American Bankers Association

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January 22, 2019

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Re: Notices of proposed rulemakings to tailor prudential standards

Ladies and Gentlemen:

The American Bankers Association[1] (ABA) appreciates the opportunity to comment on the banking agencies' (the Agencies) proposed rulemakings to tailor prudential standards (the Tailoring Proposals).[2] ABA is supportive of the recent efforts of the Agencies and other policymakers to consider the effectiveness of the numerous new prudential standards implemented in recent years, with a view toward how they can be improved.

The Tailoring Proposals are a welcome recognition that existing capital, liquidity, and systemic risk regulations have not sufficiently distinguished among banks of various sizes that are engaged in a variety of activities and therefore presenting varied risk profiles. We consider the proposals' tailoring of capital, stress testing and liquidity standards to be crucial steps toward ensuring that the character of regulation fits the character of a firm. Therefore, we support the proposed five-category framework and believe it will help ensure that relevant regulations are

[1] The American Bankers Association is the voice of the nation's $17 trillion banking industry, which is composed of small, midsize, regional, and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits and extend nearly $10 trillion in loans.

[2] Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 83 Fed. Reg. 66,024 (Dec. 21, 2017) and Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies, 83 Fed. Reg. 83 Fed. Reg. 61,408 (Nov. 29, 2017).

efficient, effective, and appropriately applied. We encourage the Agencies to finalize the Tailoring Proposals promptly, subject to the comments below.

Subsequent to finalizing the Tailoring Proposals, the Agencies should continue to review how the prudential framework can be further improved and refined. In addition to the proposals related to tailored resolution and capital plans that are referenced in the Tailoring Proposals, the Agencies should embrace an ongoing effort to monitor and adjust prudential standards.

This letter is composed of four parts:

- Section I discusses the appropriateness of the factors for determining a bank's risk category.
- Section II discusses the proposed tailoring of the liquidity framework.
- Section III discusses the proposed tailoring of capital and stress testing framework.
- Section IV discusses some additional prudential standards that the regulators should review.

I. The Proposed Factors Should be Indexed and Refined

Under the Tailoring Proposals, firms would be sorted into categories based on factors that include the following:

- Asset size,
- Cross-jurisdictional activity,
- Reliance on short-term wholesale funding,
- Extent of nonbank assets, and
- Extent of off-balance sheet exposure.

The Agencies view the proposed factors as proportional to the complexity and risk inherent in a banking organization's business, believing that quantitative increases in any of the factors result in greater risk. While ABA strongly supports consideration of risk factors beyond simple measurements such as asset size, such factors should be as precise and aligned to actual risk exposure as we can reasonably realize. We believe that the method described in the Tailoring Proposals is adequate and more straightforward than the "alternative approach." However, we believe the factors can be further refined as we suggest below. We also believe it is critical that any new regulatory thresholds be indexed to a measure of the broader banking industry to ensure that the regulations are appropriate from a systemic perspective for an institution's risk and complexity.

a. The Tailoring Proposals*' risk factors should be indexed to account for changes in institutions' relative* potential systemic impact.

ABA believes that all of the factors outlined in the Tailoring Proposals can be appropriately considered in assessing the potential systemic impact of an institution. However, ABA recommends that the asset thresholds and the $75 billion thresholds for the risk-based measures be indexed to the amount of total assets of commercial banks, as presented in the Federal Reserve's H.8 Assets and Liabilities of Commercial Banks in the United States statistical release.[3] As proposed, the thresholds are static and will, over time, improperly tag banking organizations whose risk profile may not warrant additional regulation, or reflect adjustments in the risk profiles of the banking organizations unnecessarily subject to additional regulation. Indexing these regulatory thresholds to the H.8 data would ensure that the relative relationship between the measures and the size of the banking industry overall is maintained. Moreover, by employing indexing, the Agencies should provide certainty as to the frequency and nature of threshold adjustments. To enhance the transparency and certainty for covered banking organizations under the regulatory framework, any indexing should be codified as part of the Agencies' Final rules to implement the Tailoring Proposals to ensure that the thresholds in such a way as are adjusted automatically.

b. The Agencies should increase the cross-jurisdictional activity threshold or refine their measure of cross-jurisdictional activity so that it appropriately reflects the risks.

