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Perspectives on CCAR: Looking ahead to the 2017 cycle

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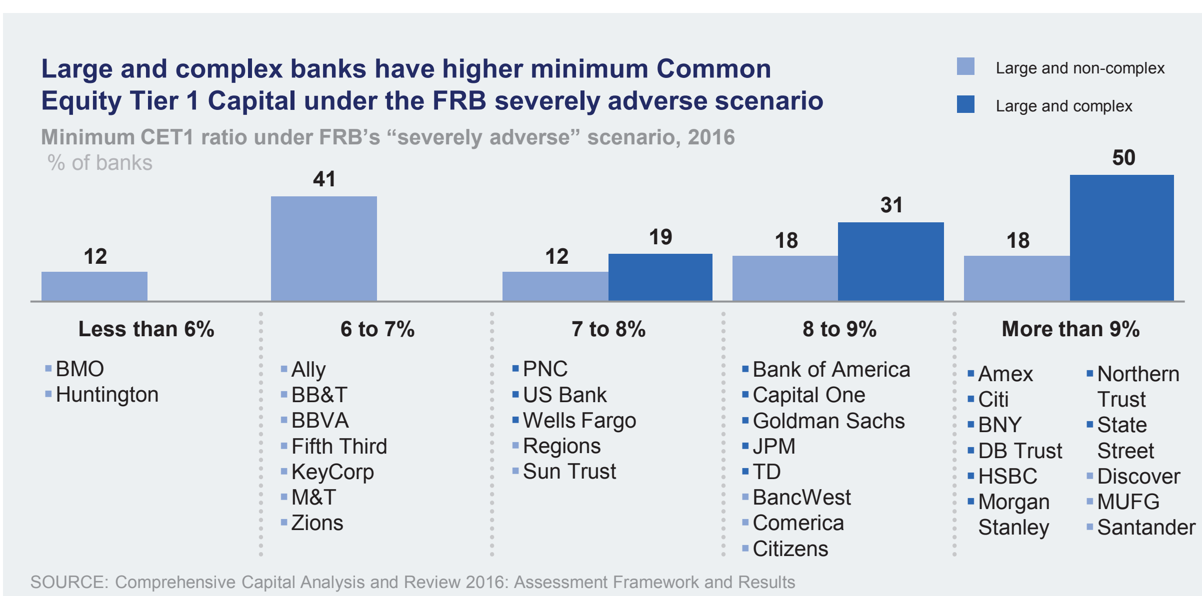
On June 29th, the Federal Reserve Board (FRB) released the results of its 2016 Comprehensive Capital Analysis and Review (CCAR) for the 33 bank holding companies (BHCs) with more than $50 billion in assets. It came as no surprise that, for the second year in a row, no bank failed on quantitative grounds. However, the FRB objected on qualitative grounds to the capital distributions proposed by Deutsche Bank Trust Corporation and Santander Holdings USA Inc., for the second and third year in a row, respectively. In addition, the FRB has required Morgan Stanley to submit a new capital plan by the end of the fourth quarter to address certain weaknesses in its capital planning processes. While the FRB did not object to the capital plans of the remaining 30 BHCs, expectations for all CCAR institutions continue to rise. We see five key themes emerging as banks ready themselves to address their CCAR 2016 shortcomings and prepare for the demands of CCAR 2017 and beyond.

1. The divide in expectations for larger and more complex banks continues to grow.

CCAR 2016 results and other recent signs reinforce that larger and more complex institutions will be held to a higher standard, first made explicit in SR 15-18 and SR 15-19, and will be required to hold yet higher amounts of capital. Regional banks already are “either meeting or close to meeting supervisory expectations,” according to the CCAR 2016 results. Furthermore, Fed Governors Tarullo and Powell have recently indicated that non-



