# Rules and Regulations

Federal Register
Vol. 79, No. 49
Thursday, March 13, 2014



## DEPARTMENT OF THE TREASURY

### Office of the Comptroller of the Currency

### 12 CFR Part 46

**[Docket No. OCC–2013–0013]**

## FEDERAL RESERVE SYSTEM

### 12 CFR Part 252

**[Docket No. OP–1485]**

## FEDERAL DEPOSIT INSURANCE CORPORATION

### 12 CFR Part 325

## Supervisory Guidance on Implementing Dodd-Frank Act Company-Run Stress Tests for Banking Organizations With Total Consolidated Assets of More Than $10 Billion but Less Than $50 Billion

**AGENCY:** Board of Governors of the Federal Reserve System (Board or Federal Reserve); Federal Deposit Insurance Corporation (FDIC); Office of the Comptroller of the Currency, Treasury (OCC).

**ACTION:** Final supervisory guidance.

**SUMMARY:** The Board, FDIC, and OCC, (collectively, the agencies) are issuing this guidance, which outlines principles for implementation of the stress tests required under section 165(i)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or DFA stress tests), applicable to all bank and savings and loan holding companies, national banks, state member banks, state nonmember banks, Federal savings associations, and state-chartered savings associations with more than $10 billion but less than $50 billion in total consolidated assets (collectively, the $10–50 billion companies). The guidance discusses supervisory expectations for DFA stress test practices and offers additional details about methodologies that should be employed by these companies.

**DATES:** Effective dates are as follows:
For the Board: April 1, 2014.
For the FDIC: March 31, 2014.
For the OCC: March 31, 2014.

**FOR FURTHER INFORMATION CONTACT:**
*Board:* David Palmer, Senior Supervisory Financial Analyst, (202) 452–2904; Joseph Cox, Financial Analyst, (202) 452–3216; Keith Coughlin, Manager, (202) 452–2056; Benjamin McDonough, Senior Counsel, (202) 452–2036; or Christine Graham, Senior Attorney, (202) 452–3005, Board of Governors of the Federal Reserve System, 20th and C Streets NW., Washington, DC 20551.

*FDIC:* Ryan Sheller, Section Chief, (202) 412–4861; Alisha Riemenschneider, Senior Financial Institutions Specialist, (712) 212–3280; Mark Flanigan, Counsel, (202) 898–7427; or Jason Fincke, Senior Attorney, (202) 898–3659, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.

*OCC:* Kari Falkenborg, Financial Analyst, (202) 649–6831; Harry Glenos, Senior Financial Advisor, (202) 649–6409; Ron Shimabukuro, Senior Counsel, or Henry Barkhausen, Attorney, Legislative and Regulatory Affairs Division, (202) 649–5490, Office of the Comptroller of the Currency, 400 7th Street SW., Washington, DC 20219.

**SUPPLEMENTARY INFORMATION:**

### I. Background

In October 2012, the agencies issued final rules implementing stress testing requirements for companies [1] with over $10 billion in total assets pursuant to section 165(i)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA stress test rules).[2] At that time, the agencies also indicated that they intended to publish supervisory guidance to accompany the final rules and assist companies in meeting rule requirements, including separate guidance for companies with between $10 billion and $50 billion in total assets. To supplement these rules, on July 30, 2013, the agencies sought public comment on proposed supervisory guidance (''proposed guidance'') that discussed supervisory expectations regarding the conduct of the DFA stress tests and offered additional details about methodologies that should be employed by these companies.[3]

The proposed guidance was organized around the DFA stress test rule requirements. In the proposed guidance, the agencies indicated that they would expect $10–50 billion companies to follow the DFA stress test rule requirements, other relevant supervisory guidance, and the expectations from the proposed guidance when conducting DFA stress tests. The final guidance is organized in a similar manner.

Consistent with the proposal, other relevant guidance includes ''Supervisory Guidance on Stress Testing for Banking Organizations With More Than $10 Billion in Total Consolidated Assets'' issued by the agencies in May 2012 (''May 2012 guidance'').[4] The May 2012 guidance sets forth broad principles for a satisfactory stress testing framework for banking organizations with total assets of more than $10 billion, including principles related to governance, controls, and use of results.

However, it is important to note that other guidance relevant for the $10–50 billion companies does not include, and these firms are not subject to, other requirements and expectations applicable to bank holding companies with assets of at least $50 billion, including the Federal Reserve's capital plan rule, annual Comprehensive Capital Analysis and Review, supervisory stress tests for capital adequacy, or the related data collections supporting the supervisory stress test.[5]

---

[1] For the OCC, the term ''company'' is used in this guidance to refer to national banks and Federal savings associations that qualify as ''covered institutions'' under the OCC Annual Stress Test Rule. 12 CFR 46.2. For the Board, the term ''company'' is used in this guidance to refer to state member banks, bank holding companies, and savings and loan holding companies. *See* 12 CFR 252.13. For the FDIC, the term ''company'' is used in this guidance to refer to insured state nonmember banks and insured state savings associations that qualify as a ''covered bank'' under the FDIC Annual Stress Test Rule. 12 CFR 325.202.

[2] *See* 77 FR 61238 (October 9, 2012) (OCC final rule), 77 FR 62378 (October 12, 2012) (Board final rule), and 77 FR 62417 (October 15, 2012) (FDIC final rule).

[3] *See* 78 FR 47217 (August 5, 2013).

[4] *See* 77 **Federal Register** 29458 (May 17, 2012).

[5] *See* 12 CFR 225.8 (capital plan rule); Supervisory and Company-Run Stress Test Requirements for Covered Companies, 12 CFR part 252, subparts E and F; and the Capital Assessment

Continued

## II. Summary of Comments

The agencies received 13 comments on the guidance from trade organizations, industry participants, vendors, and individuals. In addition to the comments, the agencies held a series of discussions with trade groups, state banking supervisors, and the banking organizations to raise awareness about the proposed guidance and solicit feedback. Some commenters expressed support for the proposed guidance. However, several commenters recommended changes to, or clarification of, certain provisions of the proposed guidance, as discussed below. In response to these comments, the agencies have clarified the principles set forth in the guidance and modified the proposed guidance in certain respects as described in this section of the **SUPPLEMENTARY INFORMATION.**

### *A. Overall Comments on the Proposed Guidance*

Commenters provided several suggestions for clarifying or modifying the proposed guidance. Commenters requested additional clarity around what practices are commensurate with a company's size and complexity and what constitutes a larger or more sophisticated company. Some commenters requested that the agencies provide additional tailoring of expectations based on the size and complexity of companies, and on each company's familiarity with stress testing. Other commenters argued that the guidance adopted an approach that was too prescriptive and should provide each company with flexibility to focus its stress test on the company's assessment of its idiosyncratic risks. Commenters also recommended that the agencies consider requiring other types of stress testing besides scenario analysis and that a more comprehensive set of risks should be addressed in the guidance.

The final guidance retains the overall structure and content of the proposal. In addition, the final guidance provides additional detail about certain key requirements already established in the DFA stress testing rules. The proposed guidance emphasized that the expectations regarding stress testing for $10–50 billion companies would generally be reduced compared to expectations for companies with $50 billion or more in assets. In order to underscore that point, the final guidance provides additional examples of certain tailored expectations for $10–50 billion companies. In addition, the final guidance provides information on the circumstances under which a $10–50 billion company should use the more advanced practices described in the guidance.

Several commenters opposed stress testing for $10–50 billion companies. The commenters argued that conducting the stress tests would be expensive, time-consuming, and of limited benefit. One commenter suggested that the stress tests would distract key personnel from conducting other types of risk management. Commenters requested that $10–50 billion companies be exempt from stress testing requirements under certain circumstances, such as if the company was well capitalized, or be allowed to use an alternative simplified stress test, such as assuming certain loss rates or conducting a local market and concentration analysis.

Stress testing for companies with more than $10 billion but less than $50 billion in total consolidated assets is a requirement of the Dodd-Frank Act. The agencies are not exempting a company based on its pre-stress capital ratios or allowing companies to conduct a simplified stress test that is not based on the supervisory scenarios provided by each agency, as those practices may not address the possibility of losses under stressful circumstances. However, as noted above, the agencies have sought to tailor the stress testing requirements and expectations for $10–50 billion companies. For example, the expectations for data sources, data segmentation, sophistication of estimation practices approaches, reporting and public disclosure are elevated for larger and more complex organizations than for $10–50 billion companies.

Commenters requested that the agencies modify the timing of the stress tests to reduce the regulatory reports that need to be completed at or shortly after year-end. Commenters noted that companies were required to file many other regulatory reports at the end of a year and that other regulatory changes are implemented at the beginning of a year. One commenter's request was to allow companies to conduct their stress tests with an as of date of December 31 and a due date of June 30. The agencies note that the DFA stress test rules do not require $10–50 billion companies to file regulatory reports by year-end. Compared to larger banking organizations, the DFA stress test rules for $10–50 billion companies provide these companies with additional time to conduct their stress tests each year, with the report due by March 31, rather than the reporting deadline of January 5 that is required for companies with $50 billion or more in assets. The agencies recognize that some companies may still face resource constraints based on the timeline of the annual stress tests, but the timeline was codified in the DFA stress test rules. Thus, modification of that timeline is outside of the scope of the final guidance.

Some commenters were appreciative of the agencies' communication regarding the guidance and one commenter requested that the agencies set up a dedicated electronic mailbox for companies to use to submit questions to the agencies about the stress tests. The agencies recognize that additional clarification about the stress tests may be necessary and are evaluating additional tools to assist in this regard. In the meantime, companies should direct questions regarding the guidance to their examination staff or to the contacts identified in the guidance.

### *B. Scenarios for DFA Stress Tests*

Under the stress test rules required by the Dodd-Frank Act, $10–50 billion companies must assess the potential impact of a minimum of three macroeconomic scenarios—baseline, adverse, and severely adverse—on their consolidated losses, revenues, balance sheet (including risk-weighted assets), and capital. The proposed guidance indicated that $10–50 billion companies should apply each supervisory scenario across all business lines and risk areas so that they can assess the effect of a common scenario on the entire enterprise, though the effect of the given scenario on different business lines and risk areas may vary.

Some commenters opposed requiring $10–50 billion companies to use the supervisory scenarios in their DFA stress tests, arguing that the national variables would not be useful or relevant for many companies, that the agencies do not have a strong record of identifying emerging risks in the past, and that the scenario variables were not sufficiently plausible to be useful as a risk management tool. Other commenters argued that translating scenario variables into projections of losses, revenues, the balance sheet, risk-weighted assets, and capital would be time-consuming, complicated, and without sufficient benefit to justify the cost. The commenters stated that $10–50 billion companies do not have the staff or expertise to perform the quantitative analysis necessary to properly translate the scenarios in the stress tests.

The use of common supervisory scenarios by all companies subject to annual company-run stress tests is a key feature of the stress test rules required

and Stress Testing information collection (FR Y–14Q, FR Y–14M, and FR Y–14A).

by the Dodd-Frank Act. However, the proposed guidance indicated that $10–50 billion companies are not required to use all of the variables in the supervisory scenarios. In addition, the proposed guidance stated that $10–50 billion companies could, but would not be required to, include additional variables or additional quarters to improve the robustness of their company-run stress tests. However, the proposed guidance indicated that the paths of any additional regional or local variables that a company used would be expected to be consistent with the path of the national variables in the supervisory scenarios. The agencies believe that the final guidance allows for substantial flexibility in translating scenario variables and are retaining these principles. Thus, consistent with the final guidance, a company is not required to use all the variables in the supervisory scenarios but could use additional variables or quarters to improve their company-run stress tests.

