



**BOARD OF GOVERNORS**  
OF THE  
**FEDERAL RESERVE SYSTEM**  
WASHINGTON, D.C. 20551

DIVISION OF BANKING  
SUPERVISION AND REGULATION

**SR 15-19**  
**December 18, 2015**

**TO THE OFFICER IN CHARGE OF SUPERVISION  
AT EACH FEDERAL RESERVE BANK**

**SUBJECT: Federal Reserve Supervisory Assessment of Capital Planning and Positions for  
Large and Noncomplex Firms**

**Applicability:** This guidance applies only to U.S. bank holding companies and intermediate holding companies of foreign banking organizations that have total consolidated assets of at least \$50 billion but less than \$250 billion, have consolidated total on-balance sheet foreign exposure of less than \$10 billion, and are not otherwise subject to the Federal Reserve’s Large Institution Supervision Coordinating Committee (LISCC) framework (referred to as a “Large and Noncomplex Firm” in this letter).

The Federal Reserve is issuing this letter to explain its supervisory expectations for capital planning at large and noncomplex bank holding companies and intermediate holding companies of foreign banking organizations, consistent with the broad supervisory expectations set forth in SR letter 12-17/CA letter 12-14, “Consolidated Supervision Framework for Large Financial Institutions.”<sup>1</sup> Capital is central to a firm’s ability to absorb unexpected losses and continue to lend to creditworthy businesses and consumers. Therefore, a firm’s processes for managing and allocating its capital resources are critical to its financial strength and resiliency, and also to the stability and effective functioning of the U.S. financial system. The attached guidance provides the Federal Reserve’s core capital planning expectations for large and noncomplex firms, building upon the capital planning requirements in the Federal Reserve’s capital plan rule and stress test rules.<sup>2,3</sup>

<sup>1</sup> The term “capital planning process” used in this document, which aligns with terminology in SR 12-17/ CA 12-14, is equivalent to the term “capital adequacy process” used in other Federal Reserve documents.

<sup>2</sup> For the capital plan rule, refer to section 225.8 of Regulation Y (12 CFR 225.8). Regulation Q (12 CFR part 217) establishes minimum capital requirements and overall capital adequacy standards for Federal Reserve-regulated institutions. Regulation YY (12 CFR part 252) establishes capital stress testing requirements for bank holding companies with total consolidated assets of \$50 billion or more, including requirements to participate in the Federal Reserve’s annual supervisory stress test and conduct their own internal capital stress tests.

<sup>3</sup> With the issuance of this letter, SR letter 99-18, “Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles,” is superseded. In addition, SR letter 09-4, “Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies,” is superseded with respect to firms subject to this guidance.

The guidance outlines capital planning expectations for:

- Governance
- Risk management
- Internal controls
- Capital policy
- Scenario design
- Projection methodologies

Further, the attached guidance includes several appendices that detail supervisory expectations on a firm's capital planning process. This guidance largely consolidates the Federal Reserve's existing capital planning guidance, including:

- Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice (August 2013)<sup>4</sup>
- Comprehensive Capital Analysis and Review 2015 Summary Instructions and Guidance (October 2014)<sup>5</sup>
- Instructions for the Capital Assessments and Stress Testing information collection (Reporting Form FR Y-14A), (OMB No. 7100-0341)<sup>6</sup>
- SR letter 11-7, "Supervisory Guidance on Model Risk Management"
- SR letter 12-7, "Supervisory Guidance on Stress Testing for Banking Organizations with More Than \$10 Billion in Total Consolidated Assets"
- SR letter 12-17/CA letter 12-14, "Consolidated Supervision Framework for Large Financial Institutions"

### **Applicability**

This guidance applies to U.S. bank holding companies and intermediate holding companies of foreign banking organizations that have total consolidated assets of at least \$50 billion but less than \$250 billion, have consolidated total on-balance sheet foreign exposure of less than \$10 billion, and are not otherwise subject to the Federal Reserve's Large Institution Supervision Coordinating Committee framework (referred to as a "Large and Noncomplex Firm")

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<sup>4</sup> Available at: <http://www.federalreserve.gov/bankinfo/bcreg20130819a1.pdf>.

<sup>5</sup> Available at: <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20141017a1.pdf>.

<sup>6</sup> Available at: <http://www.federalreserve.gov/apps/reportforms/reportdetail.aspx?sOoYJ+5BzDa2AwLR/gLe5DPhQFttuq/4>.

in this letter and attachment).<sup>7,8</sup> The guidance is effective immediately for bank holding companies that are subject to the capital plan rule as of January 1, 2016. The guidance will become effective for intermediate holding companies beginning on January 1, 2017, which is the date on which the capital plan rule applies to these firms.

The Federal Reserve has different expectations for sound capital planning and capital adequacy depending on the size, scope of operations, activities, and systemic importance of a firm. Concurrently with issuance of this guidance, the Federal Reserve is issuing separate guidance for U.S. bank holding companies and intermediate holding companies that are subject to the LISCC framework (referred to as a “LISCC Firm”) or that otherwise have total consolidated assets of \$250 billion or more or consolidated total on-balance sheet foreign exposure of \$10 billion or more (referred to as a “Large and Complex Firm”). This separate guidance clarifies that expectations for LISCC Firms and Large and Complex Firms are higher than the expectations for Large and Noncomplex Firms.

Federal Reserve Banks should distribute this letter to Large and Noncomplex Firms in their districts as well as to appropriate supervisory staff. Questions regarding this guidance may be directed to the following Board staff: Lisa Ryu, Associate Director, at (202) 263-4833, or David Palmer, Senior Supervisory Financial Analyst, at (202) 452-2904. In addition, questions may be sent to the secure CCAR Communications mailbox or via the Board’s public website.<sup>9</sup>

Michael S. Gibson  
Director

#### Attachment

- *Federal Reserve Guidance on Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms*

#### Cross References to:

- SR letter 15-3, “FFIEC Information Technology Examination Handbook”
- SR 13-19/CA 13-21, “Guidance on Managing Outsourcing Risk”

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<sup>7</sup> Total consolidated assets equals the amount of total assets reported on the firm’s Consolidated Financial Statements for Holding Companies (FR Y-9C), measured as an average over the preceding four quarters. If a firm has not filed the FR Y-9C for each of the four most recent consecutive quarters, a firm’s total consolidated assets are measured as the average of its total consolidated assets, as reported on the FR Y-9C, for the most recent quarter or consecutive quarters, as applicable. Consolidated total on-balance sheet foreign exposure equals total cross-border claims less claims with head office or guarantor located in another country plus redistributed guaranteed amounts to the country of head office or guarantor plus local country claims on local residents plus revaluation gains on foreign exchange and derivative products, calculated as of the most recent year-end in accordance with the Federal Financial Institutions Examination Council (FFIEC) 009 Country Exposure Report.

<sup>8</sup> This guidance does not apply to nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Board of Governors. Capital position and capital planning expectations will be issued for those firms at a later date.

<sup>9</sup> See: <http://www.federalreserve.gov/apps/contactus/feedback.aspx>.

- SR letter 13-1/CA letter 13-1, “Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing”
- SR letter 12-17/CA letter 12-14, “Consolidated Supervision Framework for Large Financial Institutions”
- SR letter 12-7, “Supervisory Guidance on Stress Testing for Banking Organizations with More Than \$10 Billion in Total Consolidated Assets”
- SR letter 11-7, “Supervisory Guidance on Model Risk Management”

Supersedes:

- SR letter 99-18, “Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles”
- SR letter 09-4, “Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies”  
*Note: This SR letter is superseded for a U.S. bank holding company or an intermediate holding company of a foreign banking organization with \$50 billion or more in total consolidated assets.*

**Federal Reserve Guidance on  
Supervisory Assessment of Capital Planning and Positions for  
Large and Noncomplex Firms**

**I. Introduction**

This guidance provides the Federal Reserve's core capital planning expectations for Large and Noncomplex Firms, building upon the capital planning requirements included in the Board's capital plan rule and stress test rules. This guidance outlines capital planning expectations<sup>1</sup> for these firms in the following areas:

- Governance
- Risk management
- Internal controls
- Capital policy
- Incorporating stressful conditions and events
- Estimating impact on capital positions

Further, this guidance provides detailed supervisory expectations on a firm's capital planning process in the following appendices:

- A. Use of Models and Other Estimation Approaches
- B. Model Overlays
- C. Use of Benchmark Models in the Capital Planning Process
- D. Sensitivity Analysis and Assumptions Management
- E. Role of the Internal Audit Function in the Capital Planning Process
- F. Capital Policy
- G. Scenario Design
- H. Risk-weighted Asset (RWA) Projections
- I. Operational Loss Projections

This guidance applies to U.S. bank holding companies and intermediate holding companies of foreign banking organizations that have total consolidated assets of at least \$50 billion but less than \$250 billion, have consolidated total on-balance sheet foreign exposure

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<sup>1</sup> Note that these expectations build upon the capital planning requirements set forth in the Board's capital plan rule and stress test rules (12 CFR 225.8; 12 CFR 252, subparts E and F). Other relevant rules pertaining to the Board's regulatory regime for capital planning and positions are described above in Section II, "Regulatory Requirements for Capital Positions and Planning." The Federal Reserve may not conduct or sponsor, and an organization (or a person) is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

of less than \$10 billion, and are not otherwise subject to the Federal Reserve's Large Institution Supervision Coordinating Committee (LISCC) framework<sup>2</sup> (referred to in this guidance as a "Large and Noncomplex Firm").<sup>3,4</sup> The guidance is effective immediately for bank holding companies that are subject to the capital plan rule as of January 1, 2016. The guidance will become effective for intermediate holding companies beginning on January 1, 2017, which is the date on which the capital plan rule applies to these firms.

