Federal Advisory Council

On May 11, 2012, the Federal Advisory Council met with the Board of Governors to discuss stress testing, including stress tests required by the Board's proposed rulemaking on enhanced prudential standards (Docket No. R-1438). The Council provided written comments, which are provided below.

Stress Tests:

> **What lessons do Council members draw from the results of the recently completed Comprehensive Capital Analysis and Review (CCAR) stress tests of the largest banks? What suggestions does the Council have to improve the CCAR and capital plan review process going forward?**

- In the February FAC meeting, the Council discussed the disclosure framework for CCAR and other stress testing requirements with the Board. The Council believes the Board subsequently struck the right balance with its approach to recent CCAR public disclosures, providing a perspective on bank performance under stress without creating unintended consequences or placing unnecessary focus on "baseline guidance." The Council believes that Section 165 stress test disclosures should be modeled after these successful CCAR disclosures, including the use of a template consistent with the information employed in CCAR and the disclosure of only severe stress scenario results.
- In that same spirit, we offer several recommendations today to ensure a more accurate and effective capital planning and management process, as CCAR evolves. The Council seeks significant enhancements in three key areas: 1) accuracy and rigor of modeling approaches; 2) openness of information exchange between banks and the Federal Reserve during the CCAR process; and 3) flexibility in capital plan management between CCAR exercises, as long as banks achieve target baseline and post-stress capital ratios.

High-Stakes Decisions with Imperfect Information

- The Council understands that the Federal Reserve does not want capital planning to become a mechanical compliance exercise or somehow have banks "game the system" or be perceived as doing so. We support the Federal Reserve's goal for a rigorous and balanced approach to CCAR and believe that the Federal Reserve and banks can work together to achieve one.
- The members, however, continue to have concerns about the uncertainty and confusion generated by the significant differences between the analysis utilized by the Federal Reserve in its CCAR models and that utilized by the participating banks in their own models. Those disparities place bank boards in a highly vulnerable position. Board members are literally compelled to "fly blind," in effect guessing about high-stakes capital distribution decisions that can tip the balance between the success of passing the CCAR and the market punishment associated with failure. Given these concerns, several members recommend that the Federal Reserve permit bank boards to adjust distribution plans prior to the determination of CCAR outcomes.
- A robust, accurate, and credible process is critical and will become even more so in the future as banks begin to publish summary results of their own, company-run stress tests. If

the Federal Reserve and banking institutions can converge toward more rigorous, clear, and accurate model assumptions, we can best avert the market confusion that could arise from the publication of widely differing supervisory and company stress test results.

Accuracy and Rigor of Modeling Approaches

- Increased modeling accuracy would reduce concerns about the lack of transparency in both the current Federal Reserve's models and the overall process. Based on the information available to banks, we believe that the Federal Reserve's CCAR models may rely on assumptions that are too general or simplistic. In some cases, the Federal Reserve's results were based on analytic or calculation errors that were material.
- *The Federal Reserve should ensure methodological completeness and consistency.* Here are some examples that appear to have been the experience for more than one of the participating banks:
    - The Federal Reserve's models, in many cases, produce higher losses than the banks' own models. However, when the Federal Reserve increased the losses in many portfolios, it did not decrease the amount of risk-weighted assets to reflect the higher losses in the stress scenario. At a minimum, each dollar of additional losses should directly reduce risk-weighted assets and, therefore, increase capital ratios due to the smaller denominator.
    - The Federal Reserve applied an effective tax rate of 35% to all of the participating banks. This approach ignored the very different tax rates that apply to different institutions in practice and the additional expenses used to achieve the lower rate.
    - Some banks' accounting practices capture recoveries expenses as an operating expense. The Federal Reserve's model, however, captured expenses relating to recovering charged-off debt in its net charge-off estimates. Because the Federal Reserve's model was not consistent with these banks' own accounting practices, recoveries expenses were double counted, leading to lower capital numbers.
    - Areas like these can be improved by refining models to capture the full complexity of tax and accounting issues and by averting key omissions.
- *The Federal Reserve should consider both industry-level models and banks' actual historical loss performance in order to properly credit (or penalize) differences in important bank-specific strategies and customer selection.* The Federal Reserve has alluded to the blunt estimates used by some banks for home prices and mortgage losses. Analogously, "generic" industry-wide models miss subtle but important distinctions among lenders and across portfolios and segments. In calculating stress scenario losses, the Federal Reserve relied on an industry-level model that accounted for many variables that differentiate performance but did not capture differences in important, bank-specific factors, such as customer selection, credit line assignment, account management, risk management, etc. Loans from different banks that would be scored identically by an industry-level model have been observed to consistently experience varying loss performance due to these bank-specific factors. These performance differences can be independently and objectively observed. Clearly, past performance is an imperfect predictor of future performance, but we believe that the Federal Reserve has the skills and tools to utilize bank-specific historical performance, applying appropriate conservatism.

