COMMITTEE ON CAPITAL MARKETS REGULATION

April 30, 2012

Jennifer J. Johnson
Secretary
Federal Reserve Board
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Docket No. 1438, RIN 7100 – A86).

Dear Ms. Johnson:

The Committee on Capital Markets Regulation (Committee) appreciates the opportunity to comment on the Federal Reserve Board's (Federal Reserve) proposed rule regarding enhanced prudential standards and early remediation requirements for covered companies[1] (Proposed Rules) under § 165 and § 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[2]

Since 2005, the Committee, composed of 31 members, has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled *The Global Financial Crisis: A Plan for Regulatory Reform*, which contains fifty-seven recommendations for making the U.S. financial regulatory structure more integrated, more effective, and more protective of investors in the wake of the financial crisis of 2008.[3] Since then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.

The Dodd-Frank Act requires that the Federal Reserve establish prudential standards for: (i) nonbank financial holding companies as designated by the Financial Stability Oversight Council (FSOC) (Nonbank Covered Companies) and (ii) bank holding companies with greater than $50 billion in assets (Large BHCs, and together with Nonbank Covered Companies, Covered Companies).[4] These requirements are to include liquidity requirements, overall risk management requirements and credit exposure requirements, among others, in addition to any other enhanced prudential standards determined appropriate by the Federal Reserve.[5] Certain

[1] Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (proposed Jan. 5, 2012) [hereinafter Proposed Rules].
[2] Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 165, 166, Pub. L. No. 111-203 (2010) [hereinafter Dodd-Frank Act].
[3] COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM (May 2009), http://www.capmktsreg.org/research.html.
[4] Dodd-Frank Act § 165(a)(1).
[5] *Id.*

aspects of these requirements, for example, a requirement to conduct annual stress tests as well as a requirement to establish a risk committee, also apply to smaller banks, bank holding companies and savings and loan holding companies. The Dodd-Frank Act also requires the Federal Reserve, in consultation with the FSOC and the Federal Deposit Insurance Corporation (FDIC), to prescribe regulations for early remediation of Covered Companies.[6]

As an initial matter, we note that the Federal Reserve has acknowledged it intends to consult with other FSOC members regarding any prudential standards or other requirements it may impose that are "likely to have a significant impact on a functionally regulated subsidiary or depository institution subsidiary of a covered company."[7] This coordination is critical, as entities that fall under the jurisdiction of multiple regulators could otherwise face potentially conflicting and/or duplicative regulation. We have seen, for example, three sets of proposed rules regarding stress tests, from the Office of Comptroller of the Currency (OCC), the FDIC and the Federal Reserve, and a single banking entity with multiple subsidiaries might be subject to all three sets of rules. The Federal Reserve acknowledges this concern and states: "To minimize any undue burden associated with multiple entities within one parent structure having to meet the proposed rule's requirements, the Board intends to coordinate with the other federal financial regulatory agencies, as appropriate."[8] We commend the Federal Reserve for its attention to the need for coordination. Ideally, the tests should be as close to identical as possible and the required timing of any reports, submissions or disclosure should be coordinated for different entities within the holding company structure. If there are differences in approach, there should be a clearly articulated reason for the difference. The Federal Advisory Council, in its comments to the Federal Reserve on the Proposed Rules, noted: "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."[9]

In addition, the Proposed Rules would apply the same enhanced prudential standards to all Covered Companies, including both Large BHCs and Nonbank Covered Companies. The Federal Reserve acknowledges that Dodd-Frank requires they "take into account differences among bank holding companies covered by the rule and nonbank financial companies supervised by the Board,"[10] and that the Federal Reserve "may determine…to tailor the application of the enhanced standards to different companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities, size and any other risk-related factors that the [Federal Reserve] deems appropriate."[11] However, the Federal Reserve proceeds to explain that while its Proposed Rules were "largely developed with large, complex bank holding companies in mind, some of the standards nonetheless provide sufficient