The Federal Reserve has different expectations for sound capital planning and capital adequacy depending on the size, scope of operations, activities, and systemic importance of a firm. Concurrently with issuance of this guidance, the Federal Reserve is issuing separate guidance for U.S. bank holding companies and intermediate holding companies that are subject to the LISCC framework (referred to as a "LISCC Firm") or that otherwise have total consolidated assets of \$250 billion or more or consolidated total on-balance sheet foreign exposure of \$10 billion or more (referred to as a "Large and Complex Firm"). This separate guidance clarifies that expectations for LISCC Firms and Large and Complex Firms are higher than the expectations for Large and Noncomplex Firms.

## II. Regulatory Requirements for Capital Positions and Planning

Sound capital planning for any firm begins with adherence to all applicable rules and regulations relating to capital adequacy. Three Federal Reserve regulations form the basis of the regulatory framework for capital positions and capital planning:

- 1) Regulation Q (12 CFR part 217), Capital Adequacy Requirements for Board-regulated Institutions;
- 2) Regulation YY (12 CFR part 252), Enhanced Prudential Standards; and

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<sup>2</sup> The LISCC framework is designed to materially increase the financial and operational resiliency of systemically important financial institutions to reduce the probability of, and cost associated with, their material financial distress or failure. See [www.federalreserve.gov/bankinforeg/large-institution-supervision.htm](http://www.federalreserve.gov/bankinforeg/large-institution-supervision.htm).

<sup>3</sup> Total consolidated assets equals the amount of total assets reported on the firm's Consolidated Financial Statements for Holding Companies (FR Y-9C), measured as an average over the preceding four quarters. If a firm has not filed the FR Y-9C for each of the four most recent consecutive quarters, a firm's total consolidated assets are measured as the average of its total consolidated assets, as reported on the FR Y-9C, for the most recent quarter or consecutive quarters, as applicable. Consolidated total on-balance sheet foreign exposure equals total cross-border claims less claims with head office or guarantor located in another country plus redistributed guaranteed amounts to the country of head office or guarantor plus local country claims on local residents plus revaluation gains on foreign exchange and derivative products, calculated as of the most recent year-end in accordance with the Federal Financial Institutions Examination Council (FFIEC) 009 Country Exposure Report.

<sup>4</sup> This guidance does not apply to nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Board of Governors. Capital position and capital planning expectations will be issued for those firms at a later date.

3) Section 225.8 of Regulation Y (12 CFR 225.8, also known as the capital plan rule).

Regulation Q establishes minimum capital requirements and overall capital adequacy standards for Federal Reserve-regulated institutions. Among other things, Regulation YY establishes capital stress testing requirements for bank holding companies with total consolidated assets of \$50 billion or more, including requirements to participate in the Federal Reserve's annual supervisory stress test and conduct their own internal capital stress tests. The capital plan rule establishes general capital planning requirements for a bank holding company with total consolidated assets of \$50 billion or more and requires a bank holding company to develop an annual capital plan that is approved by its board of directors.

This guidance provides the Federal Reserve's core capital planning expectations for firms subject to this guidance, building upon the capital planning requirements in the Federal Reserve's capital plan rule and stress test rules.<sup>5</sup>

### **III. Capital Planning Expectations**

Capital is central to a firm's ability to absorb unexpected losses and continue to lend to creditworthy businesses and consumers. A firm's capital planning processes are critical to its financial strength and resiliency.

SR letter 12-17/CA letter 12-14, "Consolidated Supervision Framework for Large Financial Institutions," outlines core expectations for sound capital planning for bank holding companies with total consolidated assets of \$50 billion or more. This capital planning and positions guidance provides additional details around the Federal Reserve's core capital planning expectations for Large and Noncomplex Firms, building on the capital planning requirements included in the capital plan rule and the Board's stress test rules.<sup>6</sup> A firm should maintain a sound capital planning process on an ongoing basis, including in between submissions of its annual capital plan.<sup>7</sup>

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<sup>5</sup> With the issuance of this letter, SR letter 99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles," is superseded and SR letter 09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies" is superseded with respect to firms subject to this guidance.

<sup>6</sup> The capital planning process described in this guidance is broadly equivalent to an internal capital adequacy assessment process (ICAAP) under the Federal Reserve's advanced approaches capital guidelines. The expectations articulated in this document are consistent with the U.S. federal banking agencies' supervisory guidance relating to the ICAAP (see 73 FR 44620 (July 31, 2008)).

<sup>7</sup> The term "capital planning process" used in this document, which aligns with terminology in SR 12-17/CA 12-14, is equivalent to the term "capital adequacy process" used in other Federal Reserve documents.

## A. Governance

The Federal Reserve expects a firm to have sound governance over its capital planning process. In general, senior management should establish the capital planning process and the board of directors should review and periodically approve that process.

### 1. Board of Directors

A firm's board of directors is ultimately responsible and accountable for the firm's capital-related decisions and for capital planning. The firm's capital planning should be consistent with the strategy and risk appetite set by the board and with the firm's risk levels, including how risks at the firm may emerge and evolve under stress. The board must annually review and approve the firm's capital plan.<sup>8</sup>

The board should direct senior management to provide a briefing on their assessment of the firm's capital adequacy at least quarterly, and whenever economic, financial, or firm-specific conditions warrant a more frequent update. The briefing should describe whether current capital levels and planned capital distributions remain appropriate and consistent with capital goals (see Section III.D, "Capital Policy"). In their briefing, senior management should also highlight for the board any problem areas related to capital planning identified by senior management, internal audit, or supervisors.

The board should hold senior management accountable for providing sufficient information on the firm's material risks and exposures to inform board decisions on capital adequacy and actions, including capital distributions. Information provided to the board should be clear, accurate, and timely. The board should direct senior management to provide this information at least quarterly and whenever economic, financial, or firm-specific conditions warrant a more frequent update. The information presented to the board should include consideration of a number of factors, such as:

- Macro-economic conditions and relevant market events;
- Current capital levels relative to budgets and forecasts;
- Post-stress capital goals and targeted real time capital levels (see section III.D, "Capital Policy");
- Enterprise-wide and line-of-business performance;
- Expectations from stakeholders (including shareholders, regulators, investors, lenders, counterparties, and rating agencies);
- Potential sources of stress to the firm's operating performance; and
- Risks that may emerge only under stressful conditions.

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<sup>8</sup> 12 CFR 225.8(e)(1)(iii).



After receiving the information, the board should be in a position to understand the major drivers of the firm's projections under a range of conditions, including baseline and stress scenarios.

The board should direct senior management to provide information about the firm's estimation approaches, model overlays, and assessments of model performance (see Appendix A, "Use of Models and Other Estimation Approaches" and Appendix B, "Model Overlays). The board should also receive information about uncertainties around projections of capital needs or limitations within the firm's capital planning process to understand the impact of these weaknesses on the process. This information should include key assumptions and the analysis of sensitivity of a firm's projections to changes in the assumptions (see Appendix D, "Sensitivity Analysis and Assumptions Management"). The board should incorporate uncertainties in projections and limitations in the firm's capital planning process into its decisions on capital adequacy and capital actions. It should also review and approve mitigating steps to address capital planning process weaknesses.

The board should direct senior management to establish sound controls for the entire capital planning process. The board should approve policies related to capital planning, and review them annually. The board should also approve capital planning activities and strategies. The board of directors should maintain an accurate record of its meetings pertaining to the firm's capital planning process.

