

Date: February 19, 2020  
To: Board of Governors  
From: Staff<sup>1</sup>  
Subject: Draft final rule regarding the stress capital buffer

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**ACTIONS REQUESTED:** Approval of a draft final rule that would simplify the Board’s capital framework by establishing a stress capital buffer requirement. The draft final rule would amend several of the Board’s regulations and policies, including the capital and stress test rules, and make associated changes to regulatory reports. In addition, staff seeks authority to make technical or minor changes to the draft final rule prior to publication in the Federal Register.

**EXECUTIVE SUMMARY:**

- The Board’s post-financial crisis reforms have substantially improved the resiliency of large banking firms and the financial system. Notable advances include more loss-absorbing capital; an approximate doubling in the overall amount of common equity capital since the financial crisis; a rigorous and dynamic stress test framework; and improved capital planning practices at large firms.
- In April 2018, the Board invited comment on a proposal to simplify its capital framework by integrating ongoing, non-stress capital requirements and the stress test-based capital requirements under the Comprehensive Capital Analysis and Review (CCAR) through the establishment of a stress capital buffer requirement.
- The proposed stress capital buffer requirement would have used the results of the supervisory stress test to determine large firms’ ongoing regulatory capital requirements. The proposal also would have made certain changes to the assumptions used in the supervisory stress test to simplify and remove redundant elements of the capital framework.
- The draft final rule would maintain the post-crisis gains in capital adequacy while simplifying the Board’s capital framework for bank holding companies and U.S.

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intermediate holding companies of foreign banking organizations with \$100 billion or more in total consolidated assets.

- The total number of regulatory capital requirements applicable to large firms would be reduced from 13 to 8 under the draft final rule, simplifying the Board’s capital framework (see Appendix I for further information).
- The draft final rule includes the following changes from the proposal:
  - The draft final rule does not include a stress leverage buffer requirement. Firms would continue to be subject to ongoing, non-stress leverage ratio requirements.<sup>2</sup> This change would result in a simpler capital framework and maintain leverage capital requirements as an appropriate backstop to risk-based capital requirements.
  - The draft final rule would allow firms to increase their planned capital distributions in excess of the amount included in their capital plans without prior approval of the Board. Such firms would instead be subject to automatic distribution limitations if their capital ratios fell below the buffer requirements, which would include the stress capital buffer requirement. This change would further the goal of having a unified approach in the Board’s capital framework to limitations on capital distributions.
  - In light of the integration of non-stress capital requirements and the stress test-based capital requirements under CCAR, the draft final rule would revise the definition of eligible retained income in the non-stress capital requirements to make the automatic limitations on a firm’s distributions more gradual as the firm’s capital ratios decline.
  - A material business plan change (e.g., resulting from a merger, acquisition, or divestiture) would generally not be incorporated into the calculation of the stress capital buffer requirement. This change would reduce the number of assumptions needed to calculate the stress capital buffer requirement.
- The draft final rule would preserve strong capital requirements for large firms. Based on stress test data from 2013 to 2019, the draft final rule is estimated to result in largely unchanged common equity tier 1 (CET1) capital requirements, on average, for firms subject to the rule.
  - On average, staff estimates the rule would increase CET1 capital requirements for GSIBs, the largest and most complex firms, and decrease requirements for firms subject to Category II through IV standards.<sup>3</sup> The differential impact on GSIBs

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<sup>2</sup> The non-stress leverage ratio requirements include the traditional leverage ratio and supplementary leverage ratio requirements. U.S. global systemically important bank holding companies (GSIBs) are also subject to enhanced supplementary leverage ratio standards.

<sup>3</sup> In October 2019, the Board finalized its tailoring rule, which more closely matches the regulations applicable to large banking organizations with their risk profile. The tailoring rule groups large U.S. and foreign banking organizations into four categories of standards (Category I through IV), with the most stringent standards applying to firms subject to Category I standards. 84 FR 59032 (November 1, 2019); 84 FR 59230 (November 1, 2019).

