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CCAR and
DFAST 2015 Results

Our take

CCAR and DFAST: Our Take

The Federal Reserve ("Fed") released the results of its Comprehensive Capital Analysis and Review (CCAR) for 2015 on March 11. Some key facts:

- The Fed noted two objections to capital plans out of 31 participants and a required resubmission from one of the largest firms.
- All objections and resubmissions were driven by weaknesses around qualitative issues.
- No firm failed to meet post-stress capital minimums, though three firms adjusted their capital distribution requests to do so, taking a so called "mulligan".

The prior week's release of the Dodd-Frank Act Stress Test (DFAST) provided more detailed results on the Fed's stress test. Compared to CCAR, those results exclude buybacks and capital issuances and hold past common dividends constant.

Key takeaways

- **No rest for the weary** - The Fed is maintaining its pressure on firms to continue to make steady progress in improving their capital planning processes even if there was no objection in the prior year; this especially applied to the largest institutions.
- **Capital ratio declines are worsening** - Actual to trough declines in the forecast are exacerbated compared to prior years in part due to the transitions to Basel III and more conservative stress assumptions in some areas.

- **Loan loss rates are moderating** - Lower loss rates on single family loans and credit cards had a favorable impact on aggregate losses.
- **Fed risk-weighted asset (RWA) forecasts continue to pressure ratios** - The effect on capital ratios is as much as 160 basis points in aggregate compared to a no-growth assumption.
- **Tier 1 risk-based capital and Tier 1 leverage ratios are the most constraining** - These ratios are the most significantly impacted under stress scenarios, bringing several firms close to the minimum threshold.
- **Capital actions are significant** - The requested capital actions have a significant influence on minimum post stress ratios for most firms.
- **What to expect for the 2016 capital planning cycle** - The Fed and banks will have a five-quarter distance between this and the next round of CCAR and DFAST submissions; the Fed has promised to "closely monitor" progress and is likely to escalate focus on fundamentals such as data integrity/reconciliation, risk identification, and controls. Firms should also be prepared for unexpected changes in Fed scenarios, pressure from the continued phase in of Basel III ratios, and prepare detailed remediation plans to improve communication with the Fed.

Our take

Steady progress in meeting qualitative factors is a key expectation and dominates decisions.

- **Need for steady progress** - The Fed noted firms have been given time to meet generally high expectations and standards, but that the largest firms¹ especially must continue to make steady progress in areas they exhibit shortcomings
- **No guarantees** - For the third year in a row, at least one firm that received an objection or required resubmission had “passed” muster the prior year. This is a clear demonstration of the Fed’s escalating expectations and desire for steady progress over time.
- **Widespread deficiencies** - Last year, firms with objections had varying degrees of deficiencies; this year, the two firms with objections had “widespread and substantial weaknesses across their capital planning processes.”
- **The learning curve can be steep** - Notably, the two firms receiving objections were foreign-headquartered banks that were relatively new to the Fed’s oversight of capital plans; all other participants had undergone as many as three to five rounds of capital planning reviews and feedback through CCAR or the Fed’s (now retired) Capital Plan Review (CapPR) for regional firms.
- **Resurfacing of conditional approval** - Conditional approval with resubmission has resurfaced as a tool to push firms with particular, but not widespread weaknesses to remediate quickly; conditional approval and resubmission was given to two of the largest firms for the first time in 2013, none in 2014, and one in 2015.
- **Mulligan on the rise** - Three firms adjusted their capital plans after initially falling short of key ratios compared to two firms last year, highlighting an emerging regulatory tactic to fine tune capital distributions.
- **Close monitoring** - For all firms, the Fed noted that progress will be closely monitored throughout the year.
- **Time to breathe?** - It’s worth noting that for the first time, banking holding companies (BHCs) and examiners will have five quarters rather than four to review and improve between capital plan submissions - due to the CCAR cycle shifting by three months to the end of first quarter of the calendar year; that said, this also gives the Fed time to dive deeper on issues it feels need attention, such as data integrity and reconciliation, risk identification, and controls.

Larger declines in capital ratios under the severely adverse relative to prior years

The actual to trough decline in capital ratios (starting capital ratio compared to minimum post-stress capital ratio) has generally increased over time, and appears to be largely driven by the phase in of Basel III capital standards with its more stringent requirements. The Basel III effect is highlighted by the trend in the Tier 1 common decline, which improved slightly from last year. That ratio is based on a Basel I definition of capital and risk weight rules that do not vary over time.

