The voice of banking
& financial services

British Bankers' Association response to the Federal Reserve Board consultation 'Enhanced Prudential Standard and early Remediation Requirements for Covered Companies'[1]

Introduction

The British Bankers' Association ("BBA") is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 220 banking members from 60 countries on the full range of the UK and international banking issues. All the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

The BBA is pleased to the Board's consultation. But we have not addressed the sections relating to scope or single-counterparty credit exposure limits believing that they are still the subject of ongoing work, either by the Financial Stability Board or the Basel Committee on Banking Supervision. An internationally harmonised approach to these issues is imperative. Failure to take such an approach risks impairing the potency of the enhanced international regime, creating unwelcome incremental costs for the banking industry and opens up the possibility of regulatory arbitrage.

Questions 7 to 9 - Risk-based capital and leverage

Question 7: *How should the Board implement the BCBS framework discussed above, or are there alternatives to the BCBS framework the Board should consider?*

Our members believe that the BCBS G-SIFI surcharge should be implemented around the world in an internationally aligned way, just as we expect the Basel III more capital, more liquidity proposals to be.

Not to do so would potentially result in an unlevel playing field, likely result in extra costs for our members, reduce the potency of the finalised Basel framework and open up the possibility of regulatory arbitrage.

Question 8: *What is the appropriate scope of application of a quantitative capital surcharge in the United States in light of section 165 of the Dodd-Frank Act? What adaptations to the BCBS framework, or alternative surcharge assessment methodologies, would be appropriate for determining a quantitative capital surcharge for covered companies that are not identified as global systemically important banks in the BCBS framework?*

We are aware that the international authorities are currently examining the way in which the banks that are not G-SIBs but that nonetheless could be classified as

[1] http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20111220a1.pdf

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regional SIBs should be required to hold additional regulatory capital above the regulatory minimum. Although the negative impact of inconsistent implementation may be somewhat less we recommend that internationally agreed approaches to non G-SIBs be adhered to.

Question 9: *If the BCBS framework were to be applied to nonbank covered companies, how should the framework be modified to capture the systemic footprint of those companies?*

We support the application of similar capital requirements to similar risks, regardless of the type of entity that is taking them. We are aware that the FSB's work on 'shadow banking' is ongoing but expected to be largely completed by the end of 2012. so if there is international agreement that capital surcharges should be applied to non bank systemically important companies it should be adopted in the US in a way that is aligned with internationally agreed approaches.

Questions 10 to 19 - Liquidity

We welcome the strengthening of standards, including qualitative, and note the statement that standards may be bespoke. An element of proportionality is welcome.

Question 10: *Is the Board's approach to enhanced liquidity standards for covered companies appropriate? Why or why not?*

We find the approach comprehensive and balanced.

An idea of regulatory expectations with regard to materiality (in terms of legal entities, currencies and lines of business) would be helpful.

Question 11: Are there other approaches that would effectively enhance liquidity standards for covered companies? If so, provide detailed examples and explanations.

We cannot think of any other approach. The alignment with Basel is sensible.

Question 12: *The Dodd-Frank Act contemplates additional enhanced prudential standards, including a limit on short-term debt. Should the Board adopt a short-term debt limit in addition to or in place of the LCR and NSFR? Discuss why or why not?*

There are other metrics in addition to the LCR and NSFR that ought to be considered.

A concern is that there is an emphasis on the LCR which, on its own, is an imperfect measure of a bank's liquidity position, for example it

- Measures the cumulative position at day 30, not at all days during the 30 day horizon – this is also a problem with the Basel QIS
- Takes no account of depositor concentration
- Takes no account of the size - for example, a bank's 40% LCR with net outflow of USD10m requires USD6m additional liquid assets compared with another bank with a 40% LCR and net outflow of USD50bn requiring USD30bn more liquid assets. If the total balance sheet of bank 1 is USD100bn, the required additional liquid assets might be easy to achieve

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whereas bank 2 with a balance sheet of, say, USD100bn has a much bigger challenge.

Question 13: *What challenges will covered companies face in formulating and implementing liquidity stress testing described in the proposed rule? What changes, if any, should be made to the proposed liquidity stress testing requirements (including the stress scenario requirements and required assumptions) to ensure that analyses of the stress testing will provide useful information for the management of a covered company's liquidity risk? What alternatives to the proposed liquidity stress testing requirements, including the stress scenario requirements and required assumptions, should the Board consider? What additional parameters for the liquidity stress tests should the Board consider defining?*

The approach to stress testing is about right. There should be a mix of qualitative and quantitative elements. Mitigating action should be commensurate with the nature, scale and complexity of the firm.