- reflects, in part, the draft final rule's combination of the GSIB surcharge with a stress test-based capital requirement.
- The impact of the draft final rule depends, in significant part, on a firm's planned capital distributions, which rose from a relatively low level in 2013 to a relatively high level in 2019. Using an average over this period provides a through-the-cycle view of impact.
  - The draft final rule would become effective 60 days after publication in the Federal Register and, as a consequence, would apply in CCAR 2020.

## **DISCUSSION:**

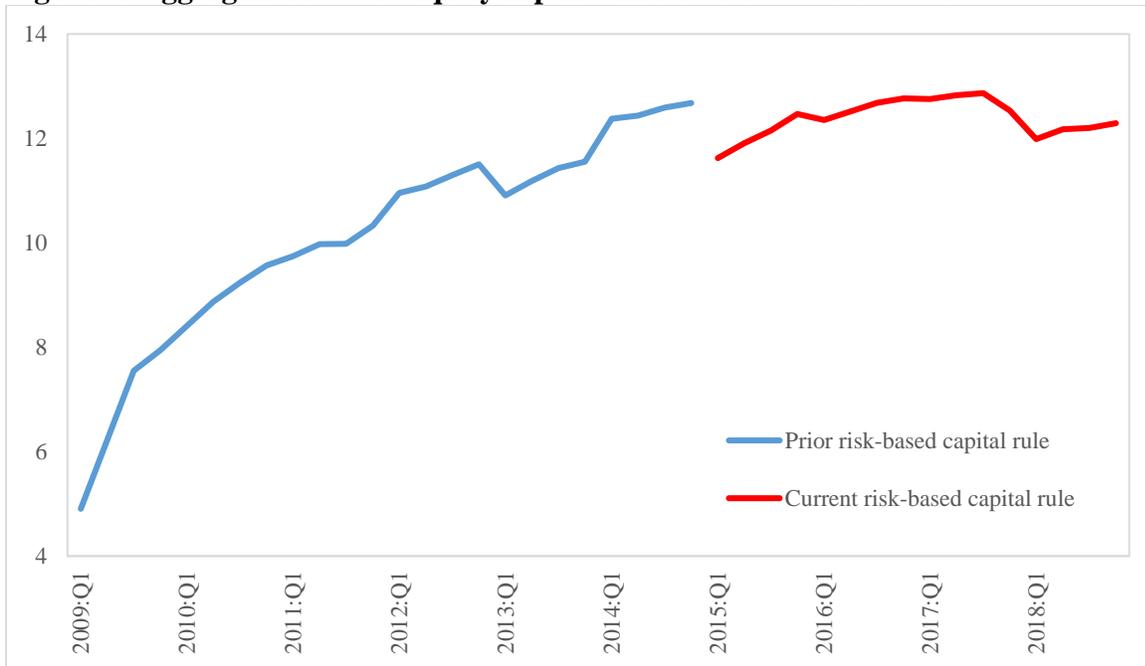
### **I. Simplifying the Board's Capital Framework for Large Firms**

Over the past ten years, stress testing has become a crucial element of the regulatory framework and supervisory program for large firms. The stress testing framework has given the Board the ability to assess more effectively whether large firms have sufficient capital to absorb potential losses and continue lending under severely adverse conditions. Additionally, it helps firms assess their future capital needs under stress. Over the past decade, the Board has also taken significant steps to strengthen ongoing, non-stress capital requirements. In 2013, the Board strengthened the quality and increased the quantity of capital required under the capital rule. The changes to the capital rule implemented several key regulatory tools, including a minimum CET1 capital ratio and a capital conservation buffer. In addition, in 2015, the Board adopted a capital surcharge for GSIBs, known as the GSIB surcharge, based on a GSIB's overall systemic risk.

These reforms to the capital framework have significantly increased the resiliency of the banking system and of the largest firms in particular. For example, firms subject to CCAR in 2019 have increased their aggregate ratio of common equity capital to risk-weighted assets from 4.9 percent in the first quarter of 2009 to 12.3 percent in the fourth quarter of 2018 (see Figure

1).<sup>4</sup> This change reflects a total increase of approximately \$660 billion in common equity capital, bringing total CET1 capital at these firms to over \$1 trillion in the fourth quarter of 2018.

