American Bankers Association

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January 22, 2018

The Honorable Janet L. Yellen
Chair
Board of Governors of the Federal Reserve System
Eccles Board Building
20th and C Street, N.W.
Washington, D.C. 20219

Re: Package of Proposals to Increase Transparency of the Federal Reserve's Stress Testing Program.

Dear Chair Yellen,

The American Bankers Association[1] (ABA) appreciates the opportunity to comment on the Federal Reserve's package of proposals designed to increase transparency in the agency's stress testing program (Transparency Package). ABA supports efforts to bring greater transparency to the stress testing process as beneficial for making stress testing even more beneficial for supervisory as well as for bank management purposes.

ABA has long been concerned about the opaque nature of the program, as the stakes for banks and the economy are high. Particularly concerning within the stress testing regime is the opaque nature of the supervisory model, the development of scenarios, and the standards of the qualitative review (applied to banks with more than $250 billion in assets). The administrative details of the program have never been exposed to the public for review and comment, even though stress testing results directly bear on the return banks can provide to their investors, and thus drive investment interest in the industry as well as banks' lending decisions.

We view the Transparency Package as an important step in what we would recommend as an iterative process to achieving a more transparent stress testing regime. The three proposals within the Transparency Package would provide useful but limited information about the models the Federal Reserve uses to estimate the hypothetical losses in the stress tests, limited information on the development of hypothetical scenarios and variables, and an improved description of the Federal Reserve's approach to model development, implementation, use, and validation. We recommend that the Federal Reserve finalize the proposal titled "Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test" as quickly as

[1] The American Bankers Association is the voice of the nation's $17 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits, and extend more than $9 trillion in loans.

possible so that the disclosures will be relevant to this year's Comprehensive Capital Analysis and Review (CCAR) cycle. We further encourage the Federal Reserve to continue these efforts by expanding model and scenario development disclosures and consider other amendments recommended below and detailed in ABA's Stress Testing White Paper, submitted to the Secretary of the Treasury in April 2017.[2]

I. Safety and Soundness Standards Must Be Understood by those Subject to Them

Important elements of safety and soundness should not be a mystery. Safety and soundness rules should be sufficiently consistent and transparent so as to encourage appropriate risk management practices, not surprise banks and the customers who rely on them and the investors who support them. Yet, for too long, banks have been subject to standards that are unknown to the regulated banks and the public.

When viewed through the lens of CCAR (CCAR stress tests), the supervisory models and scenarios directly affect how much capital a bank needs to hold for particular assets. Indeed, they can be as much or more determinative of capital levels than are the Basel capital rules that were adopted following extensive public review and comment. The stress testing program as currently administered arguably has many virtues above and beyond the Basel capital rules, including more flexible identification of risk. It does not have the virtue of avoiding the appearance of being arbitrary and capricious. For example, it allows the Federal Reserve to pick and choose preferred assets and institutional models at its sole discretion, based on its opinion as to bank performance against hypothetical assumptions of future conditions, through obscure procedures.

The consequences extend beyond the bank to the customers of the bank and can affect the economy more generally. As to the borrower, banks will tend to shift lending away from sectors that are disfavored by the regulator's supervisory model and scenario assumptions. This can affect credit availability in certain sectors and have an impact—at least at microeconomic levels—on growth and job creation. Taken together, across all affected banks, there could be macroeconomic effects.

Development and administration of these regulatory constraints have been conducted outside of the public notice and comment process required by the Administrative Procedure Act (APA). It should be understood that in material degree the CCAR stress tests are the binding capital constraint for most large banks, overriding the regulatory capital standards that were developed in a transparent process and subject to notice and comment pursuant to the APA. Impacted banks, bank customers, bank investors, and the broader public have not had a chance to weigh in on the structure, standards, or processes involved with the CCAR.

Inadequate transparency also creates high levels of management uncertainty, structural complexity, and impedes the capital allocation process. Banks must manage, price, and allocate capital without a fully informed view of key regulatory drivers and expectations. Efficient capital management is frustrated by unnecessary regulatory mystery. The regulatory riposte has been that if banks know what the scenarios are and how they will be administered, then the banks will

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[2] See https://www.aba.com/Advocacy/Documents/Stress-Testing-whitepaper-04242017.pdf.

"study for the test," that is arrange their business in line with the expected stresses. Is that not, however, the purpose of bank supervision, to guide banks in their preparations for risks, rather than to surprise them with unforeseen regulatory expectations? Keeping banks in the dark threatens to convert stress testing into a game rather than an optimally effective supervisory tool.

II. Additional Steps Needed to Increase Transparency

a. Tailoring the Stress Testing Program to Bank Specific Risks and Activities

The Federal Reserve's supervisory stress test uses models that were developed internally at the Federal Reserve. While these models rely on detailed portfolio data provided by banks, they are typically not calibrated to the idiosyncratic risks and activities of each firm.