[6] *Id.* § 166(a).
[7] Proposed Rules at 596.
[8] *Id.* at 632.
[9] Memorandum from the Fed. Advisory Council to the Bd. of Governors of the Fed. Reserve Sys. (Feb. 3, 2012), http://www.federalreserve.gov/SECRS/2012/February/20120228/R-1438/R-1438_022412_105569_535302029000_1.pdf.
[10] Proposed Rules at 596.
[11] *Id.* at 597.

flexibility to be readily implemented by covered companies that are not bank holding companies."[12] We are concerned that the Federal Reserve has provided no indication of what the different standards might be, or when they might apply. It is critical that any such tailored enhanced prudential standards for Nonbank Covered Companies be proposed publicly, and that market participants have an opportunity to comment.

We will now address several specific concerns with the Proposed Rules.

Liquidity Requirements

The Federal Reserve proposes implementing its liquidity requirement proposals, which consist of both liquidity risk management requirements as well as quantitative liquidity requirements,[13] in two stages. The quantitative liquidity requirements will be implemented through future rulemakings as part of the new Basel III reforms, and could include a Liquidity Coverage Ratio and a Net Stable Funding Ratio.[14]

Regarding the liquidity risk management requirements, the Proposed Rules introduce a liquidity stress test requirement as well as a requirement that Covered Companies maintain a "liquidity buffer" of liquid assets to meet projected outflows under certain stress scenarios. The Proposed Rules also require Covered Companies to produce cash flow projections, to establish and monitor liquidity risk tolerances and to maintain contingency plans if normal funding sources are not available.[15]

The Proposed Rules outline the role of the Covered Company's board of directors in the risk management process, which includes numerous specific duties such as establishing the Covered Company's liquidity risk tolerance;[16] reviewing and approving (either directly or through the board's risk committee) liquidity costs, benefits and risks of each significant new business line and significant new product before implementing or offering the product; at least annually reviewing all significant business lines and products for liquidity risk; reviewing and approving the Covered Company's contingency funding plan (CFP) at least annually; and performing a series of additional reviews (either directly or through the risk committee), at least quarterly, regarding cash flow projections, stress testing, liquidity buffers, and other factors.[17] These extremely detailed requirements for extensive involvement by the board in granular business operations are problematic, and arise again in other provisions of the Proposed Rules (in particular the Risk Management provisions of the Proposed Rules). The enumerated risk management responsibilities will be very time-consuming, and compliance with the Proposed Rules could easily become a full-time job for board members. It would be an unfortunate result if such reviews became pro-forma and mere "window dressing" because boards were unable to devote adequate time to them alongside their other responsibilities. We encourage the Federal Reserve to consider whether certain of these responsibilities would be better placed with senior

[12] *Id.*
[13] *Id.* at 604.
[14] *Id.* at 600.
[15] *Id.* at 604.
[16] *Id.* at 605.
[17] *Id.* at 606.

management, who are more intimately involved in the day to day operations of the Covered Companies and who can devote the proper level of time and attention to these matters.

The Proposed Rules also require that Covered Companies conduct liquidity stress testing at least monthly, in addition to performing ad hoc liquidity stress tests.[18] We believe that monthly may be too often, particularly for Covered Companies whose overall portfolio holdings do not change with the level of frequency, for example, of other firms that engage in significant investment banking activities. We encourage the Federal Reserve to re-consider the required frequency of these stress tests, and to propose different frequencies for Covered Companies as appropriate, based on their business models.