Commenters requested further clarification regarding the translation of the supervisory scenarios into projections of losses and revenues. One commenter questioned whether idiosyncratic risks should be addressed in relation to the supervisory scenarios or through the use of alternative scenarios that might not be consistent with the supervisory scenarios. Consistent with principles articulated in the May 2012 stress testing guidance, the final guidance reiterates that no single stress test can accurately estimate the effect of all stressful events and circumstances. Accordingly, the final guidance clarifies that while additional variables may be used to better link the scenario variables in the supervisory scenarios with companies' projections, the DFA stress tests may not capture the effects of all of a company's risks and vulnerabilities.

The agencies received several comments regarding the translation of national variables in the supervisory scenarios to regional variables. Commenters requested additional flexibility in the use of regional variables and in projecting regional variables in cases where data on local conditions may be less readily available. Commenters suggested that $10–50 billion companies will have to rely on vendors for intermediate variables as they lack the expertise to create those variables internally. For these reasons, some commenters suggested that the agencies assist companies in developing regional variables, either by directly providing local variables or by approving of specific third-party provided variables or specific vendors who provide scenario variables.

The agencies believe that the guidance provides sufficient flexibility regarding the use of regional variables. The guidance does not require a $10–50 billion company to project regional variables, and to the extent that a $10–50 billion company decides to project one or more regional variables, the guidance simply provides that the paths of the regional variables should be consistent with the paths of the national variables. For example, it would be inappropriate to use a regional or local variable that exhibited limited stress compared to variables in the macroeconomic scenarios provided by the agencies because the approach for deriving that additional variable would be based on relatively benign conditions. The agencies do not currently plan to include regional variables in the supervisory scenarios as it would be difficult to provide a single set of regional variables that would be appropriate and stressful for every company subject to DFA stress tests. The agencies do not supervise third-party vendors or consultants and do not endorse any vendor products, including those relating to scenario variables for use in the DFA stress tests. The final guidance retains the expectation that each company should ensure that they understand any vendor-supplied variables they use and confirm that such variables are relevant for and relate to company-specific characteristics.

*C. Data Sources and Segmentation*

The proposed guidance indicated that if a company does not currently have sufficient internal data to conduct a stress test, it would be permitted to use an alternative data source as a proxy for its own risk profile and exposures. However, the proposed guidance noted that companies with limited data would be expected to develop strategies to accumulate sufficient data to improve their stress test estimation processes over time.

While one commenter appreciated the proposed guidance's caution regarding the use of historical data, several commenters requested further clarification on expectations for data sources. Commenters believed that compiling internal historical data would be cost prohibitive and suggested that companies should be able to make reasonable assumptions to address limitations of the history or applicability of data. Other commenters requested that the agencies specify what factors are most relevant to determining whether proxy data are appropriate and another commenter requested that the agencies specifically instruct companies about which historical periods from which to collect data. Other commenters requested that the agencies clarify the expected timeline for improving the quality of internal data and circumstances where use of proxy data would be appropriate on a continuing basis.

Developing high-quality internal data is a crucial project for improving a company's stress testing estimation practices. However, in response to comments, the final guidance states that in some cases where a company may initially lack internal data on certain portfolios it may need to rely on proxy data for some time. Such practices may be acceptable provided that the company demonstrates that proxy data are relevant to the company's own exposures and appropriate for the estimation being conducted, and that the company is actively collecting internal data.

*D. Model Risk Management*

The proposed guidance indicated that companies should have in place effective model risk management practices, including validation, for all models used in DFA stress tests, consistent with existing supervisory guidance.[6] Commenters requested additional guidance on the use of benchmarking and challenger models and on whether models needed to be validated before the stress test results are submitted to the agencies.

In response, the agencies have clarified that, consistent with existing supervisory guidance on model risk management, in some cases, companies may not be able to validate all the models used in their DFA stress tests prior to submission. The final guidance indicates that the use of such models may be appropriate provided that companies made an effort to identify and prioritize validation for models based on materiality and highest risk; applied compensating controls so that the output from models that have not been validated or have only been partially validated is not treated the same as the output from fully validated models; and documented clearly such cases and made them transparent in reports to model users, senior management, and other relevant parties. The final guidance also notes that companies should have timelines with explicit plans for conducting the remaining areas of validation for such

[6] "Supervisory Guidance on Model Risk Management," OCC 2011–12 and "Guidance on Model Risk Management," Federal Reserve SR letter 11–7.

models and recognize that any provisional use of models without validation is temporary. Furthermore, the final guidance does not contain any expectations regarding the use of challenger or benchmarking models.

The proposed guidance indicated that companies should ensure that their model risk management policies and practices generally apply to the use of vendor and third-party products as well. While some commenters stated that the expectations regarding the use of vendor models from the proposed guidance seemed fairly straightforward, other commenters requested modifications. One suggestion was that the agencies encourage companies to take ownership of stress tests rather than relying on vendors. One commenter suggested that $10–50 billion companies be provided discretion to select and utilize vendor products and services as long as the companies, with the help of the vendors, conduct their stress tests in accordance with the rules and supervisory guidance.

Other commenters requested clarification on the validation of vendor models. Some noted that it would be burdensome to require independent parties to validate vendor models and duplicative for each company to independently validate models from the same vendor. The commenters requested that the agencies evaluate and approve the use of certain products and services from vendors that meet stress testing guidelines. Alternatively, commenters suggested the agencies should put out specific guidelines for vendors to follow and allow a company to rely on vendor certification that it follows these guidelines.

Regarding vendor models, similar to the existing supervisory guidance on model risk management, the final guidance does not indicate whether $10–50 billion companies should or should not use vendor models and does not prescribe which vendors should be used. The guidance does indicate that existing supervisory guidance provides guidelines for companies regarding model risk management for vendors, and states that vendor models should be validated in a manner similar to internal models. Because model risk management, including validation of vendor models, is the responsibility of individual companies, it would not be appropriate for the agencies to provide the specific assistance suggested by commenters, such as vetting vendors. Consistent with their past practice, the agencies plan to use the normal supervisory process to work with individual companies regarding expectations for appropriate model risk management for vendor products and services.

*E. Loss Estimation*

The proposed guidance clarified that credit losses associated with loan portfolios and securities holdings should be estimated directly and separately, whereas other types of losses should be incorporated into estimated pre-provision net revenue (''PPNR''). The proposed guidance stated that larger or more sophisticated companies should consider more advanced loss estimation practices that identify the key drivers of losses for a given portfolio, segment, or loan; determine how those drivers would be affected in supervisory scenarios; and estimate resulting losses. Loss estimation practices should be commensurate with the materiality of the risks measured and well supported by sound, empirical analysis.

Commenters requested that the agencies provide additional information about credit loss estimation, as this is by far the most material risk to $10–50 billion companies. Some commenters suggested that the agencies provide explicit instructions for how to calculate loan losses under the stress tests. The final guidance retains the substantial flexibility regarding loss estimation practices, including for credit losses, provided in the proposed guidance. Notwithstanding some commenters' request for additional specificity, the agencies believe it is important for the guidance to provide this flexibility in light of evolving loss estimation techniques and the different levels of complexity at different companies.

Another commenter requested clarification regarding when it would be appropriate to use the simpler estimation approaches described in the guidance, especially because in some cases simpler approaches may be superior or more robust than sophisticated quantitative approaches for estimating loan losses. Similarly, one commenter requested that the agencies state that they did not have a preference for bottom-up stress testing for $10–50 billion companies. The final guidance provides some additional information on when a $10–50 billion company should use the more advanced practices described in the guidance. For example, the final guidance notes that each company's loss estimation practices should be commensurate with the materiality of the risks measured and that $10–50 billion companies should consider using more than just the minimum expectations for the exposures and activities that present the highest risk. However, the final guidance does not categorically preclude any specific estimation approach, including bottom-up stress testing.

The proposed guidance stated that companies could use different processes for the baseline scenario than for the adverse and severely adverse scenarios in order to better capture the loss potential under stressful conditions, including using their budgeting process if it was conditioned on the supervisory scenario. While some commenters supported the potential use of the budgeting process for projections under the baseline scenario, one commenter noted that companies will be challenged to use their internal budgeting processes if the internal process must be conditioned on the supervisory baseline scenario. The use of scenarios provided by each agency is a requirement of the Dodd-Frank Act that was codified in the DFA stress test rules. While a company may use its budgeting process for the DFA stress tests conducted under the baseline scenario, provided that the company can link the budgeting process to the supervisory baseline scenario, companies are not required or expected to use the supervisory baseline scenario for any of their budgeting processes.

*F. Pre-Provision Net Revenue Estimation*

With respect to PPNR, commenters requested that $10–50 billion companies be allowed to focus on projecting net-interest margin rather than on projecting expenses or revenue from fees unless there were material risks uncovered as part of the stress tests. The proposed guidance indicated that in some cases it may be appropriate for companies to use simpler approaches for projecting PPNR. For example, companies could project each of three main components of PPNR (net interest income, non-interest income, and non-interest expense) on an aggregate level for the entire company or by business line based on internal or industry historical experience. The agencies agree that net-interest margin is an important component of projecting PPNR and that, where fees are not a material source of revenue, a company would not be expected to use the same level of sophistication in estimating fee income as it used in estimating the company's net interest margin.

Some commenters requested additional information about the expectations for addressing operational risk in the stress tests. One commenter noted that operational risk is central to managing the key risks to banking organizations because operational risk directly affects the implementation of a business model, and its execution affects market, liquidity, and credit risk.

However, the commenter argued it would be a mistake to apply credit risk models to strategic or operational risk modeling. Another commenter noted that a company's operational risk may not be directly related to the scenarios, and requested additional clarification about estimating operational risk losses in DFA stress testing.

The proposed guidance did not prescribe the use of any specific type of operational risk modeling and indicated that losses from operational risk events would need to be estimated only if such events are related to the supervisory scenarios provided, or if there are pending related issues, such as ongoing litigation, that could affect losses or revenues over the planning horizon. The final guidance follows a similar approach and clarifies there may be certain aspects of operational risk that a company is not required to address in its DFA stress tests; however, the company should consider those other aspects of operational risk as part of broader stress testing described in the May 2012 stress testing guidance.

*G. Balance Sheet and Risk-Weighted Assets*

Under the proposed guidance, a company would have been expected to ensure that projected balance sheet and risk-weighted assets remain consistent with regulatory and accounting changes, are applied consistently across the company, and are consistent with the scenario and the company's past history of managing through different business environments. The guidance noted that in certain cases, it may be appropriate for a company to use simpler approaches for balance sheet and risk-weighted asset projections, such as a constant portfolio assumption.

One commenter asked for examples of circumstances where it would be appropriate to assume a constant portfolio. In response, the final guidance states that $10–50 billion companies may be able to use an assumption of a static balance sheet and static risk-weighted assets over the planning horizon; however, companies should consider whether such an approach is appropriate if the company has more volatile balance sheets and risk-weighted assets, such as from mergers and acquisitions or internal growth. In addition, the final guidance clarifies that cases in which balance sheet and risk-weighted asset projections decline over the planning horizon, and thus positively affect capital ratios, should be very well supported by analysis and documentation.

