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MID-SIZE BANK COALITION OF AMERICA

September 25, 2013

Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
400 7th Street, S.W., Suite 3E-218
Mail Stop 9W-11
Washington, DC 20219
Docket No. OCC–2013–0013

Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Docket No. OP-1461

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Re: Proposed Supervisory Guidance on Implementing Dodd-Frank Act Company-Run Stress Tests for Banking Organizations with Total Consolidated Assets of More than $10 Billion but Less than $50 Billion

Ladies and Gentlemen:

On behalf of the Mid-size Bank Coalition of America ("MBCA" or the "Coalition"), I am writing to provide comments on the above-referenced joint proposed supervisory guidance ("Proposed Guidance") published by the Office of the Comptroller of the Currency, the Board of Governors of

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the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, "the Agencies") in the Federal Register on August 5, 2013.[1]

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, with now 45 members, was formed for the purpose of better representing mid-size banks (defined as having assets between approximately $10 – 50 billion) within the overall banking industry, and to educate lawmakers about the financial regulatory issues and policies affecting the ability of mid-sized banks to compete fairly and to more fully support and contribute to the growth of the U.S. economy.

As a group, the MBCA's 45 member banks do business through more than 6,900 branches in 44 states, Washington D.C. and three U.S. territories. The MBCA's banks' combined assets currently exceed $785 billion with an average size of $17 billion and, together, employ approximately 130,000 people. Member banks have nearly $600 billion in deposits and total loans of more than $480 billion.

The MBCA appreciates the Agencies' effort to provide guidance for implementing the stress test requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") applicable to institutions and holding companies with more than $10 billion but less than $50 billion in total consolidated assets ("mid-size banks"). We offer below some general comments on the Proposed Guidance and respond to the questions the Agencies specifically posed for public comment.

I. General Comments

Mid-size banks are much more flexible than large banks. We can respond to changing economic conditions quickly. We can act quickly to conserve capital, by adjusting business activities or cutting dividends, for example. As a result, we should be allowed some flexibility in our stress testing practices.

The Proposed Guidance appears to suggest that a satisfactory stress testing program must depend on complex statistical models. Such models may be mathematically sophisticated, but they may not necessarily be more accurate than traditional practices that mid-size banks have already incorporated into their risk management programs.

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[1] *Proposed Supervisory Guidance on Implementing Dodd-Frank Act Company-Run Stress Tests for Banking Organizations with Total Consolidated Assets of More than $10 Billion but Less than $50 Billion*, 78 Fed. Reg. 47217 (Aug. 5, 2013).

The Proposed Guidance states the Agencies' expectation that a company's post-stress capital ratios under the adverse and severely adverse scenarios will be lower than under the baseline scenario. This predetermination of test results is misplaced for mid-size banks. In adverse economic conditions, a mid-size bank may attain higher capital ratios due to slower new originations, higher paydowns and accelerated charge-offs, which result in improved credit quality in the remaining loan portfolio. As a result, even though capital does not grow as quickly (or may even be reduced) in a stress scenario, the capital ratios do not necessarily decrease, given a lower amount of risk-weighted assets in the denominator. The Agencies' assumption seems to focus solely on capital without taking into account the dynamic development of the entire balance sheet. Furthermore, the impact of adverse economic conditions may be reflected in other indicators, such as an increasing allowance for loan and lease losses ("ALLL") or higher non-performing loan ratios, and not necessarily in lower capital ratios. Higher post-stress capital ratios alone do not signal any failure to capture the impact of adverse economic conditions in the stress test.

The Agencies' results template focuses on four capital ratios, but those capital ratios are not necessarily the most relevant or useful in the oversight and management of mid-size banks. Certain measurements, such as "Classified Exposures / Tier 1 Capital + Allowance" may be a more appropriate gauge of performance or tool for use by management.

As the Agencies recognize in the Proposed Guidance, smaller banks should not be required to employ the same advanced practices that the Agencies may expect of larger, more complex, and more sophisticated banks. It would be helpful if the Agencies could clarify whether they would set an asset-size threshold for determining whether a mid-size bank is "smaller" and thus may use less advanced practices for stress testing.

We suggest that the Agencies provide smaller mid-size banks with specific guidance for calculating loan losses. For mid-size banks that engage in traditional banking activities, credit losses are by far the biggest risk to their capital levels. By way of technical assistance to these banks, the Agencies could provide optional instructions on how to develop models, such as a net charge-off or roll-rate model, for calculating credit losses. The Agencies could consider a bank's credit loss estimation adequate if the bank followed these instructions. At the same time, these banks would have the option of using another methodology that also meets supervisory expectations.