The Tailoring Proposals heavily weight cross-jurisdictional activity as a proxy for complexity and systemic risk, and this single indicator could determine banks' inclusion in the most stringently regulated non-GSIB category. We note that not all cross-jurisdictional activities reflect complex operations or raise resolvability concerns. We believe that the $75 billion cross-jurisdictional activity threshold should either be increased significantly, because it aggregates across the balance sheet, or the measure of cross-jurisdictional activity should be refined. Below we offer several alternative recommendations about how the measure could be refined to better reflect the riskiness of such activities. We do not believe that adoption of these recommendations should result in a cross-jurisdictional activity threshold lower than $75 billion.

The Tailoring Proposals would define a firm's cross-jurisdictional activities to include both a firm's non-U.S. assets and non-U.S. liabilities. Without refinement, such counting of assets and liabilities could artificially inflate a firm's cross-jurisdictional activity and, by extension, its perceived risk exposure. ABA urges the Agencies to refine the granularity of the cross-jurisdictional activity indicator to permit exclusion or netting of certain cross-jurisdictional claims and liabilities for purposes of calculating the $75 billion threshold, where doing so would further the purposes of tailoring and better reflect the systemic risks from those claims/liabilities.

A number of institutions hold significant High Quality Liquid Assets (HQLA), such as central bank reserves, abroad to support local deposits maintained by customers doing business in those markets. Holding locally-funded liquid assets like cash and HQLA in the local jurisdiction (as opposed to making those investments in the United States) would not be expected to contribute meaningfully to the systemic risk profile of these firms. Accordingly, allowing firms to exclude, or at least net, such low-risk assets against liabilities that are in the same jurisdiction would appropriately distinguish the low risks of such assets from those of less liquid assets. This would also recognize that assets and liabilities within the same foreign jurisdiction do not present the

[3] Federal Reserve, Statistical Release H 8 – Assets and Liabilities of Commercial Banks in the United States, available at https://www.federalreserve.gov/releases/h8/ (providing weekly aggregate balance sheet for all U.S. commercial banks).

same potential liquidity and ring-fencing concerns as a liability sourced in one jurisdiction funding an asset in another jurisdiction.

Similarly, the Tailoring Proposals should permit firms to exclude certain ordinary course cross-jurisdictional operational liabilities, such as accounts payable, that do not generally contribute to a firm's systemic risk profile and could be excluded without compromising the general policy objectives of including cross-jurisdictional activity as a factor.

c. The Tailoring Proposals should refine measurement of the short-term wholesale funding risk factor to focus on original maturities.

In addition to indexing the factors for the reasons discussed above, ABA recommends that the Agencies calculate short-term wholesale funding based on obligations' original maturities. The fact that a long-term obligation matures in the near future can be appropriately considered in assessing an institution's liquidity profile, but that does not make it equivalent to short-term funding that fuels rapid and potentially risky growth. It may be appropriate to include an institution that relies on significant short-term wholesale funding in a higher risk category, but liability management that includes a broader maturity ladder/distribution should receive a less restrictive treatment.

d. Use of a four-quarter rolling average is an appropriate measurement method as long as institutions have appropriate lead time to comply.

Use of a four-quarter rolling average is appropriate in calculating risk factor levels, since it mitigates the impact of anomalous financial or operational results. If, however, an institution's rolling average will result in transition to a risk category in which more regulatory requirements are applicable, an implementation period is necessary and appropriate. ABA believes that, once the rolling average triggers a transition to such a category, the Agencies should permit a further two quarters to achieve compliance with the additional regulatory requirements applicable in the new category.

e. The risk factor for nonbank activities should exclude bank-permissible activities.

In addition to indexing this factor for the reasons discussed above, ABA recommends that the Agencies calculate the level of nonbank activities net of bank-permissible activities conducted in the entities. Though requirements for separate legal entities permit relatively easy measurement of nonbank assets and activities, in many cases those entities also have businesses that would be permissible within the institution's banking units. This is particularly important for grandfathered banking organizations owned by commercial firms. For risk measurement and tailoring purposes, the Agencies should focus on the level of the specific nonbank activities, without counting bank-permissible activities in the calculation of this risk factor.