*H. Projections for Quarterly Provisions and Ending Allowance for Loan and Lease Losses (ALLL)*

The proposed guidance stated that companies are expected to maintain an adequate loan-loss reserve through the planning horizon, consistent with supervisory guidance, accounting standards, and a company's internal practice. The proposed guidance noted that the ALLL at the end of the planning horizon should be consistent with generally accepted accounting principles (GAAP), including any losses projected beyond the nine-quarter horizon.

While some commenters said that the guidance was clear on projecting ALLL, other commenters requested that the agencies clarify expectations regarding consistency between projections of the ALLL and GAAP. One commenter argued that determining the credit impairment of a loan in accordance with GAAP required loan-level examination of credit quality. Another commenter requested that the agencies clarify the interaction between the supervisory scenarios and GAAP requirements for the appropriate level of the ALLL.

In response to comments, the final guidance clarifies that, because loss projections for the stress tests can in some cases be conducted at a portfolio level, the ALLL projections may also be conducted at a similar level, provided that they are not inconsistent with the company's existing methodologies to calculate ALLL for other regulatory purposes and for current financial statements. The key supervisory expectation in this regard is that management ensures that the company's projected ALLL is sufficient to cover remaining loan losses under the scenario for each quarter of the planning horizon, including the last quarter.

*I. Estimating the Potential Impact on Regulatory Capital Levels and Capital Ratios*

The proposed guidance stated that projected capital levels and ratios should reflect applicable regulations and accounting standards for each quarter of the planning horizon. In particular, the proposed guidance noted that, in July 2013, the Board and the OCC issued a final rule and the FDIC issued an interim final rule regarding regulatory capital requirements for banking organizations (revised capital framework). Except for the stress testing cycle that began on October 1, 2013, $10–50 billion companies must measure their regulatory capital levels and regulatory capital ratios for each quarter of the planning horizon in accordance with the rules that would be in effect during that quarter, including the transition arrangements set forth in the revised capital framework.[7]

The proposed guidance indicated an expectation that post-stress capital ratios under the adverse and severely adverse scenarios will be lower than under the baseline scenario. Commenters believed that expecting capital to be lower under stress scenarios may not be appropriate for $10–50 billion companies. Commenters argued that other factors, such as slower originations, higher paydowns, and accelerated charge-offs could result in improved credit quality and higher capital ratios in the adverse and severely adverse scenarios. Another commenter noted that it was difficult to get scenario-based forecasts of asset balances to match up with circumstances that lead to declining ratios and requested additional information about assumptions that would necessarily lead to lower capital ratios in stressful conditions than in baseline scenarios.

While there could be rare cases in which capital ratios are higher under the adverse and severely adverse scenarios, any such case should be very well supported by a $10–50 billion company with analysis and documentation. Since the stress tests are intended to assess the hypothetical negative impact on companies' capital positions from stressful conditions, the agencies generally expect companies' post-stress capital ratios under the adverse and severely adverse scenarios to be lower than under the baseline scenario.

One commenter requested clarification regarding what constitutes a reasonable and conservative management response. Another commenter suggested that dynamic hedging should not be anticipated as a risk-mitigation technique under stress scenarios. In response, the agencies note that companies should make conservative assumptions about management responses in the stress tests, and should include only those responses for which there is substantial support. Any assumptions that materially mitigate losses should be well justified. For example, as discussed

[7] Each of the agencies is providing a one-year transition period for the vast majority of $10–50 billion companies where the companies would not be required to reflect the revised regulatory capital framework in their DFA stress tests. For the stress test cycle that began on October 1, 2013, $10–50 billion companies should calculate their regulatory capital ratios using the regulatory capital framework in effect as of September 30, 2013. *See* 12 CFR 252.12(n) (Board); 12 CFR 46.6 (OCC); 12 CFR 325.205 (FDIC).

in the proposed guidance, projecting changes in balances that mitigate losses are expected to also reduce revenues.

The proposed guidance noted that while holding companies are required to use specified capital action assumptions, there are no specified capital actions for banks and thrifts. The proposed guidance indicated that a bank or thrift should use capital actions that are consistent with the scenarios and the company's internal practices in their DFA stress tests. Additionally, the proposed guidance noted that holding companies should consider that the Board's DFA stress test rules require the use of certain capital assumptions in the DFA stress tests, which may not be the same as the assumptions used by the holding company's subsidiary depository institutions.

The agencies recognize that the consistency between the capital action assumptions at the holding company level and at the subsidiary depository institution level is a complicated aspect of the DFA stress test requirements. The key supervisory expectation is that if the stress test submissions for the bank or thrift and its holding company differ in terms of projected capital actions as a result of the different requirements of the DFA stress test rules, the companies should address such differences in the narrative portion of their submissions to their primary regulators and the Board. For example, if a bank assumed that it would curtail dividends to a bank holding company, the bank holding company should discuss how it would fund any capital distributions in a stressed environment.

Some commenters appreciated the flexibility that the guidance affords regarding capital actions in stress tests. However, others stated that the capital action assumptions at the holding company level are unrealistic. One commenter noted that while the capital action differences are clearly articulated, there was no guidance on how to reconcile those differences. Another commenter requested additional flexibility for holding company capital actions as that would enhance the usefulness of the stress tests as a business planning tool and make it more actionable. In response, the agencies note that the capital action assumptions specified for holding companies are a requirement of the Board's DFA stress test rules and that modifying those assumptions is outside of the scope of this guidance.

*J. Controls, Oversight, and Documentation*

The proposed guidance indicated that, as required by the DFA stress test rules, a company's policies and procedures for DFA stress tests should be comprehensive, ensure a consistent and repeatable process, and provide transparency regarding a company's stress testing processes and practices for third parties. In addition, the guidance provided additional detail on responsibilities for senior management and boards of directors relating to the DFA stress test. Commenters requested that the agencies modify the guidance to further embed risk oversight and management into daily business decisions and activities. One commenter suggested that companies should be able to reconcile how final outcomes compare to expected outcomes.

Certain requirements for controls and oversight are codified in the DFA stress test rules. Moreover, the agencies believe that the expectations in the final guidance are appropriate and sufficient, and to a large degree, are already contained in the May 2012 stress testing guidance. Specifically, there is no need for additional guidance on controls and oversight, including on reconciling final and expected outcomes of the stress tests, since the proposed guidance, as well as related guidance, indicated the importance of evaluating stress test outcomes and the practices that produce those outcomes.

Some commenters requested that the agencies clarify their expectations for the boards of directors. Specific clarification was requested on the level of detail that the senior management should report to the board of directors regarding methodologies used in the stress tests. Another commenter suggested it was inappropriate for a board to review and approve the stress testing framework and policies. One suggestion was that the agencies hold training programs for boards that reflect stress testing obligations. Another requested that the agencies communicate to the board of directors the relative importance of the DFA stress tests as a supervisory matter. Another commenter stated that there were too many requirements for boards and that the stress testing requirements would be burdensome.

Certain requirements for boards of directors are codified in the DFA stress test final rules. These requirements will help ensure that boards of directors provide proper oversight of DFA stress tests, thereby enhancing the tests' integrity and credibility. The agencies believe that the proposed guidance and the May 2012 stress testing guidance sufficiently convey the expectations for boards of directors, by indicating that they should play an oversight role and be advised and educated about key stress testing information, but they do not need to be intimately involved in every detail of the stress testing process. For example, the proposed guidance noted that boards should receive ''summary information'' and allowed boards to have designees to evaluate such information. In addition, the proposed guidance articulated the different expectations for boards of directors versus the expectations for senior management, with the expectation that senior management should be more involved in the details of the company's stress testing activities. These expectations have been retained in the final guidance.

The proposed guidance indicated that a $10–50 billion company would be expected to ensure that its post-stress capital results are aligned with its internal capital goals and risk appetite. For cases in which post-stress capital results were not aligned with a company's internal capital goals, senior management would be expected to provide options that senior management and the board would consider to bring them into alignment. One commenter suggested that management should not be required to create action plans to enhance the level and composition of capital in response to stress tests, and that stress tests are just one of many relevant factors for evaluating capital adequacy.

The agencies' stress test rules do not require $10–50 billion companies to create capital action plans; furthermore, the DFA stress test rules do not require companies to submit a capital plan to the agencies. The agencies have existing supervisory expectations for $10–50 billion companies regarding appropriate capital planning practices that incorporate new information about their capital positions, including from capital stress tests. However, $10–50 billion companies are not subject to the Board's capital plan rule, which includes specific capital planning and assessment requirements beyond those specified in the DFA stress test rules. In addition, the agencies' DFA stress test rules do not require $10–50 billion companies to meet or maintain any specific post-stress capital ratios or targets. However, the final guidance does retain the expectation that companies determine whether their post-stress results are aligned with their own internal capital goals. The final guidance also retains the expectation that in cases in which post-stress capital results are not aligned with a company's internal capital goals, the company should provide options it would consider to bring them into alignment.

*K. Report to Supervisors and Public Disclosure of Stress Test Results*

The proposed guidance indicated that companies must report the results of their DFA company-run stress tests on the $10–50 billion reporting form.[8] One commenter requested clarification on whether a company must submit two reports even if the subsidiary bank or thrift is 98 percent of the holding company. Under the stress test rules required by the Dodd-Frank Act, all companies subject to DFA stress testing, including holding companies and subsidiary banks and thrifts, must conduct stress tests and report information to the agencies. If the holding company's assets are substantially held in the subsidiary bank or thrift the agencies expect that the report will not be significantly different at the bank and at the holding company. In addition, the agencies note that they closely coordinated on the creation of the $10–50 billion reporting form and it is generally identical for all $10–50 billion companies.

Regarding public disclosure, the proposed guidance stated that $10–50 billion companies would need to follow the requirements of the stress test rules required by the Dodd-Frank Act. One commenter expressed concern that the public disclosure of the stress tests could provide fodder for short sellers and requested that the agencies explain the hypothetical nature of the stress test results to the public. The agencies recognize the sensitive nature of public disclosure of stress testing results and have designed the disclosure requirements to reflect that sensitivity—for example, public disclosure is only required for stress tests conducted under the severely adverse scenario. However, public disclosure of the results of the stress tests is a requirement of the Dodd-Frank Act. The agencies have sought to tailor the disclosure requirement for $10–50 billion companies both in the stress testing rules required under the Dodd Frank Act and through the expectations in this guidance. The agencies have frequently communicated the hypothetical nature of the stress tests, but, in response to the commenter request, the agencies have added that clarification to the final guidance.

*L. Stress Testing at Savings and Loan Holding Companies (SLHCs)*

The agencies received several comments regarding the application of the guidance to SLHCs. Commenters generally stated that the guidance did not reflect the unique concerns of SLHCs that are substantially engaged in either insurance underwriting or commercial activities and requested further tailoring of the supervisory expectations for conducting DFA stress tests at nonbank SLHCs. Commenters noted the fundamental differences in the nonbank business and insurance risk and the banking risks in the proposed guidance. For these reasons, the commenters requested delaying the implementation for excluded SLHCs, tailoring expectations for SLHCs with substantial nonbank businesses, and providing a general exemption from stress testing for SLHCs with thrift subsidiaries with less than $10 billion in assets.

