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MID-SIZE BANK COALITION OF AMERICA

April 30, 2012

Jennifer J. Johnson
Secretary

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, DC 20551

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies Docket No. 1438; RIN 7100-AD-86

Ladies and Gentlemen:

On behalf of the Midsize Bank Coalition of America ("MBCA"), I am writing to provide the MBCA's comments on the above-referenced notice of proposed rulemaking ("Proposal") published by the Board of Governors of the Federal Reserve System ("Board" or "FRB") on January 5, 2012.[1] Specifically, the MBCA is commenting on the annual stress test and risk committee requirements in the Proposal that would apply to midsize banks and their holding companies.

By way of background, the MBCA is a non-partisan financial and economic policy organization comprising the CEOs of mid-size banks doing business in the United States. Founded in 2010, the MBCA, now with 28 members, was formed for the purpose of providing the perspectives of mid-size banks on financial regulatory reform to regulators and legislators. As a group, the MBCA banks do business through more than 3,800 branches in 41 states, Washington D.C. and three U.S. territories. The MBCA's members' combined assets exceed $450 billion (ranging in size from $7 to $30 billion) and, together, its members employ approximately 77,000 people. Member institutions hold nearly $336 billion in deposits and total loans of more than $260 billion.

[1] *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 FR 594 (Jan. 5, 2012).

The Proposal would implement the company-conducted stress test requirement of Section 165(i)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") for state member banks and depository institution holding companies that have total consolidated assets of more than $10 billion but are not considered systemically important ("over $10 billion companies").[2] As the Board stated in the Proposal, the annual stress test requirement is meant to facilitate supervisory assessments of an institution's capital adequacy in light of downside risks, and to help the institution improve its own internal assessments of capital adequacy and overall capital planning. In brief, under the Proposal, an over $10 billion company would be required to conduct an annual stress test using its financial data as of September 30th of that year to assess the potential impact on its capital of at least three different economic scenarios, reflecting baseline, adverse, and severely adverse conditions, over a forward-looking, nine-quarter planning horizon. The Proposal would also require an over $10 billion company to submit a report of the stress test results by January 5 to the Board. Furthermore, the Proposal would require an over $10 billion company to publish a summary of its annual stress test results within 90 days of submitting its report to the Board.

The Proposal would also implement the risk committee requirement of Section 165(h)(2) of the Dodd-Frank Act for publicly traded bank holding companies with total consolidated assets of $10 billion or more. Under the Proposal, such a bank holding company would be required to establish an enterprise-wide risk committee of the board of directors, including at least one risk management expert.

The MBCA supports the Board's efforts to implement the annual stress test and risk committee requirements of the Dodd-Frank Act. However, for the reasons set forth below, we have significant concerns with the public disclosures that over $10 billion companies would be required to make regarding the stress test results under the Proposal. We also offer some suggestions on stress test scenarios and the timing of the annual test, commend the Board's commitment to coordinate with other federal banking agencies to issue consistent and comparable regulations, and urge the Board to pursue an integrated rulemaking to address all aspects of the annual stress test requirement. We further urge the Board to clarify that the risk committee is responsible for formulating risk management policies and otherwise providing oversight of the company's risk management, not for day-to-day functions, and that a broad range of risk management expertise meets applicable requirements.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).

I. Public Disclosures of Stress Test Results.

Under the proposed rules, an over $10 billion company would have to publish a summary of the results of its annual stress test, including a description of the types of risks included in the stress test, and a general description of the methodologies used to estimate losses, pre-provision net revenue, allowance for loan losses, and changes in capital positions. In addition, the rules would require an over $10 billion company to publish the aggregate losses, pre-provision net revenue, allowance for loan losses, net income, and pro forma capital levels and capital ratios that would result under each scenario for each of the nine quarters of the planning horizon (the "qualitative and quantitative data"). Similar public disclosure requirements are being proposed by the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC").[3]

Publication of the qualitative and quantitative details of stress test results could adversely impact our members. Even assuming a passing grade, and notwithstanding the hypothetical nature of stress tests, any perceived weakness can have a ripple effect in the markets, and may cause the customers, counterparties and investors of a smaller institution to flee for safety (including to the perceived safety of a "too big to fail" institution). In this fashion, publication of detailed stress test data would subvert the Dodd-Frank Act's overall goal of fostering market stability.