- The Federal Reserve's one-size-fits-all approach may be appropriate for assessing the health of the industry in aggregate but is not appropriate when CCAR results are applied to individual banks in a pass/fail test. A broad-brush approach is arbitrarily punitive for some institutions or portfolios and arbitrarily favorable for others, but is inaccurate for both. It is also the case that using bank-specific assumptions, where appropriate, could result in *downward* adjustments to bank capital in some cases.

Dialogue between the Banks and the Federal Reserve

More open dialogue both before *and during* the CCAR process would enhance the accuracy, rigor, and credibility of the CCAR.

- We welcome the Federal Reserve's commitment to a CCAR-model symposium, which would permit a full two-way dialogue between the Federal Reserve and financial institutions. Banks have on staff great technical depth with access to rich institutional histories regarding credit loss and analysis. Banks may be best positioned to assess how loan portfolios will perform under extraordinary circumstances and in relation to other portfolios.
- More dialogue about complex tax and accounting treatments may disclose key issues that can be resolved prior to next year's CCAR.
- During the tests, the Federal Reserve should maintain an open line of communication. CCAR testing involves hundreds of variables and complexities for each institution. An open dialogue during the process can ensure that misunderstandings do not turn into major discrepancies.
- Several members recommend that the Federal Reserve permit bank boards to adjust distribution plans prior to the determination of CCAR outcomes. These members point out that capital distribution decisions are not static and that, in response to changed outcomes under the Federal Reserve's stress scenario, banks may appropriately wish to change their capital distribution decisions.

Ongoing Capital Plan Management

- The Council appreciates the rigor that CCAR contributes to companies' capital-planning processes. We understand that once the Federal Reserve has provided a notice of non-objection with respect to a capital plan, banks must manage to targeted baseline and post-stress capital levels and may not increase capital distributions, aside from limited exceptions provided in the capital plan rule. We believe, however, that *outside of increasing capital distributions*, it is in the best interest of the system to afford banks more flexibility with regard to particular capital actions, due to the dynamic nature of capital planning and capital markets and the fluidity of the underlying business, as long as the bank remains above its baseline and post-stress targets.
- We believe that the focus of banks and federal regulators should be on meeting target capital ratios, not on managing to specific capital actions reflected in a point-in-time capital plan with a nine-quarter planning horizon. For example, due to market or business changes, a bank may wish to alter or forego a planned capital raise as long as it remains above its target capital ratios, both in baseline and post-stress scenarios. Such changes should be subject to ongoing supervisory discussions, rather than requiring capital plan resubmissions. Resubmitting formal capital plans for any and all changes could hinder

efficient and effective capital planning and result in missed market opportunities, interfering with safety and soundness objectives.

Additional Recommendations

- *Timing* - To ensure the quality of the capital plan and related submissions, as well as a well-managed internal governance process, the Council recommends providing several more weeks for completion of CCAR and other supervisory stress tests. We recommend that supervisory scenarios and instructions be issued by October 15th to facilitate adequate planning and execution.
- *Regulatory Coordination* - The Council notes that in light of the proposed Dodd-Frank stress-testing rules from the Federal Reserve and other federal banking agencies, modeling approaches and information reporting requirements should be coordinated across the agencies.