

**COMMENTS ON
FEDERAL RESERVE SYSTEM
12 CFR PARTS 211 AND 238**

Docket No. R-1569

RIN 7100-AE82

Large Financial Institution Rating System; Regulations K and LL

By

Orlando G. Rodriguez

October 2017

Each Federal reserve bank shall keep itself informed of the general character and amount of the loans and investments of its member banks with a view to ascertaining whether *undue use is being made of bank credit for the speculative carrying of or trading in securities, real estate, or commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions*; and, in determining whether to grant or refuse advances, rediscounts or other credit accommodations, the Federal reserve bank shall give consideration to such information. *The chairman of the Federal reserve bank shall report to the Board of Governors of the Federal Reserve System any such undue use of bank credit by any member bank, together with his recommendation.* Whenever, in the judgment of the Board of Governors of the Federal Reserve System, any member bank is making such undue use of bank credit, the Board may, in its discretion, after reasonable notice and an opportunity for a hearing, suspend such bank from the use of the credit facilities of the Federal Reserve System and may terminate such suspension or may renew it from time to time.

Federal Reserve Act Section 4 Paragraph 8 – emphasis added

- 1) Are there specific considerations beyond those outlined in this proposal that should be considered in the Federal Reserve's assessment of whether an LFI has sufficient financial and operational strength and resilience to maintain safe and sound operations?

Yes, there are additional specific considerations:

- a) One consideration is the evident inability by the LFIs and their regulators to learn the lessons of earlier crises and apply those lessons in a prophylactic way.

In 1974 Franklin National Bank failed because of speculation in the foreign exchange markets.

Bankers Trust (BT), an acknowledged leader in risk management and a pioneer in derivatives trading, went haywire in 1987 due to valuation of puts and calls on currencies.

Granted it was not a bank, but in 1997, just 10 years later, Long Term Capital Management (LTCM), a firm that included two people who shared the 1997 Nobel Memorial Prize in Economic Sciences for a “new method to determine the value of derivatives”, faltered badly and precipitated a major bailout.

Bad as these were, the crises were largely centered on a single institution and were taken care of in a short period of time. And then twenty years later in 2007-2009 there was an even more pervasive and broad-based one as measured by how long it lasted and how many participants were involved.

b) The other observation is that achieving the objective of avoiding excessive risk taking by the LFIs will require extreme and harsh and punitive measures. It cannot be addressed with a BAU (Business As Usual) perspective, for that will not be successful.

c) The definition of scope found in I. Background (page 3), and more importantly, the thinking behind the Proposal, should be expanded to cover the Wells Fargo 2016 fiasco. That fiasco involved thousands of employees opening millions of phony accounts over several years. It makes for incredible risk management techniques, expertise and commitment, where the word ‘incredible’ is used advisedly.

d) Cybersecurity is terribly important. It is not a CBL, yet it can cripple a bank; therefore, the safety and soundness of a LFI’s cybersecurity is terribly important. Does cybersecurity fall under the jurisdiction of IRM, or a separate department? Who does the risk assessment for non-CBL cybersecurity issues (e.g: accounting department? IT department? IRM itself?)

- 2) Does the proposal clearly describe the firms that would be subject to the LFI system, and those firms that would continue to be subject to the RFI rating system?

Yes, they are well described (V; page 15). The issue is different. Using lessons from the past, LTCM was a hedge fund, AIG an insurance company. These were major players in the market that would not have been subject to the LFI criteria. As regulations tighten around LFI’s, business is leaking into other lightly regulated or non-regulated players. Chances are the next crisis will also be precipitated and/or exacerbated by non-LFI’s, something that tightening the screws on the LFI’s only will not prevent.

- 3) Does the proposal clearly describe the supervisory expectations for senior management in the evaluation of a firm’s governance and controls under the proposed LFI rating system?

Yes it does (VII.A.1. Senior Management) The proposal, however, does not seem to take into account the inherent structural tension that exists between CBL & IRM which can be diagrammed as follows:

CBL objective: maximize profit => maximize risk

IRM objective: minimize risk => minimize profit

- 4) Does the proposal clearly state describe how and under what circumstances a “Satisfactory Watch” rating would or would not be assigned? Does that rating provide appropriate messaging and incentives to firms to correct identified deficiencies?

Yes (II.B. pages 10-11, and 43). Yet, in a profit-maximizing environment being managed to obtain maximum personal as well as corporate compensation, a rating does not provide appropriate messaging and incentives to firms and individuals to correct identified deficiencies. To deter misbehavior, incenting should be based on applying severe personal consequences for misbehavior.

Teeth/negative consequences for misbehavior:

- a. On a corporate basis, is withholding of approval for expansion(s) the only stick available? Is access to discount window an effective threat when massive liquidity provided, no questions asked, during meltdown)?
- b. What is the division of labor with SEC/DOJ for prosecuting misbehavior/mismanagement?
- c. Dodd-Frank certification by CEO => what happened in Wells Fargo case? who was prosecuted?

