First take

A publication of PwC's financial services regulatory practice

October 22, 2014

Ten key points from the 2015 CCAR Guidance and final revised Capital Plan rule

On October 17th the Federal Reserve Board (FRB) released instructions and guidance (Guidance) for CCAR 2015 and finalized amendments to the Capital Plan rule, providing more clarity in both releases. While modifications to the Capital Plan rule were largely consistent with the June proposal,[1] the Guidance provided additional substance regarding the content and, importantly, the organization of capital plan submissions. The Guidance's focus on internal controls, model inventory, risk identification, and organization further confirms our takeaways from CCAR 2014's results – i.e., that the FRB's focus is shifting from quantitative to qualitative aspects and that the regulators' expectations continue to rise.[2]

1. **Capital Plan submissions should be organized to facilitate FRB review:** While the Guidance offers only a suggested organizational outline, firms ignore it at their peril. Although it is likely too late for most firms to significantly alter their submissions due in January 2015, the essence of the guidance is to make these tomes more easily digestible. FRB assessment teams are looking for a synthesis of information, given the limited time they have to complete their reviews. To that end, organizing the submission as closely as possible to the provided outline will improve a firm's ability to get its story across, and to make the intricacies of its capital calculations (e.g., phase-outs, deferred tax assets, and minority interest) more easily understood.

2. **Completeness in risk identification is key:** In addition to expectations around transparency, repeatability, and linkages with the firm's scenario generation and capital adequacy processes, firms are required to prove (rather than simply describe) the comprehensiveness of their risk identification process. This includes assessing the reliability and comprehensiveness of the data, infrastructure, and technology used to support risk identification. Firms should also be able to demonstrate how these risks are reflected in firm-generated scenario, which under the final Capital Plan rule are expected to produce outcomes that are at least as adverse as those resulting from the "severely adverse" supervisory scenario. Given the FRB's qualitative assessment focus, firms should ensure that they tell this part of the story well.

3. **Documentation for internal controls – the bar has been raised:** The Guidance signals that the FRB is expecting significantly enhanced documentation of internal controls, including comprehensive policies and procedures, identified weaknesses, and plans to improve the accuracy of the regulatory reporting control structure. To meet these requirements, firms should document the flow of data from their sources all the way to FR Y-14 templates and to data sets used to estimate models. The focus on internal controls is also a warning to firms to make sure that the starting capital and RWA calculations are accurate, as they will impact both the firm's and FRB's stress testing results.

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[1] See PwC's *First take: Capital plan rule* (June 13, 2014).

[2] See PwC's *A closer look, Stress testing: A look into the Fed's black box* (April 2014).

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4. **Methodology and model inventory must be mapped to FR Y-14 and be subject to internal audit:** The Guidance clarifies that each item on the firm's list of models and methodologies must be mapped to individual FR Y-14 line items for which it is used. Unlike the suggested capital plan organizational outline, this seems to be more than a suggestion, and we expect little tolerance for not organizing model inventory and methodology papers (along with validation status) for each FR Y-14 line item and each scenario. Moreover, the guidance requires that audit reports of the models and methodologies used in the process be included with firm submissions.
5. **Commonly observed themes from CCAR 2014 further clarify FRB expectations:** The Guidance included an appendix outlining commonly observed themes from the FRB's feedback to firms related to CCAR 2014. This appendix and the "Range of Practices" paper published in August 2013[3] can be taken as the FRB's cumulative statement of expectations. Accordingly, the FRB will most likely expect firms to formally assess their capital planning practices against the combined set of expectations, including a review by internal audit.
6. **Delayed CCAR 2016 brings higher expectations:** The final Capital Plan rule provides three additional months of preparation time for CCAR 2016 (by pushing the submission deadline to April 5th from January 5th, beginning in 2016). Although this delay will allow capital plan preparers time to enjoy their December holidays, it will mean an even higher expectation for enhancements to the 2016 submission. This extra time also means that firms which receive objections to their capital plans in 2015 will have more time to address regulatory feedback.
7. **BHCs of foreign firms that will be repurposed as US Intermediate Holding Companies (IHC) will effectively be subject to IHC-wide CCAR in 2016:** US BHCs of foreign firms that plan to convert to IHCs in order to meet the US's Enhanced Prudential Standards[4] will be required to submit a capital plan that includes the IHC's other subsidiaries as of the date the IHC is required to take form (i.e., July 1, 2016). For CCAR 2015, however, these BHCs need <u>not</u> include the IHC's other subsidiaries. In exchange for this concession, these BHCs may not distribute more capital in 2015 than they did in 2014, even if that means they will not be able to distribute any capital for two years in a row.
8. **Advanced Approaches not required until CCAR 2016:** Under the Capital Plan rule, a firm must calculate its regulatory capital for CCAR purposes using the methodologies that are applicable to the firm throughout the CCAR cycle's nine quarters. Therefore, the eight Advanced Approaches firms that exited parallel run earlier this year would have been required to use Advanced Approaches calculations as part of their CCAR 2015, whereas other Advanced Approaches banks that have not yet exited parallel run would be not be calculating Advanced Approaches ratios. To avoid inconsistency in CCAR results, the finalized amendments to the Capital Plan rule provide that none of the Advanced Approached firms are required to begin using Advanced Approached calculation methodologies until CCAR 2016.
9. **Capital distributions to be limited, if insufficient capital is raised:** The proposed amendments to the Capital Plan rule suggested that if a firm's capital raises fall below the level indicated in the capital plan, capital distributions must be reduced by at least an equal amount. Despite strong industry opposition, the FRB finalized this provision as proposed but created a few exceptions to prevent unnecessary market consequences (e.g., allowing scheduled distributions to proceed on non-common equity instruments). Firms did gain one potentially important concession: firms that fail to raise capital as planned may seek non-objection from the FRB to nevertheless make its planned capital distributions if certain circumstances prevented planned issuances.
10. **CCAR 2015 is likely to include more interest rate risk:** The FRB introduced interest rate risk into the supervisory adverse scenario for the first time last year. We expect this year to include an even greater level of interest rate risk, as regulators further assess this risk in the banking system.

What's next?

Similar to last year, we expect CCAR 2015 supervisory scenarios to be released by November 1st, ahead of the November 15th deadline. We also expect the global market shock parameters to be released by November 1st (with an "as of" date of October 6th), ahead of the December 1st deadline.

[3] See PwC's *Regulatory Brief, Stress Testing: Failures on the horizon?* (November 2013).

[4] See PwC's *Regulatory Brief, Foreign Banks: US admission price rising* (July 2014).

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Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

Dan Ryan
Financial Services Advisory Leader
646 471 8488
daniel.ryan@us.pwc.com

Shyam Venkat
Partner, Financial Services Risk Advisory
646 471 8296
shyam.venkat@us.pwc.com

David Sapin
Partner, Financial Services Regulatory Advisory
646 471 8481
david.sapin@us.pwc.com

Armen Meyer
Director of Regulatory Strategy
646 531 4519
armen.meyer@us.pwc.com

Contributors: Steve Pearson, Alejandro Johnston, Pranjal Shukla, Adam Mikulka, and Charles von Althann.

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