In addition to stress test requirements, the Proposed Rules also require Covered Companies continuously to maintain liquidity buffers of unencumbered, highly liquid assets that could cover projected cash outflows or impairment of existing funding sources for 30 days. We recognize that liquidity shortcomings pose perhaps more immediate risk than capital shortcomings. As an initial matter, although we support the idea of liquidity risk management, we would encourage the Federal Reserve to reconsider whether liquidity buffers can actually achieve the goal of preventing or curtailing irrational runs in the event of a crisis. We believe that it is the central bank's role as lender of last resort, rather than a pre-existing liquidity buffer, which is critical to supporting liquidity in such situations. Furthermore, we suggest that the Federal Reserve should continue to analyze, with the international community, the liquidity proposals under Basel III in order to better understand the micro- and macro-economic effects of requiring these buffers over and above capital regulation. In addition, coordination of liquidity buffer regulation internationally will be necessary, and we urge the Federal Reserve to advocate the Proposed Rules' more flexible approach to liquidity buffer regulation when engaging in international discussions on the final Basel III Rules. Only after this international process is concluded should the Federal Reserve determine the appropriate liquidity buffer regulations for Covered Companies.

Finally, turning to the specifics of the Proposed Rules, the rules set forth detailed guidance regarding the types of assets that may be included in the liquidity buffer, and requirements to discount the assets in times of market stress as well as requirements to hold diversified liquid assets.[19] The Federal Reserve asks what, if any, other assets should be included in the definition of highly liquid assets. We believe that this definition has been constructed too narrowly and should be broadened to include other sources of liquidity. Additional sources of liquid assets should be directly permitted under the Proposed Rules, rather than requiring an individual application to, and determination by, the Federal Reserve. These should, at a minimum, include qualifying foreign sovereign securities, securities or other obligations issued by multilateral development banks, securities or other obligations issued by central banks, highly liquid corporate debt and equity with appropriate haircuts for credit risk, loan payments received in 90 days and loans held-for-sale. Further, the Proposed Rules should be clarified to reflect that the Federal Reserve's discount window credit will be available in times of severe stress, and to reflect other sources of liquidity like the Federal Home Loan Bank facilities.

[18] *Id.* at 607.
[19] *Id.* at 609.

Single-Counterparty Credit Limits

The Dodd-Frank Act requires that the Federal Reserve establish single-counterparty credit concentration limits to prohibit Covered Companies from having over 25% credit exposure to an individual counterparty. The Federal Reserve has the ability to lower this threshold if necessary.[20] The Federal Reserve has addressed this requirement through the Proposed Rules with a two-tier single-counterparty credit limit, imposing a general 25% limit on Covered Companies but also proposing a lower 10% counterparty limit for major Covered Companies, defined as Nonbank Covered Companies or Large BHC's with over $500 billion in consolidated assets (Major Covered Companies).[21] Counterparties are also defined to include foreign sovereign entities.

We have several concerns with the Proposed Rules' treatment of single-counterparty credit limits. First, the 10% limitation for Major Covered Companies could be especially problematic. The Federal Reserve has not provided any explanation as to why 10% is more appropriate than 25% exposure for Major Covered Companies, nor has it satisfied the requirement under Dodd-Frank to determine that such a lower limit is "necessary to mitigate risks to the financial stability of the United States."[22] At the same time, the result of this strict limitation will be that affected firms must spread their exposures across more and smaller, potentially less stable counterparties. The Federal Reserve should explain how the 10% limitation was derived, confirm that the benefits of this lower limitation will not be offset by potentially increased risk and interconnections as Major Covered Companies are forced to spread their exposures across smaller counterparties, and more generally, support how these limits are "necessary." In addition, after the transition to central clearing, the Proposed Rules seem to work at cross-purposes with the Title VII (and global) requirement for central clearing of derivatives, by generally applying to relationships with central clearing counterparties (CCPs). We would encourage the Federal Reserve to exempt Covered Companies' exposures to CCPs until further regulation of the CCPs has been finalized, and the Federal Reserve has had the opportunity to study whether limits might be appropriate.