Question 14: *The Board requests comment on all aspects of the proposed definitions of "highly liquid assets" and "unencumbered." What, if any, other assets should be specifically listed in the definition of highly liquid assets? Why should these other assets be included (that is, describe how the asset is easily and immediately convertible into cash with little or no loss in value during liquidity stress events)? Are the criteria for identifying additional assets for inclusion in the definition of highly liquid assets appropriate? If not, how and why should the Board revise the criteria?*

We do not believe that a prescriptive definition is desirable. A principles-based approach and perhaps a list of assets, complete with ISINs, eligible at central banks may be more appropriate.

Any qualitative approach to defining a liquid asset is open to differing interpretations by different banks. To avoid such differences, it may therefore be more straightforward for the authorities to draw up and maintain a list of eligible by assets (by ISIN). We do not find this a particularly attractive option, but can see no other way around the interpretation problem.

Question 15: *What changes, if any, should the Board make to the proposed definition of unencumbered to make sure that assets in the buffer will be readily available at all times to meet a covered company's liquidity needs? The rule would require a covered company to discount the fair market value of assets that are included in the liquidity buffer. Please describe the process that covered company will use to determine the amount of the discount.*

We remark that governance processes exist to ensure that the liquid assets are controlled by a liquidity management function.

Question 16: *Are the proposed CFP requirements appropriate for all covered companies? What alternative approaches to the CFP requirements outlined above should the Board consider? If not, how should the Board amend the requirements to make them appropriate for any covered company? Are there additional modifications the Board should make to the proposed rule to enhance the ability of a covered company to comply with the CFP and establish a viable and effective plan for the management of liquidity stress events?*

The proposal is balanced and allows for differences in business model. We can't

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think of any other approach.

Question 17: *Should covered companies be required to establish and maintain limits on other potential sources of liquidity risk in addition to the three specific sources listed in the proposed rule? If so, identify these additional sources of liquidity risk.*

We do not believe that it is necessary to impose further limits.

Metrics for measuring, managing and controlling a covered company's liquidity position will be dependent upon the business model of the covered company. There is a problem, therefore, with the regulators setting out a one-size fits all approach, both in terms of which metrics to use and in terms of the limits associated therewith. Over concentration on the regulatory metrics could lead to management and boards being distracted from the most appropriate metrics to their business. It would be better to leave such decisions to the covered company to justify on a comply or explain basis when they draw up their own liquidity adequacy assessments

Question 18: *Should the Board require a covered company to monitor other areas of liquidity risk in addition to collateral positions, risk across entities, currencies, and business lines, and intraday liquidity positions? If so, what areas should be added to the list and why?*

The Board has the power to extend monitoring, which can be exercised in an emergency. This is to be expected.

Other metrics might include:

- Mismatch ladders, daily out to 3 months, weekly to 6 months, monthly to 1 year and annual thereafter
- Concentration of funding sources by counterparty, instrument and business lines

Question 19: *The Board requests comment on all aspects of the proposed rule. Specifically, what aspects of the proposed rule present implementation challenges and why? What alternative approaches to liquidity risk management should the Board consider? Are the liquidity management requirements of this proposal too specific or too narrowly defined? If, so explain how. Responses should be detailed as to the nature and impact of these challenges and should address whether the Board should consider implementing transitional arrangements in the rule to address these challenges.*

The challenges are in differences that emerge with other jurisdictions' approaches to cross-border banks and the implementation thereof.

For internationally active banks, one clear problem is the multitude of differing formats of reporting that they are required to complete by jurisdiction. We would encourage regulators to harmonise reporting formats as much as possible. This will make international comparisons easier.

We would ask regulators to use the apparently large variation in the Basel QIS interpretations to get feedback from covered banks on what additional assumptions they have used to complete their returns. If international metrics are to be used, then this information can then be used to design internationally consistent metrics with less scope for local interpretation.

The G20 agreed to ask the Basel Committee for a liquidity measure (or measures) that could be used internationally, and the LCR and NSFR have therefore been designed to set out the regulators liquidity risk appetite. We would be concerned if the US were not to adopt the measures whilst others do as it may destroy the aims of the G20 approach. If the US authorities do not believe the Basel measures (as set out in BCBS 188) are appropriate, then it would be better to redesign the international measures.