The Board's rules implementing the Dodd-Frank Act stress tests provide that an SLHC that meets the asset threshold on or before the date on which it is subject to minimum regulatory capital requirements must comply with the requirements of that subpart beginning with the stress test cycle that commences in the calendar year after the year in which the company becomes subject to the Board's minimum regulatory capital requirements, unless the Board accelerates or extends the compliance date. On July 2, 2013, the Board approved a final rule that would implement regulatory capital requirements for SLHCs, other than those that are substantially engaged in insurance underwriting or commercial activities. As discussed in the preamble to that rule, the Board excluded SLHCs that are substantially engaged in insurance underwriting or commercial activities in order to consider further development of appropriate capital requirements of these companies, and is exploring further whether and how the proposed rule should be modified for these companies in a manner consistent with section 171 of the Dodd-Frank Act and safety and soundness expectations. That preamble indicated that the Board expects to implement a framework for SLHCs that are not subject to the final rule by the time covered SLHCs must comply with the final rule in 2015.

SLHCs that are substantially engaged in insurance underwriting or commercial activities will become subject to DFA stress testing in the stress test cycle that commences in the calendar year after the year in which those companies become subject to the Board's minimum regulatory capital requirements, unless the Board accelerates or extends the compliance date. As such, the Board does not anticipate that supervisors will assess the extent to which SLHCs that are substantially engaged in insurance underwriting and commercial activities are meeting the expectations in this guidance until such SLHCs are subject to the requirements of the stress test rules required under the Dodd-Frank Act. The Board may further tailor the application of DFA stress testing as it implements the stress test requirements for these SLHCs.

## III. Administrative Law Matters

*A. Paperwork Reduction Act Analysis*

This guidance references currently approved collections of information under the Paperwork Reduction Act (44 U.S.C. 3501–3520) provided for in the DFA stress test rules.[9] This guidance does not introduce any new collections of information nor does it substantively modify the collections of information that the Office of Management and Budget (OMB) has approved. Therefore, no Paperwork Reduction Act submissions to OMB are required.

*B. Regulatory Flexibility Act Analysis*

Board:

While the guidance is not being adopted as a rule, the Board has considered the potential impact of the guidance on small companies in accordance with the Regulatory Flexibility Act (5 U.S.C. 603(b)). Based on its analysis and for the reasons stated below, the Board believes that the guidance will not have a significant economic impact on a substantial number of small entities. Nevertheless, the Board is publishing a regulatory flexibility analysis.

For the reason discussed in the **SUPPLEMENTARY INFORMATION** above, the Board is issuing this guidance to provide additional details regarding the supervisory expectations for the DFA stress tests conducted by $10–50 billion companies. Under regulations issued by the Small Business Administration (SBA), a small entity includes a depository institution, bank holding company, or SLHCs with total assets of $500 million or less (a small banking organization).[10] The guidance would apply to companies supervised by the agencies with more than $10 billion but

[8] For purposes of this guidance, the term ''$10–50 billion reporting form'' refers to the relevant reporting form a $10–50 billion company will use to report the results of its DFA stress tests to its primary Federal financial regulatory agency.

[9] *See* OMB Control Nos. 1557–0311 and 1557–0312 (OCC); 3064–0186 and 3064–0187 (FDIC); and 7100–0348 and 7100–0350 (Board).

[10] Effective July 22, 2013, the SBA revised the size standards for small banking organizations to $500 million in assets from $175 million in assets. 78 FR 37409 (June 20, 2013).

less than $50 billion in total consolidated assets, including state member banks, bank holding companies, and SLHCs. Companies that would be subject to the guidance therefore substantially exceed the $500 million total asset threshold at which a company is considered a small company under SBA regulations. In light of the foregoing, the Board does not believe that the guidance would have a significant economic impact on a substantial number of small entities.

## IV. Supervisory Guidance

The text of the supervisory guidance is as follows:

Office of the Comptroller of the Currency
Federal Reserve System
Federal Deposit Insurance Corporation

## Supervisory Guidance on Implementing Dodd-Frank Act Company-Run Stress Tests for Banking Organizations With Total Consolidated Assets of More Than $10 Billion but Less Than $50 Billion

## I. Introduction

In October 2012, the U.S. Federal banking agencies (''agencies'') issued the Dodd-Frank Act stress test rules [1] requiring companies with total consolidated assets of more than $10 billion to conduct annual company-run stress tests pursuant to section 165(i)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (''DFA'').[2] This guidance outlines key supervisory expectations for companies with total consolidated assets of more than $10 billion but less than $50 billion that are required to conduct DFA stress tests (collectively ''companies'' or ''$10–50 billion companies'').[3] As discussed further below, it builds upon the interagency stress testing guidance issued in May 2012 for companies with more than $10 billion in total consolidated assets (''May 2012 stress testing guidance''), that set forth general principles for a satisfactory stress testing framework.[4]

The supervisory expectations described in this guidance are tailored to the $10–50 billion companies, similar to the manner in which the requirements in the stress test rules required under the Dodd-Frank Act were tailored for this set of companies.[5] The additional information provided in this guidance should assist companies in complying with the stress test rules required under the Dodd-Frank Act and conducting DFA stress tests that are appropriate for their risk profile, size, complexity, business mix, and market footprint. The DFA stress test rules allow flexibility to accommodate different practices across organizations, for example by not specifying specific methodological practices. Consistent with this approach, this guidance sets general supervisory expectations for stress tests, and provides, where appropriate, some examples of possible practices that would be consistent with those expectations.[6]

This guidance does not represent a comprehensive list of potential practices, and companies are not required to use any specific methodological practices for their stress tests. Companies may use various practices to project their losses, revenues, and capital that are appropriate for their risk profile, size, complexity, business mix, market footprint and the materiality of a given portfolio.

## II. Background

Stress tests are an important part of a company's risk management practices, and the agencies have previously highlighted that importance as a means for companies to better understand the range of potential risks facing them. Specifically, the May 2012 stress testing guidance sets forth the following five principles for an effective stress testing regime:

1. A company's stress testing framework should include activities and exercises that are tailored to and sufficiently capture the company's exposures, activities, and risks;
2. An effective stress testing framework should employ multiple conceptually sound stress testing activities and approaches;
3. An effective stress testing framework should be forward-looking and flexible;
4. Stress test results should be clear, actionable, well supported, and inform decision-making; and
5. A company's stress testing framework should include strong governance and effective internal controls.

This DFA stress test guidance builds upon the May 2012 stress testing guidance, sets forth the supervisory expectations regarding each requirement of the DFA stress test rules, and provides illustrative examples of satisfactory practices. The guidance indicates where different requirements apply to banks, thrifts, and holding companies. The guidance is structured as follows:

A. DFA Stress Test Timelines
B. Scenarios for DFA Stress Tests
C. DFA Stress Test Methodologies and Practices
D. Estimating the Potential Impact on Regulatory Capital Levels and Capital Ratios
E. Controls, Oversight, and Documentation
F. Report to Supervisors, and
G. Public Disclosure of DFA Stress Tests

The agencies expect that the annual company-run stress tests required by the Dodd-Frank Act and the agencies' stress test rules will be one component of the broader stress testing activities conducted by $10–50 billion companies. Notably, the DFA stress tests produce projections of hypothetical results and are not intended to be forecasts of expected or most likely outcomes. The DFA stress tests may not necessarily capture a company's full range of risks, exposures, activities, and vulnerabilities that have a potential effect on capital adequacy. For example, DFA stress tests may not account for regional

---

[1] *See* 77 FR 61238 (October 9, 2012) (OCC), 77 FR 62396 (October 12, 2012) (Board: Annual Company-Run Stress Test Requirements for Banking Organizations with Total Consolidated Assets over $10 Billion Other than Covered Companies), and 77 FR 62417 (October 15, 2012) (FDIC).

[2] Public Law 111–203, 124 Stat. 1376 (2010). Each entity that meets the applicability criteria must conduct a separate stress test and provide a separate submission. For example, both a bank holding company between $10–50 billion in assets and its subsidiary bank with between $10–50 billion in assets must conduct a separate stress test; however, if a subsidiary bank of a $10–50 billion bank holding company has $10 billion or less in assets then it does not need to conduct a DFA stress test.

[3] For the OCC, the term ''company'' is used in this guidance to refer to a banking organization that qualifies as a ''covered institution'' under the OCC Annual Stress Test Rule. 12 CFR 46.2. For the Board, the term ''company'' is used in this guidance to refer to state member banks, bank holding companies, and savings and loan holding companies. 12 CFR 252.13. For the FDIC, the term ''company'' is used in this guidance to refer to insured state nonmember banks and insured state savings associations that qualify as a ''covered bank'' under the FDIC Annual Stress Test Rule. 12 CFR 325.202.

[4] *See* 77 FR 29458, ''Supervisory Guidance on Stress Testing for Banking Organizations With More Than $10 Billion in Total Consolidated Assets,'' (May 17, 2012).

[5] For example, expectations for data sources, data segmentation, sophistication of estimation practices, reports and public disclosure are generally reduced compared to the expectations for larger organizations. Consistent with the approach taken in the DFA stress test final rules, in general the expectations for Dodd-Frank stress testing practices among companies with at least $50 billion are elevated compared to $10–50 billion companies.

[6] Companies subject to this guidance are not subject to the Federal Reserve's capital plan rule, the Federal Reserve's annual Comprehensive Capital Analysis and Review, supervisory stress tests for capital adequacy, or the related data collections supporting the supervisory stress test. 12 CFR 225.8 (capital plan rule); Supervisory and Company-Run Stress Test Requirements for Covered Companies 12 CFR part 252, subparts E and F; and the Capital Assessment and Stress Testing information collection (FR Y–14Q, FR Y–14M, and FR Y–14A).

concentrations and unique business models and they may not fully cover the potential capital effects of interest rate risk or an operational risk event such as a regional natural disaster.[7] Consistent with the May 2012 stress testing guidance, a company is expected to consider the results of DFA stress testing together with other capital assessment activities to ensure that the company's material risks and vulnerabilities are appropriately considered in its overall assessment of capital adequacy. Finally, the DFA stress tests assess the impact of stressful outcomes on capital adequacy, and are not intended to measure the adequacy of a company's liquidity in the stress scenarios.

## III. Annual Tests Conducted by Companies

### A. DFA Stress Test Timelines

*Rule Requirement:* A company must conduct a stress test over a nine-quarter planning horizon based on data as of September 30 of the preceding calendar year.[8]

Under the DFA stress test rules, stress test projections are based on exposures with the as-of date of September 30 and extend over a nine-quarter planning horizon that begins in the quarter ending December 31 of the same year and ends with the quarter ending December 31 two years later.[9] For example, a stress test beginning in the fall of 2013 would use an as-of date of September 30, 2013, and involve quarterly projections of losses, pre-provision net revenue (''PPNR''), balance sheet, risk-weighted assets, and capital beginning on December 31, 2013 of that year and ending on December 31, 2015. In order to project quarterly provisions, a company should estimate the adequate level of the allowance for loan and lease losses (''ALLL'') to support remaining credit risk at the end of each quarter. The ALLL estimation should include the final quarter of the planning horizon, which may require additional projections of credit losses beyond 2015. The ALLL projections for DFA stress testing should be generally consistent with a company's internal ALLL approach; however, some modifications might be necessary, as discussed in more detail below.

