

DATE: October 15, 2019

MEMORANDUM TO: The Board of Directors

FROM: Doreen R. Eberley
Director
Division of Risk Management Supervision

SUBJECT: Final Rule: Company-Run Stress Testing Requirements for FDIC-supervised State Nonmember Banks and State Savings Associations

Recommendation: Staff recommends that the FDIC Board of Directors (“FDIC Board”) approve the attached final rule entitled “Company-Run Stress Testing Requirements for FDIC-supervised State Nonmember Banks and State Savings Associations” (“final rule”). The final rule would codify amendments to the FDIC’s stress testing regulations at 12 CFR Part 325 (“Part 325”) that were proposed by the FDIC on December 28, 2018 (“proposed rule or proposal”). These amendments would be adopted as proposed and would implement section 401 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (“EGRRCPA”) by: (1) raising Part 325’s applicability threshold from \$10 billion to \$250 billion, (2) revising the frequency of required stress tests, and (3) reducing the number of required stress testing scenarios from three to two. The final rule would also make certain conforming and technical changes, including some previously included in an April 2, 2018 notice of proposed rulemaking (“April NPR”) that was largely superseded by the enactment of EGRRCPA. FDIC staff developed the final rule in coordination with staff of the Board of Governors of the Federal Reserve System (“FRB”) and the Office of the Comptroller of the Currency (“OCC”), and anticipates that the FRB and OCC will issue consistent and comparable final rules. If approved,

Concurrence:

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General Counsel

the final rule will be published in the *Federal Register* with an effective date 30 days after publication.

Background

As originally enacted, section 165(i)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act¹ (“Dodd-Frank Act”) required a financial company, including an insured depository institution with total consolidated assets of more than \$10 billion and regulated by a primary federal regulatory agency, to conduct annual company-run stress tests (“stress tests”), and required, among other things, the use of “baseline,” “adverse,” and “severely adverse” scenarios. Section 165(i)(2)(C) also requires each primary federal regulator to issue consistent and comparable rules to implement the annual stress testing requirements. In October 2012, the FDIC, FRB, and OCC issued such rules,² with the FDIC’s rules incorporated in Part 325.³

Section 401 of EGRRCPA amended section 165(i)(2) by: (1) raising the minimum asset threshold for stress tests from \$10 billion to \$250 billion; (2) replacing the requirement for “annual” stress tests with a requirement for “periodic” stress tests; and (3) eliminating the “adverse” scenario requirement. The EGRRCPA amendments become effective on November 24, 2019 (eighteen months after enactment).

The April NPR proposed certain revisions to Part 325⁴ that are no longer relevant as a result of EGRRCPA’s enactment.⁵ However, other revisions originally proposed in the April

¹ 12 U.S.C. § 5365(i).

² 77 FR 62417 (October 15, 2012) (FDIC); 77 FR 62380 (October 12, 2012) (FRB); 77 FR 61238 (October 9, 2012) (OCC).

³ The FDIC’s stress test rule was originally incorporated as Subpart C of Part 325. Following the rescission of Subparts A and B of Part 325, Part 325 consists exclusively of the stress test rule and the stress test rule is no longer designated as Subpart C. 83 FR 17737 (April 24, 2018).

⁴ 83 FR 13880 (April 2, 2018).

⁵ Notably, Part 325 differentiates between “\$10 to \$50 billion covered banks” and “over \$50 billion covered banks,” with different requirements applying to each subcategory, and the April NPR proposed extending the transition

NPR remain necessary in order to maintain consistency among the FDIC's, FRB's, and OCC's stress testing regulations applicable to insured depository institutions.

Summary of the Proposed Rule

On December 28, 2018, the FDIC published the proposed rule in the *Federal Register* to amend Part 325 consistent with section 401 of EGRRCPA. Specifically, the proposal would have raised the applicability threshold for covered banks required to conduct stress tests from \$10 billion to \$250 billion, reduced the frequency by which covered banks would generally be required to conduct stress tests from annually to biennially, and eliminated the requirement that covered banks use the “adverse” scenario when conducting stress tests. The proposal also included various technical changes to facilitate the above revisions, a proposed transition period, and proposed revisions to the regulation’s reservation of authority, as well as the necessary revisions initially proposed in the April NPR, such as extending the as-of date range for trading and counterparty components for covered banks with significant trading activities.

Summary of Comments on the Proposed Rule

The FDIC received six comments in response to the proposed rule.⁶ With respect to raising the applicability threshold from \$10 to \$250 billion, some commenters supported raising the threshold, others acknowledged that such a revision was statutorily required, and others expressed concern about eliminating stress testing requirements for banks under \$250 billion. With respect to the removal of the “adverse” scenario, some commenters supported the proposed

period in which covered banks that migrated from “\$10 to \$50 billion covered banks” to “over \$50 billion covered banks” would have to comply with the requirements applicable to “over \$50 billion covered banks.” Section 401 of EGRRCPA renders this aspect of the April NPR moot by requiring stress testing by financial companies with over \$250 billion in total consolidated assets.