Questions 61 to 69 - Risk management

Question 61: *Should the Board consider specifying by regulation additional qualifications for director independence? If so, what factors should the Board consider in establishing these qualifications?*

Question 62: *Would it be appropriate for the Board to require the membership of a risk committee to include more than one independent director under certain circumstances? If so, what factors should the Board consider in establishing these requirements?*

Question 63: *Should the Board consider specifying by regulation the minimum qualifications, including educational attainment and professional experience, for risk management expertise on a risk committee?*

We do not believe that the Board should consider requiring additional qualifications for director independence, or indeed minimum educational attainment or professional experience in relation to the independent director appointed as chair of the risk committee.

However the Board may consider that it would be appropriate for it to interview potential candidates to ensure they do indeed have the necessary competency, including the ability to robustly challenge other members of the risk committee or executive board members as well as the ability to devote sufficient time to this important role.
We do not consider it appropriate that the Board should mandate that there should be more than one independent director on the Board. This decision should be left to the Board of the covered company.

Question 64: *What alternatives to the requirements for the structure of the risk committee and related requirements should the Board consider?*

We believe that the proposed structure of the risk committee is appropriate and that only in exceptional circumstances should variants be permitted, and only then after express discussion with the Board.

Question 65: *What is the appropriate role of the members of the risk committee in overseeing enterprise wide risk management practices at the company and is that role effectively addressed by this proposal?*

The role of the risk committee should not be to establish the covered company's risk appetite but to provide high level oversight to ensure that adequate systems and controls are in place and embedded within the company's risk culture that enable the board to monitor to risk profile of the covered company against its stated risk appetite.

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The independent chair of the risk committee should also provide a confidential sounding board for senior executives, in particular the chief risk officer, providing them with the opportunity to raise issues of concern if necessary.

Question 66: *Is the scope of review of enterprise-wide risk management that this proposal would require appropriate for a committee of the board of directors? Why or why not?*

Yes, we believe the scope of the enterprise wide risk management practice is appropriate for a committee of the board of directors. We agree with the Board's analysis that those banks whose most senior management were involved in the setting of risk appetite and were actively engaged in the oversight of risk management policies systems and controls were able to weather the global financial crisis better.

We firmly believe that a culture of risk awareness and management should be embedded throughout the bank; the best way to achieve this is by ensuring that such a risk culture is set at the very highest levels within the bank and that all employees are expected to abide by the good risk management practices that have been established.

Question 67: *How can the Board ensure that risk committees at companies have sufficient resources to effectively carry out the oversight role described in this proposal?*

We would expect that the Board of Directors of the covered company would recognise the need from time to time for the risk committee, and indeed all independent directors to call upon external, for instance, consultancy resources to aid them in their oversight of risk management procedures and that no unreasonable request for such assistance should be refused. We would expect the ability of the risk committee to call upon external resources as and when required to be included in its terms of reference.

Question 68: Should the Board consider specifying by regulation the minimum qualifications, including educational attainment and professional experience, for a CRO? If so, what type of additional experience or education is generally expected in the industry for positions of this importance?

We do not consider the Chief Risk Officer role-holder should be required to hold specific educational or professional requirements.

However we do note the Board's recommendation that the CRO should report directly to the risk committee and the executive committee. We believe it is most important that the CRO has a direct report, and unfettered access to the independent director chairing the risk committee but do not believe it should be an absolute requirement that s/he should report to the chief executive.

Question 69: *What alternative approaches to implementing the risk committee requirements established pursuant to the Dodd-Frank Act should the Board consider?*

We believe that the Board's recommendations in relation to the risk committee are sufficiently comprehensive but sufficient flexibility afforded by its recognition of the principle of proportionality to obviate the need for alternative approaches.

Questions 70 to 69 - Stress Tests

Question 70: Are the timing requirements of this proposal sufficient to allow a covered company or nonbank covered company to prepare, collect, and submit to the Board the information necessary to support the supervisory stress test? If not, what alternative timing should the Board consider?

The time frame is reasonable.

Question 71: What is the potential burden on covered companies stemming from the requirements to submit internal data to support the supervisory stress tests?

Such data will have to be put in the appropriate format, which may take some time.

Question 72: What alternative models or methodologies for estimating a covered company's losses and revenues should the Board consider?

We feel that these models are satisfactory.