### B. Scenarios for DFA Stress Tests

Rule Requirement: A company must use the scenarios provided annually by its primary Federal financial regulatory agency to assess the potential impact of the scenarios on its consolidated earnings, losses, and capital.[10]

Under the stress test rules implementing Dodd-Frank Act requirements, $10–50 billion companies must assess the potential impact of a minimum of three macroeconomic scenarios—baseline, adverse, and severely adverse—provided by their primary supervisor on their consolidated losses, revenues, balance sheet (including risk-weighted assets), and capital. The rules defines the three scenarios as follows:

- *Baseline scenario* means a set of conditions that affect the U.S. economy or the financial condition of a company that reflect the consensus views of the economic and financial outlook.
- *Adverse scenario* means a set of conditions that affect the U.S. economy or the financial condition of a company that are more adverse than those associated with the baseline scenario and may include trading or other additional components.
- *Severely adverse scenario* means a set of conditions that affect the U.S. economy or the financial condition of a company that overall are more severe than those associated with the adverse scenario and may include trading or other additional components.

Each agency will provide a description of the supervisory scenarios to companies no later than November 15 each calendar year. The scenarios provided by each agency are not forecasts but rather are hypothetical scenarios that companies will use to assess their capital strength in baseline and stressed economic and financial conditions. Companies should apply each scenario across all business lines and risk areas so that they can assess the effect of a common scenario on the entire enterprise, though the effect of the given scenario on different business lines and risks may vary.

The agencies believe that a uniform set of supervisory scenarios is necessary to provide a basis for comparison across companies. However, a company is not required to use all of the variables provided in the scenario, if those variables are not relevant or appropriate to the company's line of business. In addition, a company may, but is not required to, use additional variables beyond those provided by the agencies. For example, a company may decide to use a regional unemployment rate to improve the robustness of its stress test projections.[11] When using additional variables, companies should ensure that the paths of such variables (including their timing) are consistent with the general economic environment assumed in the supervisory scenarios. More specifically, it would be inappropriate to use a regional or local variable that exhibited limited stress compared to variables in the macroeconomic scenarios provided by the agencies, such as if the approach for deriving that additional variable was based on relatively benign conditions. Any use of additional variables should be well supported and documented.

In addition, a company may choose to project the paths of variables beyond the timeframe of the supervisory scenarios, if a longer horizon is necessary for the company's stress testing methodology. For example, a company may project the unemployment rate for additional quarters in order to calculate inputs to its end-of-horizon ALLL or to estimate the projected value of certain types of securities under the scenario.

Companies may use third-party vendors to assist in the development of additional variables based on the supervisory stress scenarios. In such instances, consistent with existing supervisory expectations,[12] companies should understand the third-party analysis used to develop additional variables, including the potential limitations of such analysis as it relates to stress tests, and be able to challenge key assumptions. Companies should also ensure that vendor-supplied variables they use are relevant for and relate to company-specific characteristics.

### C. DFA Stress Test Methodologies and Practices

Rule Requirement: In conducting a stress test, for each quarter of the planning horizon, a company must estimate the following for each required

[7] For purposes of this guidance, the term ''concentrations'' refers to groups of exposures and/or activities that have the potential to produce losses large enough to bring about a material change in a banking organization's risk profile or financial condition.

[8] 12 CFR 46.5 (OCC); 12 CFR 252.14 (Board); 12 CFR 325.204 (FDIC).

[9] Planning horizon means the period of at least nine quarters, beginning with the quarter ending December 31, over which the relevant stress test projections extend.

[10] 12 CFR 46.6 (OCC); 12 CFR 252.14 (Board); 12 CFR 325.204 (FDIC).

[11] The use of additional variables may be used by companies to better link the DFA stress test scenario variables in the supervisory scenarios with a company's unique portfolios and risks. However, consistent with the May 2012 stress testing guidance, no single stress test can capture all possible effects on capital, meaning that the DFA stress tests may not capture the effects of all of a company's risks and vulnerabilities and may need to be supplemented by other stress testing activities.

[12] ''Supervisory Guidance on Model Risk Management,'' OCC 2011–12, or ''Guidance on Model Risk Management,'' Federal Reserve SR 11–7, April 4, 2011.

scenario: Losses, PPNR, provision for loan and lease losses, and net income.[13]

As noted above, companies must identify and determine the impact on capital from the supervisory scenarios, as represented through the supervisory scenario variables and any additional variables chosen by the company. A company's estimation processes should reasonably capture the relationship between the assumed scenario conditions and the projected impacts and outcomes to the company.[14] The agencies expect that the specific methodological practices used by companies to produce the estimates may vary across organizations.

Supervisors generally expect that all banking organizations, as part of overall safety and soundness, will continue to enhance their risk management practices. Accordingly, a $10–50 billion company's DFA stress testing practices should evolve over time. In addition, DFA stress testing practices for $10–50 billon companies should be commensurate with each company's size, complexity, and sophistication. This means that, generally, larger or more sophisticated companies should consider employing not just the minimum expectations, but the more advanced practices described in this guidance. In addition, $10–50 billion companies should consider using more than just the minimum expectations for the exposures and activities of highest impact and that present the highest risk.

The remainder of this section outlines key practices that all $10–50 billion companies should incorporate into their methodologies for estimating losses, PPNR, provision for loan and lease losses (''PLLL''), and net income. It begins with general expectations that apply across various types of estimation methodologies, and then provides additional expectations for specific areas, such as loss estimation, revenue estimation, and balance sheet projections. In making projections, companies should make conservative assumptions about management responses in the stress tests, and should include only those responses for which there is substantial support. For example, companies may account for hedges that are already in place as potential mitigating factors against losses but should be conservative in making assumptions about potential future hedging activities and not necessarily anticipate that actions taken in the past could be taken under the supervisory scenarios.

1. Data Sources

Companies are expected to have appropriate management information systems and data processes that enable them to collect, sort, aggregate, and update data and other information efficiently and reliably within business lines and across the company for use in DFA stress tests. Data used for DFA stress tests should be reliable and generally consistent across time.

In cases where a company may not currently have a full cycle of historical data or data in sufficient granularity on which to base its analyses, it may use an alternative data source, such as a data history drawn from other organizations of comparable market presence, concentrations, and risk profile (for example, regulatory reporting or vendor-supplied data), as a proxy for its own risk profile and exposures. Companies with limited internal data should develop strategies to accumulate the data necessary to improve their estimation practices over time, as having internal data relevant to current exposures generally improves loss projections and provides a better basis for assessment of those projections. The agencies recognize that in some cases companies may not initially have internal data on certain portfolios and thus may rely on proxy data for some time. Such practices may be acceptable provided that the company demonstrates that proxy data are relevant to the company's own exposures and appropriate for the estimation being conducted, and that the company is actively collecting internal data.

Over the long term, companies may continue to use proxy data to benchmark the estimates produced using internal data or to augment any gaps in internal data (for example, if a company is moving into a new business area). However, companies should use proxy data cautiously, as these data may not adequately represent a company's own exposures, business activities, underwriting, and risk characteristics.

Even when a company has extensive historical data, it should look beyond the assumptions based on or embedded in those historical data. Companies should challenge conventional assumptions to ensure that a company's stress test is not constrained by its own past experience. This is particularly important when historical data does not contain stressful periods or if the specific characteristics of the scenarios are unlike the conditions in the available historical data.

2. Data Segmentation

To account for differences in risk profiles across various exposures and activities, companies should segment their portfolios and business activities into categories based on common or related risk characteristics. The company should select the appropriate level of segmentation based on the size, materiality, and risk of a given portfolio, provided there are sufficiently granular historical data available to allow for the desired segmentation. The minimum expectation is that companies will segment their portfolios and business activities using the categories listed in the $10–50 billion reporting form.[15] A company may use more granular segmentation than the $10–50 billion reporting form categories, particularly for more material, concentrated, or relatively riskier portfolios. For instance, a company could have a commercial loan portfolio containing loans to different industries with varying sensitivities to the scenario variables.

More advanced portfolio segmentation can take several forms, such as by product (construction versus income-producing real estate), industry, loan size, credit quality, collateral type, geography, vintage, maturity, debt service coverage, or loan-to-value (LTV) ratio. The company may also pool exposures with common or correlated risk characteristics, such as segmenting loans to businesses related to automobile production. Companies may also segment the portfolio according to geography, if they engage in activities in geographic areas with differing economic and financial characteristics. Such segmentation may be particularly valuable in situations where geographic areas show varying sensitivity to national economic and financial changes or where different scenario variables are necessary to capture key risks (such as projecting wholesale loan losses for regions with different industrial concentrations). For any type of segmentation that is more granular than the categories in the $10–50 billion reporting form, a company should maintain a map of internally defined segments to the $10–50 billion reporting form categories for accurate reporting.

Some companies' business line or risk assessment functions may segment data with more granularity, that is, beyond

[13] 12 CFR 46.6 (OCC); 12 CFR 252.15(a)(1) (Board); 12 CFR 325.205(a)(1) (FDIC).

[14] Additionally, companies' methodologies should be sufficiently documented and transparent so that limitations and areas of uncertainty are clearly identified for users of stress test results and other stakeholders.

[15] For purposes of this guidance, the term ''$10–50 billion reporting form'' refers to the relevant reporting form a $10–50 billion company will use to report the results of its DFA stress tests to its primary Federal financial regulatory agency.

the $10–50 billion reporting form categories, which would support their DFA stress tests. Enhanced data details on borrower and loan characteristics may identify distinct and separate credit risks within a reporting category more effectively, and therefore yield a more accurate risk assessment than simply analyzing the larger aggregate portfolio. Greater segmentation, particularly for larger or riskier portfolios, may prove especially useful in estimating the risks to a portfolio under the adverse or severely adverse scenarios, because aggregated or less segmented portfolios may mask or distort the effect of potentially more stressful conditions on sub-portfolios. While $10–50 billion reporting form categories represent the minimum acceptable segmentation, larger or more sophisticated $10–50 billion companies should consider whether that level of segmentation is sufficient for the risk in their portfolios.

3. Model Risk Management

Companies should have in place effective model risk management practices, including validation, for all models used in DFA stress tests, consistent with existing supervisory guidance.[16] This includes ensuring that DFA stress test models are subject to appropriate standards for model development, implementation and use, model validation, and model governance. Companies should ensure an effective challenge process by unbiased, competent, and qualified parties is in place for all models. There should also be sufficient documentation of all models, including model assumptions, limitations, and uncertainties. Senior management should have appropriate understanding of DFA stress test models to provide summary information to the company's board of directors that allows directors to assess and question methodologies and results. In some cases, companies may not be able to validate all the models used in their DFA stress tests prior to submission; this may be appropriate provided that companies have (1) made an effort to identify models based on materiality and highest risk and prioritize validation activities accordingly, (2) applied compensating controls so that the output from models that are not validated or are only partially validated is not treated the same as the output from fully validated models, and (3) clearly documented such cases and made them transparent in reports to model users, senior management, and other relevant parties. Companies should have an explicit exception process when models are put into production without validation, with heightened levels of management approval for more material models. There should also be timelines with explicit plans for conducting the remaining areas of validation for such models and recognition that any provisional use without validation is temporary.

Companies should ensure that their model risk management policies and practices generally apply to the use of vendor and third-party products as well. This includes all the standards and expectations outlined above and in existing supervisory guidance. If a company is using vendor models, senior management is expected to demonstrate knowledge of the model's design, intended use, applications, limitations and assumptions. For cases in which knowledge about a vendor or third-party model is limited for proprietary or other reasons, companies should take additional steps to ensure that they have an understanding of the model and can confirm it is functioning as intended. For example, companies may need to conduct more sensitivity analysis and benchmarking if information about a vendor model is limited for proprietary or other reasons. Additionally, a company should have as much internal knowledge as possible and contingency plans to prepare for the possibility of vendor contract termination or other situations in which a vendor model is no longer available.

