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Stress Testing Under Dodd-Frank: Easing the Regulatory Burden for Midsized Financial Companies

I. INTRODUCTION

In the aftermath of the 2008 financial crisis ("the Crisis"), the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Dodd-Frank") was enacted to ensure that the catastrophic loss of jobs and savings caused by the Crisis would not reoccur.¹ One of the tools Dodd-Frank provided to accomplish this goal is the requirement that financial companies undergo periodic "stress testing" to determine whether they have enough capital to remain solvent during sudden economic downturns.²

Though Dodd-Frank Act Stress Testing ("DFAST") has stimulated increased preparedness and transparency in the companies subject to the tests, DFAST may impose a disproportionate burden on financial companies that have between $10 and $50 billion in total consolidated assets ("midsize companies").³ Consequently, alterations to testing may be necessary to increase DFAST’s efficiency, while maintaining the goal of ensuring economic stability.⁴ DFAST’s primary flaws are: (1) it unfairly subjects midsize companies, with little potential

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². Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 165(i), 12 U.S.C. § 5365(i) (2012). Under the statute, financial companies include bank holding companies and banks. See Dodd-Frank § 165(i)(2)(A), 12 U.S.C. § 5365(i)(2)(A) (requiring nonbank financial companies supervised by the Board of Governors and bank holding companies to conduct semi-annual stress tests, while requiring all other federally regulated financial companies with consolidated assets over $10 billion to conduct annual stress tests).

³. See Evan Sparks, Dodd-Frank Stress Tests a ‘Culture Shock’ for Mid-Sized Banks, ABA BANKING J. (Oct. 26, 2015), http://bankingjournal.aba.com/2015/10/dodd-frank-stress-tests-a-culture-shock-for-mid-sized-banks/ (looking at how difficult it is for some midsize companies to handle the compliance costs of DFAST but also acknowledging how much DFAST has helped stabilize and improve companies).

⁴. See id. (examining how difficult it is for some midsize companies to handle the compliance costs of DFASTS but also acknowledging how much DFAST has helped stabilize and improve banks).
for macroeconomic impact, to its compliance costs; (2) it does not reward companies for performing well on previous DFAST cycles; and (3) it fails to ensure that financial companies are tested in a manner that reflects the particular risks they present to the market.5

In light of these deficiencies, this Note suggests adjusting the threshold criteria that subject a financial institution to DFAST and stratifying midsize financial companies into tiers that correspond to each company’s risk profile to determine how frequently a company will undergo stress testing.6 The suggested changes discussed in this Note would not interfere with DFAST’s goal of ensuring that the economy is prepared for another sudden economic downturn, while optimizing the rigor of the tests for midsize companies.

This Note proceeds in five parts. Part II provides an overview of the characteristics of the midsize companies currently subject to DFAST, how DFAST works, and what it requires of midsize companies.7 Part III identifies flaws in the current system and examines how they are damaging to midsize companies.8 Part IV recognizes the benefits that DFAST provides, despite the flaws in the testing framework.9 Part V demonstrates how implementing a tiered classification system and changing the DFAST classification range would remedy the current inefficiencies and excessive costs associated with DFAST.10 Part VI concludes by emphasizing the importance of stress testing and the essential changes needed to improve the system.11

5. See Press Release, Reg’l Bank Coal., Sixty-Two Mid-Size and Regional Banks Write in Support of Shelby Systemic Risk Legislation, (May 18, 2015), http://regionalbanks.org/news/2015/05/sixty-two-mid-size-and-regional-banks-write-in-support-of-shelby-systemic-risk-legislation/ (expressing the anger of the midsize bank community for being subject to DFAST when they are not “systemically” significant); see also Adam Mustafa, 5 Takeaways From Midsize Stress Tests, BANKING EXCH. (Sept. 8, 2015, 7:21 PM), http://www.bankingexchange.com/news-feed/item/5730-5-takeaways-from-midsize-stress-tests (detailing how it is clear from the first round of testing for midsize companies that they are not adequately tailoring the tests to their idiosyncratic risks).

6. See infra Part V.

7. See infra Part II.

8. See infra Part III.

9. See infra Part IV.

10. See infra Part V.

11. See infra Part VI.
II. A Profile of Midsize Companies: Annual Stress Testing Requirements and Scenarios

A. Characteristics of Midsize Companies

Although midsize financial companies have a much smaller impact on the nation’s economy than large financial companies (“large companies” or “SIFIs”), they are key actors in the economy, especially in smaller communities.\(^\text{12}\) Typically, midsize companies are established in towns and small cities as stand-alone banks, and, as they grow, remain dedicated to providing banking services to their immediate communities and regions.\(^\text{13}\) When compared with large financial companies, midsize companies generally engage in less risky or speculative banking activities.\(^\text{14}\)

The Federal Reserve Board (“the Fed”) holds midsize companies to lower DFAST standards than large companies.\(^\text{15}\) Midsize companies are deemed less systemically significant than large companies, which are “so large, leveraged, and interconnected that their failure could pose a risk to [the country’s] overall financial stability.”\(^\text{16}\) Accordingly, current

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12. See, e.g., About, Mid-Size Bank Coal. of Am. http://midsizebanks.com/about/ (last visited Jan. 10, 2016) [hereinafter Mid-Size Bank Coal. of Am.] (explaining the focus on local communities that midsize companies have had and how important they are to those communities). “Large companies” or “systemically important financial institutions” (“SIFIs”) are banks or bank holding companies that possess $50 billion in consolidated assets or more. Systemically Important Financial Institutions and the Dodd-Frank Act: Hearing Before the H. Subcomm. on Fin. Inst.’s and Consumer Credit, H. Comm. on Fin. Serv.’s, 112th Cong. (2012) (statement of Michael S. Gibson, Director, Division of Banking Supervision and Regulation) [hereinafter Gibson].