We request that the Agencies clarify the requirement in the Proposed Guidance that ALLL under each stress test scenario be consistent with generally accepted accounting principles ("GAAP"). GAAP requires a bank's management to exercise prudent judgment in determining the appropriate level of ALLL. Such judgment must be based on an evaluation of all relevant

factors that affect collectability, including macroeconomic factors. GAAP precludes multiple estimates of ALLL based on different macroeconomic scenarios. Therefore, stress testing under different supervisory scenarios is inconsistent with ALLL estimation under GAAP. We request clarification that the Agencies' supervisory expectation is that management should follow GAAP in determining ALLL, except that management's judgment regarding macroeconomic factors should be replaced with each stress test scenario as defined by the Agencies.

We urge the Agencies to consider permitting a bank to undertake a focused stress test and, if the results were satisfactory, to opt out of the full stress test. In the focused stress test, the Agencies could require banks to calculate pro-forma regulatory capital ratios, assuming a certain level of loan losses (say, 2% loan losses over a two-year period). If the ratios were above a certain level, further stress testing would not be required. As a result, banks would have strong incentives to maintain higher levels of capital to avoid incurring onerous regulatory obligations. This approach would help banks save time and costs, avoid diverting bank staff and resources away from managing risk, moderate excessive reliance on sophisticated modeling that is not necessarily precise, and contribute to more effective management of capital.

We also urge the Agencies to change the timing of the required stress test and allow mid-size banks to conduct their stress tests based on financial data as of March 31. Under the current rule, mid-size banks have to begin work on the stress test in November each year and complete it by March 31 of the following year. During this period, the staff of a bank has to complete the year-end Call Report, the Federal Reserve annual report on Form Y-9, SEC reporting, and many other regulatory reporting requirements. Moreover, regulatory changes are often implemented at the beginning of each year. The staff is already overworked during this time. Requiring the same staff to complete the stress test during this time will put huge strains needlessly on mid-size banks. Unlike a large bank that has hundreds of thousands of employees, a mid-size bank generally has less than 1,000 employees. Thus, a mid-size bank is less likely to have employees who are not fully occupied during the busy season and can help out colleagues facing a time crunch. Accordingly, we urge that the date for completion of the stress test be moved from March 31 to September 30 of a given year.

II. Specific Questions in the Proposed Guidance

<u>Question 1:</u> What challenges do companies expect in relating the national variables in the scenarios to regional and local market footprints?

Many of the national variables are fairly highly correlated with local and regional ones. For example, the unemployment rate of a particular state may be similar to the national rate, and the economy of a particular region may grow at about the same pace as the GDP. However, this may not be the case for regional and local markets that tend to experience large fluctuations in economic activity, that are rural or less-populated, that heavily depend on a single industry, that are particularly resilient in certain economic areas, or that otherwise have a distinct pattern of economic activity. For example, when commercial real estate is severely distressed nationally, a bank that conducts the majority of its business within a small radius of midtown Manhattan may experience a much lower level of distress in its commercial real estate portfolio than the national average. Therefore, the divergence between national variables and regional or local ones could pose a big challenge for some banks, particularly because such divergence could be significant over a nine-quarter period.

Attempting to develop statistically meaningful relationships between national variables and regional or local variables internally would be cost-prohibitive, requiring a significant amount of resources and expertise. Therefore, banks are exploring the use of third-party data providers, such as Moody's Analytics, that provide expanded local variables based on the supervisory stress scenarios. It would be extremely helpful if the Agencies could pre-approve specific third-party vendors to help mid-size banks obtain regional variables in a cost-effective way, and then respond to bank inquiries as to whether a particular vendor were pre-approved. Alternatively, we suggest that the Agencies publish variables for broadly-defined regions (such as the mid-Atlantic region) in addition to national variables. Such variables would provide a better fit with local market conditions and at the same time they would not require the Agencies to undertake the difficult task of collecting data at the local level.

Data for smaller metropolitan statistical areas and rural areas, and other areas not fully covered by commercial data providers, are less readily available than national variables. Therefore, a bank located in such markets should be given more flexibility in making assumptions about any regional variables that it may use, or about the impact of national variables on its balance sheet. Sometimes, a bank may find it beneficial to retain third parties (for example, asset/liability management consultants and experienced economists at university economic research centers) to provide expert opinions, which the bank uses to inform its assumptions. The Agencies should accept such assumptions if the third parties have reasonably

established their expertise. For example, an economist may show that it is likely that when the national unemployment rate is 8%, the rate in the bank's market area is 6%. To the extent that such assumptions are clearly defined and consistently applied, the Agencies would be able to assess the quality of the stress tests.