In cases where there are noted weaknesses or limitations in models or data used for stress tests, a company may choose to apply qualitative adjustments to the model or its output that are expert judgment-based. In most cases, however, estimation solely based or heavily reliant on qualitative adjustments should not be the main component of final loss estimates. Where qualitative adjustments are made, they should be consistently determined and applied, and subject to a well-defined process that includes a well-supported rationale, methodology, proper controls, and strong documentation. When expert judgment is used on an ongoing basis, the estimates generated by such judgment should be subject to outcomes analysis, to assess performance equivalent to that used to evaluate a quantitative model. Large qualitative adjustments to the stress test results, especially on a repeated basis, may be indicative of a flawed process.

4. Loss Estimation

For their DFA stress tests, companies are expected to have credible loss estimation practices that capture the risks associated with their portfolios, business lines, and activities. Credit losses associated with loan portfolios and securities holdings should be estimated directly and separately (as described in this section), whereas other types of losses should be incorporated into estimated PPNR (as described in the next section). Processes for loss estimation should be consistent, repeatable, transparent, and well documented. Companies should have a transparent and consistent approach for aggregating loss estimates across the enterprise. For example, inputs from all parts of the company should rely on common assumptions and map to specific loss categories of the $10–50 billion reporting form. A company should ensure that all enterprise loss estimation approaches reflect reasonably sufficient rigor and conservatism, and that, for loss estimation, the scenarios are applied consistently across the company.

Each company's loss estimation practices should be commensurate with the materiality of the risks measured and well supported by sound, empirical analysis. The practices may vary in complexity, depending on data availability and the materiality of a given portfolio. In general, loss estimation practices for credit risk are expected to be more advanced than other elements of the stress test, given that credit risk usually represents the largest potential risk to capital adequacy among $10–50 billion companies.

Companies should be aware that the credit performance in a benign economic environment could differ markedly from that during more stressful periods, and the differences could become greater as the severity of stress increases. For example, companies that experienced low losses on their construction loans during a benign economic environment, due to the presence of interest reserves or other risk-mitigating factors, may experience a sharp and rapid rise in losses in a scenario where market conditions deteriorate for a prolonged period. A company's decision whether to use consistent or different loss estimation processes for various supervisory scenarios should depend on the sensitivity of a company's loss estimation process to a given scenario.

A company may use a consistent process for loss estimation for all scenarios if that process is sufficiently sensitive to the severity of each scenario. Alternately, a company may use different loss estimation processes for different scenarios if the process it uses for the baseline scenario does not

[16] OCC 2011–12 and FR SR 11–7.

adequately capture the sensitivity of loss estimates to adverse and severely adverse scenarios. For example, a company may use its budgeting process for its baseline loss projections, if appropriate, but it should use a different process for the adverse and severely adverse scenarios if its budgeting process does not capture the potential for sharply elevated losses during stressful conditions. Whatever processes a company chooses should be conditioned on each of the three macroeconomic scenarios provided by supervisors.

Companies may choose loss estimation processes from a range of available methods, techniques, and levels of granularity, depending on the type and materiality of a portfolio, and the type and quality of data available. For instance, some companies may choose to base their stress loss estimates on industry historical loss experience, provided that those estimates are consistent with the conditions in the supervisory scenarios. Companies should choose a method that best serves the structure of their credit portfolios, and they may choose different methods for different portfolios (for example, wholesale versus retail). Furthermore, companies may use multiple methods to estimate losses on any given credit portfolio, and investigate different methods before settling on a particular approach or approaches. Regardless of whether a company uses historical loss experience or a more sophisticated modeling technique to estimate losses in a given scenario, the company should verify that resulting loss estimates are appropriately conditioned on the scenario, and any assumptions used are well understood and documented.

In estimating losses based on historical experiences, companies should ensure that historical loss experience contains at least one period when losses were substantially elevated and revenues substantially reduced, such as the downturn of a credit cycle. In addition, companies should ensure that any historical loss data used are consistent with the company's current exposures and condition. This could occur, for instance, if a company has shifted the proportion of its commercial lending from large corporations to smaller businesses, and the shift is not appropriately reflected in its historical loss data. If neither a company's own data history nor industry loss data include periods of stress comparable to the supervisory adverse or severely adverse scenario, the company should make reasonable, conservative assumptions based on available data.

Companies may choose to estimate credit losses at an aggregate level, at a loan-segment level, or at a loan-by-loan level. Aggregate approaches generally involve estimating loan losses for portfolios of loans, such as the $10–50 billion reporting form categories or more granular categories. Loan segmentation approaches group individual loans into segments or pools of obligors with similar risk characteristics to estimate losses. For example, individual 30-year fixed-rate mortgage loans may be pooled into one segment, and 5-year adjustable-rate mortgages (ARMs) into another segment, each to be modeled separately based on the balance, loss, and default history in that loan segment. Loan segments can also be determined based on additional risk characteristics, such as credit score, LTV ratio, borrower location, and payment status. Finally, loan-level approaches estimate losses for each loan or borrower and aggregate those estimates to arrive at portfolio-level losses.

Some of the more commonly used modeling techniques for estimating loan losses include net charge-off models, roll-rate models, and transition matrices. Net charge-off models typically estimate the net charge-off rate for a given portfolio, based on the historical relationship between the net charge offs and relevant risk factors, including macroeconomic variables. Roll-rate models generally estimate the rate at which loans that are current or delinquent in a given quarter roll into delinquent or default status in the next quarter, conditioning such estimates on relevant risk factors. Transition matrices estimate the probability that risk ratings on loans could change from quarter to quarter and observe how transition rates differ in stressful periods compared with less stressful or baseline periods. Some companies may also use an approach where the probability of default, loss given default, and exposure at default are estimated for individual loans, conditioning such estimates on each loan or portfolio risk characteristics and the economic scenario. Companies can benefit from exploring different modeling approaches, giving due consideration to cost effectiveness and with the understanding that more sophisticated methodologies will not necessarily prove more practicable or robust.

Loss estimation practices should be commensurate with the overall size, complexity, and sophistication of the company, as well as with individual portfolios, to ensure they fully capture a company's risk profile. Accordingly, smaller, less sophisticated $10–50 billion companies may employ simpler loss estimation practices that rely on industry historical loss experience at a higher level of aggregation. On the other hand, larger or more sophisticated $10–50 billion companies, including those with more complex portfolios, should consider more advanced loss estimation practices that identify the key drivers of losses for a given portfolio, segment, or loan, determine how those drivers would be affected in supervisory scenarios, and estimate resulting losses.

Loss estimates should include projections of other-than-temporary impairments (OTTI) for securities both held for sale and held to maturity. OTTI projections should be based on positions as of September 30 and should be consistent with the supervisory scenarios and standard accounting treatment. Companies should ensure that their securities loss estimation practices, including definitions of loss used, remain current with regulatory and accounting changes.

5. Pre-Provision Net Revenue Estimation

The projection of potential revenues is a key element of a stress test. For the DFA stress test, companies are required to project PPNR over the planning horizon for each supervisory scenario.[17] Companies should estimate PPNR at a level at least as granular as the components outlined in the $10–50 billion reporting form. Companies should be mindful that revenue patterns could differ markedly in baseline versus stress periods, and should therefore not make assumptions that revenue streams will remain the same or follow similar paths across all scenarios. In estimating PPNR, companies should consider, among other things, how potentially higher nonaccruals, increased collection costs, and changes in funding sources during the adverse and severely adverse scenarios could affect PPNR. Companies should ensure that PPNR projections are generally consistent with projections of losses, the balance sheet, and risk-weighted assets. For example, if a company projects that loan losses would be reduced because of declining loan balances under a severely adverse scenario, PPNR would also be expected to decline under the same scenario due to the decline in interest income. Companies should ensure transparency and appropriate documentation of all material assumptions related to PPNR.

There are various ways to estimate PPNR under stress scenarios and companies are not required to use any

[17] The DFA stress test rules define PPNR as net interest income plus non-interest income less non-interest expense. Non-operational or non-recurring income and expense items should be excluded.

specific method. For example, companies may project each of the three main components of PPNR (net interest income, non-interest income, and non-interest expense) or sub-components of PPNR (e.g., interest income or fee income), on an aggregate level for the entire company or by business line. Companies may base their PPNR estimates on internal or industry historical experience, or use a more sophisticated model-based approach to project PPNR. For example, some companies may project PPNR based on a historical relationship between PPNR or broad components of PPNR and macroeconomic variables. In those instances, companies may use the level of PPNR or the ratio of PPNR to a relevant balance sheet measure, such as assets or loans. Some companies may use a more granular breakout of PPNR (for example, interest income on loans), identify relevant economic variables (for example, interest rates), and employ models based on historical data to project PPNR. Some companies may use their asset-liability management models to project some components of PPNR, such as net-interest income.

A company may estimate the stressed components of PPNR based on its own or industry-wide historical income and expense experience, particularly during the early development of a company's stress testing practices. When using its own history, a company should ensure that the data include at least one stressful period; when using industry data, a company should ensure that such data are relevant to its portfolios and businesses and appropriately reflect potential PPNR under each supervisory scenario. If neither its own data nor industry data include the period of stress that is comparable to the supervisory adverse or severely adverse scenario, a company should make conservative assumptions, based on available data, and appropriately adjust its historical PPNR data downward in its stressed estimate. A company that has been experiencing merger activity, rapid growth, volatile revenues, or changing business models should rely less on its own historical experience, and generally make conservative assumptions.

It may be appropriate for smaller or less sophisticated $10–50 billion companies to employ PPNR estimation approaches that project the three main components of PPNR at the aggregate, company-wide level based on industry experience. Larger or more sophisticated $10–50 billion companies should consider PPNR estimation practices that more fully capture potential risks to their business and strategy by collecting internal revenue data, estimating revenues within specific business lines, exploring more advanced techniques that identify the specific drivers of revenue, and analyzing how the supervisory scenarios affect those revenue drivers. Whatever process a company chooses to employ, projected revenues and expenses should be credible and reflect a reasonable translation of expected outcomes consistent with the key scenario variables.

In addition to the credit losses associated with loan portfolios and securities holdings, described in the previous section, that should be estimated directly and separately, companies may determine that other types of losses could arise under the supervisory scenarios. These other types of losses should be included in projections of PPNR to the extent they would arise under the specified scenario conditions. For example, any trading losses arising from the scenario conditions should be included in the non-interest income component of PPNR. As another example, companies should estimate under the non-interest expense component of PPNR any losses associated with requests by mortgage investors—including both government-sponsored enterprises as well as private-label securities holders—to repurchase loans deemed to have breached representations and warranties, or with investor litigation that broadly seeks damages from companies for losses.

Companies with material representation and warranty risk may consider a range of legal process outcomes, including worse than expected resolutions of the various contract claims or threatened or pending litigation against a company and against various industry participants. Additionally, in estimating non-interest income, companies with significant mortgage servicing operations should consider the effect of the supervisory scenarios on revenue and expenses related to mortgage servicing rights and the associated impact to regulatory capital.

PPNR estimates should also include any operational losses that a company estimates based on the supervisory scenarios provided. Companies should address operational risk in their PPNR projections if such events are related to the supervisory scenarios provided, or if there are pending related issues, such as ongoing litigation, that could affect losses or revenues over the planning horizon.[18]

6. Balance Sheet and Risk-Weighted Asset Projections

A company is expected to project its balance sheet and risk-weighted assets for each of the supervisory scenarios. In doing so, these projections should be consistent with scenario conditions and the company's prior history of managing through the different business environments, especially stressful ones. For example, a company that has reduced its business activity and balance sheet during past periods of stress or that has contingent exposures should take these factors into consideration. The projections of the balance sheet and risk-weighted assets should be consistent with other aspects of stress test projections, such as losses and PPNR. In addition, balance sheet and risk-weighted asset projections should remain current with regulatory and accounting changes.