**Figure 1: Aggregate common equity capital ratio of CCAR 2019 firms<sup>5</sup>**



Source: FR Y-9C.

In 2018, the Board issued a proposed rule to simplify the Board’s capital framework by integrating the non-stress capital requirements and the stress test-based capital requirements under CCAR, while maintaining the resiliency of the financial system.<sup>6</sup> To integrate these requirements, the proposal introduced a firm-specific stress capital buffer requirement based on

<sup>4</sup> The Federal Reserve’s evaluation of firms’ common equity capital was initially measured using tier 1 common capital but is now evaluated using CET1 capital, as defined in the capital rule. Under both measures, firms have significantly increased their capital positions since 2009. This measure includes data on all firms subject to CCAR 2019, including their data as it appears on the FR Y-9C.

<sup>5</sup> The decline in the aggregate common equity capital ratio in late 2017 was largely driven by the enactment of the Tax Cuts and Jobs Act, which required firms to take one-time losses from write downs of certain tax assets and repatriation taxes.

<sup>6</sup> 83 FR 18160 (April 25, 2018).

the results of the Board's supervisory stress test. The stress capital buffer requirement would have replaced the existing fixed 2.5 percent capital conservation buffer. The proposal also would have modified certain assumptions used in CCAR to simplify and remove redundant elements of the capital framework. The stress capital buffer requirement would have included four quarters of a firm's planned common stock dividends, based on the experience of the 2007-2008 financial crisis, where large bank holding companies continued to pay dividends at nearly the pre-crisis rate through 2008. Lastly, the proposal would have introduced a stress leverage buffer requirement.

The Board received twenty-six comment letters on the proposal from banking organizations, public interest groups, private individuals, and other interested parties. Many commenters were supportive of the proposal's goals of simplifying the Board's capital framework and preserving strong capital requirements for large firms. Commenters had mixed views, however, on the calibration of the stress capital buffer requirement, the need for a stress leverage buffer requirement, the proposed changes to the assumptions in CCAR, the volatility in the Board's stress testing framework, and the flexibility provided to firms in their capital planning.