## *2. Senior Management*

Senior management should direct staff to implement board-approved capital policies, capital planning activities, and strategies in an effective manner. Senior management should make informed recommendations to the board regarding the firm's capital planning and capital adequacy, including post-stress capital goals and capital distribution decisions. Senior management's proposed capital goals and capital distributions should have analytical support and take into account the expectations of important stakeholders, including shareholders, rating agencies, counterparties, depositors, creditors, and supervisors.

Senior management should design and oversee the implementation of the firm's capital planning process; identify and assess material risks and use appropriate firm-specific scenarios in the firm's stress test; monitor and assess capital planning practices to identify limitations and uncertainties and develop remediation plans; understand key assumptions used throughout a firm's capital planning process and assess the sensitivity of the firm's projections to those assumptions (see Appendix D, "Sensitivity Analysis and Assumptions Management"); and review the capital planning process at least semi-annually.

Senior management should establish a process for independent review of the firm's capital planning process, including the elements outlined in this guidance. The independent review process should be designed to identify the weaknesses and limitations of the capital planning process and the potential impact of those weaknesses on the process. Senior management should also develop remediation plans for any identified weaknesses affecting the reliability of capital planning results. Both the specific identified weaknesses and the remediation plans should be reported to the board of directors in a timely manner.

**Differences in Expectations for LISCC Firms and Large and Complex Firms,  
as compared to Large and Noncomplex Firms**

The Federal Reserve expects senior management of a LISCC Firm and a Large and Complex Firm to have a higher level of engagement in the capital planning process than the senior management of a Large and Noncomplex Firm. Specifically, senior management of a LISCC Firm and a Large and Complex Firm should review the capital planning process quarterly, whereas senior management of a Large and Noncomplex Firm should review the capital planning process at least semi-annually.

**B. Risk Management**

A firm should have a risk management infrastructure that appropriately identifies, measures, and assesses material risks and provides a strong foundation for capital planning.<sup>9</sup> This risk management infrastructure should be supported by comprehensive policies and procedures, clear and well-established roles and responsibilities, and strong and independent internal controls. In addition, the risk management infrastructure should be built upon sound information technology and management information systems. The Federal Reserve's supervisory assessment of the sufficiency of a firm's capital planning process will depend in large part on the effectiveness of the firm's risk management infrastructure and the strength of its process to identify unique risks under normal and stressful conditions, as well as on the strength of its overall governance and internal control processes.

*1. Risk Identification and Assessment Process*

A firm's risk identification process should include a comprehensive assessment of risks stemming from its unique business activities and associated exposures. The assessment should include on-balance sheet assets and liabilities, off-balance sheet exposures, vulnerability of the firm's earnings, and other major firm-specific determinants of capital adequacy under normal and stressed conditions. This assessment should also capture those risks that only materialize or become apparent under stressful conditions.

The specifics of the risk identification process will differ across firms given differences in organizational structure, business activities, and size and complexity of operations. However, the risk identification process at all firms subject to this guidance should be dynamic, inclusive, and comprehensive, and drive the firm's capital adequacy analysis. A firm should:

- Evaluate material risks across the enterprise to ensure comprehensive risk capture on an ongoing basis;
- Actively monitor its material risks; and

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<sup>9</sup> 12 CFR 225.8(e)(2).

- Use identified material risks to inform key aspects of the firm’s capital planning, including the development of stress scenarios, the assessment of the adequacy of post-stress capital levels, and the appropriateness of potential capital actions in light of the firm’s capital objectives.

A firm should be able to demonstrate how material risks are accounted for in its capital planning process. For risks not well captured by scenario analysis, the firm should clearly articulate how the risks are otherwise captured and addressed in the capital planning process and factored into decisions about capital needs and distributions.

## *2. Risk Measurement and Risk Materiality*

A firm should have a sound risk measurement process that informs senior management about the size and risk characteristics of exposures and business activities under both normal and stressful operating conditions. A firm should employ risk measurement approaches that are appropriate for its size, complexity and risk profile.

Identified weaknesses, limitations, biases, and assumptions in the firm’s risk measurement processes should be assessed for their potential impact on the integrity of a firm’s capital planning process (see Appendix D, “Sensitivity Analysis and Assumptions Management”). A firm should have a process in place for determining materiality in the context of material risk identification and capital planning. This process should include a sound analysis of relevant quantitative and qualitative considerations, including, but not limited to, the firm’s risk profile, size, and complexity, and their effects on the firm’s projected regulatory capital ratios in stressed scenarios.<sup>10</sup>

A firm should identify how and where its material risks are accounted for within the capital planning process. The firm should be able to specify material risks that are captured in its scenario design, the approaches used to estimate the impact on capital, and the risk drivers associated with each material risk.

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<sup>10</sup> For simplicity, the terms “quantitative” and “qualitative” are used to describe two different types of approaches, with the recognition that all quantitative estimation approaches involve some qualitative/judgmental aspects, and qualitative estimation approaches produce quantitative output.

### **Differences in Expectations for LISCC Firms and Large and Complex Firms, as compared to Large and Noncomplex Firms**

The Federal Reserve expects a LISCC Firm and a Large and Complex Firm to have a more formal risk identification process with quarterly updates, identify difficult-to-quantify risks, segment risks at more granular levels, involve multiple stakeholders across the firm in identifying material risks, critically assess risk transfer techniques, and use quantitative approaches supported by expert judgment for risk management. In contrast, the Federal Reserve expects a Large and Noncomplex Firm to have a less formal risk identification process, has lower expectations regarding identification of difficult-to-quantify risks, segmentation, engagement with stakeholders, and assessment of risk transfer techniques, and provides the option for a Large and Noncomplex Firm to use either qualitative or quantitative risk measurement approaches for risk management.

### **C. Internal Controls**

A firm should have a sound internal control framework that helps ensure that all aspects of the capital planning process are functioning as designed and result in sound assessments of the firm's capital needs. The framework should include:

- An independent internal audit function;
- Independent review and validation practices; and
- Integrated management information systems, effective reporting, and change control processes.

A firm's internal control framework should support its entire capital planning process, including the sufficiency of and adherence to policies and procedures; risk identification, measurement, and management practices and systems used to produce input data; and the models, management overlays, and other methods used to generate inputs to post-stress capital estimates. Any part of the capital planning process that relies on manual procedures should receive heightened attention. The internal control framework should also assess the aggregation and reporting process used to produce reports to senior management and to the board of directors and the process used to support capital adequacy recommendations to the board.

#### *1. Comprehensive Policies, Procedures and Documentation for Capital Planning*

A firm should have policies and procedures that support consistent and repeatable capital planning processes.<sup>11</sup> Policies and procedures should describe the capital planning process in a manner that informs internal and external stakeholders of the firm's expectations for internal practices, documentation, and business line controls. The firm's documentation should be sufficient to provide relevant information to those making decisions about capital actions. The

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<sup>11</sup> See Instructions for the Capital Planning and Stress Testing Information Collection (Reporting Form FR Y-14A), Appendix A (Supporting Documentation), available at: <http://www.federalreserve.gov/apps/reportforms/reportdetail.aspx?sOoYJ+5BzDa2AwLR/gLe5DPhQFttuq/4>.

documentation should also allow parties unfamiliar with a process or model to understand generally how it operates, as well as its main limitations, key assumptions, and uncertainties.

Policies and procedures should also clearly identify roles and responsibilities of staff involved in capital planning and provide accountability for those responsible for the capital planning process. A firm should also have an established process for policy exceptions. Such exceptions should be approved by the appropriate level of management based upon the gravity of the exception. Policies and procedures should reflect the firm's current practices, and be reviewed and updated as appropriate, but at least annually.

## *2. Model Validation and Independent Review of Estimation Approaches*

Models used in the capital planning process should be reviewed for suitability for their intended uses. A firm should give particular consideration to the validity of models used for calculating post-stress capital positions. In particular, models designed for ongoing business activities may be inappropriate for estimating losses, revenue, and expenses under stressed conditions. If a firm identifies weaknesses or uncertainties in a material model, the firm should make adjustments to model output if the findings would otherwise result in the material understatement of capital needs (see Appendix B, "Model Overlays"). If the deficiencies are critical, the firm should restrict the use of the model, apply overlays, or avoid using the model entirely.

A firm should independently validate or otherwise conduct effective challenge of models used in internal capital planning, consistent with supervisory guidance on model risk management, with priority given to more material models.<sup>12</sup> The model review and validation process should include an evaluation of conceptual soundness of models and ongoing monitoring of the model performance. The firm's validation staff should have the necessary technical competencies, sufficient stature within the organization, and appropriate independence from model developers and business areas to provide a critical and unbiased evaluation of the estimation approaches.