Companies may use a variety of methods to project balance sheet and risk-weighted assets. In certain cases, it may be appropriate for a company to use simpler approaches for balance sheet and risk-weighted asset projections, such as a static balance sheet and static risk-weighted assets over the planning horizon; however, companies should consider whether such an approach is appropriate if they have more volatile balance sheets and risk-weighted assets, such as from mergers, acquisitions, or organic growth. Alternatively, a company may rely on estimates of changes in balance sheet and risk-weighted assets based on their own or industry-wide historical experience, provided that the internal or external historical balance sheet and risk-weighted asset experience contains stressful periods. As in the case of loss estimation and PPNR, using industry-wide data might be more appropriate when internal data lack sufficient history, granularity, or observations from stressful periods; however, companies should take caution when using the industry data and provide appropriate documentation for all material assumptions.

Some companies may choose to employ more advanced, model-based approaches to project balance sheet and risk-weighted assets. For example, a company may project outstanding balances for assets and liabilities based on the historical relationship between those balances and macroeconomic variables. In other cases, a company could project certain components of the

[18] As noted above, there may be certain aspects of operational risk that a company is not expected to address in DFA stress tests; however, the company should consider those other aspects of operational risk as part of broader stress testing described in the May 2012 stress testing guidance.

balance sheet, for example, based on projections for originations, paydowns, drawdowns, and losses for its loan portfolios under each scenario. Estimated prepayment behavior conditioned on the relevant scenario and the maturity profile of the asset portfolio could inform balance sheet projections.

In stress scenarios, companies should justify major changes in the composition of risk-weighted assets, for example, based on assumptions about a company's strategic direction, including events such as material sales, purchases, or acquisitions. Furthermore, companies should be mindful that any assumptions about reductions in business activity that would reduce their balance sheets and risk-weighted assets over the planning horizon (such as tightened underwriting) are also likely to reduce PPNR. Such assumptions should also be reasonable in that they do not substantially alter the company's core businesses and earnings capacity. Any case in which balance sheet and risk-weighted asset projections decline over the period, and therefore positively affect capital ratios, should be well supported by analysis and data.

7. Estimates for Immaterial Portfolios

Although stress testing should be applied to all exposures as described above, the same level of rigor and analysis may not be necessary for lower-risk, immaterial, portfolios. Portfolios considered immaterial are those that would not represent a consequential effect on capital adequacy under any of the scenarios provided. For such portfolios, it may be appropriate for a company to use a less sophisticated approach for its stress test projections, provided that the results of that approach are conservative and well documented. For example, estimating losses under the supervisory scenarios for a small portfolio of municipal securities may not involve the same sophistication as a larger portfolio of commercial mortgages.

8. Projections for Quarterly Provisions and Ending Allowance for Loan and Lease Losses

The DFA stress test rules require companies to project quarterly PLLL.[19] Companies are expected to project PLLL based on projections of quarterly loan and lease losses and the appropriate ALLL balance at each quarter-end for each scenario. In projecting PLLL, companies are expected to maintain an adequate loan-loss reserve through the planning horizon, consistent with supervisory guidance, accounting standards, and a company's internal practice. Estimated provisions should recognize the potential need for higher reserve levels in the adverse and severely adverse scenarios, since economic stress leads to poorer loan performance.

The ALLL at the end of the planning horizon should include any losses projected beyond the nine-quarter horizon. Given that loss projections for the stress tests can in some cases be conducted at a portfolio level, the ALLL projections may also be conducted at a similar level, provided that they are consistent with the company's existing methodologies to calculate ALLL. Management should ensure that the company's projected ALLL is sufficient to cover remaining loan losses under the scenario for each quarter of the planning horizon, including the last quarter.

9. Projections for Quarterly Net Income

Under the DFA stress test rules, companies must estimate projected quarterly net income for each scenario. Net income projections should be based on loss, revenue, and expense projections described above. Companies should also ensure that tax estimates, including deferred taxes and tax assets, are consistent with relevant balance sheet and income (loss) assumptions and reflect appropriate accounting, tax, and regulatory changes.

*D. Estimating the Potential Impact on Regulatory Capital Levels and Capital Ratios*

*Rule Requirement:* In conducting a stress test, for each quarter of the planning horizon a company must estimate: the potential impact on regulatory capital levels and capital ratios (including regulatory capital ratios and any other capital ratios specified by the primary supervisor), incorporating the effects of any capital actions over the planning horizon and maintenance of an allowance for loan losses appropriate for credit exposures throughout the planning horizon.[20]

In the DFA stress test rules, companies are required to estimate the impact of supervisory scenarios on capital levels and ratios, based on the estimates of losses, PPNR, loan and lease provisions, and net income, as well as projections of the balance sheet and risk-weighted assets. Companies must estimate projected quarterly regulatory capital levels and regulatory capital ratios for each scenario. Stress tests are intended to assess the negative impact on companies' capital positions from hypothetical stress conditions; as such, the agencies expect companies' post-stress capital ratios under the adverse and severely adverse scenarios to be lower than under the baseline scenario. Any rare cases in which ratios are higher under the adverse and severely adverse scenarios should be very well supported by analysis and documentation. Projected capital levels and ratios should reflect applicable regulations and accounting standards for each quarter of the planning horizon.

*Rule Requirement:* A bank holding company or savings and loan holding company is required to make the following assumptions regarding its capital actions over the planning horizon:

1. For the first quarter of the planning horizon, the bank holding company or savings and loan holding company must take into account its actual capital actions as of the end of that quarter.

2. For each of the second through ninth quarters of the planning horizon, the bank holding company or savings and loan holding company must include in the projections of capital:

(a) Common stock dividends equal to the quarterly average dollar amount of common stock dividends that the company paid in the previous year (that is, the first quarter of the planning horizon and the preceding three calendar quarters);

(b) Payments on any other instrument that is eligible for inclusion in the numerator of a regulatory capital ratio equal to the stated dividend, interest, or principal due on such instrument during the quarter; and

(c) An assumption of no redemption or repurchase of any capital instrument that is eligible for inclusion in the numerator of a regulatory capital ratio.[21]

In their DFA stress tests, bank holding companies and savings and loan holding companies are required to calculate pro forma capital ratios using a set of capital action assumptions based on historical distributions, contracted payments, and a general assumption of no redemptions, repurchases, or issuances of capital instruments. A holding company should also assume it will not issue any new common stock, preferred stock, or other instrument that would count in regulatory capital in the second through ninth quarters of the planning horizon, except for any common issuances related to expensed employee compensation.

While holding companies are required to use specified capital action

[19] 12 CFR 46.6(a)(1) (OCC); 12 CFR 252.15(a)(1) (Board); 12 CFR 325.206(b) (FDIC).

[20] 12 CFR 46.6(a)(2) (OCC); 12 CFR 252.15(a)(2) (Board); 12 CFR 325.205(a)(2) (FDIC).

[21] 12 CFR 252.15(b).

assumptions, there are no specified capital actions for banks and thrifts. A bank or thrift should use capital actions that are consistent with the scenarios and the company's internal practices in their DFA stress tests. For banks and thrifts, projections of dividends that represent a significant change from practice in recent quarters, for example to conserve capital in a stress scenario, should be evaluated in the context of corporate restrictions and board decisions in historical stress periods. Additionally, a holding company should consider that it is required to use certain capital assumptions that may not be the same as the assumptions used by its bank subsidiaries. Finally, any assumptions about mergers or acquisitions, and other strategic actions should be well documented and should be consistent with past practices of management and the board during stressed economic periods. Should the stress-test submissions for the bank or thrift and its holding company differ in terms of projected capital actions (e.g., different dividend payout assumptions during the stress test horizon for the bank versus the holding company) as a result of the different requirements of the DFA stress test rules, the institution should address such differences in the narrative portion of their submissions.

### *E. Controls, Oversight, and Documentation*

*Rule requirement:* Senior management must establish and maintain a system of controls, oversight and documentation, including policies and procedures, that are designed to ensure that its stress testing processes are effective in meeting the requirements of the DFA stress test rule. These policies and procedures must, at a minimum, describe the company's stress testing practices and methodologies, and describe the processes for validating and updating practices and methodologies consistent with applicable laws, regulations, and supervisory guidance. The board of directors, or a committee thereof, of a company must approve and review the policies and procedures of the stress testing processes as frequently as economic conditions or the condition of the company may warrant, but no less than annually.[22]

Pursuant to the DFA stress test requirement, a company must establish and maintain a system of controls, oversight, and documentation, including policies and procedures that apply to all of its DFA stress test components. This system of controls, oversight, and documentation should be consistent with the May 2012 stress testing guidance. Policies and procedures for DFA stress tests should be comprehensive, ensure a consistent and repeatable process, and provide transparency regarding a company's stress testing processes and practices for third parties. The policies and procedures should provide a clear articulation of the manner in which DFA stress tests should be conducted, roles and responsibilities of parties involved (including any external resources), and describe how DFA stress test results are to be used. These policies and procedures also should be integrated into other policies and procedures for the company. The board (or a committee thereof) must approve and review the policies and procedures for DFA stress tests to ensure that policies and procedures remain current, relevant, and consistent with existing regulatory and accounting requirements and expectations as frequently as economic conditions or the condition of the company may warrant, but no less than annually.

Senior management must establish policies and procedures for DFA stress tests and should ensure compliance with those policies and procedures, assign competent staff, oversee stress test development and implementation, evaluate stress test results, and review any findings related to the functioning of stress testing processes. Senior management should ensure that weaknesses—as well as key assumptions, limitations and uncertainties—in DFA stress testing processes and results are identified, communicated appropriately within the organization, and evaluated for the magnitude of impact, taking prompt remedial action where necessary. Senior management, directly and through relevant committees, should also be responsible for regularly reporting to the board regarding DFA stress test developments (including the process to design tests and augment or map supervisory scenarios), DFA stress test results, and compliance with a company's stress testing policy.

A company's system of documentation should include the methodologies used, data types, key assumptions, and results, as well as coverage of the DFA stress tests (including risks and exposures included). For any models used, documentation should include sufficient detail about design, inputs, assumptions, specifications, limitations, testing, and output. In general, documentation on methodologies used should be consistent with existing supervisory guidance.

Companies should ensure that other aspects of governance over methodologies used for DFA stress tests are appropriate, consistent with the May 2012 stress testing guidance. Specifically, companies should have policies, procedures, and standards for any models used. Effective governance should include validation and effective challenge for any assumptions or models used, and a description of any remedial steps in cases where models are not validated or validation identifies substantial issues. A company should ensure that internal audit evaluates model risk management activities related to DFA stress tests, which should include a review of whether practices align with policies, as well as how deficiencies are identified, monitored, and addressed.