14. See Reg’l Bank Coal., supra note 5 (“These sixty-two institutions that serve Main Street have joined together to make one thing clear: their business models look nothing like those on Wall Street, and they shouldn’t be regulated like Wall Street either.”); see also Robert G. Wilmers, Small Banks, Big Banks, Giant Differences, BLOOMBERG VIEW (June 13, 2011), http://www.bloombergview.com/articles/2011-06-13/small-banks-big-banks-giant-differences-robert-g-wilmers (examining the differences in how the largest banks and smaller banks conduct business and the highly speculative trading that the largest banks participate in).

15. See Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd Frank”) § 165(i), 12 U.S.C. § 5365(i) (2012) (detailing how midsize companies are held to less stringent DFAST requirements, especially in the number of annual DFAST cycles); see also CHARYN FANZKA, STRESS TESTING FOR MID-SIZED BANKS, SAS INST., support.sas.com/resources/papers/proceedings15/3478-2015.pdf (discussing the technical differences in testing and testing expectations between large and midsize companies).

DFAST rules require large financial companies to participate in an annual supervisory stress test conducted by the Fed in conjunction with the company’s supervisory agency—an instance, the Federal Reserve, the Office of the Comptroller of the Currency, or Federal Deposit Insurance Corporation. However, midsize companies, however, do not have a supervisory test requirement. Large financial companies are obligated to conduct two annual company-run stress tests, whereas midsize financial companies are only required to conduct one company-run stress test. The difference in systemic importance, and the rationale for different DFAST treatment, is clear after comparing the percentage of assets managed by large financial companies and the assets managed by smaller financial companies. While large financial companies hold approximately eighty percent of assets in the banking industry, all financial companies that have under $50 billion in assets—not just the midsize companies—manage roughly twenty percent of the assets. Though financial companies that have less than $50 billion in assets hold only a sliver of the total banking assets in the United States, they provide half of the banking services used on “Main Street.” These “Main Street” banking services, which include taking deposits, lending to businesses in the local community, and providing financing to single families acquiring homes, are basic services crucial to local communities and considered less speculative than many of the large financial companies’ activities.

19. Id.
20. See The Fed. Reserve Bd., Insured U.S.-Chartered Commercial Banks That Have Consolidated Assets of $300 Million or More, Ranked by Consolidated Assets (June 30, 2015), http://www.federalreserve.gov/releases/lbr/current/#content (ranking commercial banks by asset size and demonstrating how much bigger the banks at the top are relative to the other banks); see also Mid-Size Bank Coal. of Am., supra note 12 (detailing the disparity between assets banks with over $50 billion control and the assets all other banks control).
22. Mid-Size Bank Coal. of Am., supra note 12.
23. Id.
B. Stress Testing for Midsize Companies

DFAST rules attempt to account for the differences in the overall risks posed by midsize and large companies.\textsuperscript{24} Unlike large companies, midsize companies are exempt from supervisory tests and are subject to fewer annual tests.\textsuperscript{25} In addition to being subject to fewer total tests on an annual basis (one, compared to three), specific aspects within DFAST differentiate midsize and large companies.\textsuperscript{26} Compared to large companies, there are lower expectations for midsize companies in their company-run tests in terms of level of detail required in their reporting, data segmentation, sophistication of their estimation practices, and public disclosures.\textsuperscript{27} For example, DFAST currently requires midsize companies to submit an annual report with approximately “100 line items per scenario,” while large companies are required to submit reports with nearly “2,500 line items per scenario.”\textsuperscript{28} Accordingly, the company-run stress testing process for large companies is decisively more extensive than it is for midsize companies.\textsuperscript{29}

Midsize companies evaluate themselves under three scenarios in company-run stress tests: baseline, adverse, and severely adverse.\textsuperscript{30} Each economic scenario includes manipulation of variables, including “economic activity, unemployment, exchange rates, prices, incomes, and interest rates.”\textsuperscript{31} The “adverse” and “severely adverse” test scenarios attempt to categorize the strength and resilience of financial institutions in hypothetical adverse economic climates.\textsuperscript{32}

\begin{itemize}
  \item \textsuperscript{24} See \textit{Faenza}, \textit{supra} note 15, at 2–4 (explaining the testing differences between midsize and large companies, with large companies having more DFAST requirements).
  \item \textsuperscript{25} See Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 165(i), 12 U.S.C. § 5365(i) (explaining the testing differences between midsize and large companies with large companies having more DFAST requirements); see also \textit{Faenza}, \textit{supra} note 15, at 2–4.
  \item \textsuperscript{26} \textit{Faenza}, \textit{supra} note 15, at 2–4.
  \item \textsuperscript{27} \textit{Id}.
  \item \textsuperscript{28} \textit{Id.} at 3.
  \item \textsuperscript{29} See \textit{id.} at 2 (“The regulators clearly state that their expectations for mid-sized banks are not the same as their expectations for the large banks.”).
  \item \textsuperscript{32} \textit{Id.} For example, “adverse and severely adverse scenarios describe hypothetical sets of events designed to assess the strength of banking organizations and their resilience.” Press Release, Bd. of Governors of the Fed. Reserve System (Jan. 28, 2016),
\end{itemize}
Midsize companies are expected to not only use the adverse economic scenarios designed by the Fed, but also to add scenarios that reflect the specific risks they face. In their guidance for midsize bank stress testing, the Fed, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation stated, “[a] company’s stress testing framework should include activities and exercises that are tailored to, and sufficiently capture, the company’s exposures, activities, and risks.” This language demonstrates that regulators expect customization of company-run stress tests to reflect the particularized risks that each institution poses to the economy.