Actual to minimum declines (percentage points) under DFAST (severely adverse scenario)

Ratio	Ratio (%)		Change year-over-year
	2014	2015	
Basel III based			
Tier 1 RBC	4.4	5.1	0.7
Total	4.6	5.4	0.8
Leverage	2.5	2.9	0.4
Basel I based			
Tier 1 common	3.9	3.6	(0.3)

The potential drivers of year-over-year changes in actual to trough declines include:

- Severity of the stress scenario
- Any changes in the Fed's stress models for losses, revenues, and RWA
- Changes in the underlying risk of BHCs portfolios that flow to Fed models
- Phase-in of Basel III over time

For the most part the severity of the macro economic assumptions in the severely adverse scenario and forecasts for RWA appears to have been relatively stable over the past year. A combination of improving underlying credit quality and possible Fed model refinements has lowered overall loan loss rates. On the other hand, some of the largest banks faced stronger pressure from more severe assumptions for the global market shock on trading and counterparty positions. In addition, all banks faced pressure from the phase-in of Basel III, with stricter definitions of capital elements. For some large advanced approaches banks, the phase in of Basel III deductions for accumulated other comprehensive income (AOCI) were particularly impactful.

Some interesting observations are highlighted below:

- **Loans loss rates fall** - As shown in the chart below, compared to the prior year, aggregate loan loss rates fell compared to the prior year stress test, driven by a significant decline in first lien mortgage loss rates and moderate decline in credit cards. At the same time, commercial real estate loss rates rose slightly.

Projected 9Q loan loss rates, by type of loan, by submission year

Loan type	Loan loss percentage (%)			Change from 2014 to 2015
	2013	2014	2015	
Total loan losses	7.5	6.9	6.1	(0.8)
First-lien mortgages, domestic	6.6	5.7	3.6	(2.1)
Junior liens and HELOCs, domestic	9.6	9.6	8.0	(1.6)
Commercial & industrial	6.8	5.4	5.4	0.0
Commercial real estate, domestic	8.0	8.4	8.6	0.2
Credit cards	16.7	15.2	13.1	(2.1)
Other consumer	6.1	6.0	5.8	(0.2)
Other loans	1.8	2.7	2.9	0.2

- **Trading and counterparty losses rise** - Losses from the global market shock and counterparty positions applied to the eight trading and custody banks rose \$5 billion or around five percent relative to prior years. The Fed noted the shock continues to be comparable to 2008, but that asset classes with currently more favorable pricing (e.g., equities and noninvestment grade bonds) were subjected to more severe declines, and that mortgage-backed securities were subject to larger option adjusted spread declines.