A firm should maintain an inventory of all estimation approaches used in the capital planning process, including models used to produce projections or estimates used by the models that generate final loss, revenue, expense, and capital projections.<sup>13</sup> Material models should receive greater attention.<sup>14</sup> The intensity and frequency of validation work should be a function of the importance of those models in generating estimates of post-stress capital.

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<sup>12</sup> See SR letter 11-7, "Supervisory Guidance on Model Risk Management." The term "effective challenge" means critical review by objective, informed parties who have the proper incentives, competence, and influence to challenge the model and its results.

<sup>13</sup> The definition of a model covers quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgment, provided that the output is quantitative in nature.

<sup>14</sup> Materiality of the model is a function of both the importance of the business or portfolio assessed and the impact of the model on the firm's overall results.

Not all models can be fully validated prior to use in capital planning. However, a firm should make efforts to conduct a conceptual soundness review of its material models prior to their use in capital planning. If such a conceptual soundness review is not possible, the absence of that review should be made transparent to users of model output and the firm should determine whether the use of compensating controls (such as conservative adjustments) are warranted.

Further, a firm should treat output from material models for which there are model risk management shortcomings with caution.

### *3. Management Information Systems and Change Control Processes*

A firm should have internal controls that ensure the integrity of reported results and that make certain the firm is identifying, documenting, reviewing, and tracking all material changes to the capital planning process and its components. The firm should ensure that such controls exist at all levels of the capital planning process. Specific controls should ensure:

- Sufficiently sound management information systems to support the firm's capital planning process;
- Comprehensive reconciliation and data integrity processes for key reports;
- The accurate and complete presentation of capital planning process results, including a description of adjustments made to compensate for identified weaknesses; and
- That information provided to senior management and the board is accurate and timely.

Many of the processes used to assess capital adequacy, including models, data, and management information systems, are tightly integrated and interdependent. As a result, a firm should ensure consistent change control oversight across the entire firm, in line with existing supervisory guidance.<sup>15</sup> A firm should establish and maintain a policy describing minimum internal control standards for managing change in capital planning process policies and procedures, model development, information technology, and data. Control standards for these areas should address risk, testing, authorization and approval, timing of implementation, and post-installation verification.

### *4. Internal Audit Function*

Internal audit should play a key role in evaluating capital planning and the elements described in this guidance to ensure that the entire process is functioning in accordance with supervisory expectations and the firm's policies and procedures. Internal audit should review the manner in which deficiencies are identified, tracked, and remediated. Furthermore, internal audit

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<sup>15</sup> Federal Financial Institutions Examination Council, "IT Examination Handbook—Operations Booklet," available at: [http://ithandbook.ffiec.gov/ITBooklets/FFIEC\\_ITBooklet\\_Operations.pdf](http://ithandbook.ffiec.gov/ITBooklets/FFIEC_ITBooklet_Operations.pdf). See also SR letter 15-3, "FFIEC Information Technology Examination Handbook."

should ensure appropriate independent review and challenge is occurring at all key levels within the capital planning process.

As discussed further in Appendix E, “Role of the Internal Audit Function in the Capital Planning Process,” internal audit staff should have the appropriate competence and influence to identify and escalate key issues. All deficiencies, limitations, weaknesses and uncertainties identified by the internal audit function that relate to the firm’s capital planning process should be reported to senior management, and material deficiencies should be reported to the board of directors (or the audit committee of the board) in a timely manner.<sup>16</sup>

**Differences in Expectations for LISCC Firms and Large and Complex Firms,  
as compared to Large and Noncomplex Firms**

The Federal Reserve expects a LISCC Firm and a Large and Complex Firm to complete a conceptual soundness review of all models prior to use, maintain comprehensive documentation of its capital planning process, and have compensating controls for known model uncertainties. In contrast, the Federal Reserve expects a Large and Noncomplex Firm to make an effort to review its material models prior to use; further, the Federal Reserve has lower expectations regarding documentation and compensating controls.

In addition, the Federal Reserve expects a LISCC Firm and a Large and Complex Firm to subject benchmark models to validation, to the extent the models contribute to post-stress capital estimates. In contrast, a Large and Noncomplex Firm is not expected to use benchmark models in its capital planning process.

The Federal Reserve expects that the change control process of a LISCC Firm and a Large and Complex Firm would take into account recovery plans, whereas the Federal Reserve does not have this expectation for Large and Noncomplex Firms.

Last, the Federal Reserve expects a LISCC Firm and a Large and Complex Firm to more clearly integrate the separate components of the capital planning process at the enterprise-wide level, as compared to a Large and Noncomplex Firm.

**D. Capital Policy**

A capital policy is a firm’s written assessment of the principles and guidelines used for capital planning, issuance, usage, and distributions.<sup>17</sup> This includes internal post-stress capital goals (as discussed in more detail below and in Appendix F, “Estimating Impact on Capital

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<sup>16</sup> For additional information on supervisory expectations for internal audit see SR letter 13-1, “Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing.”

<sup>17</sup> 12 CFR 225.8(d)(7).

Positions”) and real-time targeted capital levels; guidelines for dividend payments and stock repurchases; strategies for addressing potential capital shortfalls; and internal governance responsibilities and procedures for the capital policy. The capital policy must be approved by the firm’s board of directors or a designated committee of the board.<sup>18</sup>

The capital policy should be reevaluated at least annually and revised as necessary to address changes to the firm’s business strategy, risk appetite, organizational structure, governance structure, post-stress capital goals, real-time targeted capital levels, regulatory environment, and other factors potentially affecting the firm’s capital adequacy.

A capital policy should describe the firm’s capital adequacy decision-making process, including the decision-making process for common stock dividend payments or stock repurchases.<sup>19</sup> The policy should incorporate actionable protocols, including governance and escalation, in the event a post-stress capital goal, real-time targeted capital level, or other early warning metric is breached.

### *1. Post-Stress Capital Goals*

A firm should establish post-stress capital goals that are aligned with its risk appetite and risk profile, its ability to act as a financial intermediary in times of stress, and the expectations of internal and external stakeholders. Post-stress capital goals should be calibrated based on the firm’s own internal analysis, independent of regulatory capital requirements, of the minimum level of post-stress capital the firm has deemed necessary to remain a going concern over the planning horizon. A firm should also determine targets for real-time capital ratios and capital levels that ensure that capital ratios and levels would not fall below the firm’s internal post-stress capital goals (including regulatory minimums) under stressful conditions at any point over the planning horizon. For more details, see Appendix F, “Capital Policy.”

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<sup>18</sup> 12 CFR 225.8(e)(1)(iii).

<sup>19</sup> Consistent with the Board’s November 14, 1985, Policy Statement on the Payment of Cash Dividends, the principles of which are incorporated into this guidance, firms should have comprehensive policies on dividend payments that clearly articulate the firm’s objectives and approaches for maintaining a strong capital position and achieving the objectives of the policy statement. See *Bank Holding Company Supervision Manual*, section 2020.5.1.1, *Intercompany Transactions (Dividends)*, available at: <http://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc.pdf>.



**Differences in Expectations for LISCC Firms and Large and Complex Firms,  
as compared to Large and Noncomplex Firms**

The Federal Reserve expects the capital policy of a LISCC Firm and a Large and Complex Firm to cover a broader set of topics, including roles and responsibilities of key parties and metrics influencing capital distributions, than the capital policies of a Large and Noncomplex Firm.

*See Appendix F, “Capital Policy” for additional differentiated expectations for a firm’s capital policy.*

### **E. Incorporating Stressful Conditions and Events**

As part of its capital planning process, a firm should incorporate appropriately stressful conditions and events that could adversely affect the firm’s capital adequacy into its capital planning. As part of its capital plan, a firm must use at least one scenario that stresses the specific vulnerabilities of the firm’s activities and associated risks, including those related to the company’s capital adequacy and financial condition.<sup>20</sup>

#### *1. Scenario design*

A firm should either develop a complete internal scenario or adjust the Federal Reserve’s supervisory scenarios for the specific vulnerabilities of the firm’s risk profile and operations, as needed, to appropriately capture the firm’s risks (see Appendix G, “Scenario Design”).

#### *2. Scenario narrative*

A firm’s stress scenario should be supported by a brief narrative describing how the scenario addresses the firm’s particular material risks and vulnerabilities, and how the paths of the scenario variables relate to each other.

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<sup>20</sup> 12 CFR 225.8(e)(2).

