

# State Farm Bank, F.S.B.

2016 Annual Stress Test Disclosure  
Dodd-Frank Act Company–Run Stress Test Results  
Supervisory Severely Adverse Scenario

October 27, 2016

# Regulatory Requirement

The 2016 Annual Stress Test Disclosure presents the results of the annual stress test conducted by State Farm Bank, F.S.B. (the “Bank”) pursuant to the Dodd-Frank Act Stress Test (DFAST) requirements.

Regulations issued by the Office of the Comptroller of the Currency (“OCC”), the Bank’s primary regulator, under DFAST require banks to conduct an annual company-run stress test. The purpose of the annual stress test is to assess the potential impact of hypothetical economic scenarios on a bank’s consolidated earnings, losses, and capital over a forecast horizon, taking into account a bank’s current condition, risks, exposures, strategies and activities.

The provisions of DFAST require banks to evaluate, report to regulators and publically disclose the results of the supervisory severely adverse stress test scenario.

The company-run stress test forecast horizon spans nine quarters, starting with 1<sup>st</sup> quarter 2016 through 1<sup>st</sup> quarter 2018.

# Important Considerations

The 2016 stress test results presented herein represent the Bank's projected financial measures under the hypothetical severely adverse stress test scenario published by the Office of the Comptroller of the Currency.

The supervisory severely adverse scenario describes hypothetical sets of events designed to assess the strength of banking organizations and their resilience to unfavorable economic conditions. The Bank's severely adverse stress test scenario results do not represent forecasts of expected losses, revenues, net income or capital ratios and do not include all potential mitigating actions Bank management would likely implement in the event of an economic stress.

The Bank's results may not be comparable to other bank stress test results because of different geographic footprints, types of risks, business models, sophistication of models used in the stress test, severity of assumptions and internal processes.

# State Farm Bank Overview

State Farm Bank, F.S.B. was organized as a federally chartered savings bank and began operations on March 12, 1999. The Bank is a wholly owned subsidiary of State Farm Mutual Automobile Insurance Company.

State Farm Mutual Automobile Insurance Company and its insurance and financial services affiliates' (State Farm) primary business focus is personal lines of insurance. There are approximately 18,000 independent contractor, exclusive agents who market only State Farm products or products for which State Farm has entered into an alliance with an unaffiliated third party to offer. The Bank offers banking products primarily through the independent contractor insurance agents throughout the USA. Certain products are also available through the Internet and call center distribution channels. The Bank does not have a physical branch network.

The Bank has a simple and conservative loan portfolio concentrated in retail products with minimal commercial loan activity. The retail product portfolio is comprised of traditional products including direct auto loans, first mortgage loans, home equity loans and lines of credit and credit cards (primarily consumer). The Bank's total assets were \$16.7 billion as of December 31, 2015.

# Executive Summary

The annual stress test results indicate the Bank's financial position and capital levels are sufficient to weather the OCC severely adverse scenario.

The Bank's allowance for loan losses and capital levels could absorb losses in the OCC's severely adverse scenario with adequate post stress loan loss reserves and projected capital levels that exceed regulatory "well capitalized" thresholds.

The Bank's stress test results also indicate strong liquidity over the stress test forecast horizon.

# Severely Adverse Scenario Description

The severely adverse scenario published by the OCC is characterized by a severe global recession. The stress test forecast horizon spans nine quarters, starting with 1<sup>st</sup> quarter 2016 through 1<sup>st</sup> quarter 2018.

## Unemployment

- The unemployment rate peaks at 10.0% in 3<sup>rd</sup> quarter 2017.

## Gross Domestic Product (GDP)

- The level of U.S. real GDP begins to decline in the 1<sup>st</sup> quarter of 2016 and reaches a trough in the 1<sup>st</sup> quarter of 2017 that is 6.25% below the pre-recession peak.

## Consumer Price Index (CPI)

- The annualized rate of change in the CPI slowly increases from 0.2% in the 1<sup>st</sup> quarter 2016 to 1.9% by 3<sup>rd</sup> quarter 2017, before starting to decrease.

## Equity Market

- Equity prices decrease by approximately 50% through the end of 2016.
- Equity market volatility increases sharply.

## Real Estate

- House prices decline by 25% through the 3<sup>rd</sup> quarter of 2018.
- Commercial real estate prices decline by 30% through the 2<sup>nd</sup> quarter of 2018.

## Interest Rates

- Short-term Treasury rates fall to negative ½ percent by mid-2016 and remain at that level through the end of the scenario.

# Projected Net Revenue, Losses and Net Income

The following table depicts the Bank's cumulative projected revenues, losses and net income (after tax) over the stress test forecast horizon, 1<sup>st</sup> quarter 2016 through 1<sup>st</sup> quarter 2018.