Unlike large company stress testing, there is no formal declaration of whether a midsize bank passed or failed DFAST. However, “regulators will likely consider a firm’s stress test processes and results when evaluating proposed actions that impact the firm’s capital, including but not limited to: M&A transactions; [d]ividend payments; and [r]edemptions of regulatory capital instruments.” This means that if companies do not properly tailor the tests or they return unsatisfactory results, regulators could restrict the company’s transactions and dividends they return to shareholders, which would have a significant impact on the company’s outlook.

Preparing and performing well on DFAST each year is not a walk in the park. At least initially, most companies need to enlist the services of third-party vendors to build forecast models for the DFAST

http://www.federalreserve.gov/newsevents/press/bcreg/20160128a.htm. These scenarios typically include the manipulation of variables such as, raised unemployment, and different degrees of recession and deflation. Id.

33. Mustafa, supra note 5.


35. Id.


37. Id.

38. See id. (detailing the potential consequences that poor performance on DFAST brings midsize companies).

39. See Sparks, supra note 3 (emphasizing the extensive business collaboration, contracting, and time that DFAST compliance requires).
scenarios. These vendors allow institutions access to statisticians, economists, and model developers that assist in the DFAST compliance process. Hiring this kind of outside help is a costly endeavor, because DFAST “requires collaboration from across the institution.” However, perhaps the most significant DFAST compliance cost is the amount of company time that is required to ensure compliance. Senior member of the House Financial Services Committee Rep. Ed Royce (R-CA) asserted that with Dodd-Frank we “have a situation where for every employee who is helping a customer, [we] have 1.2 man hours spent on compliance.” This is a huge burden for midsize banks that do not have the personnel of larger companies, but still have to dedicate a significant amount of their workers’ time to compliance. Both the monetary costs and the costs in time imposed by DFAST significantly drain midsize companies’ resources.

III. DEFECTS IN THE DFAST FRAMEWORK AND THE CONSEQUENTIAL BURdens THEY IMPOSE ON MIDSIZE COMPANIES

A. DFAST’s Disincentive to Growth and the Damage of its Arbitrary Asset Threshold

A critical failure of the current DFAST system is the imposition of the arbitrary $10 billion to $50 billion asset range that classifies companies as “midsize.” The implementation of arbitrary ranges is a well-intentioned effort to avoid a “one size fits all” approach to banking regulation. However, DFAST is too broad and does not properly

40. Id.
41. Id.
42. Id.
44. Id. at 5.
45. Id.
46. Id.; see Sparks, supra note 3 (emphasizing that preparation for DFAST should begin a year and a half in advance).
47. See Peter Cherpack, Act Fast to Raise Midsize Banks’ Asset Threshold, AM. BANKER, July 22, 2015 http://www.americanbanker.com/bankthink/act-fast-to-raise-mid-sized-banks-asset-threshold-1075569-1.html (detailing the negative effect that the $10 billion DFAST threshold has on organic growth for those banks just below $10 billion in assets and the need for DFAST that corresponds to risk profile).
48. Id.
classify midsize companies according to the risks they present to the economy in the event of a recession. DFAST’s arbitrary range discourages banks from pursuing organic growth and forces high compliance costs on truly non-systemically significant companies. Because of DFAST, companies hovering just below the $10 billion asset threshold are hesitant to increase their assets. These smaller companies fear that the compliance costs they would incur by growing, such as gathering and maintaining complex data systems and hiring outside consultants, would completely offset the benefits of such growth.

As an example, National Penn Bancshares (“National Penn”), a bank with just under $10 billion in assets, tried to acquire smaller banks in order to have sufficient economies of scale to weather new DFAST costs. The impetus behind these efforts was National Penn’s fear that the bank could not handle the increased regulatory burden of preparing for DFAST. When it could not find a satisfactory deal, the National Penn shareholders voted to sell to Branch Banking and Trust Corporation (“BB&T”), as it could not handle the increased compliance costs as it organically grew over the $10 billion threshold.

Karla Payne, Chief Financial Officer of Arvest Bank—a bank nearing the DFAST range—experienced firsthand the incredible challenges facing banks that are growing over the $10 billion threshold, not just in terms of money, but also time. Payne recommends that banks hovering near the $10 billion threshold initiate preparations a year and a half in advance of the intended crossing. These length preparations are

49. Id.
50. Id.
52. Id.
53. Id.
54. Id.
56. See Weinberger, supra note 51.
57. Sparks, supra note 3. Arvest is an Arkansas based bank with $15.8 billion in assets that operates much like a network of community banks in Arkansas, Oklahoma, Kansas, and Missouri. See About, ARVEST BANK, https://www.arvest.com/about [hereinafter ARVEST BANK] (highlighting the history, operations and geographic focus of Arvest Bank).
58. Sparks, supra note 3.
necessary for a midsize company to address the challenges of consolidating the necessary data required to perform DFAST.\textsuperscript{59} Included in the data preparation is the extremely high cost of hiring outside companies to build, and implement, the models for testing.\textsuperscript{60}

The asset range currently in place under DFAST imposes high compliance costs on smaller midsize financial companies, which fail to correspond to their respective risk profiles.\textsuperscript{61} Furthermore, decision-making, previously focused on business risk and strategic opportunities, has shifted to whether decisions to grow will result in an increased regulatory burden that renders the growth unprofitable.\textsuperscript{62} These compliance costs, consequently, discourage growth by impeding profitability for an entire segment of financial companies.\textsuperscript{63} DFAST’s current range could benefit from reformulation in order to remove artificial barriers to growth and ensure that smaller banks can focus on serving their communities, rather than on the costly burden of complying with stress tests.\textsuperscript{64}

