DATE: January 17, 2012

MEMORANDUM TO: Board of Directors

FROM: Sandra L. Thompson
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General Counsel

SUBJECT: Stress Testing Requirements for Certain Banks: Notice of Proposed Rulemaking to Implement Section 165(i)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act

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Recommendation: Staff recommends that the Board approve a *Notice of Proposed Rulemaking* (NPR) to implement section 165(i)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). The NPR requires certain banks to perform annual stress tests subject to parameters prescribed by the FDIC. The Office of the Comptroller of the Currency ("OCC") and the Federal Reserve Board ("FRB") will issue substantively identical proposed rules. If approved, the NPR will be published in the *Federal Register* with a 60-day public comment period.

I. Introduction

Section 165(i)(2) of the Act instructs the FDIC to issue regulations that require FDIC-insured state nonmember banks and FDIC-insured state-chartered savings associations with total consolidated assets of more than $10 billion ("covered banks") to conduct certain stress tests on an annual basis. Further, the Act requires that such regulations: (1) define the term "stress test"; (2) establish methodologies for the conduct of the stress tests that provide for at least three different sets of conditions, including baseline, adverse, and severely adverse conditions; (3) establish the form and content of a required regulatory report on the stress tests; and (4) require covered banks to publish a summary of the results of their stress tests.

The NPR proposes to implement section 165(i)(2) of the Act which requires each primary federal financial regulatory agency, including the Corporation, to issue consistent and comparable stress testing regulations in coordination with the Board and the Federal Insurance Office. The NPR will be issued along with the OCC's proposed stress testing requirements for covered national banks and the FRB's proposed rules relating to stress testing for covered companies and covered state member banks. Staff anticipates that the federal banking agencies will issue supplemental guidance and instructions dealing with stress testing activities in general and compliance with this regulation in particular.

The stress testing requirements detailed in the NPR will provide the Corporation with forward-looking information regarding a covered bank that will assist the Corporation in assessing that bank's capital adequacy. The stress testing requirements would also help the Corporation better identify potential downside risks and the potential impact of adverse outcomes on a covered bank's capital adequacy and assist in ensuring each covered bank's financial stability. In addition, the stress testing requirements will improve covered banks' internal assessments of capital adequacy and overall capital planning processes.

II. Summary of the NPR

The NPR would require covered banks to conduct annual stress tests. Covered banks are defined as any state nonmember bank or state-chartered savings association that has more than $10 billion in total consolidated assets, as determined based on the average total consolidated assets as reported on the state nonmember bank's four most recent Reports of Condition and Income (Call Reports) or on the state savings association's four most recent Thrift Financial Reports (TFRs). Once an entity becomes a covered bank, it would remain a covered bank unless and until it has $10 billion or less in total consolidated assets, as determined based on the average total consolidated assets as reported on either its four most recent Call Reports or its four most recent TFRs.

The NPR would recognize that certain parent company structures of covered banks may include one or more financial companies, each with total consolidated assets greater than $10 billion.

The stress test requirements of section 165(i)(2) apply to the parent company and to each subsidiary financial company (including covered banks) that individually have more than $10 billion in total consolidated assets. Accordingly, the NPR states that the Corporation will coordinate with the other primary federal financial regulatory agencies to avoid unnecessary complexity or duplication of effort associated with these requirements, including by coordinating the development of scenarios, as appropriate.

The NPR would define the term "stress test" as a process to assess the potential impact on a covered bank of economic and financial conditions on the consolidated earnings, losses, and capital of a covered bank over a set nine-quarter planning horizon, taking into account the current condition of the covered bank and its risks, exposures, strategies, and activities.

In advance of the annual stress tests required of all covered banks, the FDIC would provide at least three scenarios (baseline, adverse, and severely adverse scenarios) that each covered bank must use to conduct its annual stress test. Each covered bank would be required to conduct annual stress tests using data as of September 30 for any given calendar year.

Each covered bank would be required to use the applicable scenarios, as provided annually by the FDIC, to calculate, for each quarter-end within the planning horizon: (i) potential losses, (ii) pre-provision net revenues, (iii) loan loss reserves, and (iv) *pro forma* capital positions over the planning horizon, including the impact on capital levels and ratios. Each covered bank would also be required to calculate, for each quarter-end within the planning horizon, the potential impact of the specific scenarios on its capital ratios.

In early January of each following year, the FDIC would collect a covered bank's stress test results and additional qualitative and quantitative information about the tests on a confidential basis. Staff anticipates that the specific requirements and instructions for the report that covered banks would submit to the FDIC would be published separately for notice and comment (in coordination with the other federal financial regulatory agencies) before requiring banks to perform the stress tests described in the NPR. Within 90 days of the end of the stress tests, each covered bank would also be required to publish a summary of its results.

Following the submissions of the required reports from covered banks, the Corporation would conduct an analysis of the quality of each covered bank's stress test processes and related results. Staff envisions that feedback about such analysis would be provided to a covered bank through the supervisory process. In addition, each covered bank would be required to take into account the results of the annual stress test, in conjunction with the FDIC's analyses of those results, when making changes, if appropriate, to: the bank's capital structure (including the level and composition of capital); its exposures, concentrations, and risk positions; any plans of the covered bank for recovery and resolution; and improvement of the overall risk management of the firm.

The NPR would require each covered bank to establish and maintain a system of controls, oversight, and documentation, including policies and procedures, designed to ensure that the stress testing processes used by the bank are effective in meeting the requirements of the NPR. The policies and procedures must, at a minimum, describe the covered bank's stress testing practices and methodologies, validation processes, use of stress test results, and processes for updating the bank's stress testing practices consistent with applicable supervisory guidance. The board of directors and senior management of each covered bank must approve and annually review the controls, oversight, and documentation, including policies and procedures of the covered bank established in the NPR.

Staff expects that the stress test requirements contained in the NPR would be one component of the broader stress testing activities conducted by covered banks. The broader stress testing activities should address the impact of a broad range of potentially adverse outcomes across a broad set of risk types affecting other aspects of a bank's financial condition beyond capital adequacy alone.

III. Conclusion

Staff recommends that the Board approve for publication in the *Federal Register* the attached NPR. The NPR establishes stress testing requirements for covered banks to provide the FDIC with forward-looking information to assist in assessments of a covered bank's capital adequacy, help to better identify potential downside risks and the potential impact of adverse outcomes on the covered bank's capital adequacy, and to assist in ensuring the institution's financial stability.

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