Projected Net Revenue, Losses and Net Income	Nine Quarter Cumulative, Ending March 31, 2018 (\$ in millions)	Percent of Average Assets <sup>(1)</sup>
Pre-Provision Net Revenue (PPNR)	\$(16.8)	(0.1)%
Less: Provision for Loan Losses	\$489.6	3.3%
Net (Loss)/Income After Tax	\$(343.2)	(2.3)%

<sup>(1)</sup>Average Assets were calculated as the average of projected Total Assets over the stress test horizon.

# Capital Ratios

The following table depicts the Bank's projected stressed capital ratios over the stress test forecast horizon, 1<sup>st</sup> quarter 2016 through 1<sup>st</sup> quarter 2018.

The most significant cause of the decrease in the projected capital ratios over the stress test forecast horizon in the hypothetical severely adverse scenario was increased provision for loan losses resulting from estimated credit losses. The Bank's concentration in consumer lending was primarily stressed by pressures from unemployment increases and housing price declines as reflected in the scenario. The Bank's projected minimum capital ratios over the nine quarter stress test forecast horizon remained significantly above regulatory minimum thresholds.

Capital Ratios	Actual December 31, 2015	Stressed Pro Forma Ratios		Required Regulatory Minimum
		March 31, 2018	Minimum (Over Nine Quarter Forecast Horizon)	
Common Equity Tier 1	16.3%	15.0%	15.0%	4.5%
Tier 1 Risk-Based Capital	16.3%	15.0%	15.0%	6.0%
Total Risk-Based Capital	17.6%	16.3%	16.3%	8.0%
Tier 1 Leverage	10.7%	10.3%	10.3%	4.0%



# Description of Risks

The key risks considered in the Bank's annual stress test include the following:

## Credit Risk

- The risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise perform as agreed.
- Found in all activities where success depends on counterparty, issuer or borrower performance.
- Arises any time bank funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether reflected on or off the balance sheet.
- State Farm Bank's credit risk is primarily limited to retail portfolio exposure.

## Interest Rate Risk

- The risk to earnings or capital arising from movements in interest rates.
- Arises from differences between the timing of rate changes and the timing of cash flows (repricing risk), from changing rate relationships among different yield curves affecting bank activities (basis risk), from changing rate relationships across the spectrum of maturities (yield curve risk) and interest-related options embedded in bank products (options risk).

## Liquidity Risk

- The risk to earnings or capital arising from a bank's inability to meet its obligations when they come due without incurring unacceptable losses.
- Includes the inability to manage unplanned decreases or changes in funding sources.
- Arises from the failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

## Operational Risk

- The risk to earnings or capital arising from inadequate or failed internal processes or systems, the misconduct or errors of people and adverse external events.
- Results from internal fraud; external fraud; employment practices and workplace safety; clients, products, and business practices; damage to physical assets; business disruption and systems failures; and execution, delivery, and process management.

# Summary Description of Methodologies Used

The Bank used both quantitative models and qualitative analysis to estimate revenues, losses and capital ratios in the annual stress test. The primary methodologies used to project the balance sheet, credit losses, and PPNR (net interest income, non-interest income and non-interest expense) are summarized as follows:

## Balance Sheet

- Loan and deposit production was primarily modeled using historical Bank production data and the severely adverse scenario macroeconomic variables.
- Projected balance sheet composition was used as a basis for projecting funding needs and sources throughout the stress test forecast horizon.
- Models were used to predict loan prepayment and deposit decay based on the severely adverse scenario interest rate forecasts.

## Credit Losses

- Estimated primarily through the use of time series models with qualitative adjustments, where appropriate, based on management expert judgment.
- Loan loss provision expense was estimated through application of the Bank's allowance for loan and lease losses methodology.

## Net Interest Income

- Estimated primarily through the use of models to predict loan prepayment and deposit decay, taking into consideration modeled balance sheet growth estimates, contractual terms of existing balance sheet assets and liabilities and the interest rates included in the severely adverse scenario.

## Non-Interest Income and Expense

- Estimated using various methods including business plan projections, management judgment, historical data points and analytics.

# Governance and Controls

State Farm Bank has a strong governance structure and effective internal controls over the annual stress test process.

## Governance by Management and the Board of Directors

- The Bank Board Risk Committee and executive management committees provide governance over the Bank's annual stress test activities.
- The Bank has board and management level stress test policies which outline roles and responsibilities and govern the Bank's annual stress test activities.
- Bank management established an effective system of internal controls, oversight and documentation, including policies and procedures designed to ensure the stress test program is effective in meeting regulatory requirements.

## Model Risk Management

- Model risk management is a key component of the governance over the models used in the Bank's annual stress test.
- The Bank has board and management level model risk management policies which outline roles and responsibilities and govern the Bank's model risk management activities.
- The Bank maintains a model inventory, monitors model performance and administers model validation activities.

## Internal Audit

- State Farm's Internal Audit Department performs a review of the Bank's annual stress test process, model risk management activities, and DFAST regulatory filing.