Question 73: What are the benefits and drawbacks associated with company-specific disclosures? What, if any, company-specific items relating to the supervisory stress tests would present challenges or raise issues if disclosed, and what is the nature of those challenges or issues? What specific concerns about the possible release of a company's proprietary information exist? What alternatives to the company-specific disclosures being proposed should the Board consider?

Disclosure should be in such a way as to protect the company's sensitive information and avoid a run.

Question 74: What alternative to the public disclosure requirements of the proposed rule should the Board consider? What are the potential consequences of the proposed public disclosures of the company-run stress test results?

The current system is fit for purpose.

Question 75: Is the proposed timing of stress testing appropriate, and why? If not, what alternatives would be more appropriate? What, if any, specific challenges exist with respect to the proposed steps and timeframes? What specific alternatives exist to address these challenges that still allow the Board to meet its statutory requirements? Please comment on the use of the "as of" date of September 30 (and March 31 for additional stress tests), the January 5 reporting date (and July 5 for additional stress test) the publication date, and the sufficiency of time for completion of the stress tests.

There is enough notice for firms to marshal their resources.

Question 76: Does the immediate effectiveness of the proposed rule provide sufficient time for an institution that is covered at the effective date of the rule to conduct its first annual stress test? Would over $10 billion companies, in particular, have sufficient time to prepare for the first annual stress test, under either the proposed initial or proposed ongoing applicability rules?

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The time frame is reasonable.

Questions 78 to 95 - Early remediation

Question 78: *The Board recognizes that liquidity ratios can provide an early indication of difficulties at a covered company and seeks comment on the costs and benefits of including a quantitative liquidity trigger in the early remediation regime. If the Board were to include a quantitative liquidity trigger in the regime, what quantitative liquidity trigger should be used and how should it be calibrated?*

We believe that, as liquidity can be ephemeral and dependent on market conditions quantitative liquidity triggers would be inappropriate. Rather the Board should have the ability to closely monitor a covered company's liquidity position and be able to assess it in the context of current market conditions and the liquidity positions of the covered company's peer group.

Question 79: *The Board also seeks comment on the value of including balance sheet measures, such as nonperforming loans and loan concentrations, in the early remediation regime as triggers. What balance sheet measures, if any, should the Board include, and how should they be calibrated?*

We agree that balance sheet measures of the sort summarised in Tables 4 and 5 should be taken into account as the Board but counsel against their specific inclusion as triggers. In the sensitive process of ensuring a bank does not tip into resolution there will need to be an element of informed judgement involved, particularly of the covered company's recovery plan, which it should remain the responsibility of a management team appointed by the shareholders to implement.

Question 80: *The Board seeks comment on the proposed mandatory actions that would occur at each level of remediation. What, if any, additional or different restrictions should the Board impose on distressed covered companies?*

We broadly agree with the mandatory actions proposed by the Board that it would require a covered company to undertake as it progressed deeper into the remediation process. The imposition of additional restrictions, particularly if applied differentially to different covered companies would reduce the authorities' flexibility of response which we believe if necessary when dealing with a failing bank.

Question 81: *The Board seeks comment on the proposed risk-based capital and leverage triggers. What alternative or additional risk-based capital or leverage triggering events, if any, should the Board adopt? Provide a detailed explanation of such alternative triggering events with supporting data.*

Whilst we understand that the US Prompt Corrective Action regime is built around hard triggers of the type described we would prefer to characterise the proposed trigger as early warning signals (rather than hard triggers) that will catalyse further discussion. We believe the latitude that our preferred approach of viewing quantitative metrics as triggers for discussion, rather than triggers for action is particularly relevant to g-SIBs

Question 82: *What additional factors should the Board consider when incorporating stress test results into the early remediation framework? Is the severely adverse scenario appropriately incorporated as a triggering event? Why or why not?*

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We fully support the use of forward looking stress testing on a consolidated basis. These tests are used to identify the post-stress capital positions but as the Board recognises they are standardised across all covered companies and based on particular scenario(s) which play out over a period of time. It may be that some covered companies may be more susceptible, depending on their business model to a jump to default failure as opposed to a slow burn one so the rapidity with which a covered company could progress to level 4 must be taken into account.
Question 83: *The Board seeks comment on triggers tied to risk management weaknesses. Should the Board consider specific risk management triggers tied to particular events? If so, what might such triggers involve? How should failure to promptly address material risk management weaknesses be addressed by the early remediation regime? Under such circumstances, should companies be moved to progressively more stringent levels of remediation, or are other actions more appropriate? Provide a detailed explanation.*

We agree with the Board that a covered company with weak risk management systems and controls should be required to improve them or otherwise face the threat of the imposition of remediation tools. However in many cases it will not be able to swiftly introduce the required improvements so we believe that the covered company and the Board should agree to a pragmatic implementation programme over a realistic but tight timetable with additional sanctions only being introduced if it becomes apparent that the company is materially deviating from it.