II. Liquidity

We appreciate and support the Agencies' recognition that banking organizations have varying degrees of liquidity exposures, and that arbitrary asset thresholds are not the most effective way to identify liquidity risks or distinguish among liquidity risk profiles of banking organizations. As discussed above, we support the Tailoring Proposals. However, we believe that the proposed tailoring of the liquidity framework could be further improved by using the modified Liquidity Coverage Ratio (LCR)[4] (and, if promulgated, the proposed modified Net Stable Funding Ratio (NSFR) as a starting point to tailor liquidity requirements for Category III firms and by conforming the liquidity reporting and disclosure for Category IV firms, among other items. We continue to urge the Agencies to implement technical corrections to the LCR and reassess the value of the NSFR.[5]

a. Use the modified LCR, and proposed modified NSFR, instead of a haircut, as a starting point for tailoring.

When the Agencies implemented the LCR in the United States, (the "full LCR"), they finalized the rule in tandem with a modified LCR that was promulgated by the Federal Reserve under the Dodd-Frank Act. The final rule is based on the Basel Committee on Banking Supervision's standard and currently applies to all bank holding companies with $250 billion or more in assets or $10 billion or more in foreign exposure and their bank subsidiaries with over $10 billion in assets. The modified LCR is less stringent and was intended for U.S. banking organizations that are generally smaller, simpler and have different liquidity exposures than those subject to the full LCR. Similarly, the 2016 proposal to implement the Basel Committee's NSFR standard featured a less stringent modified NSFR for banking organizations with lower liquidity risk profiles.

In recognition of the different liquidity risks current Category III firms face, the Tailoring Proposals request comment on how the LCR and NSFR should apply to such firms. In order to better tailor the LCR and – if promulgated, NSFR requirements - to the liquidity risks of firms proposed to be in Category III, we recommend that the Agencies use the modified LCR as a starting point. Because the full LCR and NSFR were calibrated for larger and more complex internationally active firms, this modified LCR approach would allow for a cleaner, more efficient way to tailor the LCR standard to the liquidity risk exposures of smaller, less complex firms. Application of the full LCR, as proposed, including its inapposite features such as trapped liquidity and the maturity mismatch add-on, would undermine the goals of the Tailoring Proposals as it would be a punitive measure for firms that maintain a simple legal entity structure and traditional banking model.

With respect to reporting and disclosure under a modified LCR method, Category III firms could be required to monitor their LCR on a daily basis and comply with the 1.0 LCR threshold on the last business day of each month. In addition, consistent with the current modified LCR framework, Category III firms would provide public LCR disclosures based on their month-end LCR values. These firms currently report quantitative information about their LCR calculations to the Federal Reserve on a monthly basis in their FR 2052a submissions, and the current LCR

[4] https://www.govinfo.gov/content/pkg/FR-2014-10-10/pdf/2014-22520.pdf
[5] https://www.aba.com/Advocacy/commentletters/Documents/lcr-treatment-municipal-obligations-hqla-100118.pdf

rule does not require more frequent reporting absent an LCR shortfall. The same manner and frequency for this regulatory reporting would apply to public reporting.

Importantly, should the Agencies consider a final LCR regime that applies to both the holding company and the lead bank, the bank holding company should be allowed to include eligible HQLA held at a subsidiary, to the extent allowed by other regulations.[6] Similarly, under the NSFR, while we support the haircut in an effort to tailor the rule, we urge the Agencies to allow 100 percent transferability of available stable funding from the subsidiary to the holding company.

Regarding Category II institutions, we believe that the policy goals of the Tailoring Proposals would be further achieved by a reduced LCR and NSFR. As discussed above, the full liquidity standards were calibrated to the risks and activities of the largest global firms. The activities and subsequent liquidity risk exposures do not warrant the full LCR and NSFR, due to their generally lower risk profile and the nature of custody activities. Moreover, while Category II firms should be subject to monthly reporting under the FR 2052a, these firms should not be required to submit the report daily. The FR 2052a filings do not change significantly from day to day, as these firms' funding sources are simple and stable, largely consisting of client' cash deposits. Because daily FR 2052a reports would not be of much marginal value to the agencies and because of the significant initial and ongoing costs that daily reporting would impose on custody banks, Category II institutions should not be required to submit daily FR 2052a reports.

b. Liquidity reporting and disclosure for Category III and IV firms should be better correlated to the proposed changes.

