Financial Services Management

Stress Capital Buffer Framework

Cite
FRB, Final Rule; Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules

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Impact Assessment

- In general, large-BHC capital requirements will fall compared to those projected by the NPR or those under prior rules. However, capital-impact calculations depend on assumptions that will lead to wide outcome variance. Further, recent stress may make it difficult to differentiate CCAR 2020 results due to the SCB from those due to exogenous factors.
- Large BHCs are no longer required to serve as lending and liquidity utilities under stress, with the SCB deleting current CCAR requirements assuming ongoing balance-sheet growth under even severely-adverse scenarios. This is not likely to change actual cyclical behavior, but provides additional capital relief.
- Capital planning is now more flexible due to the increased ability for banks to raise capital distributions as long as they comply with the SCB.
- Overall capital changes are not so significant as to suggest heightened systemic risk or material reconfigurations of large-bank strategy. The extent to which capital is more counter-cyclical, systemic and macroeconomic risk will drop.

Overview

The Federal Reserve has finalized standards that, like the initial proposal,[1] create a new prudential framework combining risk-based capital regulation for the largest banking organizations with the Board's stress-testing CCAR construct.[2] However, unlike the original stress capital buffer (SCB) and an accompanying

[1] See **STRESS29**, *Financial Services Management*, April 18, 2018.

[2] See *Client Report* **STRESS31**, February 7, 2020.

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proposal,[3] the final rule does not add the enhanced supplementary leverage ratio (eSLR) into the new stress leverage buffer. Instead, as with the GSIB surcharge[4] and the counter-cyclical capital buffer (CCyB),[5] the eSLR remains part of the overall construct with which large banking organizations must comply to ensure capital-distribution capacity. Capital relief under this rule combines non-GSIB BHCs with assets over $100 billion and certain foreign banking organizations under the new tailoring framework[6] and CCAR standards to provide a simplified, more standardized, and less costly framework. The final rule also advances proposed changes to the Board's capital-plan requirements eliminating the authority the Board retained to object to a capital plan on quantitative grounds when it decided to eliminate its qualitative authority to do so for non-GSIB organizations. Instead, firms that fail the SCB are subject to automatic distribution restrictions.

Impact

In a break from the initial post-crisis capital and stress-test framework, the SCB replaces prior minimum risk-based capital (RBC) standards with a stressed framework that also, but to a more limited, non-stressed extent, takes the leverage ratio (LR) into account. The new approach is simpler than the prior multi-layer framework for large banks, reducing the number of applicable standards from thirteen to eight. It does so in part by incorporating minimum requirements without consideration of the current capital-conservation buffer[7] into a stressed framework requiring BHCs with assets over $100 billion to maintain all applicable minimum ratios including the GSIB surcharge and any CCyB in force at the time – plus any additional amount determined under CCAR.

This is thus likely to be a more counter-cyclical construct because assets will be risk-weighted not only for unexpected loss under benign scenarios, but also against the severely-adverse scenarios in CCAR. The CCAR now is counter-cyclical, but incorporating stress-testing into the fabric of actual minimum risk-based capital standards will, the Fed believes, enhance counter-cyclicality and, thus, systemic and macroeconomic resilience. It may also reduce regulatory burden.

Board staff and Vice Chairman Quarles concluded that the final SCB keeps GSIB Tier 1 capital about as is and reduces it considerably for other large banks. Results across the spectrum of covered banking organizations range from an average Tier 1 reduction over these years of $102 billion to an aggregate hike of $77 billion, with averaging in this methodology starting in 2013, before the U.S. Basel III rules were finalized, moving through a period of capital accumulation, changing macroeconomic conditions, and significant tax cuts that may complicate comparisons to forward-looking capital impact.

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[3] See **LEVERAGE13**, *Financial Services Management*, April 16, 2018.

[4] See **GSIB7**, *Financial Services Management*, July 23, 2015.

[5] See **CAPITAL213**, *Financial Services Management*, September 15, 2016.

[6] See **SIFI34**, *Financial Services Management*, October 23, 2019.

[7] See **CAPITAL199**, *Financial Services Management*, July 10, 2013.

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Gov. Brainard, who voted against the final rule, looked at capital results versus the most recent CCAR exercise from a CET1 perspective, concluding that the final rule reduces GSIB capital along with that of all the other large banks, creating a higher-risk construct. She was particularly unhappy that the eSLR no longer forms part of the over-arching stressed framework, but the rule defends this on grounds that the Fed has long sought to ensure that RBC – not LR – capital is a large bank's binding constraint to prevent regulatory arbitrage and resulting risk.