The MBCA is particularly concerned that customers and investors would compare the financial projections that different institutions publish as required by the Proposal, even though the practices underlying the projections are vastly different. For example, the amount of an institution's loan loss reserves, which reduces net income, is subject to the judgment of management.[4] Therefore, two institutions that have loan portfolios with nearly identical risk profiles may project different rates of default and loss. Even though an institution's allowance for loan loss as reflected in its Call Report is also subject to management judgment, the subjectivity required is compounded for projections over a planning horizon as long as nine quarters.

In addition, the publication of net income, aggregate losses, pre-provision net revenue, capital level projections and related data for each quarter over a nine-quarter period would significantly increase litigation risk for an over $10 billion company. Under the securities laws, when an issuer of securities publicly provides estimates of projected earnings or similar data, it can face litigation for alleged fraudulent or misleading statements on the basis of the

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[3] Proposed FDIC Rule 325.207; *Annual Stress Test,* 77 FR 3166 (Jan. 23, 2012); Proposed OCC Rule 46.8; *Annual Stress Test,* 77 FR 3408 (Jan. 24, 2012).

[4] *See generally* Interagency Policy Statement on the Allowance for Loan and Lease Losses (Dec. 13, 2006).

projections or misinterpretations of them. Moreover, when a public projection is made, the issuer may have a duty to monitor and update the projection in light of intervening events.[5] Many publicly-held companies have ceased to provide earnings guidance in order to mitigate the risk of this type of liability. However, the detailed disclosures that would be required under the Proposal would effectively defeat this risk mitigation strategy.

In light of these potential consequences, we are troubled by the Proposal's lack of discussion as to how publishing this type of detailed data (*e.g.*, hypothetical projected aggregate losses over nine quarters) may contribute to a weakening of middle-tier banks. Indeed, the Proposal does not attempt to weigh the potential negative consequences against any identified benefits. Rather, the Proposal merely consigns such issues to a few broad questions for commenters.[6] Surely the Board, the FDIC, and the OCC must have some data or economic analysis that would enlighten the discussion. In this regard, we urge the Board to analyze (a) how the cost of capital may increase for banks of our sizes relative to larger banks, banks that are not subject to the proposed rules, and branches of foreign banks; (b) how customers and counterparties would react, and (c) how the volatility of markets for short-term debt, stocks, bonds, credit default swaps and other instruments may increase after the publication of the qualitative and quantitative data called for by the proposed rules. For these purposes, we believe that a review of market reactions to publication of CCAR data may provide some insight.[7] We also urge the Board to conduct a legal analysis of how the public disclosure of the quantitative and qualitative data may implicate liabilities under the securities laws.

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[5] *See Ill. State Bd. of Inv. v. Authentidate Holding Corp.*, 369 Fed. Appx. 260, 263 (2d Cir. 2010).

[6] 77 FR at 633. Indeed, the Proposal has no cost-benefit analysis. The Proposal states it would not trigger the Regulatory Flexibility Act's ("RFA's") requirement for a cost-benefit analysis because it would not have a significant impact on a substantial number of small entities (firms with $175 million or less in assets). Yet, it would have a significant impact on many smaller entities that are customers and counterparties of mid-size banks. Smaller entities may incur higher costs when transacting with an over $10 billion company that must recover higher compliance costs, or if they change providers in reaction to stress test results. The RFA applies not only where a rule directly applies to an entity, but where the rule "directly affects" it. *See Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011); *Aeronautical Repair Station Assoc., Inc. v. FAA*, 494 F.3d 161 (D.C. Cir. 2007). The Board must also perform a cost-benefit analysis under the Small Business Regulatory Enforcement Fairness Act of 1996 and Executive Order 13579, which directs agencies to consider costs and benefits before decisions. 76 FR 41587 (Jul. 14, 2011). Agencies may not simply request comment on effects, but must affirmatively reach, and provide evidence for, conclusions on the economic impact of a new rule. *Business Roundtable*, 647 F.3d at 1148.

[7] Nonetheless, we note that CCAR data is only a few weeks old, and it may take further time for markets to fully react to its publication. In addition, market reactions to publication of the quantitative and qualitative data for mid-size banks would be different from CCAR data due to differences in size and lines of business.

