Federal Advisory Council

On February 3, 2012, the Federal Advisory Council met with the Board of Governors to discuss the Board's proposed rulemaking concerning enhanced prudential supervision for large bank holding companies (Docket No. R-1438), including stress test requirements and the disclosure of stress test results. The Council provided written views, which are provided below.

Stress Testing

What is the Council's view on the proposals for stress tests, including the disclosure of stress test results?

Overview

The Council believes that regular stress testing is a critical and valuable aspect of ongoing risk management, capital planning, and supervisory oversight of all banks, large and small. The Supervisory Capital Assessment Program (SCAP) and Comprehensive Capital Analysis and Review (CCAR) 1.0 were both effective stress-testing exercises that bolstered confidence in the banking sector, supported improved risk and capital management, and enhanced the safety and soundness of the banking sector and individual banks. Appropriate disclosure of stress-testing results can help to achieve policy objectives by fostering transparency, market insight, and discipline.

The Council supports the policy objectives and most aspects of the proposed rule to expand and implement stress testing as an ongoing and integral part of bank risk management and supervision. However, we believe that the disclosure requirements of the proposed rule go well beyond the statutory mandate of the Dodd-Frank Act. Therefore, the requirements should be modified to ensure that policy objectives are achieved without creating market confusion or introducing unnecessary risks to the safety and soundness of individual banks and the banking sector as a whole. We also support minor modifications to the proposed rule to harmonize assumptions, processes, and disclosures across the various agencies charged with conducting stress tests.

Specifically the Council recommends that:

- The disclosures do not include expected results under the baseline scenario.
- The disclosures for the adverse and severely adverse scenarios be limited to summary- level disclosures for the cumulative nine-quarter period, rather than the details for each quarter end.

- The Federal Reserve increase the transparency to the banks of its analysis, modeling techniques, and assumptions used to analyze the banks under the supervisory stress tests.
- The disclosures be made at the times when banks are normally issuing their quarterly financial results.

Proposed Section 165 disclosure requirements essentially would result in the Federal Reserve and the banks giving forward-looking guidance over nine quarters, creating unnecessary and potentially significant safety and soundness risks.

- The proposed rule mandates detailed P&L disclosures for the nine-quarter period for baseline, adverse, and severely adverse scenarios. These disclosures are proposed to be on a quarterly basis by the Federal Reserve, and it is unclear whether the disclosures mandated for the banks are cumulative or for each quarter during the period. For institutions in excess of $50 billion in assets, the Federal Reserve will disclose the results of its annual stress tests and the institutions themselves are required to disclose twice a year the results of their company-run stress tests. Institutions with assets between $10 billion and $50 billion will be required to disclose company-run stress tests results annually.
- The level and specificity of disclosure for the baseline scenario is the equivalent of requiring banks, every six months, to provide earnings guidance and detailed P&L forecasts for the following nine quarters and would create significant and unnecessary risks for banks and the banking sector. These forward-looking statements would be used by investors to develop expectations regarding planned capital actions, key strategic initiatives, including M&A activity, and competitively sensitive business and product plans. In some cases, the institutions may be forced to disclose future plans either to dispel unreasonable expectations or to explain differences between the disclosures of the Federal Reserve and of the institution itself.
- Differences between actual results and the expectations set forth in the required baseline disclosures could create significant and unnecessary risks to the safety and soundness of banks and potentially lead to exposure to other liabilities. The required disclosures would become "checklists," and banks that failed to deliver short-term results consistent with the checklists could face significant volatility, spiraling negative perceptions and sentiment among investors and customers, and the sudden loss of liquidity from a loss of confidence among depositors and counterparties.