B. An Effectively Homogeneous Test and the Lack of Consideration for Companies’ Risk Profiles

The most significant deficiency in the DFAST framework is the lack of testing variation within the given midsize range, despite federal regulators’ efforts to the contrary.\textsuperscript{65} DFAST should reflect a high degree

\begin{itemize}
\item \textsuperscript{59} Id.
\item \textsuperscript{60} Id.
\item \textsuperscript{61} See Evan Weinberger, Midsize Bank Stress Tests May Spur More Regulatory Relief, LAW360 (June 12, 2015, 6:06 PM), http://www.law360.com/articles/667228/midsize-bank-stress-tests-may-spur-more-regulatory-relief (discussing how industry professionals believe stress testing may not be necessary for smaller banks and how DFAST becomes more necessary when companies are engaged in risky activities).
\item \textsuperscript{62} See Weinberger, BB&T’s Latest Deal Could Mark Uptick in Bank M&A, supra note 51 (examining the importance of increased compliance costs under DFAST and how that plays into institutions’ decisions).
\item \textsuperscript{63} See Cherpack, supra note 47 (detailing how the current range discourages growth for institutions nearing $10 billion in assets).
\item \textsuperscript{64} See Reg’l Bank Coal., supra note 5 (highlighting how the current DFAST format forces compliance costs on midsize companies that force them to divert resources from the communities they serve to compliance); see also Cherpack, supra note 47 (discussing how increasing the asset range for DFAST will likely encourage companies nearing $10 billion in assets to grow, because fewer compliance costs would come with that growth).
\item \textsuperscript{65} See Mustafa, supra note 45 (identifying the lack of accounting for idiosyncratic risk as one of the primary failures of the first round of publicly reported DFAST results for midsize companies).
\end{itemize}
of particularity to ensure that companies are prepared for adverse economic events that affect their unique operations, and the specific risks they pose to the economy.66 Instead of tailoring tests to companies’ unique risk profiles, as is required by the Fed, the majority of midsize companies have relied solely on the Fed’s boilerplate scenarios and failed to account for their own unique risks.67

It is possible that, because 2015 was the first year of mandated public disclosure of DFAST results for midsize financial companies, those companies were not consciously trying to skirt their responsibilities by doing a poor job customizing the tests, but were simply confused about their obligations.68 Nonetheless, it is clear that the requirements under DFAST are not being followed in the way that the Fed intended.69 The ultimate effect of this deficiency, whether inadvertent or purposeful, is that midsize companies are being subject to an inefficient, relatively uniform standard when midsize companies differ greatly in their operations and the risks they pose to the economy.70 The benefits of such a situation are decidedly less than a properly tailored standard.

In 2014, forty-two bank holding companies, twenty-eight national banks and federal thrifts, nineteen state-chartered nonmember banks, and ten state-chartered member banks completed the mandatory company-run tests for midsize companies.71 It is unrealistic to believe that Arvest Bank, a nearly $16 billion state-chartered bank, which operates much like a network of community banks in four states, poses the same risk to the national economy as City National Bank, a national bank with around $35 billion in assets that provides banking services

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66. Id.
67. Id.
68. See Michelle Sullivan & Colette Wagner, Life in DFAST Lane: Lessons Learned From Midsize Banks’ First Stress Tests, CROWE HORWATH (Aug. 2014), http://www.crowehorwath.com/ContentDetails.aspx?id=9133 (detailing lessons learned from first publicly disclosed DFAST results for midsize companies including confusion from applying the wrong test parameters); Mustafa, supra note 5.
69. See Sullivan & Wagner, supra note 68 (highlighting the confusion about DFAST requirements for midsize companies and how some midsize companies applied the large company guidance to their own tests); Mustafa, supra note 5.
70. See generally Mustafa, supra note 5 (highlighting the problem of most midsize companies preparing the same way for DFAST and not accounting for idiosyncratic risk).
throughout the country. Under the current framework, institutions such as Arvest Bank and City National Bank will have similarly burdensome compliance costs, in terms of percentage of their operating budgets, despite the institutions posing vastly different risks to the national economy.

Fed Governor Daniel Tarullo, the central bank’s head of regulatory issues, agrees that there is not enough variation in DFAST’s current format and believes that if DFAST is to continue for companies outside of SIFIs, enhanced variation is needed to reflect the risk the activities of financial companies poses. Though midsize companies are engaged in variety of activities, even speculative activities at times, only when midsize companies engage in riskier practices is heightened regulatory scrutiny justified.

The fact that DFAST has failed to effectively account for midsize companies’ risk profiles is worrisome for both midsize companies that do not need as much testing, and their customers who want their banks to devote time and resources to them, instead of compliance. Because midsize companies generally provide vital services to smaller regions and have relatively fewer resources than the larger banks, spending beyond what their risk profiles demand is profoundly damaging to the many communities that rely on midsize companies for credit and various other financial services. Accordingly, the current DFAST framework is an inefficient use of banking industry resources, and as a result, could benefit from alteration.
IV. THE BENEFITS OF MIDSIZE COMPANY STRESS TESTING

Although DFAST’s current framework may be flawed and create many unnecessary compliance obstacles for midsize companies, the goal of encouraging stability within companies of all sizes is important for the financial industry. Midsize companies, though not individually systemically significant like their larger counterparts, are also affected by strained economic conditions. Compared to midsize companies, the potential failure of a SIFI would have a more expansive effect on the national economy, but the collapse of midsize companies would have devastating localized impacts in the communities and regions in which they operate.

