



Stress Testing: Final Rules for Banking Organizations from the Federal Banking Agencies

Earlier today, the Office of the Comptroller of the Currency (“OCC”), the Federal Deposit Insurance Corporation (“FDIC”) and the Federal Reserve Board (“Board”) approved final rules, which were proposed for comment in January of this year,¹ implementing the Dodd-Frank Act’s company-run stress testing requirements for all insured depository institutions with total consolidated assets of \$10 billion or more.² In addition, the Board has simultaneously published final stress-testing rules, covering the Dodd-Frank Act’s requirements for Board-run *and* company-run stress-testing requirements for banking organizations with more than \$50 billion in total consolidated assets.³

Most of the changes between the proposed rules and the final rules involve the procedures and timelines, rather than the substance, of the required stress-testing. Highlights of today’s regulatory actions include:

Coverage of the Rules. The company-run stress-testing rules apply to all banks and savings associations⁴ with total consolidated assets of \$10 billion or more (“covered banks”), with some different requirements for covered banks with \$50 billion or more in total consolidated assets (“large covered banks”). Federal branches and agencies of foreign banks are not subject to the rules, regardless of their asset size. The Board’s stress-testing rules (Board-run and company-run) for systemically important banking organizations apply to the population of bank holding companies and savings and loan holding companies (“covered companies”) that are treated as systemically important under section 165 of the Dodd-Frank Act.

Effective Dates. Curiously, the three banking agencies have different effective dates for their respective rules. The OCC’s rules are effective on October 9, 2012, whereas the FDIC’s rules are effective upon publication in the *Federal Register*, and the Board’s rules are effective on November 15, 2012. In general, all bank holding companies, savings and loan holding companies, and covered banks have until September 30, 2013 to begin their annual stress-testing. Covered companies and large covered banks must begin their annual stress testing as of the rules’ various effective dates, *i.e.*, this year and not next year.

¹ 77 Fed. Reg. 3408 (Jan. 24, 2012) (OCC); 77 Fed. Reg. 3166 (Jan. 23, 2012) (FDIC); 77 Fed. Reg. 594 (Jan. 5, 2012) (Board).

² Dodd-Frank Act Section 165(i)(2). The OCC final rule may be accessed at <http://www.occ.treas.gov/news-issuances/news-releases/2012/nr-occ-2012-142a.pdf>. The FDIC’s final rule is available at http://www.fdic.gov/news/board/2012/2012-10-09_notice_dis-a_res.pdf. The Board’s final rule is available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20121009a1.pdf>.

³ Dodd-Frank Act Section 165(i)(1). The Board’s final covered company rule is available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20121009a2.pdf>.

⁴ Specifically, we use the term “covered banks” to cover all national and state member and nonmember banks, as well as all federal and state savings associations, with \$10 billion or more of consolidated total assets. A “large covered bank” also includes any state member bank that is a subsidiary of a large bank holding company.

Stress Test Scenarios. Each banking agency will provide its respective banking institutions with at least three economic stress scenarios—baseline, adverse, and severely adverse. Covered companies and covered banks with significant trading activities may be required to include trading and counterparty components in their adverse and severely adverse scenarios.

Stress Test Methodologies. Each covered company and covered bank must use a planning horizon of at least nine quarters over which the impact of specified scenarios would be assessed. Each covered company and covered bank will be required to calculate pre-provision net revenues, potential losses, loan loss provisions, net income, and regulatory capital levels and ratios that result from each specified scenario. In testing capital, a covered company and covered bank must incorporate the effects of any capital actions over the planning horizon and the maintenance of an appropriate allowance for lease losses. In addition, each covered company and covered bank must establish and maintain a system of controls, oversight and documentation to assure that the institution's stress-testing processes are effective in complying with the new rules.

Methodologies is something of a misnomer, since this section of the rule describes the government-provided inputs (the scenarios) and the outputs that each covered company and covered bank must generate. The rule does not address any of the formulas, algorithms, or other methods of calculation that a bank should use. Today's *Wall Street Journal* includes a story about the largely unsuccessful efforts of the large banking organizations that have already conducted stress tests to obtain greater detail about the Board's own methodology for the Board-run stress tests.⁵

Reports and Reporting Deadlines. There will be different reports and reporting deadlines for covered companies and large covered banks on the one hand, and all other covered banks on the other hand. Covered companies also must, among other things, conduct and report on a mid-cycle stress test to the Board. Further, covered companies' stress testing activities will be incorporated into the covered company requirement under Board rules to prepare and submit an annual capital plan. These reports will be treated as confidential and exempt from disclosure under the Freedom of Information Act.

Publication Requirements. All covered companies and covered banks must publish a summary of their stress test results after submitting their reports. The summary must include a description of the types of risks included in the testing; a summary description of the methodologies; estimates of aggregate losses, pre-provision net revenue, provisions for loan and lease losses, net income, and pro forma capital ratios for each of the nine quarters; and an explanation of the most significant causes of the changes in the regulatory capital ratios. Additional disclosure requirements apply to the test results under the severely adverse scenario. Further, covered companies must publish the results of their mid-cycle stress tests.

Board-Run Stress Tests (Covered Companies Only). The Board will conduct an annual stress test of covered companies, in general using the same scenarios, data points and methodologies as are used for the company-run stress tests. A covered company's directors and senior management must consider the results of the Board-run stress tests in the company's capital planning process, the evaluation of the covered company's key exposures, and in the covered company's resolution and recovery planning.

⁵ *Wall Street Journal* p. C1 (Oct. 9, 2012), available at http://online.wsj.com/article/SB10000872396390444024204578044591482524484.html?mod=business_newsreel (subscription required).

Stress Test Cycle. The annual stress test cycle starts on October 1 of each calendar year and ends on September 30 of the following calendar year. The major elements of the annual cycle are as follows:

Action taken	Covered companies and large covered banks	Other covered banks
Agency distributes annual stress test scenarios for company-run and Board-run tests	By November 15; supplementary scenarios/components by December 1	By November 15
Banking organization conducts annual stress test and reports on same to the Board and primary banking agency	By January 5. Covered companies must also submit their annual capital plans to the Board by January 5.	By March 31
Banking organization publishes company-run stress test summary	Between March 15 and 31. Board responds to covered companies' capital plans by March 31.	Between June 15 and 30
Board provides results of, and publishes, Board-run stress tests	By March 31	Not applicable
Covered company reports on mid-cycle stress tests submitted to Board	By July 5	Not applicable
Required covered company public disclosures of mid-cycle stress tests	Between September 15 and 30	Not applicable

Conclusion

The stress-testing rules issued today add to the regulatory obligations of larger banks, but, in this case, the duties clearly extend below the level of systemically important banks to cover a large number of regional banks and savings institutions. We are continuing to analyze these rules and expect to report further on them in the near future.

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