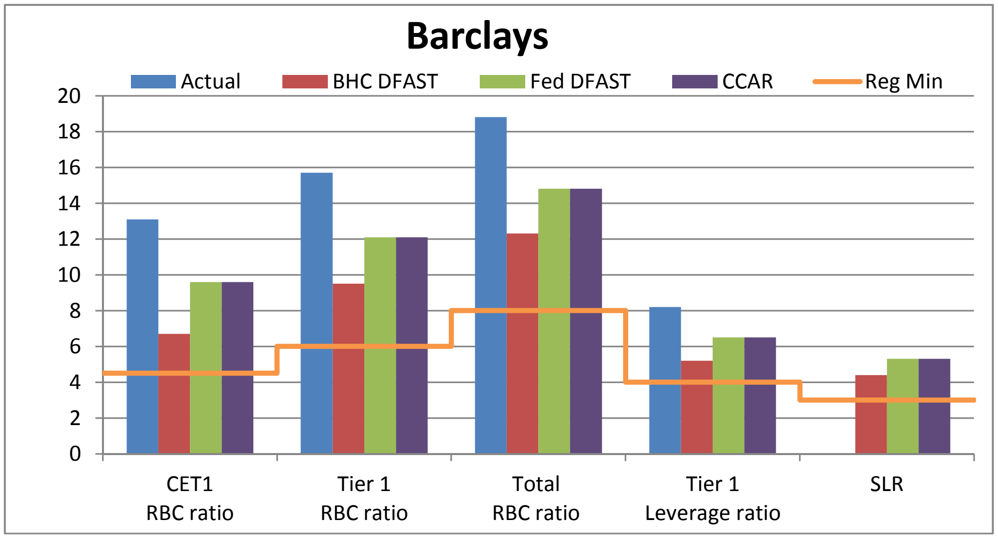

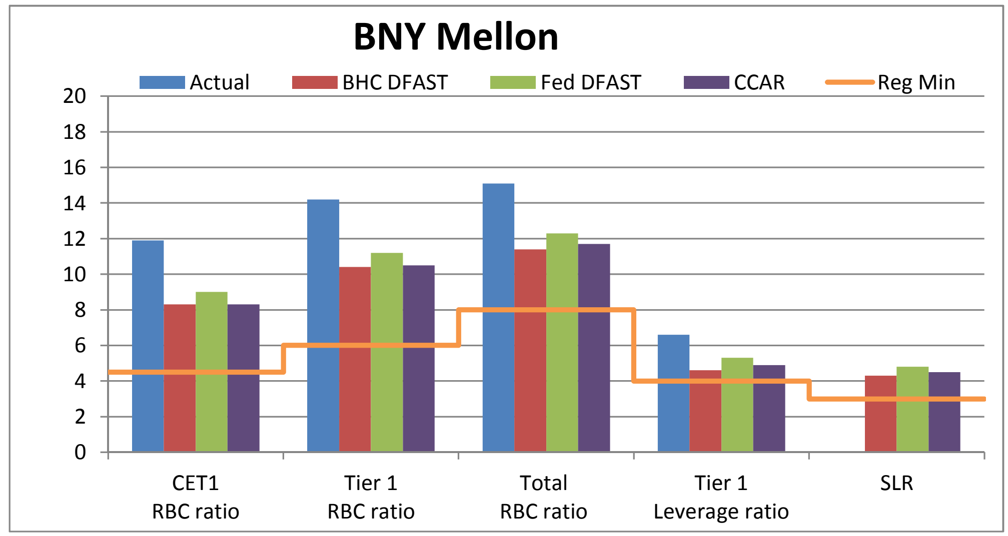

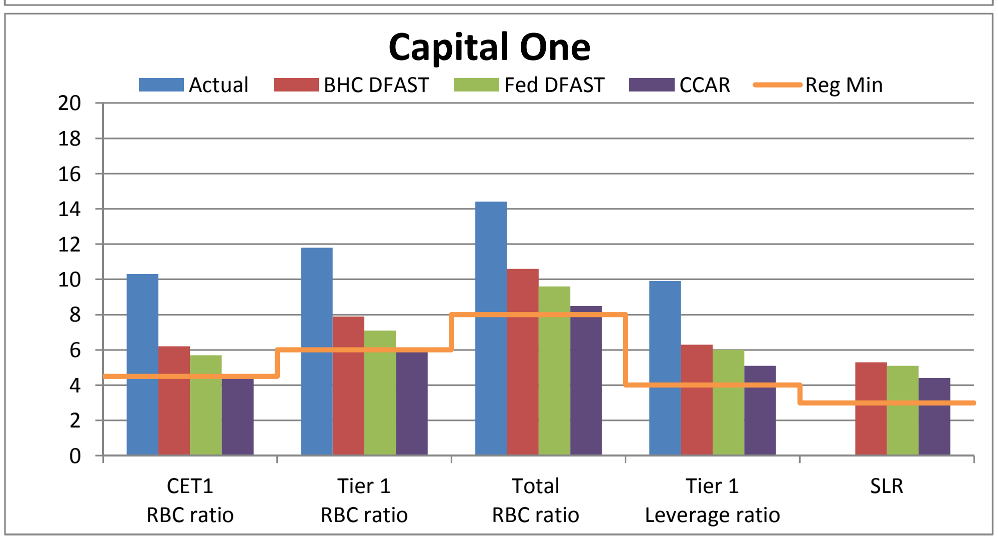

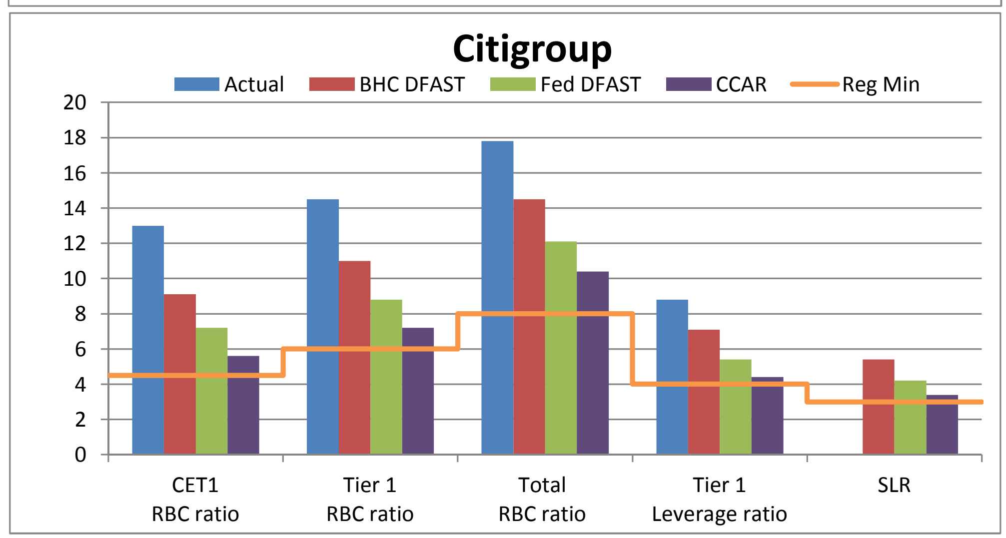

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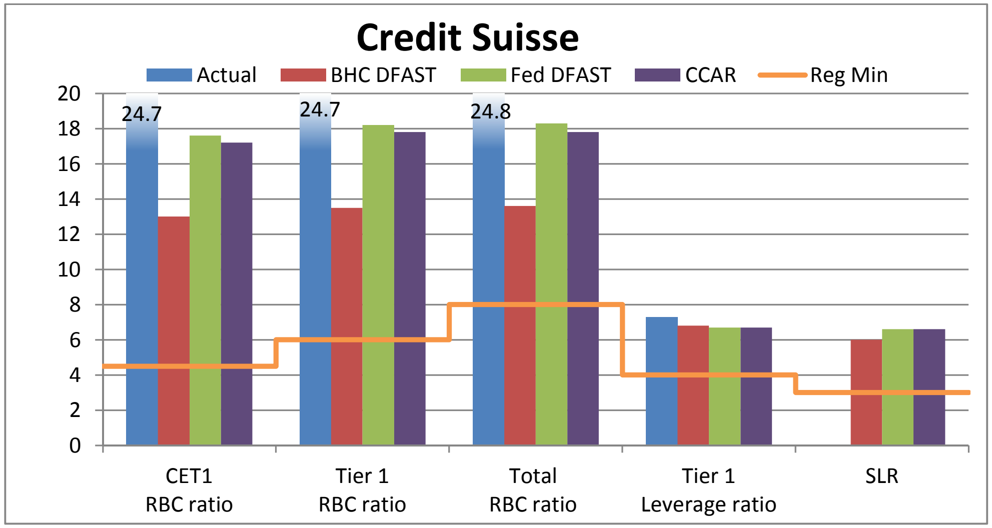