We recommend that the Federal Reserve revisit the FR 2052 reporting regime to ensure that the report is reflective of the business lines, activities and risk profiles covered institutions face and is consistent with other measures that will be implemented pursuant to the adoption of the Tailoring Proposals. For example, under the Tailoring Proposals, Category IV banks are no longer subject to LCR. By extension then, these institutions should not be subject to the 2052a liquidity reporting requirements. Understanding the Federal Reserve's desire to maintain a certain level of data of firm and systemic liquidity, we urge the Federal Reserve to reinstate 2052b for Category IV institutions, with a quarterly reporting frequency to align with the frequency of liquidity-stress-testing under Regulation YY. We urge the Federal Reserve to confirm that the reporting and the liquidity stress testing, risk management and buffer requirements under Regulation YY will not effectively bind Category IV firms to the limits of the LCR rule.

Under Regulation WW, Category IV banks are required to disclose their LCR in the first quarter of 2019. Under the Tailoring Proposals, such firms would not have to comply with the LCR. From a systems, reporting, and validations standpoint, it makes little sense to require Category IV firms to prepare public disclosures regarding adherence to a standard to which they will no

[6] As the agencies recognize, under the modified approach banking organizations may include in their HQLA amount eligible HQLA held at a subsidiary up to 100 percent of the net cash outflows of the subsidiary, plus amounts that may be transferred without restriction to the top-tier covered company.

longer be subject. We ask the Federal Reserve to act immediately to delay any LCR reporting requirements for Category IV institutions during the pendency of its rulemaking in this area.

With respect to timing, we also ask that the Federal Reserve provide more time for Category III banks to validate and submit their reports—for example by setting required submission to 10 days from month end. Currently, Category III banks must file the FR 2052 on a monthly basis and report the data on a T+2 basis. A T+10 standard is the current standard under the modified LCR rule and, given the requested changes above, would be equally appropriate for Category III banks.

c. Governance of liquidity risk should be delegable to the risk committee.

The Federal Reserve should amend the liquidity risk management standards in Regulation YY to clarify that a covered firm's board of directors can delegate primary oversight responsibility for liquidity risk, including approval of liquidity policies, to its risk committee. This would reduce redundancies while still ensuring strong independent board oversight and would better align liquidity risk oversight with other risk types under Regulation YY.

III. Capital and Stress Testing

a. Category IV banks should be subject to a two year supervisory stress testing cycle.

ABA supports the Tailoring Proposals' shift from an annual supervisory stress test to a two year supervisory stress testing for Category IV banks.

b. The Federal Reserve should immediately exclude Category IV banks from CCAR 2019.

Under the Tailoring Proposals, Category IV banks would move to a two-year cycle for supervisory stress testing and would no longer be subject to statutory company-run stress testing. At the October 31, 2018, meeting of the Federal Reserve Board at which the Tailoring Proposals were approved for public comment Vice Chairman Quarles stated—

> While the proposal will not be final in time to be formally effective for the 2019 supervisory stress tests, I expect that the Board will move promptly to vote on action making 2019 an 'off-cycle' year, in which we would rely more on normal-course supervisory tools. Effecting the two-year cycle for the firms in this size range as soon as possible would provide immediate burden relief consistent with the statute's intent.

We request that the Federal Reserve issue as soon as possible an interim final rule or other actions providing Category IV banks relief from the 2019 stress testing cycle, consistent with Vice Chairman Quarles' statement. Similarly, the immediate relief should exclude Category IV banks from requirements and disclosures relating to annual supervisory stress testing and biannual company run stress testing. Providing immediate relief would bring much needed clarity and avoid waste and distraction of effort on activity of no intended supervisory value. Until the Federal Reserve acts, Category IV banks continue to be subject to the CCAR requirements and must therefore continue the process of allocating personnel and resources in preparation[7] of the 2019 CCAR.

c. The Federal Reserve should set clear expectations about Category IV *banks'* capital planning processes.