In addition, the Federal Reserve has measured credit concentration levels in an extremely narrow way. For example, provisions for collateral haircuts are very conservative, and in fact, more conservative than those under Basel II. The Federal Reserve has not provided any explanation as to how they derived these haircuts. In addition, the Proposed Rules have no provision for offsets when a Covered Company lends and receives the same equity, which is a common practice in banks' current internal economic models. The effect of such a conservative calculation is that Covered Companies will likely face significant limitations in their ability to lend as a result of restrictions on the collateral they can accept. This impact will be most acutely felt in business lines that rely heavily on collateral, for example, in the securities lending, prime brokerage and repo businesses. Also, while the Federal Reserve's approach to measuring credit exposure has the benefit of being simple and relatively easy to apply, it lacks critical nuances. As a result, the Federal Reserve's approach to measuring credit exposure (particularly in relation to

[20] Dodd-Frank Act § 165(e).
[21] Proposed Rules at 613.
[22] Dodd-Frank Act § 165(e).

derivative exposure) will lead to determinations that are many multiples the size of the credit exposures currently identified under banks' internal tests. The Federal Reserve should revise the Proposed Rules to take into account such nuances and to apply appropriate advanced models (as accepted and approved by the Federal Reserve under capital rules) to more accurately reflect exposure of Covered Companies to their counterparties.

Another significant issue is the application of the counterparty limitation to foreign sovereign debt. While the Proposed Rules provide an exemption for certain credit exposures to the U.S. government, there is no similar exemption for exposures to state or local governments or foreign sovereigns.[23] Foreign government debt can serve as a relatively safe form of collateral, and its widespread acceptance as collateral suggests that Covered Companies will find the limits particularly restrictive. In our current environment, given the greater need for capital, liquidity and collateral, Covered Companies will be considerably constrained in their business activities when such limits impact their direct exposures to foreign sovereigns, as well as both their acquisition of sovereign debt for their own collateral posting requirements and their receipt of sovereign debt as collateral from counterparties. To address the Federal Reserve's concern about the risks posed by foreign sovereign debt, limitations could be imposed through haircuts rather than an absolute, overall quota. Note the counterparty limitations would also apply to deposits at foreign central banks, which may be required under local regulation. The Federal Reserve acknowledges this possibility and specifically asks whether credit exposures to foreign central banks, which are necessary to facilitate the operation of foreign banking business by Covered Companies, should be exempt.[24]

A further significant issue related to credit limits is the Proposed Rules' lack of interpretation of the so-called Attribution Rule in the Dodd-Frank Act. The Attribution Rule says that "...any transaction by a [Covered Company] with any person is a transaction with a company, to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that company."[25] The Federal Reserve acknowledges that too broad an interpretation of the Attribution Rule "would lead to inappropriate results and would create a daunting tracking exercise for covered companies."[26] The Attribution Rule could be interpreted to require that when a Covered Company that extends a loan to a counterparty (for example, an operating business), the Covered Company must look through its counterparty and identify and track the ultimate recipients of those funds (for example, suppliers of parts to the counterparty). The Covered Company must measure its exposure to these end suppliers, although in the event of a default, the Covered Company would have no recourse against the suppliers. This look-through could go on indefinitely and would be extremely burdensome, while at the same time, it would serve limited value in measuring the credit exposures of the Covered Company. The Federal Reserve requests comments on whether additional regulatory clarity around the Attribution Rule would be appropriate; we believe such clarity is critical. In particular, we urge the Federal Reserve to interpret this provision so that it is used only to prevent clear evasions of the counterparty limits.

[23] Proposed Rules at 615.
[24] *Id.*
[25] Dodd-Frank Act § 165(e).
[26] Proposed Rules at 618.