The benefits and importance of DFAST for midsize companies are clear from the perspective of many industry professionals. For example, Blake Coules, Chief Risk Officer for First-Citizens Bank, a Raleigh, NC, bank with nearly $30 billion in assets, although concerned about regulatory costs, asserts that stress testing is an important and worthwhile exercise for midsize companies. The cost of conducting the stress tests was substantial for First Citizens Bank, but Coules believes the tests ultimately increased their stability, internal data sources and modeling, and their chances of financial success moving forward.

Like Coules, Vince Calabrese, the CFO of First National Bank Corporation, recognizes the positive aspects of DFAST. Calabrese believes that DFAST is important because it promotes important

80. Telephone Interview with Blake R. Coules, Exec. Vice President & Chief Risk Officer, First Citizens Bank (Sept. 11, 2015); see also Sparks, supra note 3.
81. See Weinberger, supra note 61 (“Small and midsize banks still have risks and they still fail - just as much if not more than the big banks.”).
82. See id. (“Small and midsize banks still have risks and they still fail - just as much if not more than the big banks.”); see also MID-SIZE BANK COAL. OF AM., supra note 12 (discussing the vital role midsize companies play in local communities).
83. Telephone Interview with Blake R. Coules, supra note 80; see also Sparks, supra note 3 (detailing the positive effects that DFAST has had from the perspective of Vince Calabrese, CFO of F.N.B. Corporation).
85. Telephone Interview with Blake R. Coules, supra note 80.
86. Id.
87. Sparks, supra note 3. F.N.B. Corporation is a midsize bank approaching $20 billion in total assets. Id.
collaboration across departments in the pursuit of the organizational goal of increased preparedness for future economic downturns. He further emphasizes that the increased confidence in the company’s economic health, that strong performance in DFAST elicits, is important for shareholders as well as company executives.

Though the current DFAST framework imposes significant compliance burdens on non-systemically significant midsize companies, it ensures that institutions, both large and midsize, are better prepared for financial downturns. A new testing structure should balance the benefits of increased transparency and preparedness with the burden posed by compliance costs to midsize companies, ensuring that such institutions are able to focus more resources on serving their communities and customers.

V. MOVING DFAST FORWARD: A PROPOSAL TO ADJUST THE ASSET THRESHOLD FOR MIDSIZE COMPANIES AND ACCOUNT FOR RISK PROFILE AND PAST PERFORMANCE

A. A Needed Increase in Asset Threshold

The goal of DFAST is admirable and it certainly helps prepare the financial industry for future economic downturns. However, DFAST’s costs could be brought more into balance with its benefits. DFAST’s testing of companies with $10 billion to $50 billion in assets unjustifiably imposes high compliance costs—the implementation of which greatly discourages profitability and growth—warranting an overhaul.

One step toward fixing the system can be accomplished by simply adjusting the asset range upwards. Senate Banking Committee

88. Id.
89. Id.
90. Telephone Interview with Blake R. Coules, supra note 80.
91. Id.
92. Id.
93. See Sparks, supra note 3 (looking at how difficult it is for some midsize companies to handle the compliance costs of DFAST but also acknowledging how much DFAST has helped stabilize and improve banks);
94. Reg’l Bank Coal., supra note 5.
95. See Yalman Onaran, Shelby’s Bill Could Free 25 Midsize Banks From Stress Test, BLOOMBERG BUS. (May 15, 2015, 5:00 AM), http://www.bloomberg.com/news/articles/2015-
Chairman Sen. Richard Shelby (R-AL) recognizes deficiencies in the current range, and has introduced a bill that would raise the minimum amount of assets for SIFI categorization from $50 billion to $500 billion. Though this would delight the banking industry and free many banks from the undesirable SIFI classification, it is far too extreme to be implemented. Shelby’s proposed $500 billion threshold would only classify the six largest banks as SIFIs even though those six are not the only institutions that deserve the SIFI classification. The $500 billion threshold would exempt companies such as New York Mellon Corp., U.S. Bancorp, and Capital One, all of which are national in reach, and seem to have definitive importance in the national economy. In addition to the proposed $500 billion threshold being too high, Shelby’s bill practically ignores the smallest companies that are currently subject to DFASTD.

An approach to reforming DFASTD’s range, that would provide relief to the smallest institutions subject to testing, would be to double both ends of the range. Such a measure would increase the threshold for automatically qualifying as a SIFI from $50 billion to $100 billion, and would increase the bottom-end threshold from $10 billion to $20 billion. Also, though Shelby’s bill provides for an increase in SIFI range that is too aggressive, it contains a provision that would allow the Fed to designate companies with over $50 billion as SIFIs. The

05-15/shelby-s-bill-could-free-25-mid-size-u-s-banks-from-stress-test (supporting the idea of adjusting asset thresholds in DFASTD to reduce regulatory burdens).

96. See id. (examining Shelby’s bill that proposes a vast increase in SIFI threshold and the effect it could have on stress testing of banks).

97. See id. (discussing Shelby’s bill but acknowledging opposition from democrats to the $500 billion level and that analysts believe that setting the new range at $500 billion is unlikely).

98. See id. (detailing the seemingly systemically significant large companies that would be free of SIFI classification under Shelby’s bill).

99. See id.

100. See id. (examining how only the upper threshold will be effected by the proposed legislation); see also Press Release, Reg’l Bank Coal., supra note 5 (emphasizing the small impact and risk to the economy that midsize companies have).