Gov. Brainard also opposed the final rule due to numerous changes giving large banks more flexibility within buffer calculations. These changes include ending the prior approval now required when CCAR companies increase capital distributions up to ceiling restrictions, instead mandating an *ex ante* advisory to the Board. While more liberal, the final rule reiterates that capital distributions that would bring a company below its SCB are barred.

Reflecting this prohibition, the final rule also eliminates the current requirement that CCAR anticipate all planned capital distributions over the test's nine quarters no matter the fact that companies can alter dividend or stock buy-backs if conditions change. Although industry commenters hoped that the Board would give BHCs discretion to fund capital distributions on a quarter-by-quarter basis, the final rule retains a pre-funding requirement for the tests' second four quarters – i.e., for the second year of the CCAR exercise. However, even with prefunding, distributions could not be made if doing so adversely affects minimum capitalization. All of this is done, the Board says, to ensure that BHCs do not repeat crisis history and make capital distributions under acute stress to placate worried investors.

As proposed, the final rule also eliminates the current CCAR standard requiring BHCs to assume balance-sheet growth capacity even under severely-adverse conditions. The Board originally required balance-sheet growth assumptions to ensure that large banks engaged in counter-cyclical lending. However, it is in fact unlikely that BHCs would continue to lend into a downturn no matter the capital on hand with which to do so. The final rule does not, however, go as far as some comments sought, disallowing assumptions that trading assets would shrink in the severely-adverse scenario.

Current rules do not require GSIBs to include the surcharge within their minimum requirements for CCAR, leading some commenters to argue that the GSIB surcharge should either be removed from the SCB or eliminated altogether. Rejecting this, the Board notes that the SCB will, like CCAR generally, be the GSIBs' binding capital constraint, minimizing the add-on impact of including it in the buffer. Any CCyB would, however, go beyond current requirements as no CCyB is currently triggered. A new definition of retained earnings also makes distribution reductions more gradual when banking organizations are experiencing capital reductions.

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What's Next

The Fed voted 4-1 to approve this rule by notation on March 4. It will be effective sixty days after publication in the *Federal Register*, timing that as noted permits the rule to affect capital planning for purposes of the 2020 CCAR round. The SCB is effective on October 1 of each year remaining in effect until the following September 31 unless the Board recalculates its SCB (see below). In 2020, third-quarter capital distributions may proceed as previously accepted by the Fed absent a firm-specific action.

Future rulemakings increasing CCAR transparency are planned.

Analysis

A. SCB Framework

1. Calculation

The SCB calculation factors in the difference between the starting and minimum projected CET1 ratio under the severely-adverse scenario plus planned common stock dividends for the fourth through seven quarters of the cycle. Falling below this level leads to restrictions on distributions and discretionary bonuses.

Under the final rule, the definition of eligible retained income for this calculation is changed to reflect quarterly average net income net of distributions or other factors not reflected in net income when a firm's standardized-approach capital is above minimums plus 2.5 percent and any applicable GSIB surcharge or CCyB. SCB firms are expected to know their capital position on a daily basis and resulting distributions, reducing distributions early in the quarter if the daily calculation is not robust.

2. Dividend Payouts

Under the final rule, additional scrutiny would not begin if dividend payouts exceed thirty percent of distributions.

3. Balance Sheet

As noted, the Board has withdrawn prior policy assuming balance-sheet growth under even acute stress. Now, securities, trading, and credit portfolios are assumed to remain unchanged.

4. Business-Plan Changes

In a change from the NPR, the final rule does not require incorporation of material business-plan changes (e.g., M&A) into the SCB. The Board made this change on grounds that calculating these implications in the SCB and then again upon transaction consummation is duplicative and unnecessary. Even so, capital plans must include discussion of the capital and liquidity implications of any material business plan revision. If plan changes are deemed by the Fed to

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meaningfully change the organization's risk profile, the capital plan may need to be resubmitted and the Board may thereafter recalculate the SCB.

B. Capital Planning

1. FRB Judgments

As noted, there will no longer be quantitative objections to capital plans, with the Fed instead relying on the automatic distribution restrictions described above. Where qualitative objections remain an option, the Board will not look at actual SCB levels, but instead focus on outstanding material supervisory matters and similar considerations.

2. Planning

Firms must plan to comply with capital rules in their baseline-scenario projections.

3. Changes

As noted, prior approval is no longer necessary for distribution increases as long as these are below automatic-distribution restrictions or other prior-approval requirements (i.e., in the event of a qualitative objection) do not apply to the company. However, notice to applicable Reserve Banks must be sent following any such additional distributions.

C. Timelines

These are adjusted to align CCAR and the new SCB. Prior black-out periods in which distribution increases were barred are ended.

D. Regulatory Reporting

The final rule also requires a series of reports on SCB levels and components.

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