In any event, we note that publication of this level of detail is unnecessary to implement the Dodd-Frank Act's requirement that Board regulations require over $10 billion companies to "publish a summary of the results of the required stress tests." In light of this straightforward directive and the purpose of stress testing – to verify capital strength – we believe that the Act's mandate would be fulfilled by requiring an over $10 billion company to publish a description of the types of risks included in the stress test and a statement as to whether the institution meets the requirements for being "well capitalized" or "adequately capitalized" under each stress test scenario for each quarter over the planning horizon. We believe that such a summary, without specific numeric projections, is consistent with the purposes of the public disclosure requirement. As the Board recognizes in the Proposal, the annual stress test requirement of section 165(i)(2) of the Dodd-Frank Act is intended to enhance prudential supervision and maintain financial stability. Accordingly, it should be implemented in a way that contributes to safety and soundness.[8]

Finally, we suggest that the Board delay publication of any data for at least the first two annual stress tests. As noted, the results of an institution's stress test depend, to a great extent, on its stress test methodologies and practices. The supervisory agencies need time to review the differing stress test methodologies and practices of the institutions in order to assess how such differences impact stress test results. They should then adjust the public disclosure requirement to help achieve an appropriate level of consistency in the disclosures.

II. Stress Test Scenarios.

The MBCA suggests that the Board permit, but not require, an over $10 billion company to develop and use its own scenarios for the annual stress test to supplement the scenarios provided by the Board. An institution may wish to develop its own scenarios to capture economic conditions that are particularly likely to impact the institution's business operations, given the institution's client base and offering of products and services. If an institution takes this initiative, the annual stress test will become a more effective risk management tool, and it will better achieve the purpose of helping the institution improve internal assessments of capital adequacy and overall capital planning. Therefore, the Board's regulations should encourage this practice.

The MBCA further suggests that the Board provide technical assistance in the form of samples of scenarios analysis to demonstrate how an over $10 billion company should translate the macroeconomic conditions in an economic

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[8] At a minimum, the Board should allow an over $10 billion company to exclude the projections for the proximate quarters and the projections under the baseline scenario from the summary that it publishes. These projections would be particularly susceptible of being misconstrued as earnings guidance. The MBCA further urges the Board to allow an over $10 billion company to exclude any information that would reveal the institution's business plan.

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scenario into performance indicators such as default rates. Without such technical assistance, smaller institutions with limited resources would find it necessary to incur substantial costs to engage consultants for the annual stress test. The Board should not turn these samples into mandatory guidelines, however, and an institution should be allowed to conduct its own analysis to take into account its unique client base and offering of products and services.

III. Timing of the Annual Stress Test.

The MBCA suggests that the "as of" date for financial data used in the annual stress test should be December 31, with corresponding adjustments to the regulatory reporting date and public disclosure date. The MBCA further suggests that the Board should provide the stress test scenarios at the beginning of the month in which the "as of" date falls, so that there would be approximately four months between the availability date of the stress test scenarios and the regulatory reporting date.

One of the purposes of the annual stress test is to help institutions improve their capital planning, and using the full-year financial data should be more beneficial from a planning perspective. December and January is the busiest time of year for many institutions as they close their books for the year and prepare for the financial statements audit. Holiday scheduling would also make this time of year a difficult one for conducting a new labor-intensive task. Using a September 30 "as of" date, and correspondingly, a January 5 reporting date, would limit the staff and resources that an institution is able to devote to the stress test and thus have an adverse effect on its quality. We believe that, in the event that a December 31 "as of" date is not adopted, either March 31 (with a reporting date of July 5) or June 30 (with a reporting date of October 5) would be less burdensome than September 30.

Further, we suggest that the planning horizon should be the next two calendar years, with financial projections required for each year. Forecasting the balance sheet, income statement, and regulatory capital ratios for each of the next nine quarters would impose an undue burden on institutions. Projections for each of the next two years should be sufficient for monitoring capital adequacy and facilitating capital planning.