- These unnecessary risks are the primary reason that over the past two decades there has been a steady evolution away from providing EPS guidance, let alone the more detailed level of guidance and forward-looking statements required by the proposed rule.
- Furthermore, from a safety and soundness perspective, these required disclosures would likely compel the banks to prioritize the achievement of short-term results to meet checklist expectations over more appropriate longer-term risk management and sustained long-term results.
- The required disclosures could lead to confusion under the well-established current market disclosure framework and potentially result in liability under the securities laws. For example, disclosure of baseline scenarios – effectively forward-earnings guidance – may create a duty to update that guidance.
- The Council believes that the underlying public policy goal of providing transparency and market discipline around capital resilience under stress can be achieved without mandating that banks give specific P&L guidance under the baseline scenario.
- The Council strongly believes that the policy objectives of transparency and market discipline can be achieved by the summary level disclosure of *cumulative* impacts for the nine-quarter period under the adverse and severely adverse stress scenarios only (i.e., *not* for the baseline and *not* for each of the nine quarters). This recommendation applies to both the Federal Reserve and bank disclosures. Therefore, we strongly recommend that the proposed rule be revised to require only this level of disclosure by the Federal Reserve or the banks, rather than detailed quarterly P&L and capital expectations over all three scenarios. We recommend disclosure format, content, and level of detail similar to the successful disclosures provided in the SCAP process.
- Further, the Council recommends the gradual and thoughtful implementation of new disclosures of both company-run and Federal Reserve-run stress-test results. Because of the considerable risks and lack of precedent, initial disclosures (beginning with the disclosures the Federal Reserve may make in March 2012 in connection with CCAR 2.0) should focus on high-level, cumulative, summary information rather than detailed expectations and de facto guidance. Over time, as market participants become more familiar with stress testing and related disclosures, and as banks and supervisors build experience, expertise, and mutual understanding of one another's modeling and analysis, specificity and content of disclosures can be increased as appropriate. In contrast, reducing or pulling back from detailed disclosure

precedents in the event of unanticipated risks and consequences is likely to be much more difficult.

- Finally, we recommend that the Federal Reserve foster ongoing discussions with other bank regulatory agencies, OFR, SEC, and financial companies to identify all potentially unnecessary safety and soundness risks, as well as all significant considerations under securities law to ensure appropriate harmonization with well-established and proven existing disclosure expectations and obligations.

Disclosure of both supervisory and company-run stress tests must be harmonized to avoid potential confusion among investors, bank counterparties, depositors, and the public.

- Differences in assumptions and modeling across supervisory and company-run stress tests are very likely. Resulting market confusion potentially could undermine, rather than enhance, confidence in the banking sector. This may compel banks to explain the discrepancies, potentially adding further confusion and eroding confidence.
- Current CCAR practices and the proposed rule do not provide banks with sufficient transparency of supervisory modeling assumptions and analysis to facilitate appropriate understanding and ability to explain potentially different results.
- The Council recommends greater interaction between supervisors and banks as well as increased debriefing and lead time ahead of public disclosures to improve transparency and enable banks to provide appropriate explanations and communications with markets and investors.
- The Council also recommends that the Board consider what internal control and governance systems will be required within the Federal Reserve to support and ensure the accuracy of the Federal Reserve's ongoing disclosures. Robust internal controls and greater interaction between supervisors and banks could minimize the risk of market participants acting on potential errors. A Federal Reserve disclosure that contains errors could lead to a significant disruption in the market confidence of the impacted institution.

New disclosures required by the proposed rule will interact with an existing and well-tested disclosure regime. Coordination of the timing and sequencing of new and existing disclosures would improve transparency and facilitate greater understanding among market participants.

- Existing securities law and the timing of quarter-end and year-end reporting will impact banks' ability to appropriately communicate with markets

regarding new disclosures under the proposed rule. In short, SEC regulations prohibit the selective disclosure of material financial information (e.g. disclosing only selected items that might be misleading on their own rather than providing comprehensive financial disclosures). For this reason, most public companies restrict interactions between banks, analysts, and investors during "quiet periods," which generally begin two weeks before the end of each quarter and continue through the public earnings announcement (usually two to four weeks after the end of each quarter). Under the proposed rule, the Federal Reserve and banks would be required to provide disclosures that would likely be deemed selective disclosures during established quiet periods. Such timing would significantly impede banks' ability to fully communicate and explain disclosures that could, in turn, decrease transparency and diminish market participants' ability to understand the disclosed information. This issue would be exacerbated if the Federal Reserve chooses to publish baseline projections for each quarter-end in the planning horizon.

- The Council believes that modifications to the proposed timing of disclosures would fully support the policy objectives of enhanced disclosure without creating the difficulties and risks that could arise because of requirements and restrictions under existing securities law.
- The Council proposes allowing banks to have enough time to coordinate stress-test disclosures with disclosures of quarterly financial results.

While the Council believes that the proposed disclosures present the greatest risks to safety and soundness, we also have several recommendations for incremental improvements to the proposed rule to enhance the effectiveness and efficiency of the stress-testing process.

