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**Stress Testing for Banking Organizations**

Last week, the banking agencies published their final guidance (the “Guidance”) on stress testing for banks with over \$10 billion in consolidated assets. This Guidance is effective as of July 23, 2012. The final Guidance provides principles that a banking organization should follow when conducting its stress testing activities.

**Who is Covered by the Requirements?**

All institutions supervised by the Fed, the OCC or the FDIC (including branches and agencies of foreign banks) with over \$10 billion in consolidated assets. The agencies estimate that approximately 240 institutions will have to comply with the guidance.

**What Actions do Covered Institutions have to take?**

Banking organizations subject to this Guidance should develop policies on reviewing and assessing the effectiveness of their stress testing frameworks, and use those policies at least annually to assess the effectiveness of their frameworks. Adopt stress test policies to insure results are communicated, including to the Board, maintain summaries of results and logs of follow-up actions, and monitor regular reviews of results and reviews of banking activities. A key element of a stress test program will be the framework of governance and effective controls and how results are integrated into business lines.

**What will happen if a Bank does not Adopt an Effective Program?**

If a bank does not follow the Guidance, it may be cited for an “unsafe and unsound practice.”

**How are Foreign Banks to Implement the Guidance?**

The agencies recognize that an FBO's U.S. operations are part of the FBO's global enterprise and thus subject to requirements of its home country. The agencies admit that certain aspects of the Guidance may not apply to U.S. branches and agencies of FBOs (such as the portions related to capital stress testing) or may apply differently (such as portions related to governance and controls). It is expected that examiners will take these differences into consideration when determining if the U.S. offices of foreign banks are meeting the Guidance.

#### Will Banks be Required to Publish the Results of their Stress Tests?

The Guidance does not require this. However, banking organizations may be required to disclose information about their stress tests pursuant to other statutory, regulatory, or supervisory requirements.

#### How will Regulators use the Results of Stress Tests?

The agencies expect to consider a banking organization's stress test results and the appropriateness of its overall stress testing framework, along with all other relevant information, in assessing a banking organization's risk management practices, as well as its capital and liquidity adequacy.

#### What Areas need to be Emphasized?

Stress testing for capital and liquidity adequacy should be conducted in coordination with a banking organization's overall business strategy and annual planning cycles. Results should be refreshed in the event of major strategic decisions. The agencies clarified that while capital stress tests should generally be conducted with a horizon of at least two years, organizations should recognize that the effects of certain stress conditions could extend beyond that horizon. Consolidated stress tests should account for the fact that certain legal entities within the consolidated organization are required to meet regulatory capital requirements.

#### What Governance Measures and Controls need to be implemented?

A banking organization's board and senior management should establish a comprehensive, integrated and effective stress testing framework that fits into the broader risk management of the banking organization. A banking organization should ensure that the stress testing framework is not isolated within a banking organization's risk management function, but is firmly integrated into business lines, capital and asset-liability committees, and other decision-making bodies.

#### How should the Board of Directors of a Bank be Involved?

The agencies have modified the final Guidance to clarify that senior management, not the board of directors, should have the primary responsibility for stress testing implementation and technical design. Directors should be provided with information from

senior management on stress testing developments (including the process to design tests and develop scenarios) and on stress testing results. Stress testing results should be considered directly by the board and senior management for decisions relating to capital and liquidity adequacy.

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