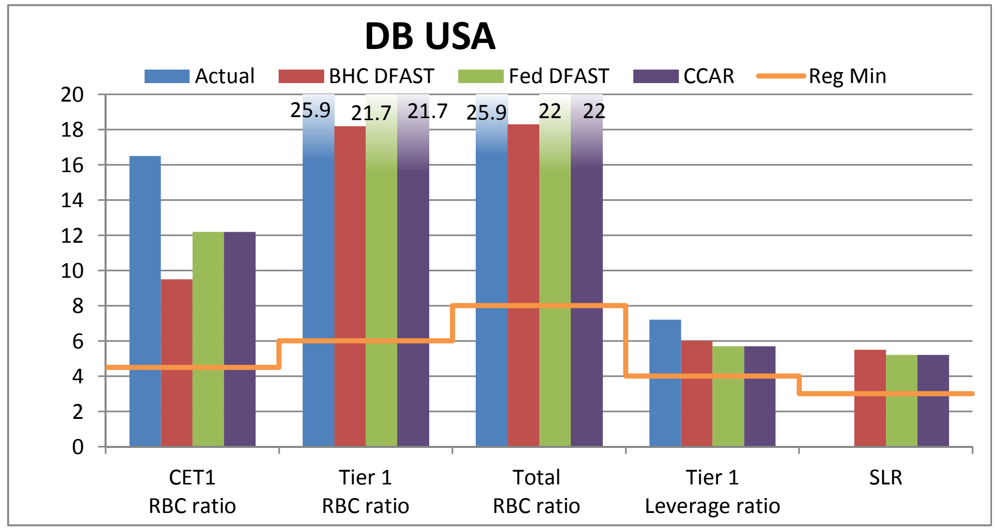

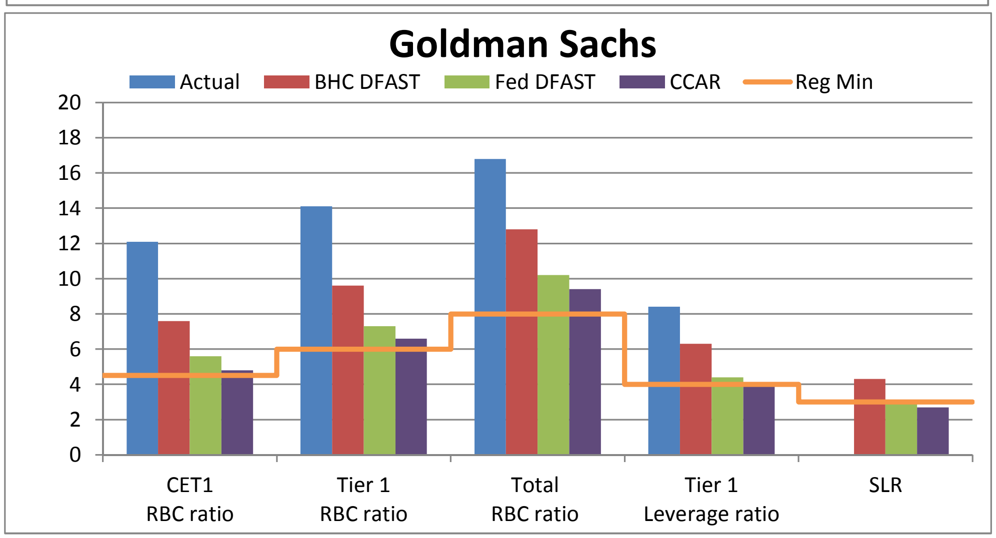

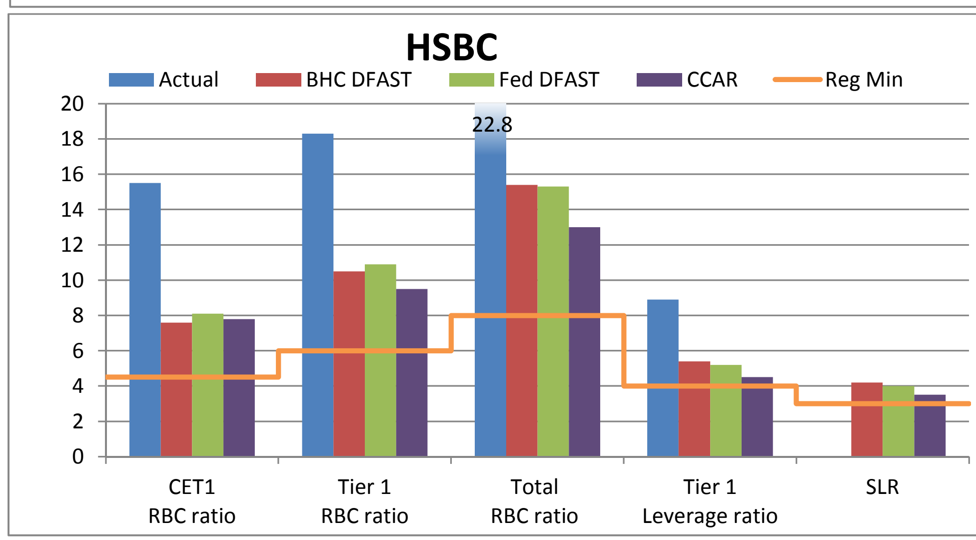

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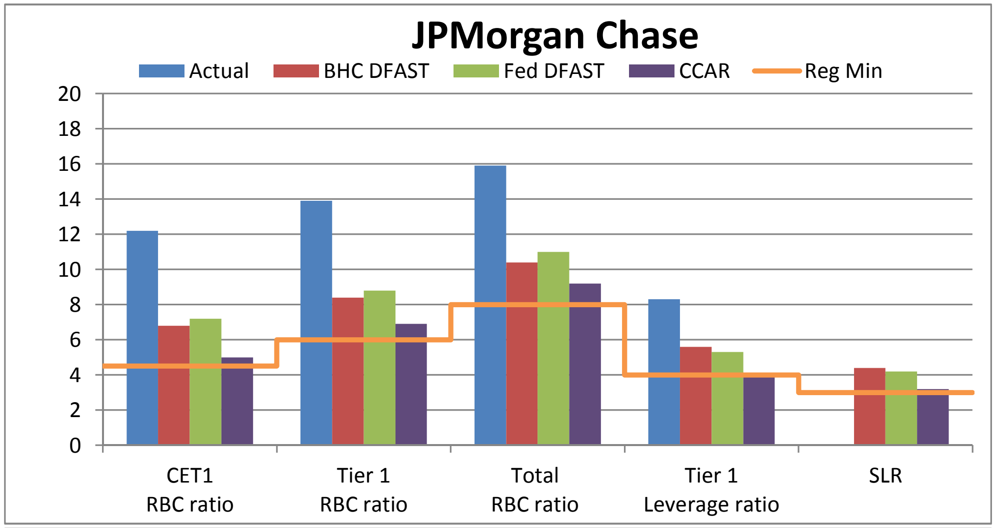