⁶ Comments are available on the FDIC’s website at: <https://www.fdic.gov/regulations/laws/federal/2018/2018-company-run-stress-testing-requirements-3064-ae84.html>.

rule's elimination of the "adverse" scenario,⁷ some acknowledged that removing the "adverse" scenario is statutorily required, and others expressed concern that eliminating the "adverse" scenario may reduce the efficacy of company-run stress testing.

With respect to the proposed rule's requirement that covered banks generally be subject to biennial stress testing, some commenters supported this as an appropriate frequency for most covered banks, while others contended that changing the frequency from annual to biennial would not be appropriate and raised risk management and testing credibility concerns.

The Final Rule

Staff recommends that the Board adopt the final rule without change as described in detail below.

Covered Banks

Section 401 of EGRRCPA raised the applicability threshold for company-run stress testing by financial companies from \$10 billion to \$250 billion. Like the proposed rule, the final rule would eliminate the two existing subcategories of "covered bank"—"\$10 to \$50 billion covered bank" and "over \$50 billion covered bank"—and would revise the term "covered bank" to mean a state nonmember bank or state savings association with average total consolidated assets that are greater than \$250 billion. In addition, the final rule would make certain technical and conforming changes to 12 CFR Part 325 in order to consolidate requirements, such as those related to reporting and publication, that are currently referenced separately with respect to \$10 billion to \$50 billion covered banks and over \$50 billion covered banks.

⁷ One commenter recommended that the FDIC, OCC, and FRB not include the adverse scenario in the 2019 stress tests. The FDIC did not consider it necessary to do so, and notes that the EGRRCPA amendments to the Dodd-Frank Act's company-run stress testing requirements are effective November 24, 2019.

Frequency of stress testing

Section 401 of EGRRCPA changed the requirement under section 165 of the Dodd-Frank Act to conduct stress tests from “annual” to “periodic.” The final rule would provide that, in general, an FDIC-supervised institution that is a covered bank as of December 31, 2019, would be required to conduct, report, and publish a stress test once every two years, beginning on January 1, 2020, and continuing every even-numbered year thereafter (*i.e.*, 2022, 2024, 2026, etc.). The final rule would add a new defined term, “reporting year,” to the definitions at 12 CFR § 325.2. A covered bank’s reporting year would be the year in which a covered bank must conduct, report, and publish its stress test. As noted above, the reporting year for most covered banks would generally be every even-numbered year.

Under the final rule, certain covered banks may be required to conduct stress tests annually. This subset of covered banks would be limited to those that are consolidated under holding companies that are required to conduct stress tests more frequently than once every other year. On October 10, 2019, the FRB adopted a final rule that would establish risk-based categories for determining the application of prudential standards, including stress testing.⁸ The final rule distinguishes between four risk-based categories for holding companies. Three of these categories—“Category I” bank holding companies, “Category II” bank holding companies, and “Category III” bank holding companies—would be required to conduct company-run stress tests. Category I holding companies, which are those that are global systemically important bank holding companies, and Category II holding companies would be required to conduct company-

⁸ See “Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies,” 83 FR 61408 (Nov. 29, 2018).

run stress tests annually, while Category III holding companies would be required to conduct company-run stress tests biennially.⁹

Because the final rule would require a covered institution to conduct stress tests annually if its parent holding company is required to do so under FRB regulations, the FDIC's stress testing regulation would incorporate by reference the changes to stress testing frequency in the FRB's regulations. This treatment aligns with the FDIC's, OCC's, and FRB's long-standing policy of applying similar standards to holding companies and their subsidiary banks, and reflects the FDIC's expectation that covered banks that would be required to stress test on an annual basis would be subsidiaries of the largest and most systemically important banking organizations, (i.e., under the FRB's final rule, subsidiaries of global systemically important bank holding companies or bank holding companies that have \$700 billion or more in total assets or cross-jurisdictional activity of \$75 billion). There are currently no FDIC-supervised covered banks that are subsidiaries of bank holding companies that would be required to conduct annual company-run stress tests under the FRB's final rule.

For covered banks that are required to conduct stress tests biennially or annually, the dates and deadlines in the final rule would apply for each reporting year for a covered bank. For example, a biennial stress testing covered bank preparing its 2022 stress test would rely on financial data available as of December 31, 2021; use stress test scenarios that would be provided by the FDIC no later than February 15, 2022; provide its report of the stress test to the FDIC by April 5, 2022; and publish a summary of the results of its stress test in the period starting June 15 and ending July 15 of 2022.

⁹ A Category III holding company would be a holding company that is not a Category II holding company and that has (1) \$250 billion or more in average total consolidated assets or (2) \$100 billion or more in average total consolidated assets and \$75 billion or more in total consolidated assets in one of three risk indicators.

Removal of “Adverse” Scenario

Under the final rule, the number of required stress test scenarios would be reduced from three to two. The “adverse” stress-testing scenario has provided limited incremental information to the FDIC and market participants beyond what the “baseline” and “severely adverse” stress testing scenarios provide. The final rule would remove the “adverse” scenario in the FDIC’s stress testing rule and maintain the requirements to conduct stress tests under the “baseline” and “severely adverse” stress testing scenarios. The final rule also would amend the definition of “severely adverse scenario” so that the term is defined relative to the “baseline scenario,” rather than the “adverse scenario.”