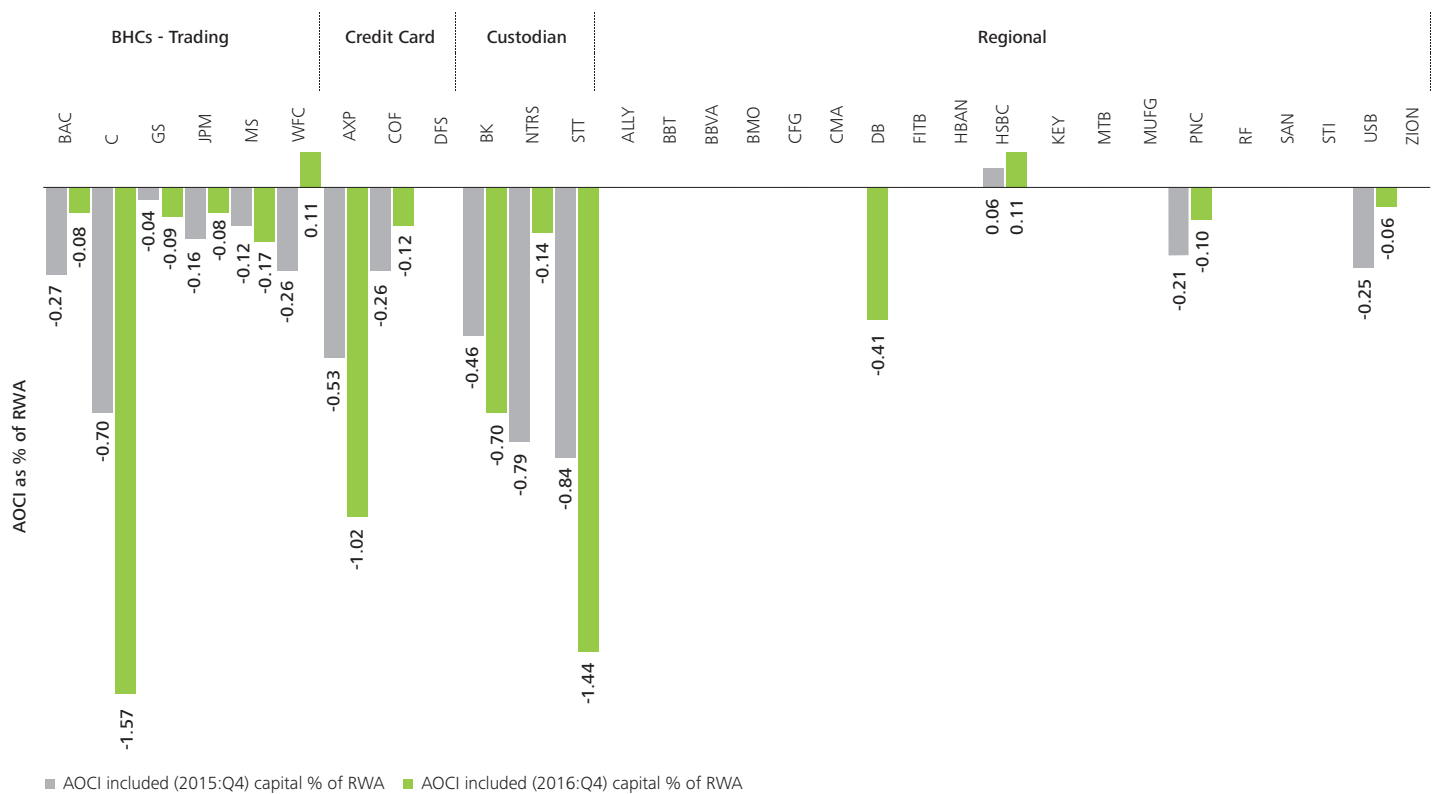
Trading and Counterpart Losses Cumulative over 9 quarters by DFAST submission year			
Losses in \$billions	2013 ²	2014	2015
	97	98	103

- **RWA increases are high and stable**- RWAs over the forecast horizon were up 13.2 percent over the nine quarters compared to 12.6 percent for the prior year; the higher RWAs put downward pressure on BHCs capital ratios, and demonstrate that BHCs would have the capacity to lend through a downturn in the economy. For example, in aggregate, the Tier 1 capital ratio of banks would have been 1.6 percentage points higher if forecasted RWA were flat as opposed to an increase of 13 percent.

- **AOCI phase in affects some banks more than others-** Under the Basel III transition rules, unrealized gains and losses embodied in the AOCI³ account are included in capital in an increasing proportion over time, with 40 percent of that account included as of year-end 2015 and 60 percent as of year-end 2016. Under the severely adverse scenario, included AOCI was forecast to be \$22 billion at Q4 2015 in last year's DFAST, compared to a forecast of \$27 billion at Q4 2016 in this year's DFAST. While the total negative effect on capital ratios this year was only 0.28 percent of aggregate RWA, its effect on individual institutions varied widely. American Express, Citigroup and State Street in particular had the largest negative AOCI.

It should also be noted, that while the adverse scenario has a more moderate downturn in the economy, the interest rate increases in that scenario contributed to larger declines in securities portfolio (AFS), resulting in unrealized losses included in capital more than three-fold larger than the severely adverse scenario at \$93 billion.