In addition to the stated objective of reducing administrative burden, the Federal Reserve has indicated that any future capital plan proposal will provide "greater flexibility" to Category IV banks to develop their annual capital plans. A main feature of this proposal should be to allow banks the flexibility to manage the timing and amount of their capital distributions within the bounds of their operating capital requirements as specified in their capital policies, inclusive of the consideration of any regulatory minimums such as the Stress Capital Buffer.

The proposal should also set clear expectations for Category IV banks' capital planning activities. Specifically the proposal should—

- During an "off-cycle year," provide banks the option to request the Federal Reserve to run a supervisory stress test to refresh a firm's Stress Capital Buffer;[8]
- Offer all institutions the flexibility to modify their capital actions during the course of a year as long as their capital ratios satisfy all regulatory thresholds (including Stress Capital Buffer, if/as effective);
- Clarify that the Stress Capital Buffer and minimum capital requirements are the only regulatory constraints on capital actions;
- Outline clear expectations for "forward-looking assessments" used by Category IV banks as part of capital planning, while permitting flexibility for such banks to design assessments tailored to individual circumstances;
- Provide an affirmative statement that Category IV banks are not required to conduct stress tests based on the Agencies' scenarios;
- Provide guidance on how information pertaining to an institution's Capital Plan will be collected and reviewed, such as alternatives for the FR Y-14A and Capital Plan Narrative;
- Detail the supporting documentation requirements and finalization dates for the capital plan; and,
- Explain how a bi-annual supervisory stress test or an institution's annual capital plan feed into the firm's LFI Rating.

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[7] For example preparations include: Updating and maintaining systems, tools, models, etc., to accommodate running the Supervisory scenarios and population of FR Y-14A reporting; Generating supporting submission documentation; and, Scheduling of required governance committee meetings (including the Board of Directors) to support the capital plan review, challenge, and approval cadence.

[8] While supportive of the Proposals' shift to a two-year cycle, ABA is concerned that the two-year cycle could mean that a Category IV bank would have an unnecessarily high Stress Capital Buffer for a prolonged period of time. For example, if the risk profile of a Category IV bank improved substantially due to a merger or portfolio acquisition in the period after its Stress Capital Buffer was calculated it could be placed at a competitive disadvantage for a period of up to two years by having a larger than necessary Stress Capital Buffer not aligned with the institution's underlying risk. Similarly, we anticipate that most severe scenarios would likely be at the height of the economic cycle resulting in a Category IV bank potentially have an inflated Stress Capital Buffer for two years during a recessionary period. This could have profound impacts on the communities in which a bank in this situation lends.

d. The qualitative objection should be eliminated and instead made part of the ongoing supervisory process.

Under the Tailoring Proposals, the Federal Reserve would continue to apply the CCAR qualitative assessment of a bank's capital plan to Category I, II, and III banks. In discussing the qualitative assessment in a 2016 report, the Government Accountability Office found that the Federal Reserve, "has not disclosed information needed to fully understand its assessment approach or the reasons for decisions to object to a company's capital plan. Transparency is a key feature of accountability and this limited disclosure may hinder understanding of the CCAR program and limit public and market confidence in the program and the extent to which the Federal Reserve can be held accountable for its decisions."[9]

Including qualitative elements in the Stress Capital Buffer framework, especially given its inherent reliance on hypothetical predictions, raises the unwelcome specter of arbitrary regulatory action. The Federal Reserve has not made a compelling and transparent case for a qualitative objection to the capital plan of any banks. Qualitative issues are already addressed by supervisors as part of the normal, comprehensive bank examination process. The Federal Reserve should remove the qualitative objection in the stress test framework for all banks.

e. The mid-cycle company run stress test requirement should be eliminated immediately.

The Tailoring Proposals eliminate the mid-cycle company run stress tests for Category I, II, III, and IV banks, stating—

> In the Board's experience, the mandatory mid-cycle stress test has provided modest risk management benefits and limited incremental information to market participants beyond what the annual company-run stress test provides.