complex banks up to $250 billion in assets may no longer be subjected to the qualitative CCAR assessment, potentially as soon as the 2017 CCAR cycle. This change could affect as many as two-thirds of the 33 banks subject to this years' test. By contrast, the FRB has signaled that larger and more complex institutions are not where they need to be, despite passing results in CCAR 2016. Such banks, which are expected to have more sophisticated, comprehensive and robust capital planning processes, "continue to fall short of [qualitative] expectations." Quantitative requirements may also be going up. Tarullo and Powell have signaled that the Fed is likely to require the eight designated systemically important financial institutions (SIFIs) to include SIFI surcharges in their minimum capital thresholds, beginning in the 2018 cycle. As a net result, even as CCAR enters its seventh year, the Fed refuses to let the largest and most complex banks grow complacent – ensuring focused application of higher standards by narrowing the comparator set, explicitly raising qualitative expectations, and heightening the quantitative stakes.

2. The bar for Audit and internal controls rises another notch.

Increasingly, the Fed expects banks to be their own source of review, challenge, and validation, rather than having the regulator serve these roles externally. Audit will be a particularly prominent near-term focus. The Fed will expect demonstrated progress by next year's CCAR cycle. The upcoming horizontal review of internal audit functions is likely to be hard-hitting, and only the first in a series of steps. Audit functions will need to expand their talent base and become less insular, understanding more about the range of industry practice, to meet this challenge. Internal controls and governance, spanning process and data controls, model risk management, senior management and Board-level challenge, will also remain in the spotlight. Specific challenges will vary by bank, but the general standard of demonstrating reliability and credibility of results will be universal.

3. Attention shifts further toward qualitative elements underpinning forecasts.

For the most part, institutions' statistical modeling practices have matured and no longer draw criticism. Supervisory focus has shifted toward non-statistical forecasts, model overlays, and the assumptions, uncertainties, and sensitivities associated with all forecasts, including statistical models. This shift is particularly evident in pre-provision net revenue (PPNR) and operational-risk modeling. At some institutions, PPNR is a final hold-out, where a meaningful number of forecasts are made using non-statistical methods or where model overlays are large compared to the model forecasts. The standard for justifying such methods in the absence of accompanying statistical models is growing untenably high. Operational risk forecasting will also be affected. Though expectations remain in flux, with no consensus approach having emerged, there are signals that qualitative approaches, including thoughtful analysis of operational and legal loss scenarios, are becoming more important. Across all forecasting domains, institutions that improve their understanding and control of assumptions, uncertainties, and sensitivities will not only meet supervisory expectations, but will also improve their ability to set capital buffers that are sufficient but not overly conservative.

4. The boundary between CCAR and fundamental risk management grows yet more fluid.

Increasingly, banks will need effective two-way dialogue between capital-planning and more traditional aspects of enterprise risk management. In one direction, the tools of fundamental risk management are expected to feed CCAR. The spotlight remains on risk identification, with increasingly explicit emphasis on its link to scenario development and understanding of the vulnerabilities of specific business activities under stress. Conversely, CCAR is also expected to serve as a tool to inform and strengthen risk management, even beyond the traditional realm of capital planning. Correspondingly, the Fed continues to emphasize that it may object to a capital plan on the basis of material unresolved supervisory issues, even if unrelated to capital planning. Forward looking banks are responding to this trend by incorporating stress testing into business-as-usual practice, linking it to risk appetite, risk identification and assessment, baseline planning, and strategic decision-making.

5. Data is the next frontier, complementing revenue-linked efforts if approached thoughtfully.

As a follow-up to the January 1, 2016 deadline for G-SIB compliance with BCBS 239[1] principles, regulators have begun conducting "BCBS 239 readiness" examinations and have been setting a high bar for these exams. Upcoming CCAR cycles will present one natural forum for testing these principles in action. On the one hand, this will present a major challenge for the many banks whose CCAR processes do not demonstrate BCBS principles such as a framework for automation, or well-governed and independent validation of data. On the other hand, this impetus represents an opportunity to nearly every institution, since addressing CCAR data while meeting BCBS principles will drive a better understanding of both customers and business performance, and thus, perhaps unusually within the CCAR context, offers potential for true revenue upside.

1 Basel Committee on Banking Supervision, "Principles for effective risk data aggregation and risk reporting," January 2013, bis.org.

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