Question 84: *The Board seeks comment on the proposed approach to market-based triggers detailed below, alternative specifications of market-based indicators, and the potential benefits and challenges of introducing additional market-based triggers for levels 2, 3, or 4 of the proposed early remediation regime. In addition, the Board seeks comment on the sufficiency of information content in market-based indicators generally.*

Question 85: *Should the Board include market indicators described above in the early remediation regime? If not, what other forward-looking indicators should the Board include?*

Question 86: *Are the indicators outlined above the correct set of indicators to consider? Should other market-based triggers be considered?*

As we have cautioned above the strict use of triggers, be they based on regulatory or market based metrics should be approached with caution, in part because of the risk of them becoming a self-fulfilling proposition.

We prefer that the proposed triggers, particularly in the early stage of the remediation process, are viewed as stimuli fro increasingly robust discussions with management, who are still answerable to shareholders and responsible for running the covered company

Question 87: *How should the Board consider the liquidity of an underlying security when it chooses indicators?*

A number of metrics could be considered as being indicative of degrees of liquidity, including, bid-offer spread, number of market maker quoting firm, prices changes in daily traded volumes (based on information available from a global trade depository) and price volatility although it is of course unlikely that any one of thee metrics will perfectly explain liquidity premia.

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Question 88: *The Board proposes using both absolute levels and changes in indicators. Over what period should changes be calculated?*

We support the use of trend based information which we believe is likely to provide a better indication of market perception that point-in-time data.

As liquidity conditions can change very quickly we would encourage the Board to look for rapidly developing micro bursts within the storm system as these are likely to be the most damaging.

Question 89: *Should the Board use both time-variant and time-invariant indicators? What are the comparative advantages of using one or the other?*

Question 90: *Is the proposed trigger time (when the median value over a period of 22 consecutive business days crosses the predetermined threshold) to trigger heightened supervisory review appropriate? What periods should be considered and why?*

Question 91: *Should the Board use a statistical threshold to trigger heightened supervisory review or some other framework?*

Both time-variant and time-invariant based triggers may be useful as indicators but we caution against creating an over-engineered system to calculate the relevant thresholds – supervisory judgement based on good market intelligence of which market indicators can be one useful component, will always be necessary.

Question 92: *Should the Board consider using market indicators to move covered companies directly to level 2 (initial remediation)? If so, what time thresholds should be considered for such a trigger? What would be the drawbacks of such a second trigger?*

We do not believe the movement of a covered company to level 2 should be based solely on market triggers – which will just be one of a number of factors in the decision process. Even entry into initial remediation will have a significant impact (as we recognise it its designed to do) on the way a covered company operates. Such a decision should not be taken mechanistically.

Question 93: *To what extent do these indicators convey different information about the short-term and long-term performance of covered companies that should be taken into account for the supervisory review?*

Both sets of indicators, long and short term, should have a bearing on supervisory decisions but we suspect that the most damaging types of failure will come out of left field suggesting that short term indicators should be more highly weighted in the decisions process.

Question 94: *Should the Board use peer comparisons to trigger heightened supervisory review? If so, should the Board consider only low-risk covered companies for the peer group or a broader range of financial companies? If a broader a range is more appropriate, how should the peer group be defined?*

The objective of the Board's rule is to reduce the perception that some financial institutions, not just banks, are too big to fail in order to ensure that never again

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should tax payer funding be used to bail-out a failing institution. We fully support this objective and therefore believe that peer group review should be based on a broader range of financial companies identified by the type of activity they undertake rather than regulatory classification. We are aware that the Financial Stability Board is continuing to address this through its analysis of the shadow banking system and counsel that the Board's eventual approach should be informed by the results of the FSB's work.

Question 95: *How should the Board account for overall market movements in order to isolate idiosyncratic risk of covered companies?*

We have no views to offer in relation to this question.

Please do contact the following responsible executives if you have any questions arising from our response.

Risk-based capital, risk management and early remediation

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Liquidity and stress testing

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