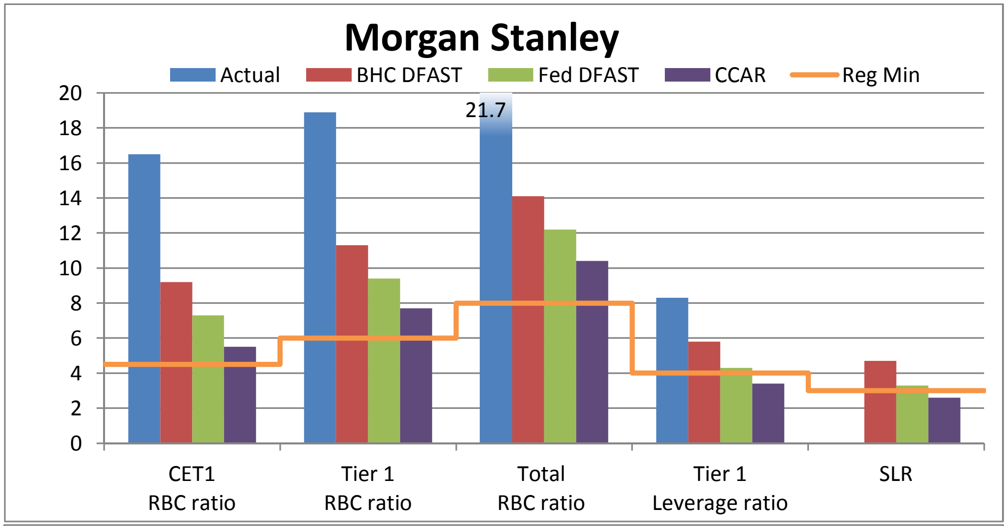

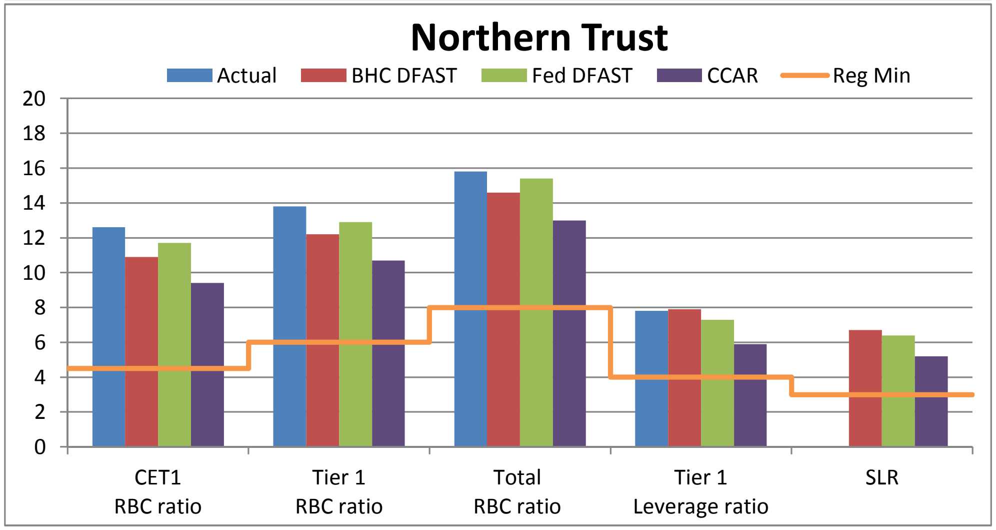

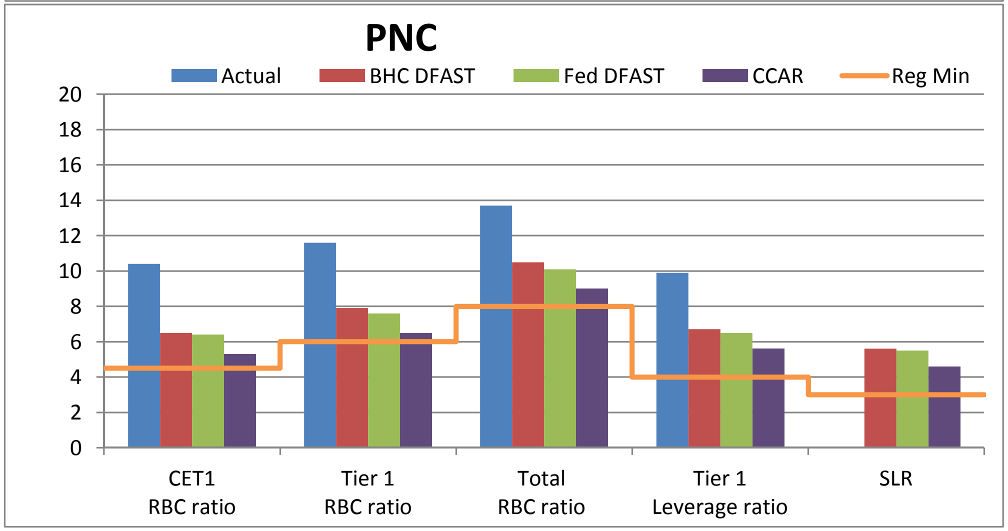

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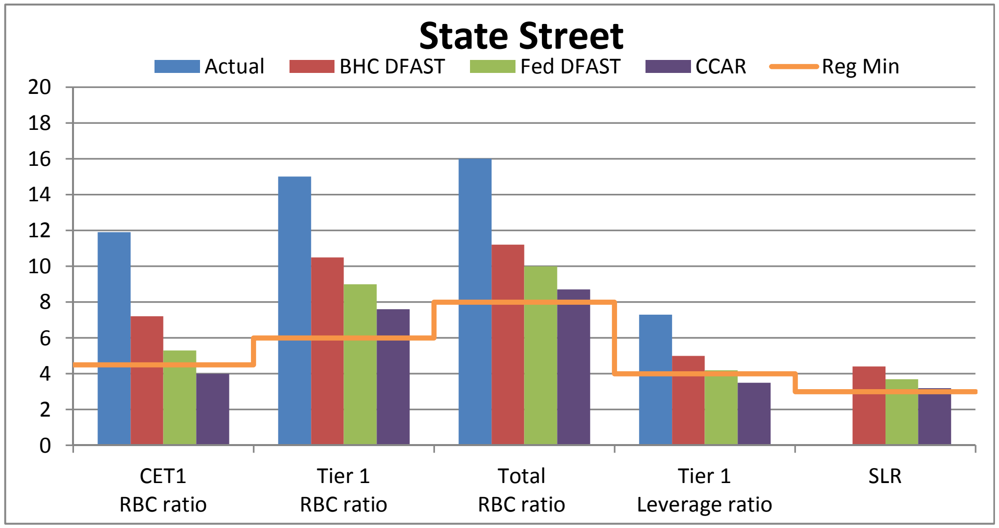