AOCI Q4 2015 and Q4 2016 as % of RWA

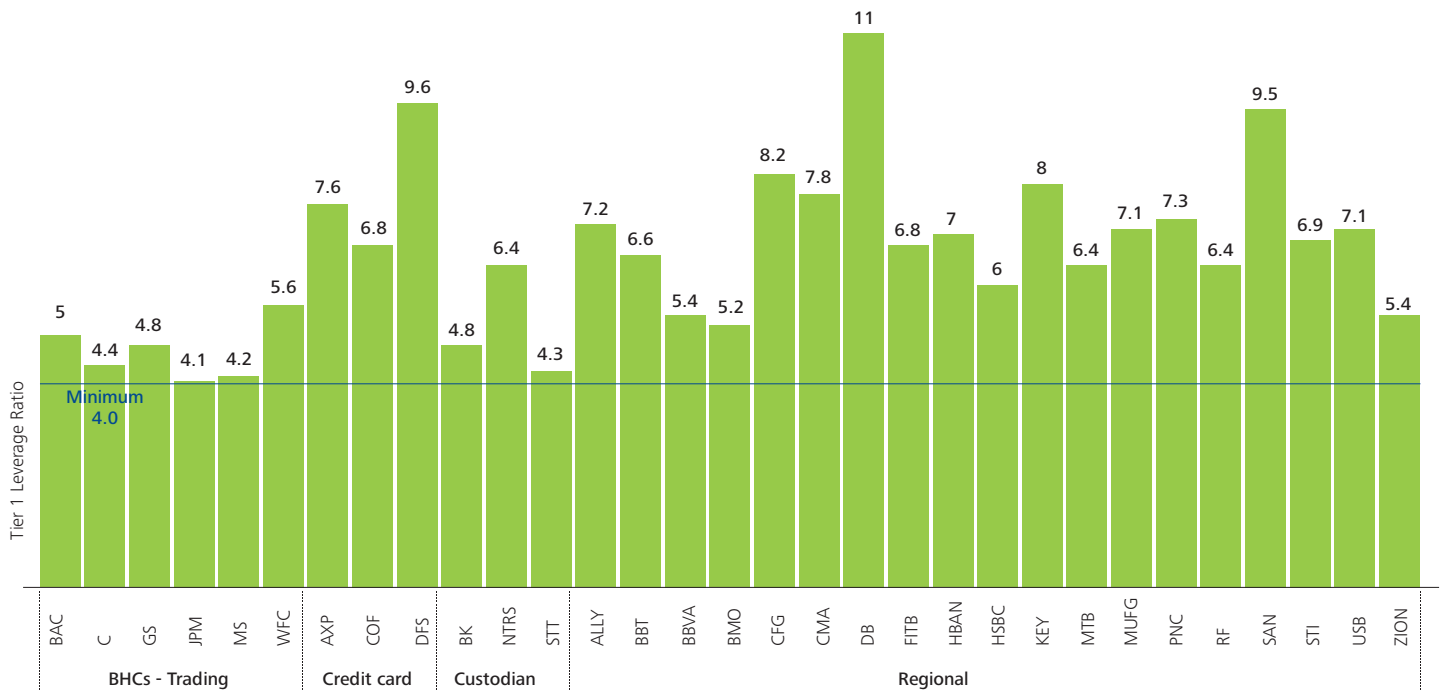


Tier 1 capital risk-based and leverage are most constraining

While all banks met minimum regulatory capital requirements throughout the stress test horizon, several firms' lowest ratios came very close to the minimums. Three institutions had to revise capital distribution plans (i.e. scale back dividend or buyback plans) in order to meet minimums.⁴ Interestingly, firms had different constraining ratios among leverage among leverage and Tier 1 and total risk-weighted capital.

The vast majority of institutions had adequate headroom (i.e. difference between the regulatory minimums and their minimum capital ratio under stress) with median buffers of between 2.3 and 2.5 percentage points. Both the Tier 1 Capital and leverage ratios demonstrated the lowest margin of safety for institutions. Below is an illustration of the wide range of capital headroom across institutions for the leverage ratio, with trading and custody banks having the least remaining post stress cushion.