Another challenge is that many banks do not have systems for storing data on the impact of national variables on regional and local markets in a readily retrievable way. The cost to develop and maintain such data systems over time is high. The Agencies should take this into account in evaluating stress tests.

Overall, even though the Agencies have provided for flexibility on whether or not to use regional or local variables, the process of translating economic variables prescribed by the Agencies into bank-specific projections is a hugely complex, costly, and imprecise. Mid-size banks typically do not have sufficient staff with the quantitative capabilities needed to perform regression analyses to translate economic variables into bank-specific projections. But if they were to use regression models not built upon a true understanding of the bank, the resulting projections would be questionable. Furthermore, regional data may be necessary for some banks because their operations do not fit the national economic data. All this underscores that the work entailed in integrating the required variables into stress testing is hugely time-consuming, complicated, and without sufficient benefit to justify the cost.

Question 2: What additional clarity might be needed regarding the appropriate use of historical experience in the loss, revenue, balance sheet, and risk-weighted asset estimation process?

If the Agencies require sophisticated regression techniques throughout the business units and financial statements of a bank, the bank would face great difficulty and the results would be uncertain for lack of appropriate internal resources and expertise. The Agencies should trim down the scope of required projections. Focus should be placed mostly on credit losses and net interest margins where bank risk typically exists, and less on complicated quantitative methods to estimate fees and expenses unless material issues are uncovered in the stress-testing process. If the Agencies demand a statistical approach to projections, they may divert a bank from safeguarding against the true common-sense risks that it faces.

We suggest that the Agencies provide more specific guidance on which historical data should be used in stress testing, especially for smaller or less sophisticated mid-size banks. The Agencies could instruct smaller, less sophisticated mid-size banks to use historical data from a specific period, unless such banks can justify using data from some other period. For

example, most banks experienced extreme stress during the recession beginning in 2007. The Agencies could instruct that data from that period would be appropriate, with adjustments for the current mix of assets and liabilities and reasonable projections.

We suggest that the Agencies recognize the important role of appropriate assumptions in using historical data. For a recently established bank, historical data are limited, making it very difficult to make estimations based on the past. Even for a bank with a long history to draw upon, the available historical data may not fit with the supervisory stress scenarios. History may not predict the future accurately. A bank's Asset/Liability Committee ("ALCO") should have the experience of making reasonable assumptions to address these issues, however. If a bank clearly defines its assumptions and applies them consistently, such assumptions help the bank make better predictions about its balance sheet.

We request the Agencies to clarify their expectations for portfolio segmentation based on historical data. It would take a significant amount of resources for a mid-size bank to compile internal data necessary for the analysis to support portfolio segmentation, particularly if granularity is expected. It would be cost-prohibitive if the Agencies expect a bank to compile internal historical data that show statistically significant relationships as opposed to historical trend lines sufficient to inform management judgment.

We also request the Agencies to provide more guidance on what criteria a bank should use in selecting alternative historical data when the bank does not have sufficient internal historical data. Which sources (including third-party data providers) would be acceptable? Which factor—similarity to the bank in terms of footprint, concentrations, or risk profile—do the Agencies consider to be most relevant in determining which proxy data are appropriate?

<u>Question 3:</u> What additional clarity should the guidance provide about the use of vendor or other third-party products and services that companies might choose to employ for DFA stress tests?

Mid-size banks often find it necessary to use regional and local variables provided by external data providers (such as Moody's Analytics) because it would be too costly for them to develop such variables in-house. Mid-size banks may also have to rely on third-party vendors and their products and services to translate the variables in the supervisory stress scenarios into estimations that are specific to their portfolios. The required use of complex statistical methods may not be appropriate in itself. And it would also be very expensive and require significant human and financial resources if mid-size banks are required to understand all the complex

statistical models and analysis from which the vendors derive their output. Just purchasing access to the third-party services will be expensive enough. Also, because banks gravitate toward high-quality stress testing products and services, most banks would end up purchasing from the same vendors. It would be an inefficient use of resources to have each bank validate the same products and services.