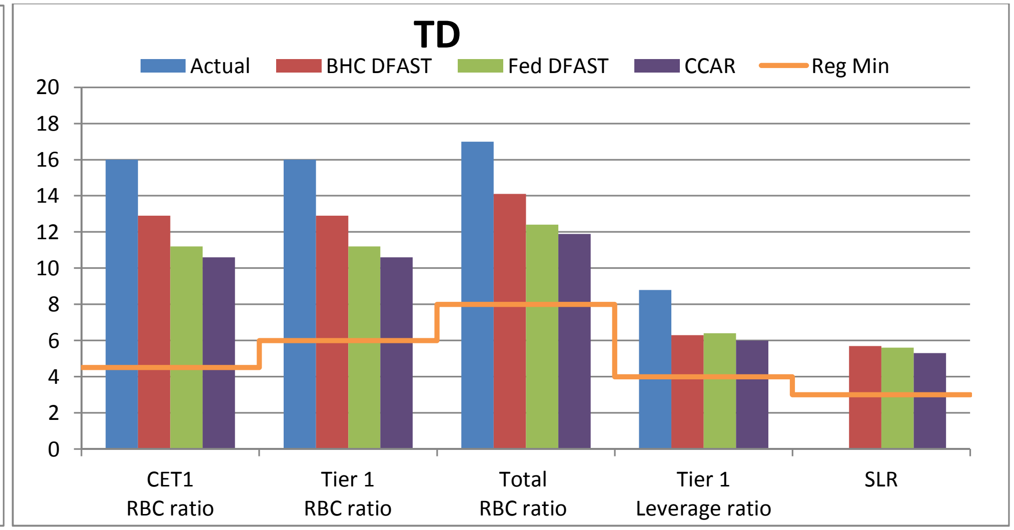

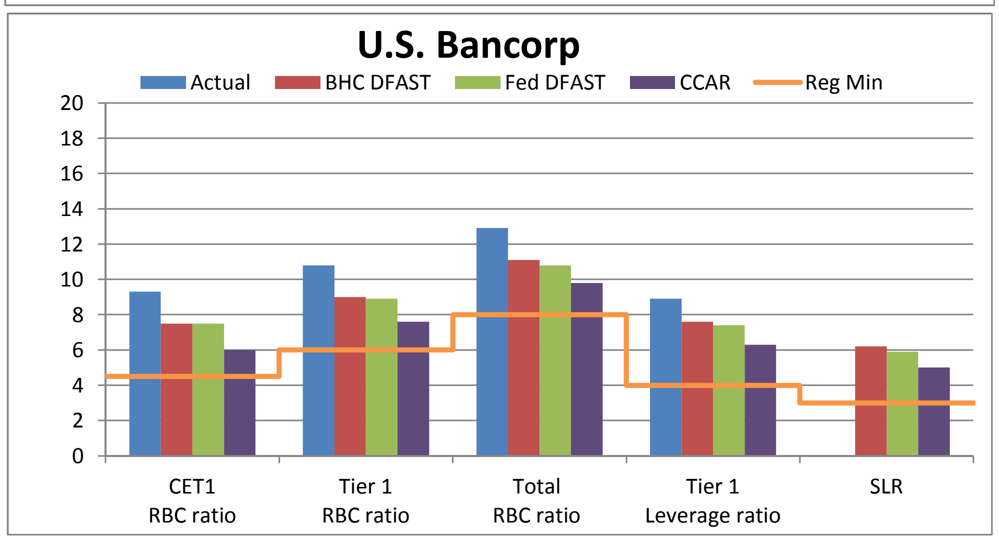

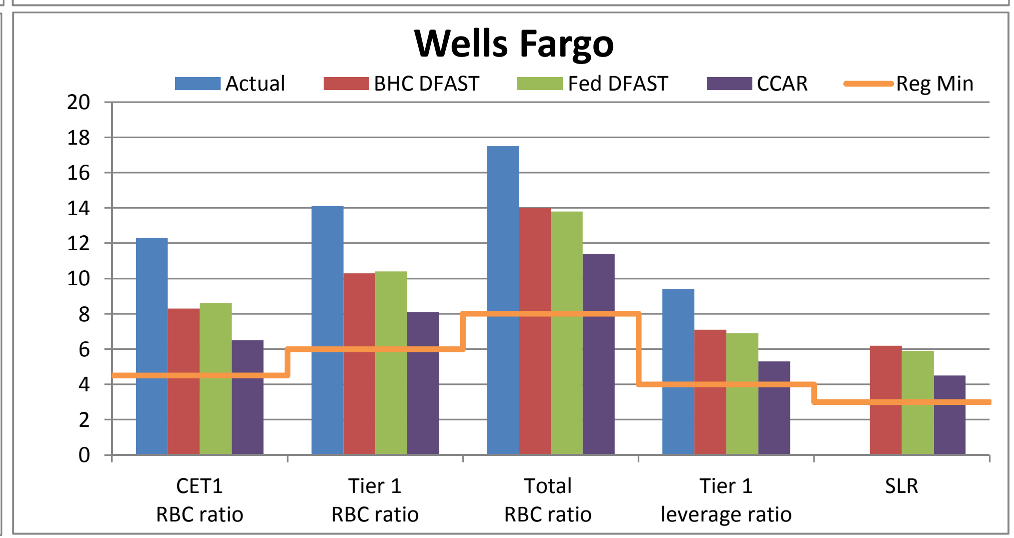

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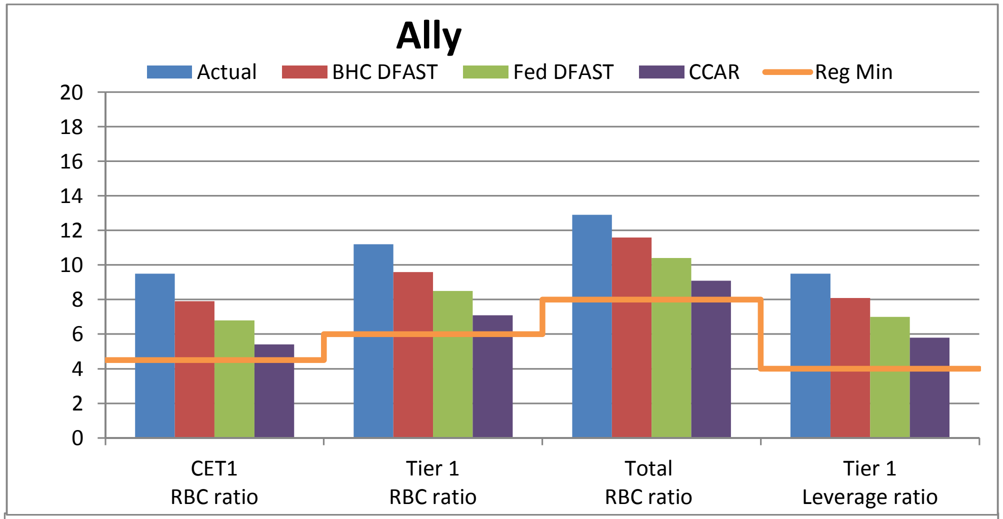
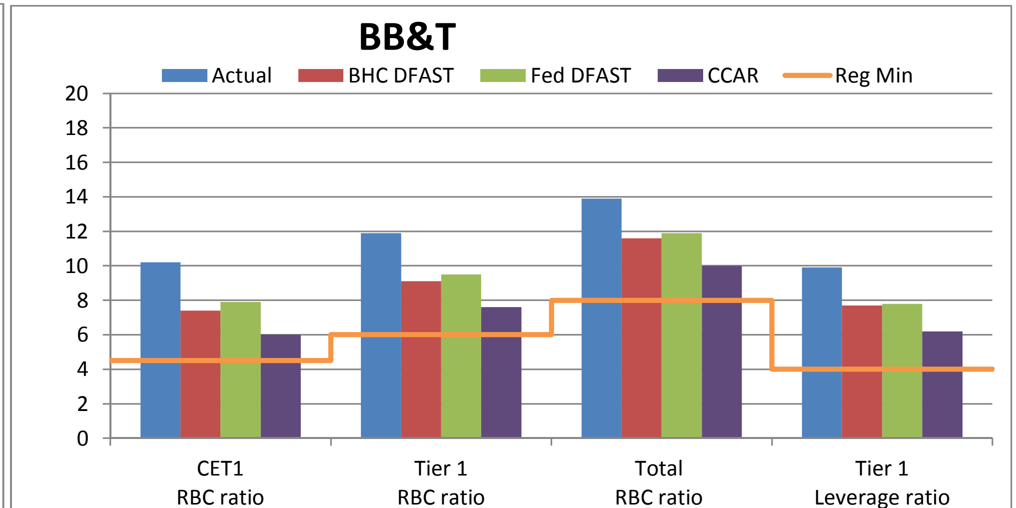
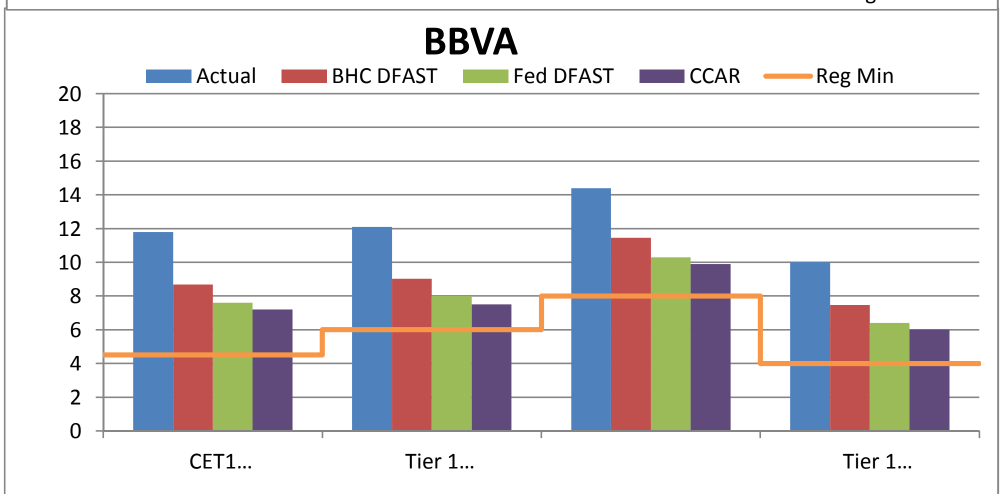
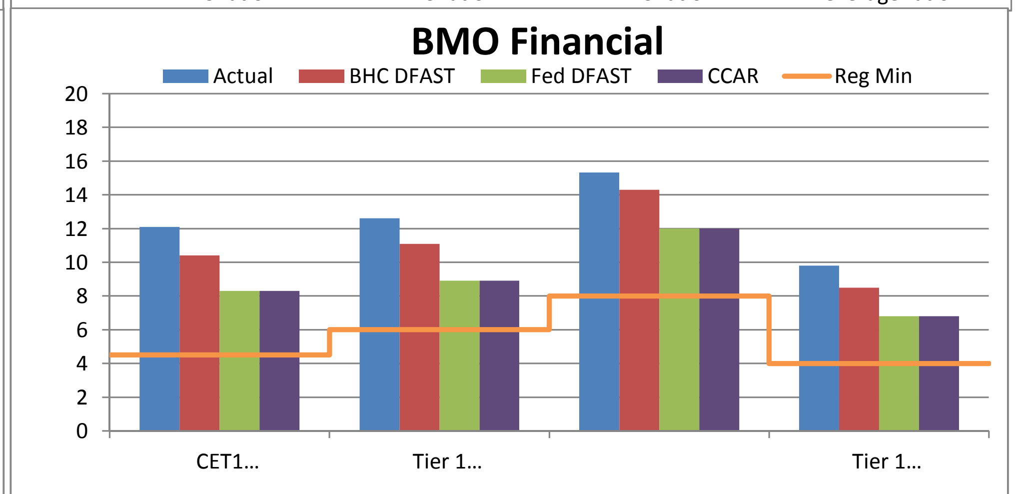
Non-Advanced Approaches BHCs