- *Improve transparency.* Increasing the direct interaction between banks and the modeling teams would help prevent misinterpretations. This is particularly important as the Federal Reserve's modeling results will be disclosed, which raises the stakes on modeling errors due to miscommunication or misunderstanding. Greater communication would also help the Federal Reserve better answer the question of how resilient a bank is versus how well it "took the test."
- *Ease operational burden from artificially compressed timelines.* Providing scenarios earlier would allow for more complete modeling and thoughtful responses. Alternatively, shifting the timeframe so that it does not overlap with holidays and end-of-year activities would also allow for higher quality output with less operational strain on institutions.

- *Jointly work with all stakeholders to develop "best practices."* Validating key approaches and assumptions with experts and then benchmarking them would lead to better outcomes and a safer system. For example, establishing an annual stress-test, best-practices conference or forum would allow banks and Federal Reserve modelers to learn from each other and converge on best practices and common assumptions. This knowledge sharing would lead to new insights, better answers, and a continuous refinement of approaches.
- *Coordinate across the regulatory community.* Aligning stress-test procedures and assumptions across the Federal Reserve, OCC, and FDIC will ensure that holding companies and bank subsidiaries are subject to a consistent set of requirements. There are also opportunities to leverage existing regulatory data repositories where available and to coordinate with the FDIC with respect to how stress tests are leveraged with required resolution and recovery plans. Finally, regulators should consider ways to tailor stress-testing requirements to lessen the impact on smaller institutions when appropriate.

Strengthening Regulation and Supervision of Large Bank Holding Companies

(A) Risk-based capital, leverage, and early remediation

i. *Risk-based capital and leverage requirements*
What is the Council's view on the proposals for risk-based capital and leverage requirements?

While we are supportive of the overall framework of risk-based capital and leverage requirements in order to promote and enhance systemic stability, the Council does have concerns with specific requirements and their implementation:

- The rules should be consistent across nonbank covered companies and jurisdictions to ensure a level playing field and prevent the risk from shifting from regulated U.S. banks to the shadow banking system, different jurisdictions, or financial institutions regulated under different regulatory structure.
    - In addition, the impact of mandated capital thresholds that vary by global significance may have uncertain implications including, perversely, funneling wholesale and retail deposits toward the GSIBs at the expense of non-GSIBs and even more so to non-covered banks.
- There continues to be the need to calibrate capital methodologies and risk weightings to balance market stabilization and economic growth:

- Procyclicality of the framework could inadvertently create a bias favoring the "haves" and disadvantaging the "have-nots" disproportionately to their underlying risk.
- The liquidity proposal encourages covered companies to hold large amounts of sovereign debt (as "low risk" assets), while the credit requirement forces additional capital charges on that same sovereign debt, reducing banks' private-sector lending capacity.
- Infrastructure, project, and trade-finance risk weightings and leverage-ratio requirements make these activities less likely. This may be particularly important as European banks deleverage.

- The inclusion of Other Comprehensive Income (OCI) will require that the after-tax unrealized losses on banks' Available For Sale (AFS) securities portfolio reduce a bank's tier 1 capital dollar for dollar. This may result in meaningful volatility in capital and may require banks to hold additional buffers. While this affects all banks, it may have a disproportionate impact on custody and community banks since they hold a meaningful portion of their balance sheets in high-quality investment securities.
  - While banks can respond by moving securities into Held-to-Maturity (HTM) status, which allows them to avoid marking to market these securities, this may overly reduce liquidity at a time when Basel introduces new liquidity requirements.
  - As a result of a diminishing pool of asset classes available to them, as well as the need to hedge deposits, community and midsized banks rely on high-quality bond portfolios as a significant earning asset class. Counting OCI as capital effectively increases the capital requirement and potentially increases the incentive to hold higher risk (and therefore higher-return) securities on the balance sheet instead of current medium- and long-term Treasuries, mortgage-backed securities, and municipals. One suggestion is to weight OCI by the risk weightings currently assigned to the securities which give rise to it (just as various credit risk weightings for different asset classes have been used in Basel for years) or eliminate it altogether.
- The Council notes the importance of ensuring proportionality in the capital planning process and believe that components of the Basel Committee on Banking Supervision capital surcharge framework do not properly measure the systemic riskiness of a company, appear to provide equal weight to size and risk, and do not reflect differences in business models and activities:
  - The proposed methodology aggregates cross-jurisdictional assets and liabilities, double counting the footprint of a bank, when in fact a locally

matched balance sheet is inherently less risky and less systemically disruptive upon failure.
  - Under the proposed methodology, banks could collectively reduce their systemic importance and yet not reduce the capital surcharge applicable to them.
  - Many of the services provided by GSIBs (e.g., deposit taking, lending, and underwriting) are in competitive markets with substitutes at minimal switching costs. Such services should have a much smaller significance as an indicator for a GSIB's systemic riskiness. Furthermore, the proposal does not give credit for local subsidiaries ring-fenced by local regulators.
  - The proposal creates the incentive to concentrate activities and assets that are not penalized under the methodology, thereby creating a "herding behavior" and amplifying the potential for systemic disruptions (e.g. encourages concentration in shorter-term and higher-quality credit assets, meaning qualified borrowers will be incented to borrow on a short-term basis).