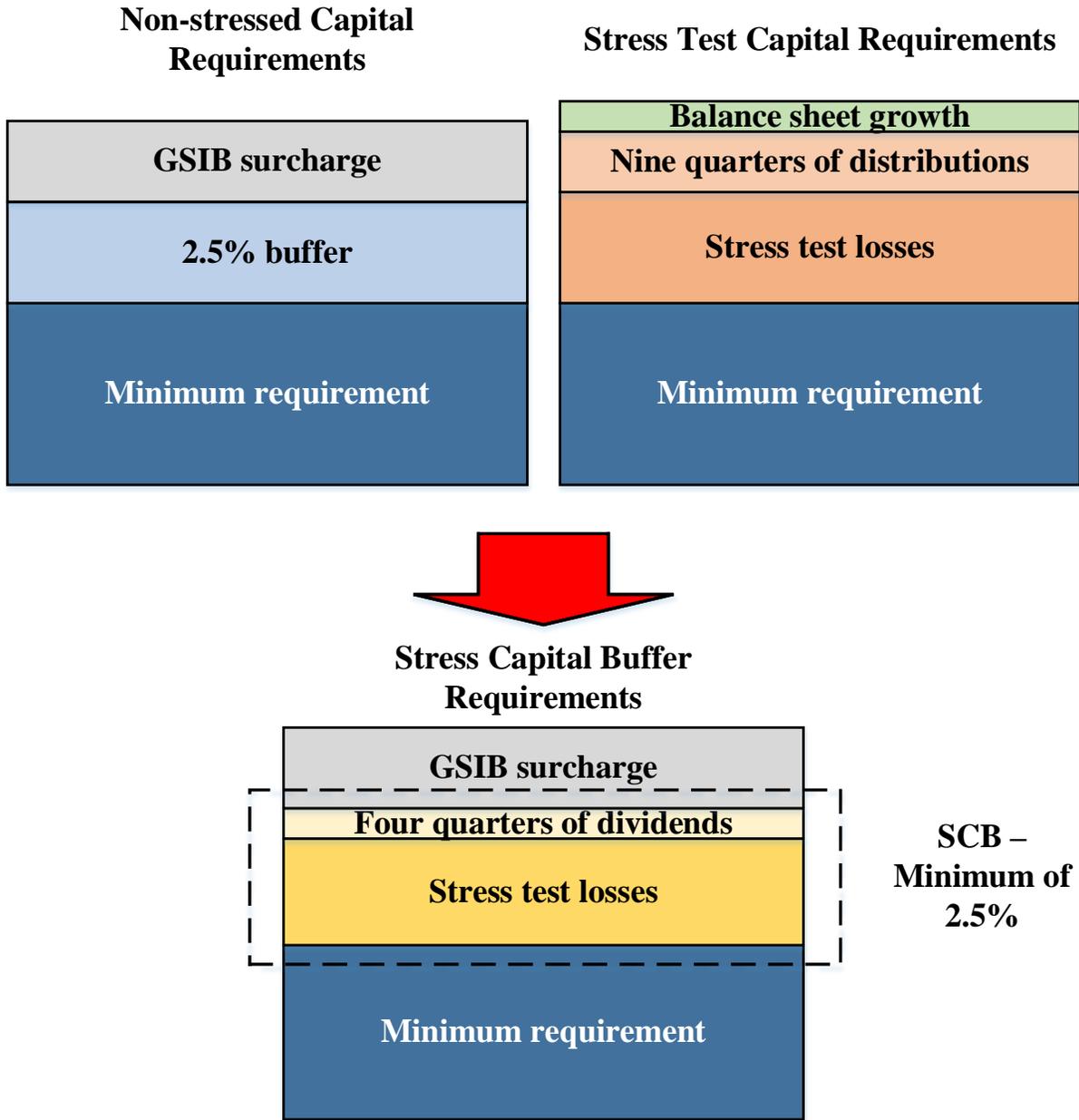
## **II. Overview of the Final Rule**

Staff recommends that the Board adopt the draft final rule as proposed, with certain key changes in response to comments, described in Section III below. Under the draft final rule, a firm's stress capital buffer requirement would be calculated as: (1) the difference between the firm's starting and minimum projected CET1 capital ratios under the severely adverse scenario in the supervisory stress test, plus (2) four quarters of planned common stock dividends as a percentage of risk-weighted assets. The stress capital buffer requirement, which would apply in

addition to a firm's minimum risk-based capital requirements, could be no less than 2.5 percent of risk-weighted assets (see Figure 2). A firm whose capital ratios are at or below its minimum plus its stress capital buffer requirements and any applicable GSIB surcharge and countercyclical capital buffer would be subject to automatic restrictions on capital distributions.

The draft final rule would modify CCAR by no longer assuming that a firm makes nine quarters of planned capital actions, including dividends and repurchases, under stress. Instead, the stress capital buffer requirement would incorporate four quarters of planned dividends. In addition, the draft final rule would modify CCAR by assuming that a firm maintains a constant level of assets over the planning horizon rather than assuming a growing balance sheet over the planning horizon. These changes would better reflect conditions in a stressful situation and simplify the capital framework. In addition, to further simplify CCAR, the draft final rule would remove the 30 percent dividend payout ratio currently applied as a criterion for heightened supervisory scrutiny of a firm's capital plan. This criterion was adopted to encourage firms to increase payouts through additional share repurchases rather than dividends. Staff believes it is no longer necessary to retain a dividend payout ratio criterion because the draft final rule's automatic distribution limitations, combined with the perceived market signaling effect of dividend cuts, will sufficiently restrict dividend increases in the future. The draft final rule also would indicate that the Board intends to propose at a future date modifications to further simplify and increase the transparency of the stress testing framework. The draft final rule would become effective 60 days after publication in the Federal Register and, as a consequence, would apply in CCAR 2020.