101. See generally Weinberger, supra note 61 (supporting the idea that banks under $100 billion in assets should have DFASTD requirements eliminated or have the tests tailored to fit their profiles).

adoption of a similar discretionary provision is endorsed by this Note’s proposal as a means of affording the Fed regulatory flexibility that will allow it to adapt quicker to changing market conditions.\textsuperscript{103} This Note’s proposal also asserts that companies in the $50 billion to $100 billion range should not automatically qualify as SIFIs.\textsuperscript{104} But, if the Financial Stability Oversight Council determines that companies’ activities warrant increased regulation, it should have the ability to impose SIFI regulation requirements accordingly.\textsuperscript{105} Despite their lesser classification, companies of that size can pose a range of risks to the economy—thus, the flexibility provided by this discretion is key.\textsuperscript{106}

At first glance, while the increase from $10 billion to $20 billion seems insignificant and arbitrary, this change would exempt over fifty percent of the midsize companies currently subject to DFAST.\textsuperscript{107} This modest increase would alleviate DFAST’s burden on smaller midsize companies, which have an overall miniscule share of the nation’s economy, and allow these community-driven banks to not only focus more on their customers, but also grow without fear.\textsuperscript{108}

\textsuperscript{103} See id. (supporting the provision of Shelby’s bill that allows regulators’ discretion to judge whether certain companies over $50 billion in assets warrant increased regulatory supervision).

\textsuperscript{104} See id. (“[A] $50 billion bank holding company is nowhere near systemically important.”).

\textsuperscript{105} Id.

\textsuperscript{106} Id.

\textsuperscript{107} To arrive at over fifty percent, I obtained rankings (current as of Sept. 30, 2015) by assets of bank holding companies, banks, thrifts, and credit unions. I then calculated the number of companies within the $10 – $20 billion range that would no longer be subject to DFAST under this Note’s proposal and divided it by the total number of companies that would be tested under the current scheme (47/84=55%). The numbers used may not reflect the banks that have actually been through DFAST as these asset totals are current through September 2015 and DFAST results were solicited and released earlier in 2015. Reports of Leading Domestic Financial/Bank Holding Companies, iBanknet, http://www.ibanknet.com/scripts/callreports/fiList.aspx?type=fry9 (last visited Feb. 12, 2016); Financial Reports of Leading Banks, iBanknet, http://www.ibanknet.com/scripts/callreports/fiList.aspx?type=031 (last visited Feb. 12, 2016); Financial Reports of Leading Thrifts, iBanknet, http://www.ibanknet.com/scripts/callreports/fiList.aspx?type=ots (last visited Feb. 12, 2016); Financial Reports of Leading Credit Unions, iBanknet, http://www.ibanknet.com/scripts/callreports/fiList.aspx?type=ncua (last visited Feb. 12, 2016).

\textsuperscript{108} Id; see also Reg’l Bank Coal., supra note 5.
### Table

<table>
<thead>
<tr>
<th></th>
<th>Current DFAST ($10 billion – $50 billion for “midsize companies”, and above $50 billion for “SIFIs” or “large companies”)</th>
<th>This Note’s Proposal ($20 billion – $100 billion for “midsize companies”, and above $100 billion for “SIFIs” or “large companies”)</th>
<th>Shelby’s Proposal ($10 billion – $500 billion for “midsize companies”, and above $500 billion for “SIFIs” or “large companies”)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of “midsize companies”</td>
<td>84</td>
<td>54</td>
<td>123</td>
</tr>
<tr>
<td>Number of “SIFIs” or “large companies”</td>
<td>38</td>
<td>27</td>
<td>6</td>
</tr>
</tbody>
</table>

This proposed increase would not only provide needed relief to those at the lower end of the current threshold but also, to those banks that have between $50 and $100 billion in assets. Approximately thirty-eight percent of the companies that currently automatically classify as SIFIs would fall in the new midsize company classification of $20 billion to $100 billion. Under current DFAST rules, an entity like

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109. This is a chart using the listing of banks and bank holding companies to determine how many companies would be categorized as SIFIs or midsize companies under current DFAST rule, Shelby’s proposal, and this Note’s proposal. It may not reflect the banks that have actually been through DFAST as these asset totals are current through September 2015 and DFAST results were solicited and released earlier in 2015. *Reports of Leading Domestic Financial/Bank Holding Companies, supra note 107; Financial Reports of Leading Banks, supra note 107; Financial Reports of Leading Thrifts, supra note 107; Financial Reports of Leading Credit Unions, supra note 107.*

110. *Reports of Leading Domestic Financial/Bank Holding Companies, supra note 107; Financial Reports of Leading Banks, supra note 107; Financial Reports of Leading Thrifts, supra note 107; Financial Reports of Leading Credit Unions, supra note 107.*

111. To arrive at thirty-eight percent, I obtained rankings (current as of Sept. 30, 2015) by assets of bank holding companies, banks, thrifts, and credit unions. I then calculated the number of companies within the $50 – $100 billion range that would no longer automatically qualify as SIFIs under this Note’s proposal and divided it by the total number of companies that would automatically be SIFIs under the current scheme (17/44≈38%). The numbers used
Zions Bancorp, a company with approximately $58 billion in total assets, is subject to the same degree of testing as JPMorgan Chase, a company with nearly forty times as many assets. With this new proposal, Zions Bancorp would be more appropriately classified with institutions that do not differ so drastically in asset size.

As will be discussed in the following section, correctly determining what constitutes a midsize company is not the only change that could improve DFAST. Midsize companies could be sorted into DFAST tiers based on the riskiness of their activities. Each midsize company could be placed into one of three tiers based on their individual risk profile and accordingly, be subject to DFAST in a manner that is proportionate to their overall risk in the event of an economic downturn.

This Note’s proposed range would relieve many of the smallest DFAST companies from testing, so that they could avoid regulation and instead, focus on efficiently serving their customers. As mentioned, this proposal would also allow federal regulators some discretion in categorizing financial companies in the $50 billion to $100 billion range based on the specific risks they present to the economy. The new range by itself would be a significant improvement, but an additional layer of classification could further correct the deficiencies of the current DFAST format.

