January 22, 2018

Ms. Ann Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Docket No. OP-1586, Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test; Docket No. OP-1587, Stress Testing Policy Statement; and Docket No. OP-1588, Policy Statement on the Scenario Design Framework for Stress Testing

Dear Ms. Misback:

The Financial Services Roundtable (FSR)[1] appreciates the opportunity to comment on the Federal Reserve Board's (Board) proposals on: (1) enhanced disclosure of the models used in the Board's supervisory stress test; (2) a new Stress Testing Policy Statement; and (3) amendments to the Board's Policy Statement on Scenario Design Framework for Stress Testing.[2]

Our comments are divided into three main sections. Section I, Introductory Comments, expresses our general support for the proposals. Section II, Recommendations for Additional Disclosures, lists some additional disclosures related to the Board's supervisory model that would further enhance the transparency of the model and improve the supervisory stress testing process. Section III, Other Recommendations, lists some other reforms to the stress testing and comprehensive capital analysis and review (CCAR) process that we urge the Board to consider.

[1] The Financial Services Roundtable represents the largest banking and payment companies financing the American economy. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO.

[2] Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test, 82 Fed. Reg. 59,547 (Dec. 15, 2017) (Docket No. OP-1586); Stress Testing Policy Statement, 82 Fed. Reg. 59,528 (Dec. 15, 2017) (Docket No. OP-1587); Policy Statement on the Scenario Design Framework for Stress Testing, 82 Fed. Reg. 59,533 (Dec. 15, 2017) (Docket No. OP-1588).

I. Introductory Comments

We support the proposals.

FSR supports greater transparency surrounding the models used in the Board's supervisory stress test. Last year, in a submission to the Treasury Department, we noted that greater transparency surrounding the Board's models for stress testing would enhance the accountability of the process and would encourage a public dialogue on how to improve the process.[3] In that submission, we also endorsed the various recommendations made by the Government Accountability Office regarding stress test modeling and the capital planning process.[4]

The release of enhanced descriptions of the models, modeled loss rates on pools of loans, and portfolios of hypothetical losses on material loan portfolios would be a positive step in the direction of greater transparency. The release of this information will improve the effectiveness of the supervisory stress test process for both companies and the Board. Likewise, the proposed new Stress Testing Policy Statement and the proposed amendments to the existing Policy Statement on Scenario Design Framework for Stress Testing would provide useful information on the Board's overall approach to the supervisory stress test. The Stress Testing Policy Statement provides information on the development, implementation, and validation of the models used in the test. The amendments to the Policy Statement on Scenario Design Framework for Stress Testing clarify the Board's approach to changing the unemployment rate assumption in the severely adverse scenario, and add explicit information on the housing prices used in the severely adverse scenario. Additionally, providing more information on the Board's model should generate research on the condition of the industry. The results of this research would aid in determining current risk trends that deviate from historical precedent and would ultimately improve the safety and soundness of the banking industry. Therefore, we support these proposals.

II. Recommendations for Additional Disclosures

We believe the Board could make additional disclosures that would further improve the supervisory stress test process. Our recommendations for additional disclosures follow below.

---

[3] Letter to Craig Phillips, Counsel to the Secretary, U.S. Department of the Treasury, from Richard Foster, Senior Vice President and Senior Counsel for Regulatory and Legal Affairs, Financial Services Roundtable, May 2, 2017, *available at* http://www.fsroundtable.org/wp-content/uploads/2017/06/FSR-Letter-to-Treasury-on-Core-Principles-May-3.pdf.

[4] Additional Actions Could Help Ensure the Achievement of Stress Test Goals, Government Accountability Office, GAO-17-48, November 2016.

Accelerate the Release of the Scenarios

We recommend the Board set a fixed date in early January of each year for the release of the scenarios and additional components used in the supervisory stress test.