**Figure 2: Changes to capital regime for GSIBs**



**III. Comments Received and Changes from the Proposal**

*Calibration of the stress capital buffer requirement:* A number of commenters asserted that the proposed stress capital buffer requirement was too stringent, particularly when combined

with the GSIB surcharge and the countercyclical capital buffer, and suggested alternatives to reduce purported redundancies. Notwithstanding commenters' views, each component of a firm's buffer requirements would serve a distinct purpose and has been calibrated and designed to effectuate that purpose. For example, the GSIB surcharge is designed to mitigate the risk posed to financial stability by GSIBs, and is calibrated based on the externalities posed by these firms, whereas the stress capital buffer requirement would be calibrated based on each firm's vulnerability to adverse economic or financial market conditions. Accordingly, staff recommends adopting the calibration of the stress capital buffer requirement as proposed. (See pp 43–49 of the draft final rule.)

*Capital distribution assumptions:* Currently, the Board assumes in CCAR that a firm would continue to make all planned dividends and share repurchases under stress, and therefore requires firms to pre-fund nine quarters of planned distributions. The proposal would have instead included only four quarters of dividends in a firm's stress capital buffer requirement. Some commenters were opposed to this four-quarter dividend add-on, viewing it as unnecessary given the capital rule's automatic restrictions on capital distributions. Other commenters supported the four-quarter dividend add-on, arguing it creates strong incentives for disciplined, forward-looking capital planning.

Requiring firms to pre-fund four quarters of dividends is one way of promoting forward-looking dividend planning and mitigating the procyclicality of the Board's stress testing framework. Accordingly, staff recommends adopting the modifications to the capital

distribution assumptions as proposed.<sup>7</sup> Staff will continue to consider possible additional refinements to the capital framework with the goals of reducing complexity and redundancies, limiting procyclicality, increasing transparency, and preserving strong capital requirements. (See pp 13–16 of the draft final rule.)

*Material business plan changes:* Under the proposal, a firm’s stress capital buffer requirement would have included the impact of any material business plan change (e.g., resulting from a merger, acquisition, or divestiture). Commenters asserted that the Board should not incorporate a material business plan change into the stress capital buffer requirement since the impact of such a change would be reflected in the firm’s regulatory capital ratios once the change is consummated.

In response to this comment and to further reduce burden and simplify the capital framework, staff recommends that the stress capital buffer requirement not include the effect of an unconsummated material business plan change. In the event of a change to a firm’s business plan that does or could result in a material change in the firm’s risk profile, the Board would retain the authority under the draft final rule to require the firm to submit an updated capital plan and to update the firm’s stress capital buffer based on that plan. (See pp 17–19 of the draft final rule.)

*Stress leverage buffer requirement:* The proposal included a stress leverage buffer requirement to complement the stress capital buffer requirement. Some commenters asserted that a stress leverage buffer requirement would be inappropriate, as leverage requirements are

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<sup>7</sup> In a change from the proposal, the draft final rule would simplify the calculation of the four-quarter dividend add-on by calculating it as a percentage of one quarter of projected risk-weighted assets instead of a percentage of four quarters of projected risk-weighted assets.

designed to be a backstop to risk-based measures and to be risk-insensitive, making them inconsistent with the concept of a risk-sensitive stress buffer requirement. Other commenters supported adopting the proposed stress leverage buffer requirement.

Because the leverage ratio is not risk-sensitive, the Board has long held the view that leverage ratio requirements should serve as a robust backstop to the risk-based requirements. In light of the integration of CCAR and the Board's non-stress capital requirements, which include leverage ratio requirements that serve as a backstop to the risk-based requirements, the draft final rule would not include a stress leverage buffer requirement.<sup>8</sup> Non-stress leverage ratio requirements would remain for all large firms. As discussed below, the draft final rule results in unchanged CET1 capital requirements for large banking firms in the aggregate and not imposing a stress leverage buffer requirement increases the likelihood that risk-based requirements will be the most binding requirements for firms. (See p 25 of the draft final rule.)

*Volatility and abrupt distribution restrictions:* Given the proposed integration of non-stress capital requirements and the stress test-based capital requirements under CCAR, some commenters recommended that the Board take additional steps to address the volatility in the Board's stress testing framework to provide more predictability in a firm's capital requirements.