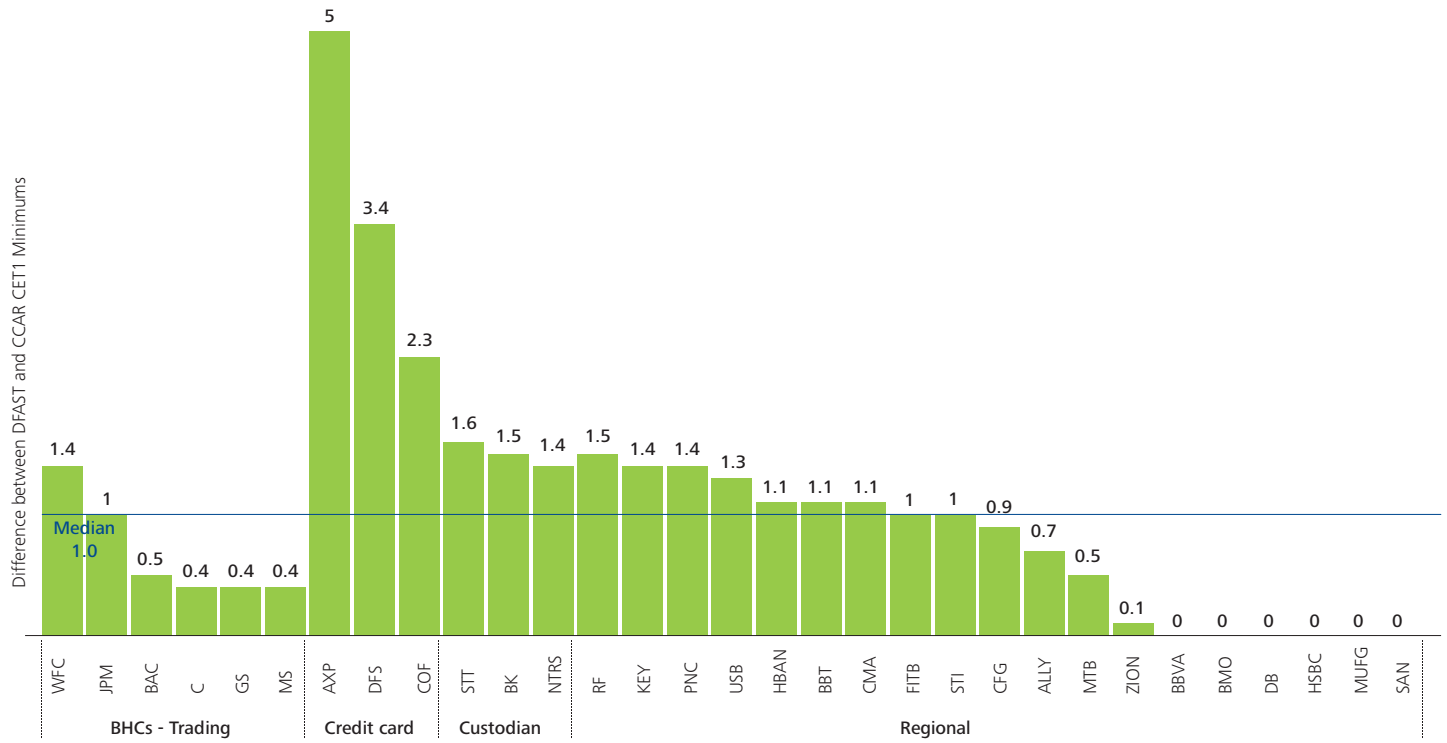
2015 CCAR post stress Tier 1 leverage minimum for 31 banks under severely adverse scenario



Dividends and buybacks make a big difference in lowest minimum ratios

While the Fed’s CCAR results do not disclose a BHC’s proposed capital actions over the nine quarters, comparing the minimum capital ratios between DFAST results and CCAR results can provide some insights. This is because DFAST uses average actual trailing 4 quarter common dividends for year-end 2014, while CCAR includes any increase in common dividends, buybacks, and issuances, generally producing a lower minimum. The chart below shows the negative impact on the minimum common equity Tier 1 ratio attributable to each firm’s proposed capital actions. The median difference in the lowest CCAR capital ratio relative to DFAST was one percentage point.

2015 DFAST vs. CCAR (Fed) post stress CET1 minimum for all banks under severely adverse scenario



Ways firms can prepare for next year

Expect the unexpected - While stress scenarios have been relatively stable over time, the Fed has received criticism for making the scenarios too predictable. Might the Fed change its approach to scenario design next year? Having a flexible CCAR program that can respond to a wide range of macro and idiosyncratic scenarios could be key to effectively navigating the next CCAR cycle.