**Differences in Expectations for LISCC Firms and Large and Complex Firms,  
as compared to Large and Noncomplex Firms**

The Federal Reserve has elevated expectations for a LISCC Firm and a Large and Complex Firm relating to scenario design. Specifically, the Federal Reserve expects a LISCC Firm and a Large and Complex Firm to develop a scenario that is directly linked to the firm's risk identification process and its risk assessment, and engage a broad range of stakeholders. In contrast, a Large and Noncomplex Firm is expected to either develop a firm-specific scenario or adjust the Federal Reserve's scenario to reflect the firm's own risk profile.

In addition, a LISCC Firm and a Large and Complex Firm should use multiple firm-specific scenarios as part of its ongoing efforts to assess a broad range of risks, stressful conditions, or events that could impact the firm's capital adequacy. A Large and Noncomplex Firm is not expected to use multiple firm-specific scenarios in its capital adequacy assessment.

Further, the Federal Reserve has higher expectations for the scenario narrative of a LISCC Firm and a Large and Complex Firm and expects these firms to articulate how risks not captured by scenario analysis are otherwise addressed in the capital planning process.

## **F. Estimating Impact on Capital Positions**

A firm should employ estimation approaches that allow it to project the impact on capital positions of various types of stressful conditions and events. The firm's stress testing practices should capture the potential increase in losses or decrease in pre-provision net revenue (PPNR) that could result from the firm's risks, exposures, and activities under stressful scenarios. A firm should estimate losses, revenues, expenses, and capital using a sound method that relates macroeconomic and other risk drivers to its estimates. The firm should be able to identify the manner in which key variables, factors, and events in a scenario affect losses, revenue, expenses, and capital over the planning horizon. The firm may use simple approaches for their non-material portfolios or business lines, such as application of loss or revenue rates during the prior stress periods or other conservative assumptions.

### *1. Loss estimation*

A firm should provide support for the assumed relationship between risk drivers and losses. A firm is expected to estimate losses by type of business activity.

#### **a. Credit risk losses on loans and securities**

A firm should develop sound methods to estimate credit losses under stress that take into account the type and size of portfolios, risk characteristics, and data availability. A firm should understand the key characteristics of its loss estimation approach. In addition, a firm's reserves for each quarter of the planning horizon, including the last quarter, should be sufficient to cover estimated loan losses consistent with generally accepted accounting standards.

A firm should test credit-sensitive securities for potential other-than-temporary impairment (OTTI) regardless of current impairment status. The threshold for determining OTTI

for structured products should be based on cash-flow analysis and credit analysis of underlying obligors.

#### **b. Operational-risk losses**

A firm should maintain a sound process for estimating operational risk losses in its capital planning process. Operational losses can rise from various sources, including inadequate or failed internal processes, people, and systems, or from external events (see Appendix I, “Operational Loss Projections”).

#### *2. PPNR*

In projecting PPNR, a firm should take into account not only its current positions, but also how its activities, business strategy, and revenue drivers may evolve over time under the varying circumstances and operating environments. The firm should ensure that the various PPNR components, including net interest income, non-interest income and non-interest expense, and other key items projected by the firm such as balance sheet positions, RWA, and losses, are projected in a manner that is internally consistent.

The ability to effectively project net interest income is dependent upon the firm’s ability to identify and aggregate current positions and their attributes; project future changes in accruing balances due to a variety of factors; and appropriately translate the impact of these factors and relevant interest rates into net interest income based on assumed conditions. Accordingly, a firm’s current portfolio of interest-bearing assets and liabilities should serve as the foundation for its forward-looking estimates of net interest income.

Non-interest income is derived from a diverse set of sources, including fees and certain realized gains and losses. Non-interest income generally is more susceptible to rapid changes than net interest income, especially if certain market measures move sharply. A firm’s projections should incorporate material factors that could affect the generation of non-interest income under stress, including the firm’s business strategy, the competitive landscape, and changing regulations.

Non-interest expenses include both expenses that are likely to vary with certain stressful conditions and those that are not. Projections of expenses that are closely linked to revenues or balances should vary with projected changes in revenue or balance sheet levels.

#### *3. Aggregating Estimation Results*

A firm should have well-documented processes for projecting the size and composition of on- and off-balance sheet positions and RWAs over the planning horizon that feed in to the wider capital planning process (see Appendix H, “Risk-weighted Asset (RWA) Projections”).

A firm should have a consistently executed process for aggregating enterprise-wide stress test projections of losses, revenues, and expenses, including estimating on- and off-balance sheet exposures, and RWAs, and for calculating post-stress capital positions and ratios. The aggregation system should be able to bring together data and information across business lines,

portfolios, and risk types and should include the data systems and sources, data reconciliation points, data quality checks, and appropriate internal control points to ensure accurate and consistent projection of financial data within enterprise-wide scenario analysis. Internal processes for aggregating projections from all relevant systems and regulatory templates should be identified and documented. In addition, the beginning points for projections and scenario variables should align with the end of the historical reference period.

**Differences in Expectations for LISCC Firms and Large and Complex Firms,  
as compared to Large and Noncomplex Firms**

The Federal Reserve has elevated expectations for a LISCC Firm and a Large and Complex Firm regarding its use of models in loss and revenue estimation. As noted above, a LISCC Firm and a Large and Complex Firm is generally expected to use quantitative approaches in estimating losses and PPNR, whereas a Large and Noncomplex Firm may use either quantitative or qualitative approaches. In addition, a LISCC Firm and a Large and Complex Firms are expected to project losses and PPNR at a greater level of granularity and are held to higher expectations regarding their estimations in other areas, including with respect to setting reserves, modeling operational risk, and identifying key risk drivers.

In addition, a LISCC Firm and a Large and Complex Firm are held to expectations for estimation approaches for certain exposures, such as fair value option loans and market risks for trading exposures, that do not apply to a Large and Noncomplex Firm.

*See Appendix A, "Use of Models and Other Estimation Approaches," for additional differentiated expectations for a firm's estimation approaches.*

## Appendix A: Use of Models and Other Estimation Approaches

Projections of losses and PPNR under various scenarios are key components of enterprise-wide stress testing and capital planning. The firm should ensure that its material projection approaches, including any specific processes or methodologies employed, are well supported, transparent, and repeatable over time.

A firm may use either quantitative methods or qualitative approaches for generating projections. A firm is not expected to employ a sophisticated modeled approach, particularly if the firm can demonstrate that a simpler approach, combined with well-supported expert judgment, produces credible and transparent output. A firm can apply simple assumptions to generate losses or PPNR for its non-material portfolios or business lines.

A firm should adhere to supervisory guidance on model risk management (SR 11-7) when using models, and should have sound internal controls around both quantitative and qualitative approaches.

### 1. *Quantitative Approaches*

If a firm decides to employ quantitative approaches, it is not expected to use any specific quantitative estimation method. Any quantitative approach should be appropriate for the type and materiality of the portfolio or activity for which it is used and the granularity and length of available data. The firm should also ensure that the quantitative approach selected generates credible estimates that are consistent with assumed scenario conditions. A firm should separately estimate losses and PPNR for portfolios or business lines that are either sensitive to different risk drivers or sensitive to risk drivers in a markedly different way, particularly during periods of stress.

#### a. **Use of Data**

A firm may use either internal or external data to estimate losses and PPNR as part of its enterprise-wide stress testing and capital planning practices.<sup>21</sup> If a firm uses external data to estimate its losses or PPNR, the firm should ensure that the external data reasonably approximate underlying risk characteristics of the firm's portfolios or business lines. Further, the firm should make adjustments to estimation methods or outputs, as appropriate, to account for identified differences in risk characteristics and performance reflected in internal and external data. If internal data are not available, a firm should strive to collect internal data over time to augment its projections.

For material portfolios and business lines, a firm should generally include all available data in its analysis, unless the firm no longer engages in a line of business or its activities have changed such that the firm is no longer exposed to a particular risk. The firm should not

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<sup>21</sup> Firms are required to collect and report a substantial amount of risk information to the Federal Reserve on FR Y-14 schedules. These data may help to support the firms' enterprise-wide stress test. *See* Capital Assessments and Stress Testing information collection, Reporting Forms FR Y-14A, Q, and M.

selectively exclude data for material portfolios and business lines based on the changing nature of the ongoing business or activity without strong empirical support. For example, excluding certain loans only on the basis that they were underwritten to standards that no longer apply or on the basis that the loans were acquired by the firm is not sound practice.