To preserve anonymity and avoid the market getting spooked when learning that an institution and/or an individual has been misbehaving, the penalties can be made discreet, i.e., not visible: e.g. ego things (restrict use of the corporate jet/attendance at boondoggles) as well as lucrative but obscure financial monetary disincentives (e.g.: conditional and/or permanent cuts to golden parachutes/long-term compensation; cutbacks to funding for preferred charities).

Also, at what stage do CandD/ written agreements/supervisory letters/board resolutions/MOU's and/or firing of management &/or BofDs' happen?

- 5) Should the LFI rating system be revised at a future date to assess the sufficiency of a firm's resolution planning efforts undertaken to reduce the impact on the financial system in the event of a firm's failure? If yes, what should the Federal Reserve specifically consider in conducting that assessment?

It is absolutely essential that the LFI rating system be assessed continuously to determine its sufficiency. Just like security protocols are reviewed constantly to keep up with and adapt to an ever-evolving field, the Federal Reserve should be constantly vigilant, as loopholes, new markets, new products, new derivatives, etc. will change the financial landscape and require new definitions and new penalties. Deficiencies must be identified and remedied promptly. IRM must provide a scorecard and measure on a continuous basis predictions vs actual, calculate deviations, and report findings to senior management, and to the Federal Reserve simultaneously.

- 6) Are there options that should be considered to enhance the transparency of LFI ratings in order to incent more timely and comprehensive remediation of supervisory deficiencies or issues?

VII. Timing and Implementation:

page 16 says:

In accordance with the Federal Reserve's regulations governing confidential supervisory information, ratings assigned under the LFI system would be communicated by the Federal Reserve to the firm but not disclosed publicly

This appears to be a conundrum: how can something that will not be made public be made more transparent?

Also, a leak, i.e, an unauthorized release of the classification, whether willful or inadvertent, and its harmful impacts, should be anticipated and considered. And we do work inside goldfish bowls...

- 7) What specific issues should the Federal Reserve consider when using the LFI rating system to inform future revisions to other supervisory rating systems used to assess the the U.S. operations of foreign banking organizations?

A specific issue is how LFI rating mesh with BIS, Basel A III, B of E, European Central Bank standards, now and going forward.

XII.C. Solicitation of Comments on the Use of Plain Language page 34:

Need a glossary of acronyms (see list below for an illustration); abundant use of acronyms is detrimental to smooth reading by a non-insider.

Items	
LFI	CRO
LISCC	IRM
CCAR	CAE
RFI/C(D)	BE
CLAR	MRIA
CBL	MRA

Other issues/comments:

- 1) The proposal is highly qualitative. To make it operational, quantitative criteria/arguments need to be made, e.g.:

“CBL management should provide a CBL with sufficient resources and infrastructure to meet financial goals and strategic objectives ... [to] include sufficient personnel with appropriate training and expertise and management information systems.” Page 21

As presented above, there is a natural tension between IRM and CBL. IRM is an expense center, CBL a profit center. The relative ranking in the corporate pecking order has to be measured. Questions include

Who funds IRM? Is it a general corporate overhead allocation? Is it that each line of business contributes to the IRM they face off against?
How is the relative priority of IRM resources established?
What is the ratio of \$ allocated, the number of personnel for each, their seniority, their reporting lines?

2) “CBL management should also clearly present to senior management the risks emanating from the business line’s activities and explain how those risks are managed and align with the firm’s risk tolerance.” Page 20

- Should it be IRM instead that performs those functions, so as not to have the fox watching the henhouse?

3) “CBL management should manage the CBL’s activities so they remain within risk limits established by IRM, consult with senior management before permitting any breaches of the limits, and follow appropriate procedures for obtaining exceptions to limits.” Page 20

-On what grounds can senior management be allowed to override IRM’s limits?
How often can that be permitted before it becomes habitual? Criteria for material vs. immaterial? Ultimately, are IRM’s limits just a fig leaf?

4) “Risk reporting should enable prompt escalation and remediation of material problems...” Page

- by whom?

5) Recusals by CBL management, required? expected? not at all? (e.g.: should/can a party who has a financial interest in a question be allowed to plead their cause/talk their position?)

6) Static vs dynamic: a rearview mirror approach not needed- were we were X months/X weeks/even X days ago not as significant as where we’ll be X days/X weeks/X months from now

7) Retrofit/Expand, e.g.:

Bear Stearns & Lehmann Brothers and AIG were outside of the Fed's purview/ . Yet, one can/should ask if their CBLs' had "specific business and risk management objectives that align[ed] with the firm wide strategy and risk tolerance." (page 20). If they did not, an alignment was clearly needed, but if their business and risk management objectives we aligned, but they just went for excessive risk-taking (the working assumption), is would be a sad commentary of need for homogenous regulation across the whole field of players in finance.

8) page 10: if 4-tiered classification been applied to subject institutions in 2006 what would the distribution have looked like? What is the desired distribution among the 4-tier risk classification? What is an acceptable distribution? What is a distribution that would indicate undue systemic risk exists?

9) How do resolution plans (living wills) under Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act fit in?

There is a tremendous need for a new Hellhound of Wall Street. One should not the wonder if Ferdinand Pecora were alive and entrusted with the responsibility of finding a mechanism that would mitigate the chances of another financial crisis he would again change the structure of how Wall Street works rather than just tinker around the edges.