Stress Tests

The Dodd-Frank Act directs the Federal Reserve to implement rules regarding annual stress tests, in coordination with the appropriate primary Federal regulatory agencies and the Federal Insurance Office.[27] These capital-based stress tests are in addition to the liquidity stress tests discussed above. They are also separate from stress tests that are part of the Federal Reserve's capital planning requirements, which were incorporated in the most recent Comprehensive Capital Analysis and Review (CCAR) issued last month. In the context of discussing the CCAR and how its capital plans will intersect with what is mandated by Dodd-Frank, the Federal Reserve has stated that stress tests mandated by Dodd-Frank "will be integrated into the ongoing assessments of BHC capital required by the capital plans rule. As set forth in the law, the Federal Reserve will be implementing the specific stress testing requirements of Dodd-Frank over the next year. The Federal Reserve expects that the stress tests required in Dodd-Frank will be an important component of the annual assessment of BHC capital plans."[28] We would expect that stress-testing requirements under the capital planning rules, the CCAR and the Proposed Rules would be conducted once, would be identical, and would be permitted to satisfy all such requirements; if they are not, the Federal Reserve should clearly explain the reasoning for duplication.

The Proposed Rules include requirements for supervisory stress tests as well as company-run stress tests, both of which will be published. The Committee is currently undertaking to review bank stress test requirements, and expects to issue more specific recommendations regarding the content and reporting of these tests in the future. We support the Federal Reserve's creation of the Model Validation Council, which will help to evaluate and improve the quality of the Federal Reserve's stress testing models.[29]

With respect to supervisory stress tests, and specifically the recent CCAR results, we understand that many institutions have called for the Federal Reserve to provide greater transparency for Covered Companies as to the models and methodologies used by the Federal Reserve. At the same time, we recognize the countervailing concern that providing too much information about how stress tests are conducted, particularly before the tests are conducted, may permit subjects to "game" the process and conduct business in order to achieve favorable results under the Federal Reserve's model. We believe this issue warrants further study, in particular, whether limited disclosure of the Federal Reserve's models and methodologies following issuance of the CCAR results could satisfy market demand without presenting a significant gaming risk.

In addition, unlike the supervisory stress tests, the company-run stress tests will not be standardized, and thus comparison of results across companies may not be possible. The Proposed Rules include minimum public summary disclosure requirements for these company-

[27] Dodd-Frank Act § 165(i).
[28] Bd. of Governors of the Fed. Reserve Sys., Comprehensive Capital Analysis and Review for 2012: Frequently Asked Questions (Nov. 22, 2011), http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20111122c1.pdf.
[29] Joshua Zumbrun, *Fed Creates Council to Study Stress Tests of U.S. Banks*, BLOOMBERG BUSINESSWEEK, Apr. 20, 2012, http://www.businessweek.com/news/2012-04-20/fed-creates-council-to-study-stress-tests-of-u-dot-s-dot-banks.

run stress tests.[30] We would encourage the Federal Reserve to provide companies with a standardized template for disclosure that would enable better understanding by the capital markets and the public.

Early Remediation Requirements

The Dodd-Frank Act requires the Federal Reserve to promulgate regulations providing for early remediation of financial distress at Covered Companies.[31] The Proposed Rules suggest various triggers which would subject a Covered Company to each of four levels of remediation review: heightened supervisory review, initial remediation, recovery and recommended resolution. Among these triggers is leverage. We would encourage the Federal Reserve to reconsider the use of leverage ratios as a metric for determining when remediation is required. While leverage ratios may pose benefits in that they are easy to calculate, they may not serve as a true indicator of risk. In addition, the Federal Reserve should ensure that these trigger events are as specific as possible, as subjectivity in the triggers can create uncertainty that is harmful to the institution, the industry and the markets. The consequences of a Covered Company falling into a particular level of remediation review are significant, and there should be no opportunity for differential treatment among institutions based on vague standards. However, we would urge that the restrictions placed on the activities of a company put into remediation be tailored to the actual trigger or event that caused the company to enter remediation. Inapposite responses to the triggering event are likely to cause more harm to the institution, rather than assisting with its rehabilitation.

Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

Respectfully submitted,

Robert Glenn Hubbard

R. Glenn Hubbard
Co-CHAIR

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[30] Proposed Rules at 633.
[31] Dodd-Frank Act §166.