#### **b. Use of Vendor Models<sup>22</sup>**

A firm should have processes to confirm that any vendor or other third-party models it uses are sound, appropriate for the given task, and implemented properly. A firm should clearly outline limitations and uncertainties associated with vendor models.

#### *2. Assessing Model Performance*

A firm should use measures to assess model performance that are appropriate for the type of model being used. The firm should outline how each performance measure is evaluated and used. A firm should also assess the sensitivity of material model estimates to key assumptions (see Appendix D, “Sensitivity Analysis and Assumptions Management”).

For models used for material portfolios and business lines, a firm should provide supporting information about the models to users of their output, including descriptions of known measurement problems, simplifying assumptions, model limitations, or other ways in which the model exhibits weaknesses in capturing the relationships being modeled. Providing such qualitative information is critical when certain quantitative criteria or tests measuring model performance are lacking.

#### *3. Qualitative Approaches*

A firm may use a qualitative approach to project losses and PPNR. When using a qualitative approach for material portfolios and business lines, the firm should substantiate assumptions and estimates using analysis of current and past risk drivers and performance, internal risk identification, forward-looking risk assessments, external analysis or other available information. The firm should conduct an initial and ongoing assessment of the performance and viability of the qualitative approach. The processes used in qualitative projection approaches should be transparent and repeatable. The firm should also clearly document material qualitative approaches and key assumptions used.

Qualitative approaches should be subject to independent review, although the review may differ from the review of quantitative approaches or models. The level of independent review should be commensurate with:

- The materiality of the portfolio or business line for which the qualitative approach is used;
- The impact of the approach’s output on the overall capital results; and
- The complexity of the approach.

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<sup>22</sup> See SR letter 13-19/CA 13-21, “Guidance on Managing Outsourcing Risk.”

Firm staff conducting the independent review of the qualitative approaches should not be involved in developing, implementing or using the approach. However, this staff can be different than the staff that conducts validation of quantitative approaches or models.

**Differences in Expectations for LISCC Firms and Large and Complex Firms,  
as compared to Large and Noncomplex Firms**

The Federal Reserve expects a LISCC Firm and a Large and Complex Firm to base their projections on internal data, include all available data in its analysis, and estimate losses and PPNR at a disaggregated level. In contrast, the Federal Reserve expects a Large and Noncomplex Firm to use either internal or external data in its projections, use all available data in analyzing material portfolios and business lines, and estimate losses and PPNR at a less granular level.

In addition, the Federal Reserve has heightened expectations for a LISCC Firm and a Large and Complex Firm regarding the variable selection process, controls around the use of vendor models, and measures for assessing model performance. In addition, the Federal Reserve expects a LISCC Firm and a Large and Complex Firm to have strong controls related to all qualitative approaches, whereas the Federal Reserve holds a Large and Noncomplex Firm to this standard only with respect to material qualitative approaches.

*See* Section F, “Estimating Impact on Capital Positions,” of the core guidance document for additional differentiated expectations for a firm’s estimation approaches.

## Appendix B: Model Overlays

A firm may need to rely on overrides or adjustments to model output (model overlay) to compensate for model, data, or other known limitations.<sup>23</sup> If well-supported, use of a model overlay can represent a sound practice.

A model overlay may be appropriate to address cases of identified weaknesses or limitations in the firm's models that cannot be otherwise addressed, or for select portfolios that have unique risks that are not well captured by the model used for those exposures and activities.<sup>24</sup> In contrast, a model overlay that functions as a general "catch all" buffer on top of targeted capital levels to account for model weaknesses generally would not represent sound practice.<sup>25</sup>

As part of its overall documentation of methodologies used in stress testing, a firm should document its use of model overlays.

### *1. Process for Applying Overlays*

A firm should establish a consistent firm-wide process for applying model overlays and for controls around model overlays. The process can vary by model type and portfolio, but should contain some key elements, as described below. This process should be outlined in the firm's policies and procedures and include a specific exception process for the use of overlays that do not follow the firm's standards. As part of model development, implementation and use, overlays for material portfolios and business lines should be well documented, supported and communicated to senior management. Model overlays should be applied in an appropriate, systematic, and transparent manner. Model results should also be reported to senior management with and without overlay adjustments.

Model overlays (including those based solely on expert or management judgment) should be subject to validation or some other type of effective challenge.<sup>26</sup> Consistent with the materiality principle in SR 11-7, the intensity of model risk management for overlays should be a function of the materiality of the model and overlay. A firm should make efforts to conduct effective challenge of its material overlays prior to their use in capital planning. If such

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<sup>23</sup> For the purposes of this appendix, the term "overlays" will be used to cover overrides, overlays, or other adjustments applied to model output. Firms should follow expectations set forth in SR letter 11-7, "Supervisory Guidance on Model Risk Management," relating to overlays.

<sup>24</sup> Expectations for the use of judgment within model development is discussed in Appendix A, "Use of Models and Other Estimation Approaches."

<sup>25</sup> Firms may choose to apply overall capital buffers as an additional conservative measure, beyond overlays applied at the model level. Overall capital buffers should be subject to the same governance processes applicable to model overlays, as described in section 2 of this appendix. However, supervisors emphasize that having such a buffer should not in any way replace sound model risk management practices for overlays at the individual model level or address the need for the overlay at the individual model level.

<sup>26</sup> The term "effective challenge" means critical review by objective, informed parties who have the proper incentives, competence, and influence to challenge the model and its results.



validation or effective challenge is not possible, those instances should be made transparent to users of the model and overlay.

Validation or other type of effective challenge of model overlays may differ from quantitative model validation. Staff responsible for effective challenge should not also be setting the overlay itself or providing significant input to the level or type of overlay. For example, a committee that develops an overlay should not also be responsible for the effective challenge of the overlay. In addition, staff engaging in the effective challenge of model overlays should meet supervisory expectations relating to incentives, competence, and influence (as outlined in SR 11-7).

## 2. *Governance of Overlays*

Overlays and adjustments used by a firm should be reviewed and approved at a level within the organization commensurate with the materiality of that overlay or adjustment to overall pro forma results. In general, the purpose and impact of material overlays should be communicated to senior management in a manner that facilitates an understanding of the issues by the firm's senior management. Material overlays to the model—either in isolation or in combination—should receive a heightened level of support and scrutiny, up to and including review by the firm's board of directors (or a designated committee), in instances where the impact on pro forma results is material.

### **Differences in Expectations for LISCC Firms and Large and Complex Firms, as compared to Large and Noncomplex Firms**

The Federal Reserve has elevated expectations for a LISCC Firm and a Large and Complex Firm regarding its use of model overlays. The Federal Reserve expects a LISCC Firm and a Large and Complex Firms to use overlays in sparing and targeted manner, subject overlays to validation or effective challenge before use, and conduct sensitivity analysis on an overlay. In contrast, a Large and Noncomplex Firm may use overlays to a greater extent, should make an effort to validate or conduct effective challenge for material overlays before use, and is not expected to conduct sensitivity analysis on an overlay.

In addition, the Federal Reserve expects a LISCC Firm and a Large and Complex Firm to have strong controls over all overlays, whereas the Federal Reserve holds a Large and Noncomplex Firm to this standard only with respect to material qualitative approaches. Last, the Federal Reserve has heightened expectations for LISCC Firm and a Large and Complex Firm relating to governance of overlays.

**Appendix C: Use of Benchmark Models in the Capital Planning Process**

As noted in Appendix A, “Use of Models and Other Estimation Approaches,” a firm should use a variety of methods to assess performance of material models and gain comfort with material model estimates. However, a firm is not expected to use benchmark models in its capital planning process.

**Differences in Expectations for LISCC Firms and Large and Complex Firms,  
as compared to Large and Noncomplex Firms**

The Federal Reserve expects a LISCC Firm and a Large and Complex Firm to use benchmark models in capital planning; a Large and Noncomplex Firm is not held to this expectation.

## **Appendix D: Sensitivity Analysis and Assumptions Management**

A firm should understand the sensitivity of its stress testing estimates used in capital planning to the various inputs and assumptions. In addition, sensitivity analysis should be used to test the robustness of material quantitative approaches and models and enhance reporting to the firm's senior management, board of directors, and supervisors. A firm should ensure that it identifies, documents, and manages the use of all key assumptions used in capital planning.

### *1. Sensitivity Analysis*

Understanding and documenting a range of potential outcomes provides insight into the inherent uncertainty and imprecision around pro forma results. A firm should assess the sensitivity of its estimates of capital ratios, losses, revenues, and RWAs to key assumptions and uncertainty across the entire firm's projections under stress. Through this assessment, a firm should calculate a range of potential estimates based on changes to assumptions and inputs.