The Board's stress test rule provides for the release of the scenarios used in the supervisory stress tests *no later* than February 15th of each year. The Board also has stated it will provide additional components and scenarios *no later* than March 1st. We recommend the Board set a fixed date in early January of each year for the release of the scenarios and additional components used in the supervisory stress test. An earlier release of this information on a fixed date, such as January 10th of each year, would reduce uncertainty surrounding the scenarios and would give companies additional time to incorporate the scenarios in their internal models. Accelerating the release of the scenarios also would give companies additional time for senior management and boards to review the results of the tests. Furthermore, we do not believe that an accelerated release date would result in scenarios that are overtaken, or become outdated, by real world events between the release of the scenarios and the conduct of the stress test. The scenarios used by the Board have been extremely conservative in their design, and would remain valid in all but the most extreme environments.

Engage in a Dialogue with Companies on Deviations in Results

We recommend the Board engage in a confidential supervisory dialogue with individual companies in those instances in which the results of the Board's supervisory stress test on any portfolio deviate from the results of the company-run test on the portfolio.

We recommend the Board engage in a confidential supervisory dialogue with individual companies in those instances in which the results of the Board's supervisory stress test on any portfolio deviate from the results of the company-run test on the portfolio. Such a dialogue would give companies a better understanding of potential deficiencies in their test. It also would further the overall goal of this process by improving the information used by the Board when conducting its stress tests.

In these individual discussions, it would be helpful for the Board to share on a confidential basis the model monitoring results of the Board's model for the company. This would help the company understand the performance of the Board's model, whether it is data or model related. It would also be informative on improving the overall stress testing approach.

These individual discussions also should include the identification of deficiencies in data submitted in the FR Y-14 schedules. We recognize the Board's sensitivity to disclosing too much information about the models, but identification of line item data deficiencies would not enable a company to reverse engineer the Board's model.

Moreover, the disclosure of line item data deficiencies will enable a company to understand if the deviation is due to a substantive difference between the company's and Board's perception of the risk in a portfolio or is a more technical data collection problem. This understanding will help to avoid conflicting messages of risk in the banking sector to third parties, including customers, investors, and rating agencies.

Explain Year-to-Year Changes in Results

We recommend the Board release information explaining the year-to-year changes in stress test results.

To help firms understand the year-to-year changes in their risk profile, we recommend the Board release information explaining the year-to-year changes in stress test results. For example, the Board could attribute the changes to a few key drivers, such as model portfolio mix/risk profile, changes in models, scenario changes, and changes in assumptions. The release of this information to individual firms, as well as on an aggregate industry basis, would provide greater transparency in test results and help firms understand the changes driven from shifts in risk as opposed to changes resulting from model enhancements.

Provide Summary Data on Multiple Asset Classes

We recommend the Board provide disclosures for all major asset classes of loans as delineated by the Board in its disclosure of loan loss rates.

In the notice accompanying the proposal for enhanced disclosure of the models used in the Board's supervisory stress test, the Board includes an illustration of the disclosures that could be made in connection with corporate loans. We recommend the Board provide disclosures for all major asset classes of loans as delineated by the Board in its disclosure of loan loss rates. Additionally, it would be useful if the loss rate disclosures could be made at the sub-asset class level for the major asset classes. For example, the disclosures related to residential mortgages should distinguish between conventional and non-conventional loans, adjustable rate loans, FHA and VA insured loans. This additional information should be made available directly to individual firms and would provide additional insight to portfolio risk based on a firm's asset mix.

Provide Transparency into Severity of the Board's Model with Publication of Scenarios

We recommend that the Board set expectations of how severe its models will be each year when scenarios are released, and uphold these expectations during the annual capital planning exercise.