Visuals of 2018 CCAR and DFAST Results

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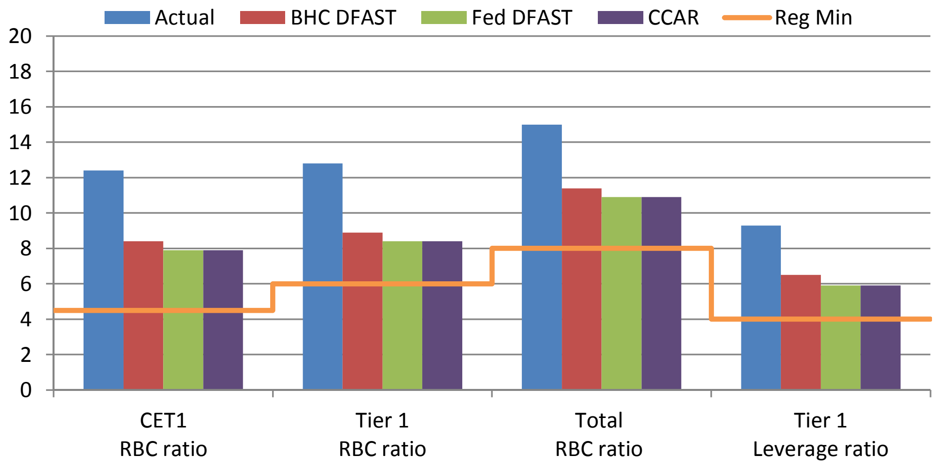
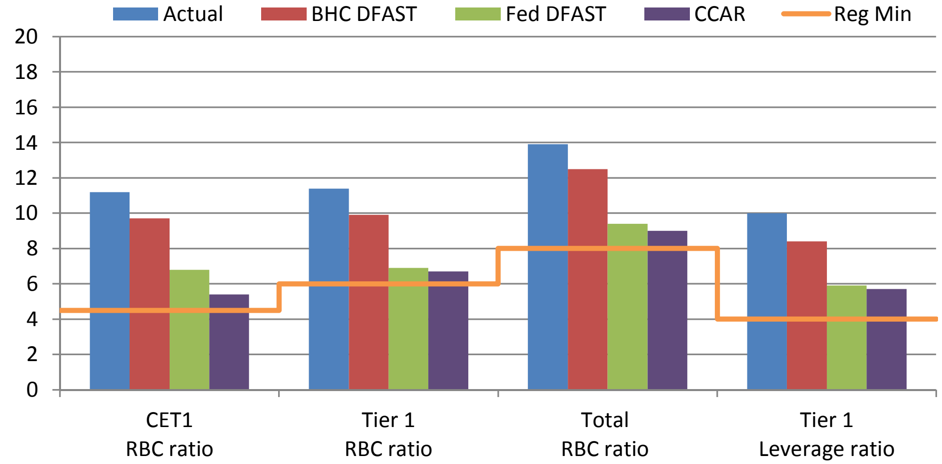
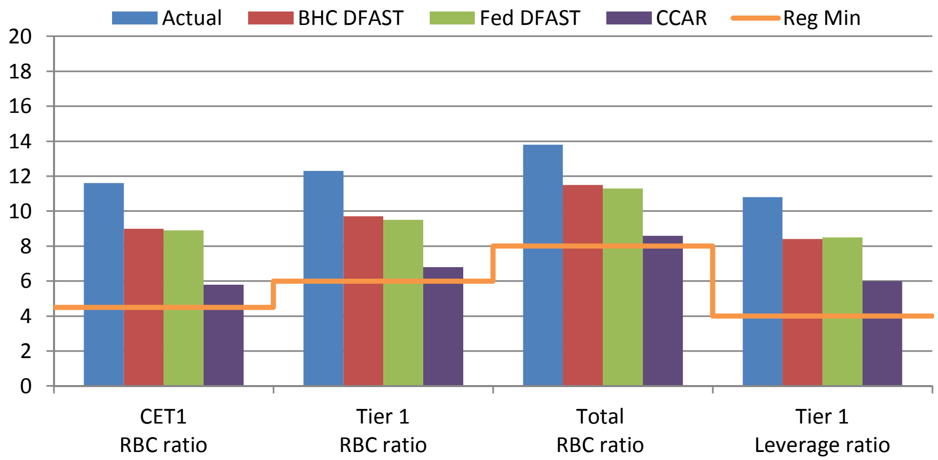
BNP Paribas