In addition, the MBCA suggests that the Board introduce the annual stress test requirement on a rolling basis according to asset size. Specifically, the Board could first impose the requirement on institutions with more than $30 billion in total consolidated assets. The initial stage of implementation would allow the Board to analyze the diversity of stress test methodologies and practices used by different institutions, and study the impact of any public disclosures on institutions and financial stability. The Board could then use the experience gained to refine the regulations and provide additional guidance to smaller institutions. Given their limited resources, smaller institutions are particularly vulnerable to unintended consequences of the Proposal. To protect their financial soundness, it is important that they conduct the annual stress test under regulations that have been tested on larger institutions. Furthermore, unlike large institutions, community banks have not participated in the stress tests conducted by the Board and thus have not benefited from that experience, particularly the knowledge of supervisory expectations gained during the stress tests. Although community banks have employed stress tests as a risk management tool, they require a period of time to build any new necessary systems, to refine processes and procedures, and to augment staff and other resources. It is appropriate to delay the application of the annual stress test requirement to them for at least one year.

IV. Coordination Among Agencies Regarding Stress Testing.

The MBCA commends the Board's commitment to coordinate with the FDIC and the OCC in implementing the annual stress test requirements. The MBCA urges the agencies to work together to issue "consistent and comparable" regulations, as the Dodd-Frank Act requires, and to coordinate their supervision of annual stress tests. If the federal banking agencies were to require different stress test scenarios, methodologies, or practices, the stress test results of different institutions would not be comparable at all. Yet they would nevertheless be compared, causing confusion among investors and the general public and penalizing institutions subject to more stringent requirements. In addition, if an institution and its holding company were subject to inconsistent stress testing requirements, each entity would have to run a parallel stress test to meet the different requirements, wasting resources and producing potentially conflicting results.

The MBCA urges the federal banking agencies to consider issuing a joint rule to implement the annual stress test requirement, or at a minimum, to assure meaningful consultation and resolve any differences before each agency issues its own implementing regulations. Furthermore, the MBCA urges the agencies to coordinate their supervision of the annual stress test by developing interagency reporting forms, formulating joint stress test scenarios, and providing consistent guidance on methodologies and practices.

V. Integrated Rulemaking for the Annual Stress Test.

The Board noted in the Proposal that specific requirements for the report of the stress test results and related instructions would be the subject of a separate future proposal. Regulatory reporting is a key aspect of the stress test requirement, and institutions should understand the specific reporting requirements so that they may provide informed comment on the reporting requirements. Therefore, the MBCA urges the Board to address regulatory reporting requirements and all other integral aspects of the annual stress test requirement in one integrated rulemaking.

VI. Clarifying Requirements for the Risk Committee.

To the extent that the Proposal could be interpreted as requiring the risk committee to be involved in the day-to-day risk management of the company, it would conflict with fundamental principles of corporate governance. Specifically, under corporate law, the board of directors is responsible for overseeing the affairs of a company while day-to-day management is delegated to executive officers. Furthermore, if the risk committee were to be involved in the daily operations of the company, issues could arise with respect to the independence of the directors on the committee. We urge the Board to clarify that the risk committee is responsible for formulating risk management policies, setting risk tolerances, and otherwise providing oversight of the company's risk management, not for daily implementation of the company's risk management functions.

The Proposal would require that at least one member of the risk committee have risk management expertise "commensurate with the company's capital structure, risk profile, complexity, activities, size, and other appropriate risk related factors." The required "risk management expertise" would include "[e]xperience developing and applying risk management practices and procedures, measuring and identifying risks, and monitoring and testing controls with respect to banking organizations" and an understanding of risk management "with respect to banking holding companies or depository institutions."[9]

We believe that the Proposal strikes the right balance by requiring one, and not more than one, member of the risk committee to have risk management expertise. However, we are concerned that this definition may artificially limit the number of available candidates. Available specialists may not have time to serve as directors because their expertise is greatly in demand, and some may not have a broad perspective that is required for board service. Accordingly, we believe that a broader range of risk management expertise should be acceptable, including experience supervising risk management staff. We further believe that risk management expertise gained in other financial services industries, such as insurance, investment management, securities brokerage and investment banking, should be deemed to meet the requirement for banking organizations.

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[9] 77 FR at 655.

VII. Conclusion.

The MBCA supports the Board's efforts to implement the annual stress test and risk committee requirement of the Dodd-Frank Act, particularly its commitment to coordinate with other federal banking agencies to issue consistent and comparable regulations. We appreciate the opportunity to express our concerns and suggestions. We look forward to discussing these matters with you in the future.

Yours Truly,

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Chairman and CEO, City National Bank

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