If a company inaccurately predicts the severity of the results produced by the Board's model, its capital request could be rejected. Due to this uncertainty, the company cannot determine if its own Board of Directors-approved capital plan will clear an unknown hurdle. If the company did not guess accurately, rejection of a capital request results in public embarrassment as well as resource burdens, given the extremely tight timelines for determining an altered request. This uncertainty needlessly complicates the process and forces companies to participate in a guessing exercise when determining one of its most important internal decisions, the capital plan. To alleviate this concern, we recommend that the Board communicate specific, quantitative guidelines for how the severely adverse scenario will affect banks of different sizes and risk types when the scenario is published, as well as the expected impacts of any model changes that year. This would reduce some of the complexity and opaqueness associated with the current process without diminishing the results of the process

Increase Disclosure of Pre-Provision Net Revenue (PPNR) Models

We recommend the Board provide additional descriptions of the components used in the Board's PPNR model.

We recommend the Board provide additional descriptions of the components used in the Board's PPNR model. Changes made to the PPNR models were described in the 2017 DFAST Methodology and Results published by the Board. However, that description was limited in its scope. For example, it did not address how significant individual PPNR line items are treated or derived. Nor did it address how significant changes in business strategies, such as acquisitions and divestitures, are factored into the results both in the year in which business plan changes templates are required or in future stress tests. Specifically, methodology documentation does not outline how the supervisory stress tests models factor in purchase accounting information supplied in the business plan changes or how realized operating leverage gains from strategies are factored into subsequent stress test results. Therefore, we specifically recommend the Board disclose: (1) how significant PPNR line items are treated or derived; (2) how significant changes in business strategies incorporated would be useful to firms; and (3) how the FR Y-14A and FR Y-14Q data factors into the PPNR derivation process.

We also recommend the Board provide confidential individual firm specific disclosures that separate operational loss projections from PPNR results, and provide additional descriptions of the modeling approaches and components used in the operational loss models. Greater transparency into PPNR and operational loss projections on an individual firm basis is warranted, given the different approaches taken to develop these projections. This information would provide the industry better insight into varying macroeconomic factor and risk sensitivities.

Increased Disclosure of Loan Loss Provisions

We recommend the Board provide additional details on the methodology used to calculate the loan loss provision.

We recommend the Board provide additional details on the methodology used to calculate the loan loss provision, including how loss rates convert into loan loss provisions. This information would give companies more information about what drives provision levels. It also could be particularly important as companies begin implementing CECL.

Increase Disclosures Related to Deferred Tax Assets (DTA)

We recommend the Board provide more transparency on the treatment of deferred tax assets (DTAs) in the supervisory stress test.

We recommend the Board provide more transparency on the treatment of DTAs in the supervisory stress test, including the components of DTAs. Income taxes and DTA calculations are extremely complex and require far more granular data than what is supplied in the FR Y-14 M, Q or A. Moreover, the calculation of DTAs can have a profound effect on the level of stressed capital at firms. While previous DFAST Methodology and Results discussed the treatment of taxes, that discussion falls short of describing the nuances and complexities surrounding the calculation of DTAs.

Increase Disclosure Related to Risk Transfer Transactions

We recommend the Board clarify the treatment of risk transfer transactions in the supervisory stress test.

We recommend the Board clarify its position on the treatment of risk transfer transactions in the supervisory stress test, which is briefly discussed in SR 13-23. Risk transfer transactions are effective mechanisms that, ideally, should receive positive treatment in the Board's models when they are structured or secured in a way which mitigates interest rate, credit, counterparty, or other types of risk. Structured properly, these transactions can provide capital to offset losses and reduce risk weighted assets in stressed scenarios. Not acknowledging the benefit of well-structured risk transfer transactions in stress tests reduces the options available to institutions to better manage their capital levels, and may reduce the market demand for these instruments, which could stifle innovation in balance sheet and capital management.

III. Other Recommendations

In addition to enhancing the transparency of the models used in the supervisory stress test, we urge the Board to consider some additional changes to the stress test and CCAR process. These other recommendations follow below.

Eliminate the Requirement that Companies Produce Internal a Severely Adverse Stress Scenario with Results that are "At Least As Severe" as the Board's Severely Adverse Scenario

We recommend the Board eliminate the requirement that companies produce stress results that are "at least as severe" as the results produced in the Board's scenario.