A firm should also evaluate the sensitivity of material models to key assumptions to evaluate model performance, assess the appropriateness of assumptions, and understand uncertainty associated with model output.

Sensitivity analysis for capital planning models should be applied in a manner consistent with the expectations outlined in the Federal Reserve's supervisory guidance on model risk management (refer to SR 11-7). Sensitivity analysis should be conducted during model development and during model validation to provide information about how models respond to changes in key inputs and assumptions, and how those models perform in stressful conditions. In addition, sensitivity analysis should be applied to understand the range of possible results from material vendor-provided models and vendor-provided scenario forecasts that have opaque or proprietary elements. Sensitivity analysis should be used to provide information to help users of model output interpret results, but does not have to result in changes to models or model outputs. Changes made based on sensitivity analysis should be clearly documented and justified.

A firm should ensure that the key sensitivities are presented to senior management and the board in advance of decision-making around the firm's capital plan and capital actions. Sensitivity analysis should also be used to inform senior management, and, as appropriate, the board of directors about the potential uncertainty associated with models employed of the firm's projections under stress.

### *2. Assumptions Management*

A firm should clearly document assumptions when estimating losses, PPNR, and balance sheet, and RWA components. Documentation should include the rationale and empirical support for assumptions and specifically address how those assumptions are consistent with and appropriate under the firm's scenario conditions.

A firm's rationale for assumptions used in capital planning should be consistent with the different effects of scenario conditions, shifts in portfolio mix, and growth or decline in balances

projected over the planning horizon. For example, the firm should scrutinize and support any assumptions about sizeable loan growth during a severe economic downturn.

A firm should generally use conservative assumptions, particularly in areas of high uncertainty. The firm should provide greater support for assumptions that appear optimistic or otherwise appear to benefit the firm (such as loss reduction or revenue enhancement). A firm should not assume that senior management will be able to realize favorable strategic actions that cannot be reasonably assured in stress scenarios given the high level of uncertainty around market conditions. Further, a firm should not assume that it would have the perfect foresight that would allow it, for example, to make significant expense reductions in the first quarter of the forecast horizon in anticipation of the forthcoming economic deterioration described in the scenario.

A firm should confirm that key assumptions used in material vendor or other third-party products are transparent and have sufficient support before using the products in stress testing. The firm should limit use of material vendor products whose assumptions are not fully transparent or supported or use those products only in conjunction with another approach or compensating controls (e.g., overlays).

**Differences in Expectations for LISCC Firms and Large and Complex Firms,  
as compared to Large and Noncomplex Firms**

The Federal Reserve expects a LISCC Firm and a Large and Complex Firm to apply sensitivity analysis, including assumptions used in vendor models, to all approaches and assumptions used in capital planning. In contrast, a Large and Noncomplex Firm is expected to use sensitivity analysis only for material approaches and assumptions used in material vendor models.

In addition, the Federal Reserve expects a LISCC Firm and a Large and Complex Firm to subject a greater range of assumptions to sensitivity analysis and subject assumptions based on historical patterns to greater scrutiny.

## **Appendix E: Role of the Internal Audit Function in the Capital Planning Process**

A firm's internal audit function should play a key role in evaluating the adequacy of the firm's capital planning process and in assessing whether the risk management and internal control practices supporting that process are comprehensive and effective. A firm should establish an audit program around its capital planning process that is consistent with SR letter 13-1, "Supplemental Policy Statement on the Internal Audit Function and its Outsourcing."

### *1. Responsibilities of Audit Function*

The internal audit function should identify all auditable processes related to capital planning and develop an associated audit plan. The audit function should also perform substantive testing to ascertain the effectiveness of the control framework supporting the firm's capital planning process, communicate identified limitations and deficiencies to senior management, and communicate material limitations and deficiencies to the board of directors (or the audit committee of the board). The audit function should comprehensively cover the firm's capital planning process.

The internal audit function should perform periodic reviews of all aspects of the internal control framework supporting the capital planning process to ensure that all individual components as well as the entire process are functioning in accordance with supervisory expectations and the firm's policies and procedures. The internal audit function should also review the manner in which deficiencies are identified, tracked, and remediated. Furthermore, the internal audit function should ensure appropriate independent review is occurring at various levels within the capital planning process.

A firm's internal audit staff should have the appropriate competence and stature to identify and escalate key issues when necessary. The internal audit function may also rely on an independent third party external to the firm to complete some of the substantive testing as long as the internal audit function can demonstrate proper independence of the third-party from the area being assessed and provide oversight over the execution and quality of the work.

### *2. Development of Audit Plan*

The internal audit function should have a documented plan describing its strategy to assess the processes and controls supporting the firm's capital planning process. When defining the annual audit universe and audit plan, the internal audit function of a firm should focus on the most significant risks relating to the capital planning process. The firm may leverage existing or regularly scheduled audits to ensure coverage of all the capital planning process components; however, the findings and conclusions of these audits should be incorporated into the overall summary of audit activities and conclusions regarding the firm's capital planning process.

### *3. Briefings to Senior Management and Board*

On an annual basis, the internal audit function should report to senior management and the board of directors on the capital planning process to inform recommendations and decisions

on the firm's capital plan. The report should provide an opinion of the capital planning process, a statement of the effectiveness of the controls and processes employed, a status update on previously identified issues and remediation plans, and any open issues or uncertainties related to the firm's capital plan. Any key processes that are not comprehensively reviewed and tested, due to timing or significant changes in processes, should be clearly documented and identified as areas with potential heightened risk.

The internal audit function should track responses to its material findings and report to the board any cases in which senior management is not implementing required changes related to audit findings or is doing so with insufficient intensity.

**Differences in Expectations for LISCC Firms and Large and Complex Firms,  
as compared to Large and Noncomplex Firms**

The expectations for internal audit at a LISCC Firm and a Large and Complex Firm are more specific and detailed than the expectations for a Large and Noncomplex Firm. For example, the internal audit function of a LISCC Firm and a Large and Complex Firm is expected to conduct a deeper, more detailed assessment of the firm's model inventory, procedures for updating processes and change and version controls, adherence to documentation standards, operational systems, and work conducted by external parties. In addition, internal audit at a LISCC Firm and a Large and Complex Firm should have more explicit procedures for updating its audit plans. Last, a LISCC Firm and a Large and Complex Firm should brief the board of directors at least quarterly about key findings related to the capital planning process (in addition to the formal annual audit report, which is an expectation for a LISCC Firm, a Large and Complex Firm, and a Large and Noncomplex Firm).

## Appendix F: Capital Policy

A firm's capital policy should describe how the firm manages, monitors, and makes decisions regarding capital planning.<sup>27</sup> The policy should include internal post-stress capital goals and real-time targeted capital levels; guidelines for dividends and stock repurchases; and strategies for addressing potential capital shortfalls.

A firm's capital policy should describe the manner in which consolidated estimates of capital positions are presented to senior management and the board of directors. The capital policy should require staff with responsibility for developing capital estimates to clearly identify and communicate to senior management and board of directors the key assumptions affecting various components that feed into the aggregate estimate of capital positions and ratios. The capital policy should require that aggregated results be directly compared against the firm's stated post-stress capital goals, and that those comparisons are included within the standard reporting to senior management and the board of directors.

### *1. Post-Stress Capital Goals*

Post-stress capital goals should provide specific minimum thresholds for the level and composition of capital that the firm intends to maintain during a stress period. Post-stress capital goals should include any capital measures that are relevant to the firm.

The firm should be able to demonstrate through its own internal analysis, independently of regulatory capital requirements, that remaining at or above its internal post-stress capital goals will allow the firm to continue to operate.

The capital policy should describe how senior management and the board concluded that the firm's post-stress capital goals are appropriate, sustainable in different conditions and environments, and consistent with its strategic objectives, business model, and capital plan. In addition, the capital policy should describe the process by which the firm establishes its post-stress capital goals, and include the supporting analysis underpinning the goals chosen by the firm.

A firm should annually review its capital goals, evaluate whether its post-stress capital goals are still appropriate based on changes in operating environment, business mix, or other conditions, and adjust those goals as needed.

A firm should adjust its real-time capital targets (that is the amount of current capital it holds above its post-stress capital goals to ensure it does not fall below those goals under stress) more frequently than it adjusts capital goals, based on changes in the business mix, operating environment or other current conditions and circumstances.

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<sup>27</sup> A capital policy is a firm's written assessment of the principles and guidelines used for capital planning, issuance, usage, and distributions. 12 CFR 225.8(d)(7).