- Other concerns:
  - The proposal is silent on the topic of the Basel SIFI surcharge. We believe this reflects the need for a common understanding and acceptance among regulators and market participants.
  - Tier 1 common is a more conservative definition of capital than tier 1 capital, yet the threshold of "well capitalized" for the first is set at 5% while the other is at 4%. A bank holding company would breach the first well before the second.
- While the leverage ratio provides a good foundational backstop to prevent over leveraging, it is restrictive at 15:1 and could incent banks with low-risk strategies to migrate their strategies out the risk curve away from the institution's core competencies where they have less experience.

ii. *Early remediation requirements*

What is the Council's view on the proposals for early remediation requirements?

Main comments

- The Council strongly supports a principles-based remediation regime that strengthens troubled institutions.

- Banks and nonbanks should compete on a level playing field. Therefore, consideration should be given to having the FSOC identify at least a first set of nonbanks that will be subject to the early remediation framework before it becomes effective.
- Level 1 Heightened Supervisory Review, as proposed, is highly discretionary. We believe it should be based on an institution's CAMEL rating (or a CAMEL-like rating for institutions where CAMEL ratings do not apply), where a CAMEL rating of 3 should correspond to Level 1 designation. This will avoid applying the designation in a "hair trigger" fashion. The Federal Reserve should confirm that a Level 1 determination would remain confidential supervisory information and not be disclosed. The Federal Reserve should also consider whether the Level 1 threshold encompasses certain matters best addressed via the existing day-to-day supervisory process.
- The early remediation framework should generally serve to augment existing prompt corrective action standards and processes, rather than as a means of promoting industry reorganization.
- Level 2 Initial Remediation should not require regulators, as the proposal currently does, to take all remedial actions specified but instead give them the flexibility to choose among remedial actions as appropriate and act with a proportional response to particular circumstances. It should be emphasized that no "one size fits all" remediation structure should ever be substituted for sound regulatory judgment.
- While market indicators are an appropriate tool for the regulators to consider, specific numerical triggers should be avoided to prevent potential market manipulation. Market indicators in Level 1 Heightened Supervisory Review in particular should not be viewed in a vacuum as they may not necessarily indicate an institution is under duress.
- The impact of the remediation is uncertain, but when combined with capital volatility, it may trigger unnecessary actions during times of rapidly increasing interest rates.
- The stress test standard in Level 2 Initial Remediation should apply only if an institution falls below the 5% common ratio in three consecutive quarters or 4.5% in one quarter (with a demonstrated inability to reach 4.75% in the next quarter).
- The current triggers refer to Basel I standards for well- and adequately capitalized definitions. It is critical that these triggers, once reissued under

Basel III's significantly higher capital requirements and accompanying buffers, continue to be calibrated at levels consistent with those currently contemplated under the existing framework (therefore, the cutoff for what is considered well-capitalized should be well below 7%).

- A dynamic process should identify a clear path that allows institutions to exit from remediation status as quickly as possible when conditions improve.
- Implementation will be time consuming and costly for institutions of all sizes.

Additional comments

- The early remediation requirements allow broad regulatory discretion ranging from heightened supervision to a recommendation that an orderly liquidation authority be invoked. This may result in significant market confusion and uncertainty during crisis periods.
- Early regulatory intervention, including any breach of triggers or mandatory actions, should be treated as confidential supervisory information. Public disclosure of early regulatory intervention could exacerbate or hasten the failure of a distressed institution.
- Early remediation regimes, triggers, and requirements employed by different regulatory agencies should be harmonized to avoid incongruous outcomes.
- It is unclear whether the framework will hinder the ability of a bank holding company to ensure the safety and soundness of an insured depository subsidiary and how the framework will integrate with the FDIC's prompt corrective action framework for subsidiary depository institutions.
- The proposal would be improved by further direction on the meaning of "signs of weakness" and "multiple deficiencies" in the triggers in order to offer guidance to banks and help ensure consistent treatment while maintaining supervisory discretion.