According to Appendix G of SR 15-19, a company's severely adverse stress scenario should be at least as severe as the Board's severely adverse scenario, measured in terms of its effect on net income and other elements that affect capital. However, the Board's severely adverse supervisory scenario is not released until after virtually all of the company's internal scenario design processes are completed and through governance review. The "at least as severe" scenario guidance, coupled with the Board's late release of scenario details, put companies in the difficult position of predicting the Board's scenario severity, which is not a productive use of resources and does not further the Board's stress testing mandate. The Board could avoid this inefficient process by eliminating the requirement that a company's scenario be "at least as severe" as the Board's scenario.

Eliminate Certain Assumptions

We recommend the Board eliminate the continuation of share repurchases and balance sheet growth assumptions used by the Board during the capital planning horizon.

We recommend the Board eliminate the continuation of share repurchases and balance sheet growth assumptions used by the Board during the capital planning horizon. These assumptions are overly conservative, place undue pressure on stress test results, and limit the amount of capital available for banking activities. We favor replacing them with the assumption that balance sheets and risk weighed assets remain constant over the planning horizon. Such an assumption aligns with the policy statement that credit availability is maintained in a stress environment. Moreover, the capital policy at most firms dictates the discontinuation of share repurchase activity during periods of stress. Allowing banks the flexibility in supervisory stress testing to manage their capital actions in accordance with their own capital policies, rather than adhere to the binding constraints of planned capital actions developed in the baseline scenario, would provide a more accurate depiction of the capital adequacy of the banking industry and its ability to sustain prolonged stress. Additionally, the current assumption on the continuation of share repurchases is inconsistent with the Board capital conservation buffer requirements that go into full effect in 2019.

Establish a Materiality Threshold for Portfolio Subject to Horizontal Review

We recommend the Board set a consistent and practical threshold for the portfolios that are chosen for horizontal review and govern the review activities.

We recommend the Board set a consistent and practical threshold for the portfolios that are chosen for horizontal review and govern the review activities. While such an internal threshold may already exist for the horizontal review, the threshold is set at such a low level that firms still must spend an inordinate amount of time addressing very small portfolios during the examination. For the participating companies, this results in an inability to tailor reporting, governance, and documentation during the capital planning cycles towards the more material portfolios, given that even small, immaterial portfolios may be chosen for examination during the horizontal review. Therefore, we recommend the threshold be raised to a level that avoids the evaluation of portfolios that could not have a material impact on the condition of the company. Such a threshold would eliminate time and expense for both the financial institution and the examiners devoted to reviewing portfolios that do not have material impact on a company's operations or financial performance, and would enable companies and examiners to focus their resources more effectively. The threshold we recommend is similar to the threshold used for inclusion in Y-14 schedules, 10% of a company's common equity tier 1 capital.

Limit the Number or Scenarios

We recommend the Board support a statutory reduction in the number of stress test scenarios.

The Policy Statement on the Scenario Design Framework for Stress Testing indicates the Board may require more than three scenarios in some years if it identifies large numbers of unrelated and uncorrelated risks.[5] We urge the Board to avoid the addition of any additional scenarios. As a practical matter, the severely adverse scenario is the binding constraint on capital actions. Therefore, to increase the efficiency, effectiveness, and tailoring of the stress testing process, we recommend companies be required to conduct stress testing under simply a baseline scenario and a severely adverse scenario. We appreciate this would require an amendment to the Dodd-Frank Act, and urge the Board to support such a change.

[5] Section 3.a. of the Policy Statement.

IV. Conclusion

Again, we appreciate the opportunity to address these issues. If you have any questions about this letter, please contact me at 202-589-2424 (Richard.Foster@FSRountable.org) or Robert Hatch at 202-589-2429 (Robert.Hatch@FSRoundtable.org).

Sincerely,

Rich Foster

Richard Foster
Senior Vice President and Senior Counsel for Legal and Regulatory Affairs