Banking Agencies Issue Proposed Supervisory Guidelines for Certain Annual Stress Tests, as Required under Dodd-Frank

08.20.2013

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On Monday, August 5, 2013, the Office of the Comptroller of the Currency (the ?OCC?), the Federal Reserve System (the ?FRS?) and the Federal Deposit Insurance Corporation (the ?FDIC?) issued proposed supervisory guidelines to aid in the implementation of the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the ?Act?) described below. Comments must be received by September 25, 2013, with respect to the OCC and the FDIC, and by September 30, 2013, with respect to the FRS.

Section 165(i)(2) of the Act requires, among other things, that bank holding companies, savings-and-loan holding companies, national banks, state member banks, state non-member banks, state-chartered savings associations and federal savings associations having total consolidated assets of more than $10 billion but less than $50 billion (collectively, ?affected companies?) conduct annual internal stress tests and report the results to their respective primary federal regulators and the FRS. A summary of the results of such testing is also required to be published. A ?stress test? is a process used to assess the potential impact on the affected company of various economic and financial conditions, with a view to the impact on the company?s consolidated earnings, losses and capital over a certain period of time.

This guidance sets forth the expectations of the federal regulators with respect to methodologies and practices to be used in conducting the stress tests. Affected companies are expected to comply with these guidelines in addition to the requirements set forth in the Act and other supervisory guidance with respect to stress testing.

The proposed guidelines address the following general areas:

1. Application of Scenarios. The Act requires that affected companies assess the potential impact of a minimum of 3 macroeconomic events (?scenarios?) on certain of the company?s financial performance indicators. The scenarios, at a minimum, must be baseline, adverse and severely adverse. The proposed guidelines would require that the affected company apply these scenarios across all of the company?s business lines and risk areas, in order to get a larger view of the effect of each scenario.

2. Segmentation of Data Sources. The guidelines suggest that an affected company divide its portfolios and business activities into categories based upon common risk characteristics. In addition, the guidelines suggest that the data be segmented in at least the level of detail set forth in the report required to be filed with the primary federal regulator and the FRS.

3. Potential Losses. For each scenario, the affected company should estimate the following: losses, pre-provision net revenue (?PPNR?), provision for loan and lease losses and net income. Potential credit losses for loan portfolios and securities holdings should be reported separately. Additional guidelines apply to larger affected companies.

4. PPNR Projections. The guidelines suggest that smaller affected companies may estimate PPNR based upon its components (net interest income, non-interest income and non-interest expense), while larger more sophisticated companies should make estimations based upon a wider number of methods, such as collection of internal revenue data, and estimating revenues within certain business lines. Additional sources of losses should also be included in these projections, such as trading losses, mortgage servicing losses and mortgage repurchase losses.

5. Balance Sheet and Risk-Weighted Assets Projections. An affected company must ensure that its projected balance sheet and risk-weighted assets remain up-to-date with regulatory and accounting changes, recognize the company?s history in past adverse economic conditions, and are applied consistently across the company.

6. Supervision and Control. The guidelines would require that each affected company maintain a policy of compliance and documentation, including policy and procedure documentation. Stress testing results must be considered by company management in normal business operations, such as risk management and capital planning.

Affected companies and other interested persons may comment, and should do so if they think that these guidelines, or the specifics of the implementation of these guidelines as published in the notice, will have an adverse effect on their businesses. According to the notice of proposed supervisory guidance, there are various methods for the submission of comments. Those commenting should review pages 47217 and 47218 of the *Federal Register* dated August 5, 2013 (Volume 78, Number 150) for instructions.

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