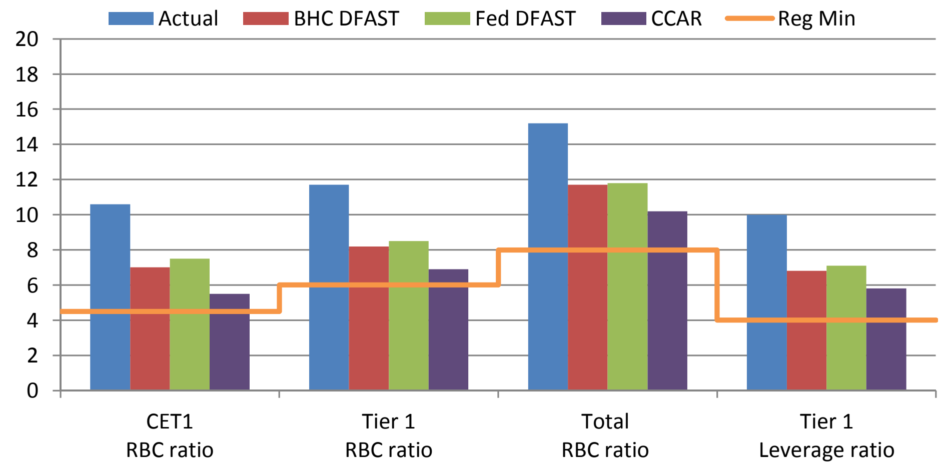
Citizens Financial



Discover



Fifth Third



Based on public data as of July 2, 2018

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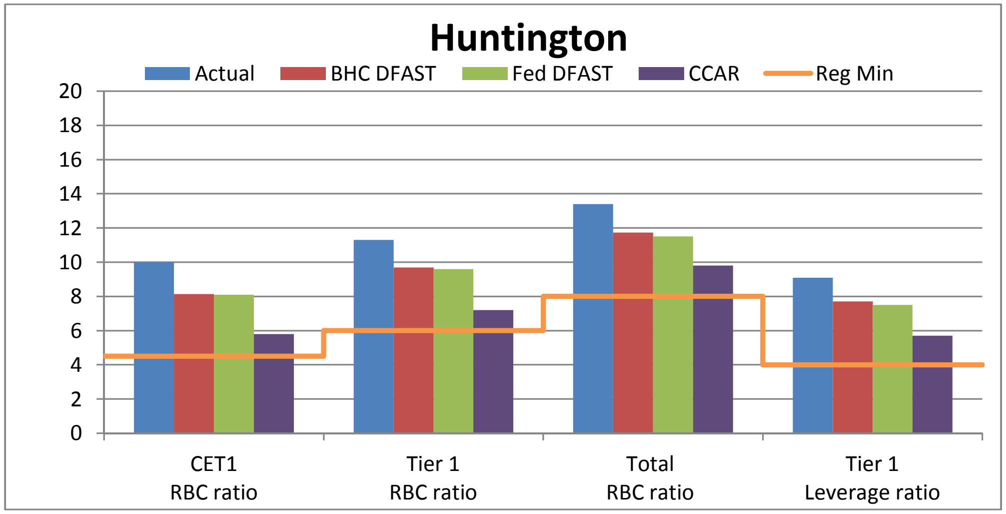

