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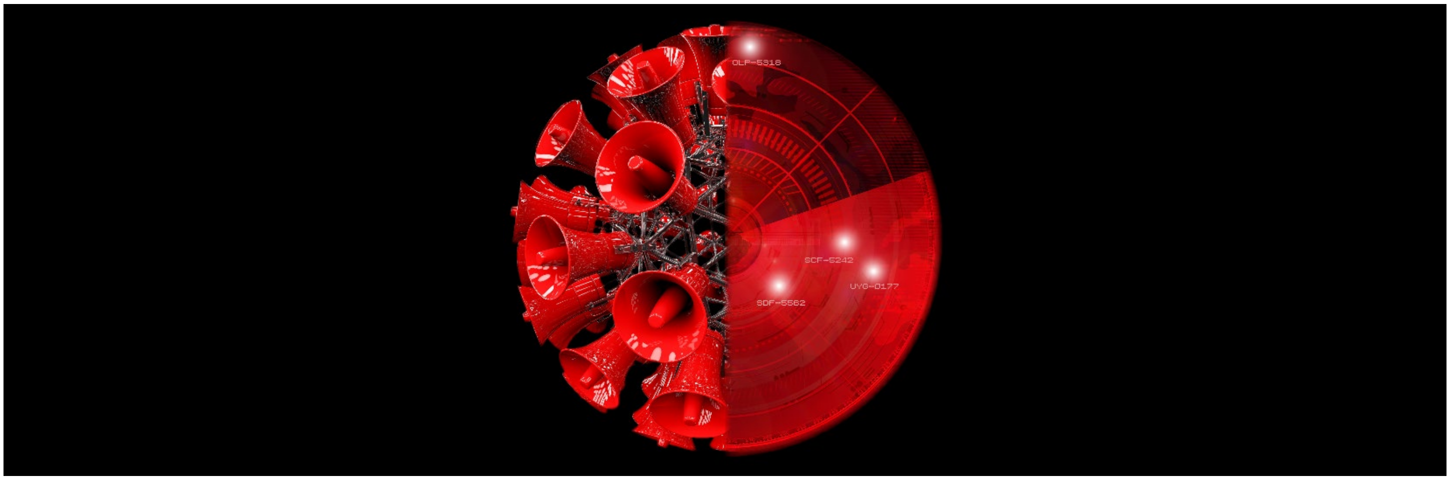

In a year of "firsts," CCAR banks enter uncharted territory

The Federal Reserve Board (FRB) released the results of the latest Dodd-Frank Stress Test (DFAST) / Comprehensive Capital Analysis and Review (CCAR) on June 25, 2020.[1] The stress tests evaluated the capital planning processes and adequacies of 33 of the largest banks. Notably, the 2020 CCAR cycle represented a series of 'firsts' for participating banks and the FRB, including areas that represent potential considerations for financial firms going forward:

- Every institution passed with no objections
- Regulators curtailed capital actions for all CCAR participants
- The capital planning process (including governance layer) was executed in a 'crisis' and essentially through an off-premise or 'virtual' environment
- A stress capital buffer (SCB) concept was added
- Resubmission was mandated for all CCAR participants later this year

In addition to the unprecedented, virtual nature of the 2020 CCAR process for both regulators and the institutions, the uncertain and rapidly evolving environment ahead makes it clear that the financial services industry is continuing its journey through uncharted territory.

Pandemic-related sensitivity analysis drives regulatory response

The 2020 CCAR results are encouraging in that banks demonstrated initial resiliency. However, the FRB cautiously noted that "the stress brought on by the COVID event has been larger than anticipated, affected sectors of the economy in a highly unusual way, and could result in an unusual relationship between the economic and financial factors and credit losses, in part because of extraordinary government actions."[2]

Attempting to get an early sense of what the pandemic's impacts could mean to aggregate and individual bank capital levels, the FRB conducted an eagerly anticipated pandemic-related sensitivity analysis and took subsequent, decisive action.[3] The analysis used three hypothetical downside scenarios: a rapid V-shaped recovery; a slower, U-shaped recovery; and a W-shaped, double-dip recession.[4] While the results of the pandemic-related sensitivity analysis were only published in the aggregate, several banks were close to the capital minimums under the more severe U-shaped and W-shaped scenarios. As the FRB noted, loss estimates approximated $560-$700 billion, with aggregate capital ratios ranging between 7.7% - 9.5% (down from the Q42019 12% level).[5]

The pandemic-related sensitivity assessment results seemingly drove the FRB to take two unprecedented actions: all bank capital actions were restricted, and all banks were required to resubmit their capital plans later this year.[6] The FRB capital action restrictions require large banks to suspend share repurchases in the third quarter and to cap dividend payments at the lower of 2Q dividend levels or the average of the trailing four quarters net income.

The upcoming resubmission is intended to provide the FRB with additional information, particularly as the pandemic's course and impact is better represented in bank data and models, and to better assess capital levels in the current environment. Resubmission results may potentially be used to help inform the FRB's decision on taking additional actions, including further capital restrictions and/or potential SCB changes.

Resubmission underscores new challenges for participating banks

Though the FRB and CCAR banks handled the 2020 CCAR cycle in the midst of the emerging pandemic during Q1/early Q2, dealing with the resubmission and other potential requirements and impacts that manifest over the remainder of the year will likely be even more challenging. Banks will need to potentially reconsider enhanced scenarios, assumptions, and forecasts. Existing bank capital planning processes and controls are likely to continue to experience compressed operational timelines and intense scrutiny that could rival the early days of CCAR implementation. Through it all, banks will need to stay vigilant and agile to address the rapidly evolving regulatory and economic environment.