## 2. *Dividends and Stock Repurchases*

A firm's capital policy should describe the processes relating to common stock dividend and repurchase decisions, including the processes to determine the timing, form, and amount of all planned distributions. The capital policy should also specify the analysis and metrics that senior management and the board use to make capital distribution decisions. The analysis should include strategic considerations such as new business initiatives, potential acquisitions, and the other relevant factors.

## 3. *Contingency Plans for Capital Shortfalls*

A firm's capital policy should include specific capital contingency actions the firm would take to remedy any current or prospective deficiencies in its capital position. The firm's capital contingency plan should reflect strategies for identifying and addressing potential capital shortfalls and specify circumstances under which the board of directors and senior management will revisit planned capital actions or otherwise institute contingency measures. A contingency plan should include a set of thresholds for metrics or events that provide early warning signs of capital deterioration and that trigger management action or scrutiny.<sup>28</sup>

Capital contingency plans should include options for actions that a firm would consider taking to remedy any current or prospective deficiencies in its capital position, such as reducing or ceasing capital distributions, raising additional capital, reducing risk, or employing other means to preserve existing capital. Contingency options in the firm's capital policy should be consequential, realistic, actionable, and comprehensive.

### **Differences in Expectations for LISCC Firms and Large and Complex Firms, as compared to Large and Noncomplex Firms**

The Federal Reserve expects a LISCC Firm and a Large and Complex Firm to include quantitative payout ratios in its distribution decision-making process, but does not have this expectation for Large and Noncomplex Firms. The Federal Reserve also expects a LISCC Firm and a Large and Complex Firm to provide more support for its post-stress capital goals than a Large and Noncomplex Firm.

In addition, the Federal Reserve expects a LISCC Firm and a Large and Complex Firm to include additional detail on contingency options in its capital contingency plan and to integrate its capital contingency plan with the firm's broader crisis management framework. In contrast, the Federal Reserve does not have these expectations for Large and Noncomplex Firms.

*See* Section D, "Capital Policy" for additional differentiated expectations for a firm's capital policy.

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<sup>28</sup> Capital contingency plans may include triggers for liquidity, earnings, debt and credit default swap spreads, ratings downgrades, stock performance, supervisory actions, general market stress, or other noncapital metrics.



### Appendix G: Scenario Design

As part of its capital plan, a firm must use at least one scenario that stresses the specific vulnerabilities of the firm's risk profile and operations, including those related to the company's capital adequacy and financial condition.<sup>29</sup> The firm's stress scenario should be at least as severe as the Federal Reserve's severely adverse supervisory scenario, measured in terms of its effect on net income and other elements that affect capital.<sup>30</sup>

As noted in the core document, a firm should create its stress scenario, either by developing a complete internal scenario, or using the Federal Reserve's supervisory scenarios, adjusted for the firm's idiosyncratic risk profile.

The stress scenario should include stressful circumstances and events that could, on a standalone basis or in combination, reduce the firm's capital levels and ratios and potentially impede the firm's ability to operate as a going concern, and cover material risks to which the firm is exposed over the course of an annual planning cycle. A firm's scenario should include factors that capture economy- or market-wide stresses and idiosyncratic risks that can put a strain on the firm. A firm should also take into account conditions and events that have not previously occurred, but that may pose a significant threat to the firm given its exposures, risk profile, and business strategy.

#### **Differences in Expectations for LISCC Firms and Large and Complex Firms, as compared to Large and Noncomplex Firms**

The Federal Reserve has elevated expectations for a LISCC Firm and a Large and Complex Firm relating to scenario design. Specifically, a LISCC Firm and a Large and Complex Firm is expected to develop a scenario that is directly linked to the idiosyncratic risks of the firm, as determined by its risk identification process and risk assessment. In contrast, a Large and Noncomplex Firm is expected to either develop a firm-specific scenario or adjust the Federal Reserve's scenario to reflect the firm's own risk profile.

In addition, a LISCC Firm and a Large and Complex Firm should use multiple internally-designed scenarios as part of its efforts to assess a broad range of risks, stressful conditions, or events that could impact the firm's capital adequacy. A Large and Noncomplex Firm is not expected to use multiple scenarios in its capital planning process.

<sup>29</sup> 12 CFR 225.8(e)(2). In addition, a firm is required to report to the Federal Reserve its projections under a baseline scenario, which captures the firm's view of the likely operating environment over the planning horizon. A firm may use the Board's baseline scenario for its own baseline scenario if the firm can demonstrate that the Board's baseline scenario is appropriate for the firm's own risks, activities, and outlook; however, a firm cannot use the Board's severely adverse scenario for its own stress scenario.

<sup>30</sup> For guidance on the severity of the scenarios, a firm should review the Board's "Policy Statement on the Scenario Design Framework for Stress Testing," which sets forth the Board's approach to designing the severely adverse scenario. See 12 CFR part 252, Appendix A.

## **Appendix H: Risk-weighted Asset (RWA) Projections**

A firm should maintain a sound process for projecting RWAs over the planning horizon. The firm's initial and projected RWA calculations should be consistent with applicable regulatory capital requirements.

Starting balances for both on- and off-balance sheet exposures and applicable risk weights form the foundation for estimates of post-stress capital ratios. Therefore, firms should verify carefully the accuracy of these starting balances. Moreover, deficiencies in starting RWA calculations are generally compounded in RWA projections over the planning horizon. A firm should ensure that it has sound controls around its RWA calculation and regulatory reporting processes as part of the firm's broader data governance program.

A firm should ensure that RWA projections are consistent with a given scenario and incorporate the impact of projected changes in exposure amounts and risk characteristics of on- and off-balance sheet exposures under the scenario. A firm should demonstrate that assumptions associated with RWA projections are clearly conditioned on a given scenario and are consistent with stated internal and external business strategies. For example, the firm should demonstrate how projected credit RWAs over the planning horizon are related to projected loan growth under the scenario. A firm should provide documented evidence for the appropriateness of key assumptions used to project RWAs.

### **Differences in Expectations for LISCC Firms and Large and Complex Firms, as compared to Large and Noncomplex Firms**

The Federal Reserve has elevated expectations for a LISCC Firm and a Large and Complex Firm relating to RWAs projections. For instance, a LISCC Firm and a Large and Complex Firm should provide more detailed support and documentation for assumptions regarding RWA projections, and implement an independent review of RWA projections. In contrast, a Large and Noncomplex Firm is not held to the heightened expectations regarding RWA projections, and is not expected to implement an independent review of RWA projections.

In addition, this appendix sets forth expectations for market RWA projections, which would apply only to a LISCC Firm and a Large and Complex Firm.

## Appendix I: Operational Loss Projections

A firm faces a wide range of operational risk in conducting its business operations. Operational losses can arise from various sources, including inadequate or failed internal processes, people, and systems, or from external events, and can differ in frequency and severity. For example, some operational loss events, such as credit card fraud, are often more predictable as they occur at high frequency, but generally have low loss severity. The outcome of other events, such as major litigation, are less certain and can result in outsized losses.

### *Risk Identification Process*

A firm should maintain a sound process for estimating operational risk losses in its capital planning process, taking into account the differences in loss characteristics of different operational loss event types. A firm's risk identification process should include the evaluation of the type of operational risk loss events to which the firm is exposed and the sensitivity of those events to internal and external operating environments. The firm-specific scenario submitted in a firm's capital plan should capture the firm's material operational risks.

### *Approaches to Operational Loss Estimation*

A firm can use a variety of estimation approaches to project operational losses for its enterprise-wide stress testing program, but should not rely on unstable or unintuitive correlations to project operational losses. The firm can use a simple, conservative approach based on historical loss data, such as applying average historical losses, or maximum historical losses, to project operational losses. A firm should also consider the use of scenario analysis to evaluate the effect of material operational risk events, especially those which are less certain or can result in outsized losses.

### *Use of Data*

The firm's operational loss projection approaches should make appropriate use of relevant reference data. The firm should supplement its internal data with relevant external data if the internal data lacks sufficient operational loss history or granularity.

### **Differences in Expectations for LISCC Firms and Large and Complex Firms, as compared to Large and Noncomplex Firms**

The Federal Reserve has elevated expectations for a LISCC Firm and a Large and Complex Firm relating to operational loss projections. For example, a LISCC Firm and a Large and Complex Firm should use scenario analysis in its operational loss projections, use both internal and external operational risk data, have greater support for its assumptions, and solicit input from senior management on operational risk events. In contrast, a Large and Noncomplex Firm is not expected to use scenario analysis, may use external data if internal data are lacking, and is not held to the same expectations related to assumptions or engagement with senior management.