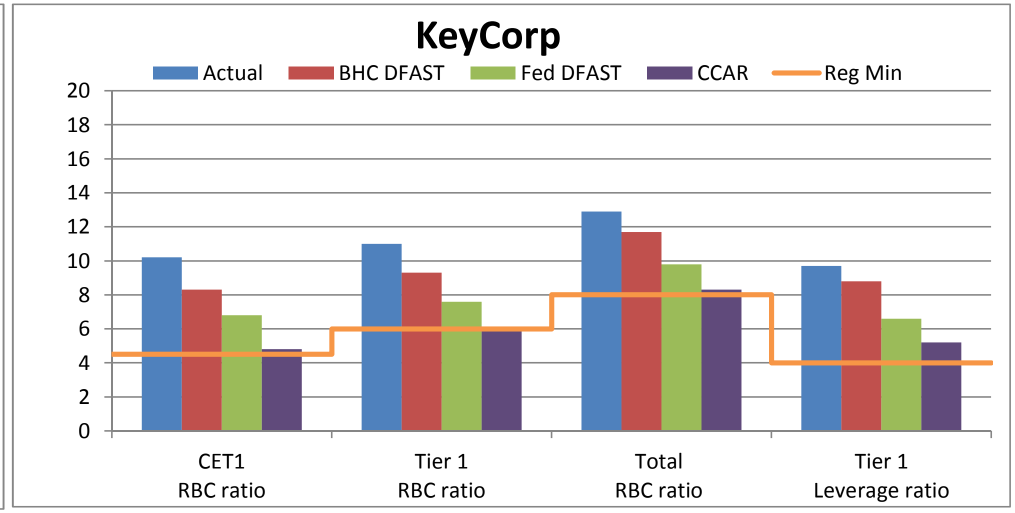

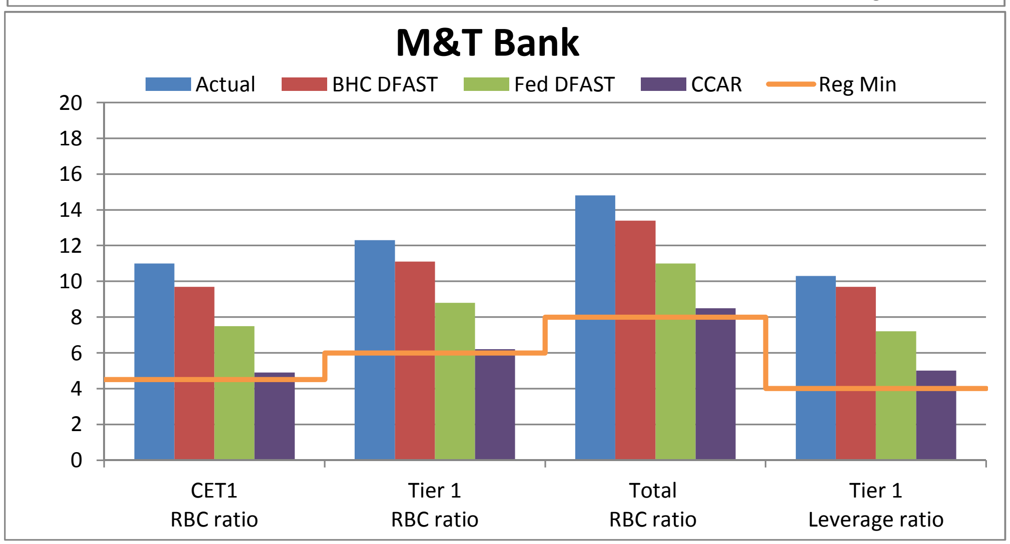

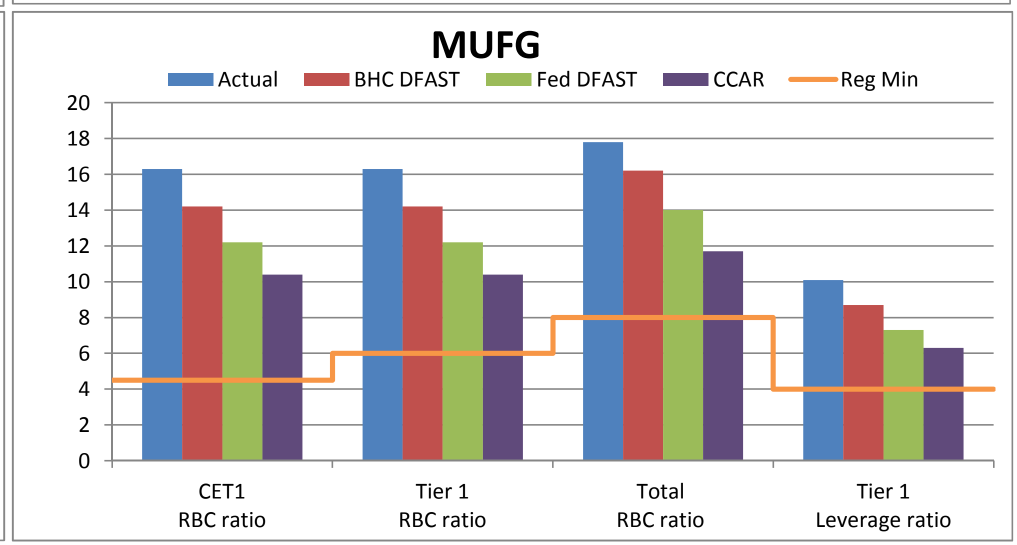

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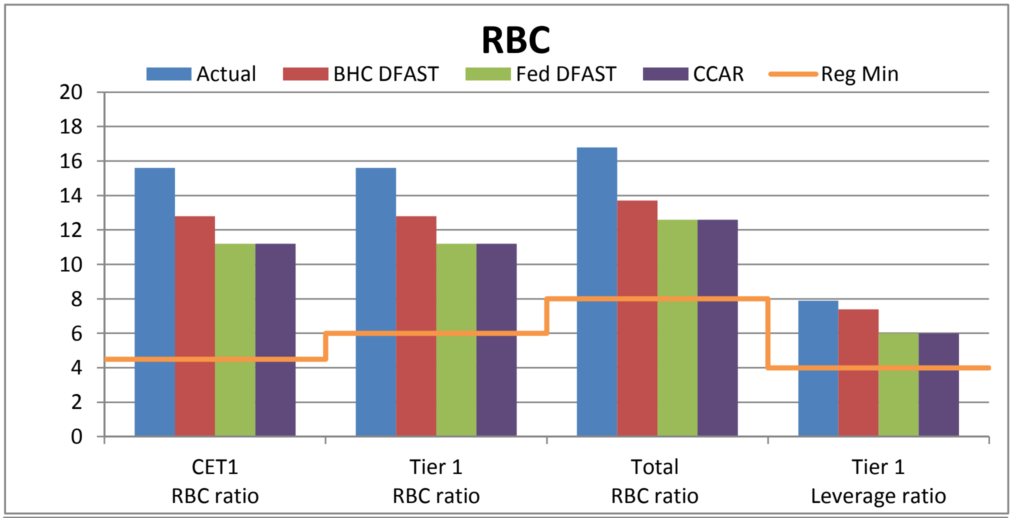