Since the Board issued the proposal, the Board has adopted a set of changes to increase the transparency of its stress testing program. On February 5, 2019, the Board issued (1) a final notice of an enhanced disclosure of the models used in the supervisory stress test; (2) a final

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<sup>8</sup> The draft final rule would not modify the requirements in the Board's supervisory stress test or company-run stress test rules whereby the Board, or a firm, will include in its stress analysis projections of regulatory capital ratios, including the tier 1 leverage ratio and the supplementary leverage ratio.

stress testing policy statement describing the principles that guide the development, implementation, and validation of the supervisory stress test models; and (3) final amendments to the Board's Policy Statement on the Scenario Design Framework for Stress Testing.<sup>9</sup> Staff will continue to consider ways to improve the transparency of the stress testing program, while maintaining the dynamism of the stress test.

Staff recommends, however, that the Board adopt a change from the proposal regarding the capital distribution limitation calculation used in the capital rule.<sup>10</sup> The distribution limitations in the non-stress capital requirements were designed to gradually restrict a firm's ability to make capital distributions as the firm's capital ratios decline toward regulatory minimums. The implementation of the stress capital buffer requirement would increase the probability that a firm would be abruptly restricted from making capital distributions, as year-over-year changes in supervisory stress test results could increase the firm's capital buffer requirements. To help ensure gradual distribution limitations for firms under most circumstances, the draft final rule would use a measure of average earnings (gross of prior capital distributions) as the base to calculate capital distribution limitations in the region of a firm's stress capital buffer requirement that is beyond 2.5 percent of risk-weighted assets.<sup>11</sup> (See pp 20-24 of the draft final rule.)

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<sup>9</sup> 84 FR 6651 (April 1, 2019); 84 FR 6664 (April 1, 2019); 84 FR 6784 (April 1, 2019).

<sup>10</sup> Specifically, a firm whose capital ratios fell into the top quartile of its capital conservation buffer would be limited to distributing 60 percent of its "eligible retained income," which is defined as the sum of the previous four quarters of net income minus distributions.

<sup>11</sup> The current distribution limitations would continue to apply if a firm's capital ratios were at or below the sum of the minimum capital requirements, the 2.5 percent capital conservation buffer requirement, any applicable GSIB surcharge, and any applicable countercyclical capital buffer requirement.

*Flexibility to make additional capital distributions:* The proposal would have retained the requirement for a firm to seek prior approval from the Board to make capital distributions in excess of the planned distributions included in the firm’s capital plan. Commenters asserted that this requirement was unnecessary and burdensome in light of the automatic distribution restrictions already in place in the non-stress capital rules.

The draft final rule would remove this requirement to harmonize the Board’s framework for capital distribution limitations and reduce burden. Accordingly, a firm would be able to make capital distributions in excess of the planned capital distributions included in its capital plan so long as the firm is in compliance with the capital framework’s automatic distribution limitations. A firm would be required to notify the Federal Reserve of changes to its planned capital actions within 15 days of executing such an action. (See pp 28–32 of the draft final rule.)

#### **IV. Regulatory Reporting**

Consistent with the proposal, the draft final rule would include revisions to the FR Y-9C and FR Y-14A regulatory reporting forms in connection with the revisions to the Board’s regulations under the draft final rule. In a change from the proposal, the revisions would not include the addition of data items relating to the stress leverage buffer requirement because the requirement is not included under the final rule. The revisions would also collect additional information related to eligible retained income to account for the new definition.

In order to implement these changes, the draft final rule would extend, with revision, the Paperwork Reduction Act (PRA) clearances for the FR Y-14 series of reports, the FR Y-9 series of reports, and the recordkeeping and reporting requirements associated with the capital plan rule (FR Y-13). Under the PRA, the Board must undertake a review prior to revising a collection of

information. The Office of Management and Budget has delegated to the Board the authority to review and approve collection of information requests and requirements pursuant to the PRA.<sup>12</sup>

The FR Y-9, FR Y-13, and FR Y-14 information collections comply with the PRA, and the information collected is not available from other sources. Information regarding the burden associated with these collections of information is included in the draft final rule.