(B) Liquidity and credit limits

i. *Liquidity requirements*

What is the Council's view on the proposals for liquidity requirements?

- Members generally welcome the liquidity requirements proposed by the Federal Reserve and believe that they represent a considerable improvement over the more prescriptive and risk-insensitive Basel III approach. It was noted that the industry has made significant strides in improving the

management of liquidity risk and that the Federal Reserve's approach reflects, in many respects, current "best practices." Also, the intended approach is likely to prove effective in addressing weaknesses in liquidity management standards that may serve to exacerbate financial crises.

- Members expressed particular support for the Federal Reserve's approach to defining assets eligible for inclusion in the required liquidity buffer. This includes the incorporation of both agency MBS and other high-quality assets that meet certain specified criteria. Some members expressed the view that FHLB advances should also be included as a source of contingent funding.
- Many members expressed the view that the Basel III LCR incorporates overly severe draw-down and run-off assumptions. This includes the treatment of committed facilities to collective investment funds and municipal entities, as well as middle-market, non-operating deposits. Therefore, they welcome the Federal Reserve's emphasis on the use of internal stress testing, informed by each firm's particular activities, exposures, and risks.
- Some members expressed concern regarding the significant operational and compliance burdens associated with the Federal Reserve's approach and noted the importance of weighing expected benefits with likely costs. This includes significantly greater reporting, analysis, and documentation requirements, as well as further integration of liquidity-risk-management processes into balance-sheet forecasting. Further, it was emphasized that the intended governance requirements are highly prescriptive and may impose burdensome new obligations on board of directors that may more appropriately be undertaken by senior management.
- Members expressed concern about a level playing field. There should be consistency between the Federal Reserve and Basel III liquidity requirements, and therefore, U.S. supervisors are encouraged to work with their international peers to address limitations in the current Basel III approach. This includes a more proportional framework for defining eligible high-quality liquid assets and better calibration of net cash outflows.
- One member expressed concerns that regulators may over time seek to create a GSIFI-like adjustment for the liquidity buffer, which may deviate from a predominantly quantitative approach.

ii. *Single-counterparty credit limits*

What is the Council's view on the proposals for single-counterparty credit limits?

Overall Comments

- Members broadly support the policy goal of limiting excessive amounts of credit concentration within the financial system. They also generally support the development and use of robust processes for the measurement of aggregate counterparty credit exposure on an enterprise-wide basis.
- Some members are concerned that the Federal Reserve's intended approach lacks risk sensitivity and that there is insufficient information regarding the potential impact of the rule on market liquidity and credit availability. The Council recommends a thorough impact assessment, along with attempts to align the rule as closely as possible with prevailing market standards.
- Members expressed broad concerns regarding the significant operational and compliance obligations inherent in the Federal Reserve's approach, including substantial information technology expenditures. This may require an extended implementation timeline for some aspects of the rule.

Specific Issues

- Several members strongly urge the Federal Reserve to expand the scope of its proposed U.S. sovereign exemption to include high-quality foreign obligors, notably central banks. In addition, some members expressed concern that the intended definition of single counterparty for state and local obligations is too broad, covering exposures that are more accurately assessed on a non-aggregated basis. One member suggested that state and local exposures should also benefit from an exemption.
- Members noted inconsistencies in the methodology for measuring credit exposure in the Federal Reserve's proposal compared to existing regulatory requirements and industry practice and expressed support for the optional use of regulator-approved internal models as an alternative to a "look up" table approach.
- Members raised specific concerns regarding the treatment of bank-owned life insurance/corporate-owned life insurance policies, the "cliff effect" of the 10% limit between the largest firms and the need for clarifications to ensure that the limits do not conflict with banks' increasing role in the Dodd-Frank Act-mandated central clearing of derivatives.
- One member is concerned that certain aspects of the Federal Reserve's proposed rule, such as credit extended in connection with payment, clearing, and settlement functions or in connection with indemnified securities lending, could limit the ability of firms to support financial transactions undertaken in the normal course of business to facilitate routine, day-to-day investment-related activities on behalf of investors.

- Members have concerns with the complexity of the proposal, including specific concerns with the requirement to count posted collateral as credit exposure to the issuer, the "attribution rule" requirement to track and count possible indirect credit exposures through third parties, and the requirement to access data from nonconsolidated entities that trigger the "control" test.