*Rule requirements:* The board of directors and senior management of the company must receive a summary of the results of the stress test. The board of directors and senior management of a company must consider the results of the stress test in the normal course of business, including, but not limited to, the company's capital planning, assessment of capital adequacy, and risk management practices.[23]

A company's board of directors is ultimately responsible for the company's DFA stress tests. Board members must receive summary information about DFA stress tests, including results from each scenario. The board or its designee should appropriately evaluate and discuss this information, ensuring that the DFA stress tests are consistent with the company's risk appetite and overall business strategy. The board should ensure it remains informed about critical review of elements of the DFA stress tests conducted by senior management or others (such as internal audit), especially regarding key assumptions, uncertainties, and limitations. In addition, the board of directors and senior management of a $10–50 billion company must consider the role of stress testing results in normal business including in the capital planning, assessment of capital adequacy, and risk management practices of the company. A company should appropriately document the manner in which DFA stress tests are used for key decisions about capital adequacy, including capital actions and capital contingency plans. The company

[22] 12 CFR 46.5(d) (OCC); 12 CFR 252.15(c) (Board); 12 CFR 325.205(b) (FDIC).

[23] 12 CFR 46.5(d) and 46.6(c)(2) (OCC); 12 CFR 252.15(c)(3) (Board); 12 CFR 325.205(b)(2) and (3) (FDIC).

should indicate the extent to which DFA stress tests are used in conjunction with other capital assessment tools, especially if the DFA stress tests may not necessarily capture a company's full range of risks, exposures, activities, and vulnerabilities that have the potential to affect capital adequacy. In addition, a company should determine whether its post-stress capital results are aligned with its internal capital goals. For cases in which post-stress capital results are not aligned with a company's internal capital goals, senior management should provide options it and the board would consider to bring them into alignment.

*F. Report to Supervisors*

*Rule Requirement:* A company must report the results of the stress test to its primary supervisor and to the Board of Governors by March 31, in the manner and form prescribed by the agency.[24]

All $10–50 billion companies must report the results of their DFA company-run stress tests on the $10–50 billion reporting form. This report will include a company's quantitative projections of losses, PPNR, balance sheet, risk-weighted assets, ALLL, and capital on a quarterly basis over the duration of the scenario and planning horizon. In addition to the quantitative projections, companies are required to submit qualitative information supporting their projections. The report of the stress test results must include, under each scenario: a description of the types of risks included in the stress test, a description of the methodologies used in the stress test, an explanation of the most significant causes for the changes in regulatory capital ratios, and any other information required by the agencies. In addition, the agencies may request supplemental information, as needed.

If significant errors or omissions are identified subsequent to filing, a company must file an amended report. For additional information, see the instructions provided with the reporting templates.

*G. Public Disclosure of DFA Test Results*

*Rule Requirement:* A company must disclose a summary of the results of the stress test in the period beginning on June 15 and ending on June 30.[25]

Under the DFA stress test rules, a company must make its first DFA stress test-related public disclosure between June 15 and June 30, 2015, by disclosing summary results of its annual DFA stress test, using September 30, 2014, financial statement data.[26] The regulation requires holding companies to include in their public disclosure a summary of the results of the stress tests conducted by any subsidiaries subject to DFA stress testing.[27] A bank can satisfy this public disclosure requirement by including a summary of the results of its stress test in its parent company's public disclosure (on the same timeline); however the agencies can require a separate disclosure if the parent company's public disclosure does not adequately capture the impact of the scenarios on the bank.

The summary of the results of the stress test, including both quantitative and qualitative information, should be included in a single release on a company's Web site, or in any other forum that is reasonably accessible to the public.

Each bank or thrift must publish a summary of its stress tests results separate from the results of stress tests conducted at the consolidated level of its parent holding company, but the company may include this summary with its holding company's public disclosure. Thus, a bank or thrift with a parent holding company that is required to conduct a company-run DFA stress test under the Federal Reserve Board's DFA stress test rules will have satisfied its public disclosures requirement when the parent holding company discloses summary results of its subsidiary's annual stress test in satisfaction of the requirements of the applicable regulations of the company's primary Federal regulator, unless the company's primary Federal regulator determines that the disclosures at the holding company level does not adequately capture the potential impact of the scenarios on the capital of the companies.

A company must disclose, at a minimum, the following information regarding the severely adverse scenario:

a. A description of the types of risks included in the stress test;

b. A summary description of the methodologies used in the stress test;

c. Estimates of—

Aggregate losses;

PPNR;

PLLL;

Net income; and

Pro forma regulatory capital ratios and any other capital ratios specified by the primary Federal regulator;

d. An explanation of the most significant causes for the changes in regulatory capital ratios; and

e. For bank holding companies and savings and loan holding companies: For a stress test conducted by an insured depository institution subsidiary of the bank holding company or savings and loan holding company pursuant to section 165(i)(2) of the Dodd-Frank Act, changes in regulatory capital ratios and any other capital ratios specified by the primary Federal regulator of the depository institution subsidiary over the planning horizon, including an explanation of the most significant causes for the changes in regulatory capital ratios.

It should be clear in the company's public disclosure that the results are conditioned on the supervisory scenarios. Items to be publicly disclosed should follow the same definitions as those provided in the confidential report to supervisors. Companies should disclose all of the required items in a single public release, as it is difficult to interpret the quantitative results without the qualitative supporting information.

DIFFERENCES IN DFA STRESS TEST REQUIREMENTS FOR HOLDING COMPANIES VERSUS BANKS AND THRIFTS

| | Bank holding companies and savings and loan holding companies | Banks and thrifts |
|---|---|---|
| Capital actions used for company-run stress tests. | Capital actions prescribed in Federal Reserve Board's DFA stress tests rules. Generally based on historical dividends, contracted payments, and no repurchases or issuances. | No prescribed capital actions. Banks and thrifts should use capital actions consistent with the scenario and their internal business practices. |

[24] 12 CFR 46.7 (OCC); 12 CFR 252.16 (Board); 12 CFR 325.206 (FDIC).

[25] 12 CFR 46.8 (OCC); 12 CFR 252.17 (Board); 12 CFR 325.207 (FDIC).

[26] The exception is any $10–50 billion state member bank that is a subsidiary of a bank holding company or a savings and loan holding company with average total consolidated assets of $50 billion or more; in that case, the state member bank subsidiary must disclose a summary of the results of the stress test in the period beginning on March 15 and ending on March 31.

[27] 12 CFR 252.17(b).

DIFFERENCES IN DFA STRESS TEST REQUIREMENTS FOR HOLDING COMPANIES VERSUS BANKS AND THRIFTS—Continued

| | Bank holding companies and savings and loan holding companies | Banks and thrifts |
|---|---|---|
| Public disclosure of company-run stress tests. | Disclosure must include information on stress tests conducted by subsidiaries subject to DFA stress tests. | Disclosure requirement met when parent company disclosure includes the required information on the bank or thrift's stress test results, unless the company's primary regulator determines that the disclosure at the holding company level does not adequately capture the potential impact of the scenarios on the capital of the company. |

Dated: February 19, 2014.

**Thomas J. Curry,**

*Comptroller of the Currency.*

By order of the Board of Governors of the Federal Reserve System, March 5, 2014.

**Robert deV. Frierson,**

*Secretary of the Board.*

Dated at Washington, DC, this 5th day of March, 2014.

Federal Deposit Insurance Corporation.

**Robert E. Feldman,**

*Executive Secretary.*

[FR Doc. 2014–05518 Filed 3–12–14; 8:45 am]

**BILLING CODE 4810–33–P; 6714–01–P; 6210–01–P**

## DEPARTMENT OF TRANSPORTATION

### Federal Aviation Administration

### 14 CFR Part 39

**[Docket No. FAA–2011–1158; Directorate Identifier 2010–SW–018–AD; Amendment 39–17765; AD 2011–22–05 R1]**

**RIN 2120–AA64**

### Airworthiness Directives; Airbus Helicopters (Type Certificate Previously Held By Eurocopter France) (Airbus Helicopters)

**AGENCY:** Federal Aviation Administration (FAA), DOT.

**ACTION:** Final rule.

**SUMMARY:** We are revising Airworthiness Directive (AD) 2011–22–05 for Eurocopter France (Eurocopter) Model AS350B, B1, B2, B3, BA, C, D, D1, AS355E, F, F1, F2, N, and NP helicopters with certain tail rotor (T/R) pitch control rods (control rods) installed. AD 2011–22–05 required checking the control rod for play before the first flight of each day. This new AD requires checking the control rod for play within 30 hours time-in-service (TIS) and, if no bearing play is detected, thereafter at intervals not to exceed 30 hours TIS. The actions in this AD are intended to prevent failure of a T/R control rod, loss of T/R control, and subsequent loss of control of the helicopter.

**DATES:** This AD is effective April 17, 2014.

**ADDRESSES:** For service information identified in this AD, contact Airbus Helicopters, Inc., 2701 N. Forum Drive, Grand Prairie, TX 75052; telephone (972) 641–0000 or (800) 232–0323; fax (972) 641–3775; or at *http://www.airbushelicopters.com/techpub.* You may view this referenced service information at the FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137.

#### Examining the AD Docket

You may examine the AD docket on the Internet at *http://www.regulations.gov* in Docket No. FAA–2011–1158 or in person at the Docket Management Facility between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The AD docket contains this AD, the European Aviation Safety Agency (EASA) AD, any incorporated-by-reference information, the economic evaluation, any comments received, and other information. The address for the Docket Office (phone: 800–647–5527) is Document Management Facility, U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590.

**FOR FURTHER INFORMATION CONTACT:** Robert Grant, Aviation Safety Engineer, Safety Management Group, FAA, 2601 Meacham Blvd., Fort Worth, Texas 76137; telephone (817) 222–5110; email *robert.grant@faa.gov.*

**SUPPLEMENTARY INFORMATION:**

#### Discussion

We issued a notice of proposed rulemaking (NPRM) to amend 14 CFR part 39 to revise AD 2011–22–05, Amendment 39–16847 (76 FR 70046, November 10, 2011). AD 2011–22–05 applied to Eurocopter Model AS350B, B1, B2, B3, BA, C, D, D1; and Model AS355E, F, F1, F2, N, and NP helicopters with T/R control rod, part number (P/N) 350A33–2100–00, –01, –02, –03, –04; P/N 350A33–2121–00, –01, –02; P/N 350A33–2143–00; or P/N 350A33–2145–00 or –01, installed. AD 2011–22–05 required checking the control rod for play before the first flight of each day. The NPRM, published in the **Federal Register** on September 26, 2013 (78 FR 59298), proposed to extend the required time to check control rod play to within 30 hours TIS and, if no bearing play is detected, thereafter at intervals not to exceed 30 hours TIS.

The NPRM was based on our determination that we can safely extend the compliance time for the initial bearing play check and the interval for recurring checks. We also clarified the requirements of that check and removed a previous requirement that if the Teflon cloth is coming out of its normal position within the bearing, or if there is discoloration or scoring on the bearing, that the control rod be replaced with an airworthy rod before further flight. These actions are intended to prevent failure of a control rod, loss of T/R control, and subsequent loss of control of the helicopter.

Since we issued the NPRM, Eurocopter France has changed its name to Airbus Helicopters. This AD reflects that change and updates the contact information to obtain service documentation.

#### Comments

We gave the public the opportunity to participate in developing this AD, but we received no comments on the NPRM (78 FR 59298, September 26, 2013).

#### FAA's Determination

These helicopters have been approved by the aviation authority of France and are approved for operation in the United States. Pursuant to our bilateral agreement with France, EASA, its technical representative, has notified us of the unsafe condition described in the EASA AD. We are issuing this AD because we evaluated all information provided by EASA and determined the unsafe condition exists and is likely to exist or develop on other helicopters of these same type designs and that air safety and the public interest require adopting the AD requirements as