## **V. Impact Analysis**

Staff analyzed the impact of the draft final rule on the capital requirements of affected firms. The analysis used data from the CCAR exercises from 2013 to 2019 to assess the impact of the final rule.<sup>13</sup> While 2013 to 2019 was a period of robust economic activity, firms' planned capital distributions – a key driver of the impact of the final rule relative to current requirements – rose from a relatively low level in 2013 to a relatively high level in 2019. As such, the average impact of the rule across this period provides a reasonable estimate of its impact through the cycle.

On average, the draft final rule would result in unchanged CET1 capital requirements, relative to the current CET1 capital requirements derived from the regular capital rules and the stress tests. Therefore, from a through-the-cycle perspective, the final rule would maintain strong capital requirements for large firms.

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<sup>12</sup> The Federal Reserve's review of the collection of information should include: (1) an evaluation of the need for the collection of information, (2) a description of the information to be collected, (3) a plan for the collection of information, (4) a specific estimate of burden, (5) an evaluation of whether burden may be reduced by use of information technology, (6) a test of the collection through a pilot program, if appropriate, and (7) a plan for the efficient management and use of the information to be collected.

<sup>13</sup> Estimates of the proposal from the 2013 and 2014 exercises use tier 1 common capital, a proxy for CET1 capital. Data from 2015 to 2019 exercises use CET1 capital, as defined in the capital rule.

For GSIBs, the largest and most systemically important firms, the draft final rule would lead to an aggregate increase in CET1 capital requirements of approximately \$46 billion, on average, a seven percent increase in their current aggregate CET1 capital requirement. The increased CET1 capital requirement for GSIBs results primarily from the combination of a stress test-based capital requirement with the GSIB surcharge. For firms subject to Category II through Category IV standards, aggregate CET1 capital requirements would decrease by approximately \$35 billion, on average, a 10 percent decrease relative to their current requirement. Across the years examined, the impact of the final rule on CET1 capital requirements ranges from a decline of approximately \$59 billion to an increase of approximately \$78 billion, reflecting primarily changes in distributions (See Table 1).

**Table 1. Impact on CET1 Capital Requirements, CCAR 2013 – 2019, USD Billions**

<b>Category</b>	<b>Average CET1 Impact</b>	<b>Range of CET1 Impacts</b>	<b>Average CET1 Impact as a Percent of Current Requirements</b>
GSIBs	\$46	\$-6 to \$84	7%
Category II - IV	\$-35	\$-53 to \$-5	-10%
Total	\$11	\$-59 to \$78	1%

Staff expects that the rule would result, on average, in a \$49 billion reduction in tier 1 capital requirements, equivalent to a four percent decrease relative to aggregate current tier 1 capital requirements for firms subject to the draft final rule. Tier 1 capital is a broader and less loss-absorbing measure of capital than CET1 capital and, as noted above, the draft final rule would result in unchanged CET1 capital requirements. The tier 1 capital requirements for GSIBs would remain unchanged, on average. The decline in tier 1 capital requirements for firms subject Category II through IV standards reflects, in part, the removal of the post-stress leverage

requirements. The removal of this requirement increases the likelihood that these firms will be bound by risk-based requirements and that leverage requirements will serve as a backstop to those requirements.

As stress losses would determine capital requirements only for firms above the stress capital buffer requirement floor, staff examined the impact of the final rule on risk sensitivity. Using data from 2013 to 2019, staff estimated that slightly more than half of firms would have had stress capital buffer requirements above 2.5 percent. In addition, staff assessed the macroeconomic consequences of the draft final rule using models of bank capital, and believe that the rule will have little to no impact on the long-run level of U.S. economic activity.<sup>14</sup> (See pp 54-57 of the final rule.)