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may not reflect the banks that have actually been through DFAST as these asset totals are current through September 2015 and DFAST results were solicited and released earlier in 2015. Reports of Leading Domestic Financial/Bank Holding Companies, supra note 107; Financial Reports of Leading Banks, supra note 107; Financial Reports of Leading Thrifts, supra note 107; Financial Reports of Leading Credit Unions, supra note 107.

112. See Reports of Leading Domestic Financial/Bank Holding Companies, supra note 107 (using a ranking of bank holding companies by assets to compare the assets held by Zions Bancorp, around $58 billion, with the assets held by JPMorgan Chase, around $2.4 trillion).

113. See id. (using the ranking by assets to see that Zions Bancorp would be placed among institutions that have somewhat similar asset totals in this Note’s proposal, unlike the current system).

114. See infra Part V.B.

115. See infra Part V.B.

116. See infra Part V.C.

117. See Press Release, Reg’l Bank Coal., supra note 5 (highlighting how midsize companies are not currently serving their local communities as much as they would like because of high DFAST costs).

118. See Kupiec, supra note 102 (detailing the general idea contained in Shelby’s bill, and this note, that the Fed should have the power to designate certain companies as SIFIs that do not automatically qualify as SIFIs by their asset totals).

119. See generally Ted Peters, These Regulatory Changes Would Give Small Banks
B. Achieving Variation in DFAST Testing: A New Proposal

As explained previously, one of the major takeaways from the first publicly disclosed stress tests for midsize companies was that the individual risk that each company presented to the market was not adequately accounted for in their company-run tests. This, along with the lack of rewards for strong performance in previous testing cycles, has created a testing system that imposes regulations and compliance costs that may not appropriately represent each company’s risk profile. To add the necessary variation to the DFAST framework, federal regulators could evaluate banks within the midsize range on a number of factors to determine the frequency of DFAST. Among the possible factors to consider are: CAMELS ratings, how the midsize companies performed in previous DFAST cycles, and current market factors that affect specific risks associated with individual company activities.

The CAMELS rating system is used to evaluate banks on their capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to interest rate risk. Each bank is given a composite score made up of ratings in each of the aforementioned categories, with a rating of “one” representing the lowest level of supervisory concern, and a rating of “five” representing the highest level of supervisory concern. Banks’ CAMELS ratings are kept private from the general public because of fears that a poor score will cause depositors to panic. Because of the importance of the anonymity of CAMELS ratings—tiers and DFAST results would be publicly available under this proposal—and the

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120. Mustafa, supra note 5.
121. See Reg’l Bank Coal., supra note 5 (discussing the problems of midsize companies not getting tested at a level that corresponds to their risk to the market).
122. See generally Peters, supra note 119 (supporting a tiered approach to DFAST frequency that focuses on bank rating).
123. See generally id. (advocating for a tiered classification system for midsize companies to determine testing frequency that uses strong CAMELS ratings as a main factor).
125. Id. at 571.
importance of the other factors to be discussed, this measure cannot be the sole means of sorting companies into testing frequency tiers.127

The current DFAST framework does not consider past performance, which leaves high-performing companies testing at the same frequency as their low-performing counterparts.128 To “reward” those who have previously demonstrated prudent capital management and to more closely monitor those who have failed to do so, the Fed could look at whether each company adequately prepared for and performed well during the previous DFAST cycle. The Fed could use these results, in conjunction with market factors and each company’s CAMELS rating, to determine the appropriate frequency of future testing.

Notably, before midsize companies can be broken up into different tiers, there would need to be a base year of testing from which to proceed. This base year, which would occur in the year after this Note’s proposal, would provide midsize companies an initial opportunity to perform well and be sorted into a favorable tier. Because previous years may not have yielded the most accurate DFAST results due to the lack of adequate accounting of idiosyncratic risk, this base test would require the Fed to increase its scrutiny of each financial company’s testing process to ensure testing is done properly.129 This first testing cycle may be onerous because of the extent to which the Fed would be involved, but it would set the stage for a right-sized DFAST framework moving forward, thereby ensuring that the economy would run more efficiently.130

C. Three DFAST Tiers for the New Midsize Company Range: Tier One

Tier One DFAST companies would be the least susceptible to another sudden economic downturn, and would thus be tested on the least

127. See id. (stating the importance of CAMELS rating anonymity because of the fear that the release of rating would cause bank runs).
128. See Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 165(i), 12 U.S.C. § 5365(i) (2012) (providing that institutions within the midsize and large asset ranges will be tested at the same frequency each year).
129. See generally Mustafa, supra note 5 (detailing the ineffectiveness and the failure of the first round of publicly disclosed DFAST results due to the lack of accounting for idiosyncratic risk).
130. See generally Peters, supra note 119 (supporting a tiered approach to DFAST that focuses on bank rating).
frequent basis. In order to qualify for Tier One, companies would first have to properly account for idiosyncratic risk in the previous DFAST, as well as perform strongly on the tailored tests. Either a lack of test customization or poor performance on the test would deny companies a chance for Tier One classification. Next, Tier One companies would need to have an extremely strong CAMELS rating. This means that Tier One companies would typically need to have a composite rating in the top twenty percent of all tested midsize companies.

The last requirement for qualifying as a Tier One company is that current market conditions, as evaluated by the Fed, cannot be such that they impact the company’s specific business activities. For example, if a company is highly concentrated in specific asset classes or markets it would probably not be eligible for Tier One. This would be the case even if it performed well on the previous DFAST cycle and has excellent CAMELS ratings. Fed discretion in determining whether market conditions favor a company may be frustrating for many, because it is out of each company’s control, but there needs to be some flexibility to account for volatile market conditions.