Expect head winds - For advanced firms that incorporate unrealized losses into their regulatory capital calculations, a higher proportion of these (80%) will be incorporated into next year's CCAR. That effect could be compounded by either a higher rate environment at year end 2015 or higher rate assumptions incorporated into the stress scenario. That in turn could put greater pressure on capital ratios and require paring back of capital distributions to compensate. Moreover, if the Fed finalizes its proposal by incorporating global systemically important financial institution buffers into post-stress minimum capital ratios, the phase in period for the largest firms to meet the 1.0-4.5 percent additional buffers will likely be quite challenging.

Clean up data and tighten controls - This CCAR cycle, the Fed emphasized the need for institutions to ensure the accuracy and completeness of their data and to evaluate the adequacy and integrity of their reconciliation processes and controls across the range of reports they supply to the Fed. A great deal of manual processes and deferred maintenance on controls need to be addressed by the next CCAR cycle or this could balloon to a deciding qualitative factor for some institutions in 2016.

Be specific and deliver on time - To address outstanding weaknesses identified by the Fed, many firms will be asked to enhance current processes and develop remediation plans, inclusive of accountable parties, activities, and, milestones to be completed prior to the next CCAR cycle or beyond. Just like BHCs, the Fed does not like surprises; so sticking to deadlines or providing updates on any slippage is key to ensuring that firms and regulators are on the same page. Not delivering key remediation items on time or of adequate quality can drive an objection decision. Moreover, being clear on items that have longer duration remediation, getting agreement, and defining a delivery date is also key to avoiding objection.

Bank holding company	Acronym
Ally Financial Inc.	ALLY
American Express Company	AXP
Bank of America Corporation	BAC
BB&T Corporation	BBT
BBVA Compass Bancshares, Inc.	BBVA
The Bank of New York Mellon Corporation	BK
BMO Financial Corp.	BMO
Citigroup Inc.	C
Citizens Financial Group, Inc.	CFG
Comerica Incorporated	CMA
Capital One Financial Corporation	COF
Deutsche Bank Trust Corporation	DB
Discover Financial Services	DFS
Fifth Third Bancorp	FITB
The Goldman Sachs Group, Inc.	GS
Huntington Bancshares Incorporated	HBAN
HSBC North America Holdings Inc.	HSBC
JPMorgan Chase & Co.	JPM
KeyCorp	KEY
Morgan Stanley	MS
M&T Bank Corporation	MTB
MUFG Americas Holding Corporation	MUFG
Northern Trust Corporation	NTRS
The PNC Financial Services Group, Inc.	PNC
Regions Financial Corporation	RF
Santander Holdings USA, Inc.	SAN
SunTrust Banks, Inc.	STI
State Street Corporation	STT
U.S. Bancorp	USB
Wells Fargo & Company	WFC
Zions Bancorporation	ZION

Sources of data utilized within this document from the Board of Governors of the Federal Reserve System are listed below.

- Comprehensive Capital Analysis and Review 2015: Assessment and Framework and Results, March 2015
- Comprehensive Capital Analysis and Review 2014: Assessment and Framework and Results, March 2014
- Comprehensive Capital Analysis and Review 2013: Assessment and Framework and Results, March 2013
- Dodd-Frank Act Stress Test 2015: Supervisory Stress Test Methodology and Results, March 2015
- Dodd-Frank Act Stress Test 2014: Supervisory Stress Test Methodology and Results, March 2014
- Dodd-Frank Act Stress Test 2013: Supervisory Stress Test Methodology and Results, March 2013

Endnotes

¹ The Federal Reserve's Large Institution Supervision Coordinating Committee oversees the following firms subject to an enhanced supervisory program: Bank of America Corporation; The Bank of New York Mellon Corporation; Citigroup Inc.; Deutsche Bank (Deutsche Bank Trust Corporation); The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; State Street Corporation; and Wells Fargo & Co.

² Excludes the largest custody banks BK and STT; they were subject to an additional counterparty default analysis in 2014, and 2015, but not the global market shock.

³ The AOCI eligible for inclusion in capital is composed of four elements

- (1) actuarial gain and losses on defined contribution pension plans,
- (2) unrealized gains and losses on qualifying cash flow hedges,
- (3) foreign currency translation adjustments, and
- (4) unrealized gains and losses on AFS securities and also on HTM securities that have experienced OTTI.

⁴ Goldman Sachs, JPMorgan, Morgan Stanley

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