#### **RECOMMENDATIONS:**

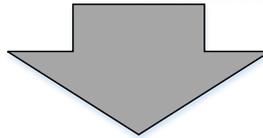
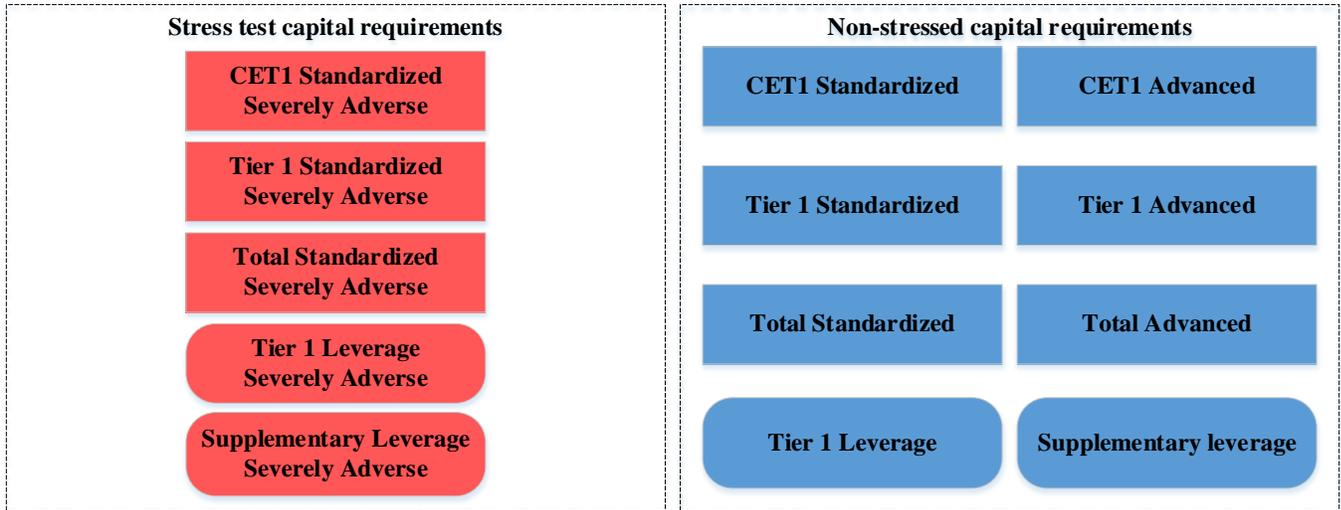
For the reasons discussed above, staff recommends that the Board approve the attached draft final rule. Staff also recommends that the Board authorize staff to make technical or minor changes to the attached materials prior to publication in the Federal Register.

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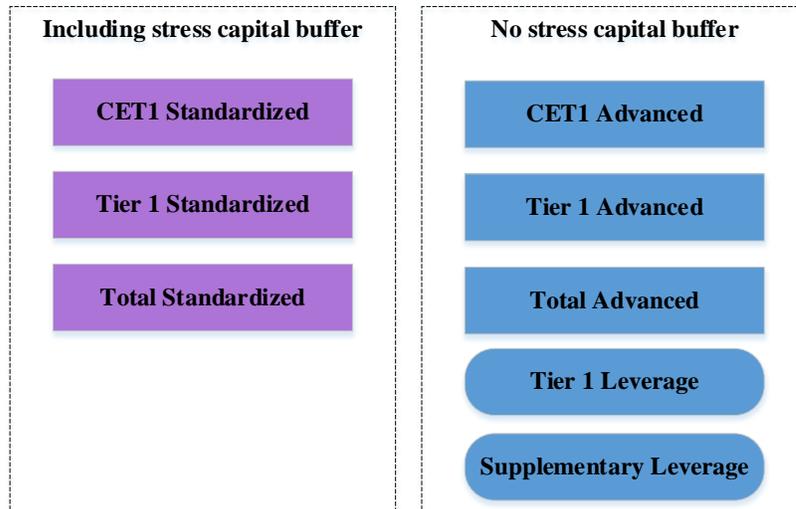
<sup>14</sup> The draft final rule includes a certification by the Board that the final rule would not have a significant economic impact on a substantial number of small entities for purposes of the Regulatory Flexibility Act. 5 U.S.C. § 601 *et seq.*

## Appendix I: Simplification of capital requirements

### Current Capital Requirements†



### Updated Capital Requirements



†This figure excludes six resolution requirements relating to total loss-absorbing capacity and long-term debt that are not directly affected by the final rule.