Therefore, we suggest that the Agencies evaluate and approve the use of the stress testing products and services of select vendors and deem mid-size banks that use those products and services as meeting the Agencies' vendor management guidelines with respect to stress testing. Alternatively, the Agencies could set specific guidelines for third-party vendors to follow. If a mid-sized bank uses the products or services of a vendor that certifies compliance with the guidelines, it should be deemed as meeting the Agencies' model validation framework with respect to stress testing. This approach would recognize the constraints on the resources of mid-size banks, such as the inability to keep highly-specialized statisticians on staff, and also help to ensure that the methodologies employed by different vendors are consistent, so that the stress test results of institutions using the products and services of different vendors can be compared meaningfully.

To the extent that a mid-size bank identifies any gap in the expertise required for stress testing, the Agencies should allow the bank to rely on outside experts to fill the gap. Instead of requiring the bank to validate the outside experts' advice, the Agencies should require that the board of directors establish appropriate standards for hiring experts, make hiring decisions according to the standards, and obtain a written certification from the experts that they have truthfully represented their credentials. This would be analogous to long-standing practices in federal courts, where persons whose expertise has been established are allowed to testify.

We request that the Agencies clarify their expectations for the timeline for "accumulat[ing] the data necessary to improve [a bank's] estimation practices over time." An outlined timeline would be useful for smaller banks that might face greater difficulty accumulating the needed data. Additionally, we appreciate the Agencies' recognition that "[o]ver the long term, companies may continue to use . . . proxy data to benchmark the estimates produced using internal data or to augment any gaps in internal data (for example, if a company is moving into a new business area)." We request the Agencies to provide more specific guidance on the circumstances in which a bank would be allowed to continue to use proxy data. For example, may a bank use proxy data to benchmark estimates for small segments within a loan portfolio that are not material to the overall portfolio and for which the bank might not have a large enough sample size internally?

<u>Question 4:</u> How could the proposed guidance be clearer about the manner in which the required capital action assumptions between holding companies and banks differ, and how those different assumptions should be reconciled within a consolidated organization?

The Proposed Guidance requires a bank holding company to assume that it will pay the same amount of common stock dividends as it did in the previous year. At the same time, the Proposed Guidance requires a company to ensure that assumptions and projections are consistent with the company's past practices during stressed economic periods. This constitutes a contradiction. In times of stress, the holding companies of mid-size banks have the flexibility of cutting dividends. They have done so in the past to conserve capital, in some cases following the instructions of the regulator, and it is reasonable to expect that they will do the same in the event that the economy becomes stressed in the future. Furthermore, the Proposed Guidance's requirement for bank holding company capital action assumptions is inconsistent with the flexibility that stand-alone banks are allowed in projecting capital actions over the planning horizon.

The Proposed Guidance is reasonably clear about the manner in which the required capital action assumptions between holding companies and their subsidiary banks differ. However, it provides no guidance on how to reconcile those different assumptions within a consolidated organization. We would appreciate the Agencies' guidance describing specific methods that should be used to reconcile such differences, and methods that should not be used.

<u>Question 5:</u> What additional clarification would be helpful to companies about the responsibilities of their boards and senior management with regard to DFA stress tests?

The Agencies should clearly communicate to bank boards how significant the Dodd-Frank Act stress tests are as a supervisory matter. Some regulators have informally expressed the view that the results of the Dodd-Frank Act stress tests are more important than CAMELS ratings as an indicator of a bank's health. If the Agencies have indeed adopted such a view, they should clearly communicate it. At the same time, the Agencies should ensure the consistent application of macroeconomic variables to the balance sheets of different banks, given that the public dissemination of stress test results based on inconsistent methodologies poses a tremendous reputational risk to banks.

The Agencies also should clarify their expectations for the precise role of bank boards of directors in relation to the stress tests. Senior management of a bank will establish the stress testing methodologies; what are the Agencies' expectations regarding the level of detail in management's

reporting to the board such that the board can make informed decisions on approval of those methodologies? The Agencies should recognize that most board members do not have the quantitative background to validate the statistical methods that the Proposed Guidance would require banks to use. The focus should be on board members' understanding of how adverse economic conditions could impact capital.

The Agencies also should clarify that a bank's board of directors is not expected to operate the bank strictly according to the assumptions made in stress tests. The board should only be expected to ensure that the assumptions made in stress tests are consistent with those used in other aspects of the bank's operations at the time of the stress tests.

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The MBCA appreciates the opportunity to express our concerns and suggestions on the Proposal Guidance. We are available to discuss them with you as appropriate.

Yours Truly,

Russell Goldsmith
Chairman, Mid-Size Bank Coalition of America
Chairman and CEO, City National Bank