However, the Tailoring Proposals do not remove the mid-cycle stress until the 2020 cycle. We agree that the mid-cycle company run stress test provides little value. Similarly, the requirement to develop or run an "adverse" stress scenario has not provided meaningful risk management or supervisory benefits and should, consistent with EGRRCPA, be eliminated from the Agencies' DFAST rules. The Agencies' DFAST rules provide the Agencies' with sufficient authority and flexibility to provide relief from these requirements immediately.

f. A Category II firm should be subject to requirements that are tailored to address the specific risk that caused the firm to be identified as a Category II firm, and such firms therefore should not be subject, for example, to either the advanced approaches or the AOCI provision.

Currently there is only one institution that falls within Category II. This institution is a custody bank that has foreign liabilities (mostly operational deposits) that are offset mostly by safe short-term assets, captured within Category II as a result of the Tailoring Proposals' focus on cross-jurisdictional activity. The Agencies justify their focus on this factor by stating—

[9] U.S. Government Accountability Office. (2016, November), Additional Actions Could Help Ensure the Achievement of Stress Test Goals, Publication No. GAO-17-48, see at https://www.gao.gov/products/GAO-17-48.

> Cross-jurisdictional activity can affect the complexity of a firm and give rise to challenges that may complicate the resolution of such a firm if it were to fail. In particular, foreign operations and cross-border positions add operational complexity in normal times and complicate the ability of a firm to undergo an orderly resolution in times of stress, generating both safety and soundness and financial stability risks.

While we agree that cross-jurisdictional activity may make a resolution more complex, we believe enhanced resolution risk is more appropriately managed through the liquidity and resolution frameworks. Requiring Category II firms to be subject to the complex and redundant Advanced Approaches or mandating AOCI deductions from capital do not in any way further the goal of orderly liquidation.

g. Category III banks should be provided an opportunity to opt-out of the AOCI provision.

The current capital rules provide non-Advanced Approaches banks a onetime opportunity to opt-out of the requirement to include unrealized gains and losses (accumulated other comprehensive income or AOCI) in regulatory capital. Although the Tailoring Proposals intend to afford Category III banks the same relief, the mechanics of the opt-out are bounded by time (i.e., such a banking organization would have to have made its AOCI opt-out election in its Call Report or FR Y–9 filed for the first reporting period after the banking organization becomes subject to the final Basel III rules). For those banking organizations in Category III, that time would have passed already. We believe that this does not fully reflect the intent of the Agencies and should be corrected in a final rule.

IV. The Suite of Prudential Standards Should Be Reviewed

We encourage the Agencies, after finalizing the Tailoring Proposals, to continue to review how the current set of prudential standards can be improved. The review should include the Basel III liquidity standards, the amendments related to tailored resolution and capital plans that are referenced in the current proposals, as well as an ongoing effort to monitor and refine existing prudential standards. A valuable component of ongoing review would be a reassessment of domestic regulations that are based on international standards to identify aspects that are 'gold-plated,'[10] redundant,[11] or have disproportionate impact on U.S. banks.[12] Identified regulations should be reopened for comment. The Agencies should also continue taking steps to rationalize and clarify standards in other areas such as liquidity, board governance, Volcker Rule compliance, model risk management, and reporting and disclosure requirements.

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[10] For example, within the LCR the maturity mismatch add-on and the punitive treatment of operational deposits from non-regulated funds is not contemplated within the Basel agreement.

[11] For example, the countercyclical capital buffer is a case of how the Federal Reserve's efforts to be "Basel compliant" can lead to redundancy. The countercyclical capital buffer should be removed from the capital framework, because both the countercyclical capital buffer and the stress testing scenarios are intended to provide a countercyclical element of supervision.

[12] Certain aspects of how the U.S. has adopted Basel capital standards have had a disproportionate impact on U.S. banks. For example, the punitive treatment of AOCI for advance approaches banks and mortgage servicing assets generally are a result of unique accounting and market issues in the U.S.

Thank you very much for considering these issues. If the Agencies would like additional information regarding these comments, please contact Hugh Carney at (202) 663-5324.

Sincerely,

Hugh C. Carney
Vice President of Capital Policy
American Bankers Association