Transition process for covered banks

Currently, 12 CFR § 325.3 provides for a transition period between when a bank becomes a covered bank and when the bank must report its first stress test. The final rule would revise the transition period in 12 CFR § 325.3 to conform to the other changes in the final rule.

Accordingly, a state nonmember bank or state savings association that becomes a covered bank after December 31, 2019, would conduct its first stress test under this part in the first reporting year that begins more than three calendar quarters after the date the state nonmember bank or state savings association becomes a covered bank. For example, if a covered bank that conducts stress tests on a biennial basis becomes a covered bank on March 31 of a non-reporting year (*e.g.*, 2023), the bank would report its first stress test in the subsequent calendar year (*i.e.*, 2024), which is its first reporting year. If the same bank becomes a covered bank on April 1 of a non-reporting year (*e.g.*, 2023), it would skip the subsequent reporting calendar year and the following, non-reporting calendar year, and would report its first stress test in the next reporting year (*i.e.*, 2026). As with other aspects of the stress test rule, the rule reserves to the FDIC the

authority to change the transition period for a particular covered bank, as appropriate in light of the nature and level of the activities, complexity, risks, operations, and regulatory capital of the covered bank, in addition to any other relevant factors.¹⁰

The final rule would not establish a transition period for covered banks that move from a biennial stress testing requirement to an annual stress testing requirement. Accordingly, a covered bank that becomes subject to annual stress testing would be required to begin stress testing annually as of the next reporting year. To the extent that particular circumstances warrant the extension of a transition period, the rule allows for a modification under the FDIC's reservation of authority and supervisory discretion.

Currently, 12 CFR § 325.5(a)(2) requires a covered bank's board of directors, or a committee thereof, to approve and review the policies and procedures of the stress testing processes as frequently as economic conditions or the bank's condition may warrant, but no less than annually. The final rule would revise the frequency of this requirement from "annual" to "once every reporting year" in order to make review by the board of directors consistent with the covered bank's stress testing cycle.

Additionally, 12 CFR § 325.1(c) currently includes a reservation of authority, pursuant to which the FDIC may revise the frequency and methodology of the stress testing requirement as appropriate for a particular covered bank. The final rule would amend the reservation of authority by clarifying the FDIC's authority to exempt a covered bank from the requirement to conduct a stress test in a particular reporting year.

¹⁰ 12 CFR § 325.1(c).

New Range of As-of Dates for Trading Scenario Component

Under 12 CFR § 325.4(c), the FDIC may require a covered bank with significant trading activities to include trading and counterparty components in its adverse and severely adverse scenarios. The trading data to be used in this component is as of a date between January 1 and March 1 of a calendar year.¹¹ On February 3, 2017, the FRB published a final rule that extended this range to run from October 1 of the calendar year preceding the year of the stress test to March 1 of the calendar year of the stress test.¹² On February 23, 2018, the OCC published a final rule making the same change to its stress testing regulation.¹³ The FDIC's April NPR and the proposed rule included this change.¹⁴ Accordingly, the final rule would extend the range of as-of dates from October 1 of the preceding calendar year to March 1 of the calendar year of the stress test, in order to ensure consistency with the FRB's and OCC's rules and increase the FDIC's flexibility to choose an appropriate as-of date.

Other changes

As originally proposed in the April NPR and in the proposed rule, the final rule would remove certain obsolete transitional language in 12 CFR § 325.3 that was included to facilitate a 2014 shift in the dates of the annual stress testing cycle.¹⁵ That transition is now complete and the regulatory transition language is no longer necessary.

Additionally, in order to update and standardize the language used in Part 325, references to "this subpart" would be changed to "this part" following the redesignation of the FDIC's

¹¹ 12 CFR 325.4(c).

¹² 82 FR 9308 (Feb 3, 2017).

¹³ 83 FR 7951 (Feb. 23, 2018).

¹⁴ 83 FR 13880 (April 2, 2018).

¹⁵ 79 FR 69365 (Nov. 21, 2014).

stress test rule from Subpart C of 12 CFR Part 325 to occupy all of Part 325.¹⁶ Lastly, the final rule would eliminate the reference to supervisory guidance in 12 CFR 325.5(b)(1).¹⁷

Expected Effects of the Final Rule

As described above, the final rule would conform Part 325 to section 165(i)(2), as amended by section 401 of EGRRCPA, to raise the applicability threshold from \$10 billion to \$250 billion. Currently, there are no state nonmember banks and state savings associations that exceed this \$250 billion threshold. Therefore, Part 325, as amended by the final rule, would not immediately apply to any FDIC-supervised institutions.

Conclusion

Staff recommends that the Board approve publication of the attached final rule in the *Federal Register* with an effective date 30 days after publication.

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¹⁶ 83 FR 17737 (Apr. 24, 2018).

¹⁷ See Interagency Statement Clarifying the Role of Supervisory Guidance, Financial Institution Letter 49-2018 (Sep. 11, 2018).