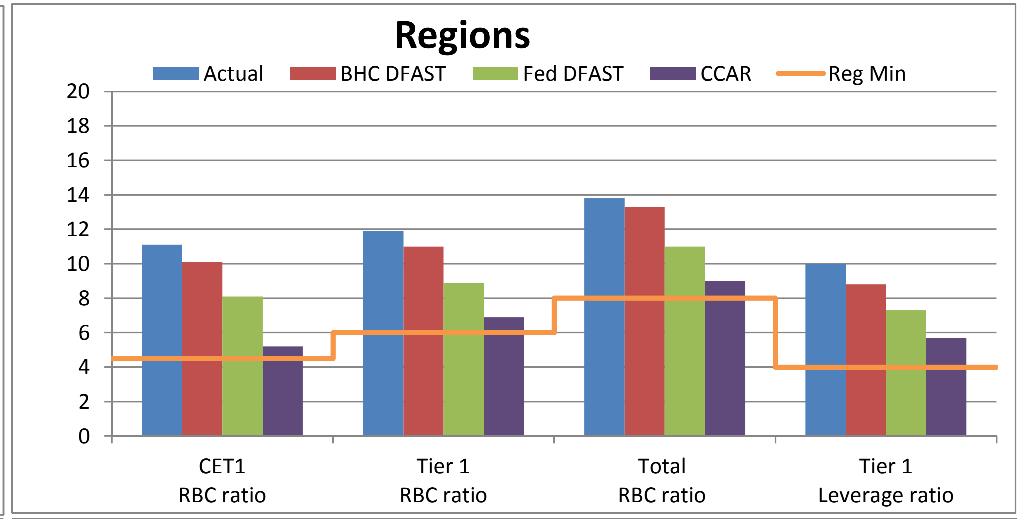

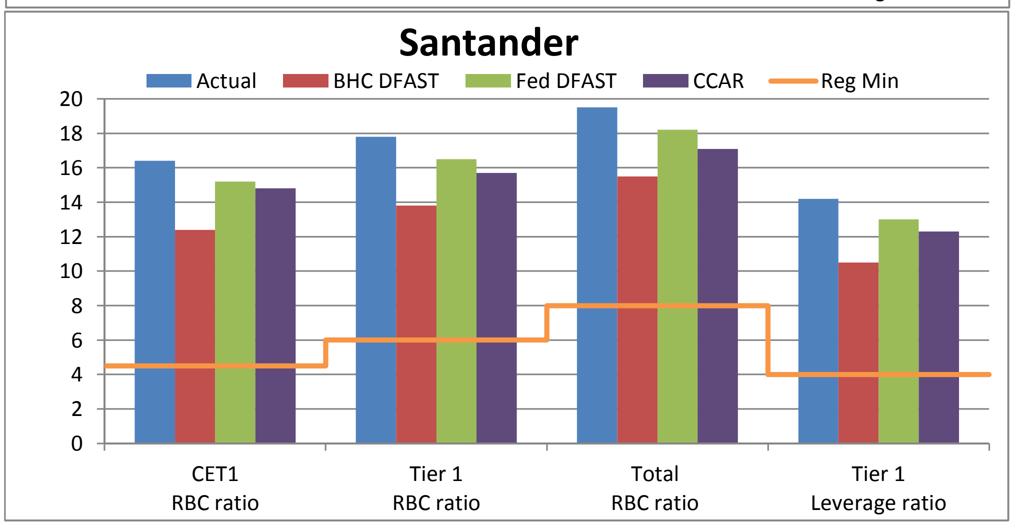

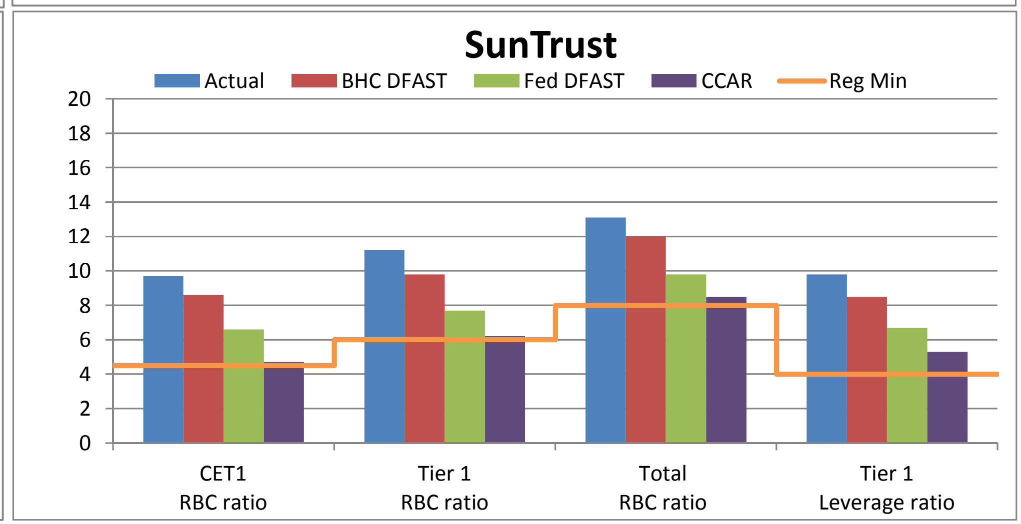

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