Starting from the base test year, Tier One companies would be subject to DFAST every two years, which is a long time in between test cycles, but it is the reason that the requirements to qualify as a Tier One company are so stringent. Tier One companies would present very little, if any, risk to the stability of the economy and this would be reflected in reduced testing.

D. Tier Two

Tier Two is the category into which most companies would fall. Companies in this category would conduct their next tests eighteen months after the base DFAST cycle proposed in this Note. These companies would be considered to present higher risk to the economy than Tier One companies but at the same time, would not be considered to inhabit an extremely precarious position.

131. See generally id. (advocating for a tiered classification system for midsize companies to determine testing frequency that uses strong CAMELS ratings as a main factor).
132. See generally id.
133. See generally id. (advocating for a tiered classification system that tests the highest performing midsize companies every two years).
The composite CAMELS rating for Tier Two companies should be around the average CAMELS rating of the tested midsize companies. On top of having an average CAMELS rating, Tier Two companies typically would have achieved the previous cycle’s requirements but not to the degree that a Tier One company performed on previous DFAST cycles. Also, market conditions cannot be such that gravely impact their specific business operations or risks.

This tier may seem somewhat vague and flexible, but that is for good reason; it is meant to contain the majority of the midsize companies to be tested under DFAST. Testing midsize companies that present a small risk to the economy every year seems excessive when, in the aggregate, they make up a relatively small market share. A reasonable compromise that does not impose high annual compliance costs on the average performing midsize company, yet still provides the regulatory oversight intended by DFAST, is testing every eighteen months.

E. Tier Three

Tier Three, the final DFAST testing tier, would test companies annually after the base year, and would be comprised of those companies most susceptible to another economic downturn. Tier Three companies would typically have a CAMELS rating in the bottom twenty percent of the tested midsize companies’ CAMELS ratings and would have struggled to meet the standards of customization and performance in the previous cycle. The majority of the midsize companies will avoid this classification and not be subject to high yearly compliance costs. The companies that warrant increased oversight, however, will be checked annually in an effort to improve their resilience.

VI. Conclusion

DFAST, though a worthwhile regulatory measure that helps ensure that the financial industry is prepared for sudden adverse economic conditions, has certain inefficiencies that could use

134. See generally id.
135. See Mid-size Bank Coal. of Am., supra note 12 (highlighting the small market share that midsize companies control).
adjustment. Optimizing the DFAST framework will alleviate burdens on midsize companies, while still achieving the objective of maintaining economic preparedness and stability. The current midsize range of $10 to $50 billion in assets forces companies that have minimal impact on the national economy to second-guess growth, which distracts attention from the communities they serve. Additionally, although DFAST attempts to account for the individual risks financial companies present to the economy, such variation is simply not occurring in practice. The result is that companies engaging in low-risk banking activities are tested at the same frequency, and, consequently, are likely incurring relatively similar costs as those that are engaging in risky investment markets.

However, these negative DFAST effects can be solved by adjusting the threshold for midsize financial company qualification and by adequately accounting for companies’ risk profiles. This Note’s proposed range of $20 billion to $100 billion would provide relief to a large portion of smaller midsize companies, which are currently subject to the onerous DFAST rules and provide them more opportunity for unfettered growth. Furthermore, sorting midsize companies into tiers after considering each company’s CAMELS ratings, its past performance, and market factors, would account for the idiosyncratic practices across the widened range of midsize companies and ensure that midsize companies would be tested at a frequency that matches the risk they present to the economy. The proposed changes would allow companies that are not systemically significant to focus their resources on increasing the return for their shareholders and serving the

136. See Sparks, supra note 3 (looking at how difficult it is for some midsize companies to handle the compliance costs of DFAST but also acknowledging how much DFAST has helped stabilize and improve banks); see also Reg’l Bank Coal., supra note 5 (highlighting the issue of midsize companies sacrificing to comply with DFAST instead of providing more services and credit to their local communities).

137. See Reg’l Bank Coal., supra note 5.

138. Mustafa, supra note 5.

139. See id. (discussing the lack in midsize testing variation in the first round of publicly released midsize DFAST); see also Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) § 165(i), 12 U.S.C. § 5365(i) (2012) (providing that companies with over $50 billion in assets will be tested each year, regardless of their previous DFAST performance).

140. See Dodd-Frank (“Dodd-Frank”) § 165(i), 12 U.S.C. § 5365(i) (requiring institutions with over $10 billion in assets to conduct DFAST); see also Sparks, supra note 3 (looking at how difficult it is for some midsize companies to handle the compliance costs of DFAST but also acknowledging how much DFAST has helped stabilize and improve banks).
DFAST no doubt provides increased stability to the economy, but it is also may be flawed in the way it burdens companies that pose very little risk to the national economy. However, with an upward shift to the midsize threshold and forced tailoring of the tests to fit midsize companies’ risk profiles, the banking industry, as well as the national economy, would run more efficiently, and Dodd-Frank’s goals of increased economic stability and preparedness would be more fully realized.

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141. See Press Release, Reg’l Bank Coal., supra note 5 (highlighting how the current DFAST format forces compliance costs on midsize companies that force them to divert resources from the communities they serve to compliance); see also Weinberger, supra note 51 (examining the importance of increased compliance costs under DFAST and how that plays into institutions’ decisions).
142. See Sparks, supra note 3.
143. See Presidential Remarks, supra note 1 (discussing Dodd-Franks goals of economic stability and the prevention of another economic catastrophe like the Crisis).