Incorporating pandemic impacts

Incorporating pandemic impacts on business and portfolio performance presents unique challenges for banks. Whether through FRB guidance and/or determining how to incorporate pandemic impacts on their own, banks will need to rethink existing scenarios, assumptions, data, models, adjustments, challenge processes, among other items.

Since the onset of the pandemic, even outside of the recent CCAR process, banks have been scenario planning and assessing drivers and impacts to financials and loss forecasts. As resubmission activities and capital planning continues through the remainder of the year, these activities can serve both as a foundation and a further point of alignment. Impacts should be incorporated in a timely fashion to ensure sufficient time for review and challenge. Also, given the uneven and uncertain nature of the impact of COVID-19 on borrowers and portfolios (e.g. new risk drivers, sector concentrations), banks should strive to ensure a holistic approach to addressing areas to be enhanced for purposes of the upcoming resubmission.

Executing the capital planning process under duress

While banks' investments in people, modeling, data, and process certainly were beneficial in executing the highly atypical 2020 CCAR cycle, the resubmission process will likely further present operational challenges unlike previous cycles.

Established governance and oversight mechanisms will need to ensure there is heightened coordination and alignment as the above enhancements are occurring across multiple points of the organization. Data stakeholders will need to ensure incrementally required data (e.g., either driven by regulatory requirements and/or internal requirements to support enhanced forecasting approaches) is complete, timely, and accurate. The process and control environment will be expected to execute within tight timelines, in a continued virtual workplace, with a need to report final results to the regulators but also provide early views of results to a host of internal validation and review stakeholders.

Of particular note, given the increased frequency and import of supervisory monitoring tools (e.g., including the emerging risk data collections of a select number of large banks) that the FRB is leveraging for interim analysis prior to the resubmissions, banks should recognize the need for high levels of data quality in the information being provided to regulators – and the implications of providing data that may be in some way lacking.

Staying agile

'Uncertainty' seems to succinctly capture the current capital planning environment and how to think about the remainder of the year. At the start of the year, no one would have predicted that a second stress test submission would be required for all banks later in 2020. The course of the pandemic is unpredictable and subsequent regulatory, government, and economic activity is currently unknown.

As the situation continues to play out, additional regulatory asks will need to be addressed in the coming months, in both bespoke data requests and potentially more ongoing data requests. Legislative action (or inaction and the Department of Treasury and FRB's economic programs) are expected to more fully impact the economy, the banks, and actual portfolio losses. Strategic and business decisions are being made by banks in real-time to help manage their risks and optimize their performance and should be reflected in assumptions and forecasts and structured under their governance processes that include their boards of directors. As all of these dynamics become clearer over time, the banks' stress testing and capital planning processes will need to stay dynamic and keep pace with the rapid evolution and understanding of the situation.

Looking ahead

The importance and challenges of the next round of stress testing should not be underestimated. Even though banks were well-positioned entering this recession,[7] the fundamental uncertainty associated with the course of the pandemic and the corresponding uncertainty of subsequent government response and ultimately the impact to business and portfolio performance make the stress test resubmission both critically important and immensely challenging for participating CCAR banks.

Unlike in previous crises, for the first-time, banks and regulators have a sophisticated framework and infrastructure to help support effective capital management outcomes. We will know over the coming months whether all the effort and resources expended by banks and regulators over the last decade is up to the challenge currently being faced.

This is the first in a series of analysis on the liquidity and capital conditions of banks in the current environment. We–like you–will continue to monitor developments as conditions evolve to reflect more current stresses related to the pandemic and its longer-term impact on the financial services sector and broader economy.

Endnotes

1. Federal Reserve Board (FRB), "Dodd-Frank Act Stress Test 2020: Supervisory Stress Test Results," and "Assessment of Bank Capital during the Recent Coronavirus Event," accessed on June 25, 2020.
2. FRB, "Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event," accessed on June 25, 2020.
3. Ibid.
4. FRB, "Dodd-Frank Act Stress Test 2020: Supervisory Stress Test Results," and "Assessment of Bank Capital during the Recent Coronavirus Event," accessed on June 25, 2020.
5. For additional information, please see "Aggregate CET1 capital ratio, actual 2019:Q4 and projected 2022:Q1 post-stress" from FRB, "Assessment of Bank Capital during the Recent Coronavirus Event," accessed on June 25, 2020.
6. FRB, "Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event," accessed on June 25, 2020.
7. FRB, "Monetary Policy Report," accessed on June 25, 2020.

Contacts

Alexandre Brady
Principal | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Courtney Davis
Principal | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Craig Brown
Managing Director | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Greg Norwood
Managing Director | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Deloitte Center for Regulatory Strategy

Irena Gecas-McCarthy
FSI Director, Deloitte Center for Regulatory Strategy, Americas
Principal | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Austin Tuell
Manager | Deloitte Risk & Financial Advisory
Deloitte Center for Regulatory Strategy
Deloitte & Touche LLP

Kyle Cooke
Senior Consultant | Deloitte Risk & Financial Advisory
Deloitte Center for Regulatory Strategy
Deloitte & Touche LLP

Deloitte Center for Financial Services

Jim Eckenrode
Executive Director, Deloitte Center for Financial Services
Managing Director | Deloitte Services LP
Deloitte & Touche LLP

Val Srinivas, PhD
Research Leader, Deloitte Center for Financial Services
Senior Manager | Deloitte Services LP

Contributors

John Corston
Independent Senior Advisor to Deloitte & Touche LLP

Kenneth Lamar
Independent Senior Advisor to Deloitte & Touche LLP