Given that CCAR is the binding capital constraint for most of the banks subject to it, currently it is the Federal Reserve's models that often serve to allocate capital for the marketplace. This creates several challenges:

- Uncertainty, inefficiency. Due to the limited disclosure of supervisory models and supervisory scenario forecasting processes, there is uncertainty in the amount of capital that will be required to remain above stress thresholds each year. This takes capital allocation decision-making out of firms' hands, creating uncertainty and capital inefficiency that hinder capital deployment, economic growth, and market liquidity.

- Inaccuracy relative to firms' idiosyncratic risks. A one-size-fits-all approach is contrary to the Federal Reserve's SR 11-17 and SR 15-18 guidance, which require that stress testing be based on granular modeling of firm idiosyncratic risk profiles. Supervisory models could more appropriately serve as macro guide to company-run forecasts.

- Model risk. Further, even with the proposed additional model transparency, the public would have limited information regarding Federal Reserve models' backtesting, validation outcomes, and limitations. Full transparency of these aspects would enable the public to fully evaluate the reliability of results from supervisory models and aid the Federal Reserve in improving its modeling.

We believe that it is imperative that the Federal Reserve engage in further discussions with the industry about how these challenges can be addressed, how the stress testing program can be better tailored to each institution, and how to allow banks to assess capital requirements relative to their risks. For example, the Federal Reserve could consider increasing reliance on bank models or working with individual institutions to customize or overlay Federal Reserve models to address an institution's particular set of business activities.

b. Expand Model Disclosures Beyond Credit Risk

If the Federal Reserve does continue to use its models to determine individual bank capital levels, more transparency is needed to address the aforementioned concerns of uncertainty, inefficiency, and model risk. The proposal titled, "Enhanced Disclosures of the Models Used in the Federal Reserve's Supervisory Stress Test," takes the important first step of proposing to disclose certain loan loss information. However, banks would still have no insight into most relevant factors in the supervisory stress test.

To improve the quality of the supervisory stress test projections, the enhanced modeling disclosures should be expanded beyond loan-loss models. Pre-provision net revenue (PPNR), inclusive of the bifurcation of Operational Risk losses, Balance Sheet projections, depletion assumptions, and NII / Non-Interest Income and Expenses should all be considered for disclosure. Additional information would not jeopardize the integrity of the Federal Reserve's models or precipitate increased concentration risk or regulatory gamesmanship. Rather, the increased disclosure would allow for more effective feedback between the private sector and regulators to tailor the supervisory models to firm-specific risks, with additional positive externalities for financial markets as they gain a better understanding of the risks facing the financial sector. As an example, the request for suggestions about the incorporation of a funding shock cannot be contemplated without an understanding of what assumptions are already incorporated within existing models. Increased transparency would at once improve the quality of the Federal Reserve's models while allowing firms to understand the basis of the CCAR projections, and by extension enable the usage of the stress tests to make sound risk decisions.

c. Release Model Information No Later than January of Each Year

We recommend that the Board release the enhanced disclosures of Supervisory models in January of each year. Further, we recommend that the Board set a fixed date in early January of each year for the release of the scenarios and additional components used in the supervisory stress test, and release the enhanced model disclosures concurrently with this information. Current regulation states that the Board will provide the scenarios that will be applied to conduct the analysis for each stress test cycle by no later than February 15 of each year, except with respect to trading or any other components of the scenarios and any additional scenarios, which will be communicated by no later than March 1 of that year. The current rule does not preclude the Board from releasing this information earlier. Accelerating the release of scenarios and enhanced model disclosures to a fixed date, such as January 15th of each year, would reduce uncertainty surrounding the scenarios and the potential need for firm overlays, and would allow appropriate time for review of stress test results by senior management and boards of directors.

d. More Information Needed in Scenario Design Proposal

As part of the Transparency Package, the Federal Reserve proposed the "Policy Statement on the Scenario Design Framework for Stress Testing." This policy statement is designed to clarify when the Board may adopt a change in the unemployment rate in the severely adverse scenario, institute counter-cyclical guidance for the change in the house price index in the severely adverse scenario, and provide notice that the Board plans to incorporate wholesale funding costs for banking organizations in the scenarios. ABA is supportive of efforts to bring more transparency to the scenario design process. As with the Federal Reserve's models, the Federal Reserve's scenarios can be used to set capital requirements at banks arbitrarily and even disproportionately impact asset classes.

While the scenario proposal is insightful in some areas, it highlights the need for further transparency and details. For example, the Federal Reserve states that the scenario policy statement "provides notice" that it intends to incorporate a funding shock into the scenarios. However, further information is required to comment meaningfully. Specifically:

- The Federal Reserve needs to state a clear objective of the proposed change.[3]
- It is unclear how funding costs are evaluated as part of the existing stress testing framework.
- The proposal does not specify the types of liabilities that will be stressed, the magnitude of the stress, or the duration of the stress.
- There is no specification as to how the stress will be incorporated into the existing stress testing framework (e.g., as a separate component like the Global Market Shock, or as an integrated component of PPNR forecasting).
- There is no information on how the funding shock will interact with, and potentially duplicate, the Compressive Liquidity Analysis and Review (CLAR) and liquidity stress testing frameworks.

It is nearly impossible to evaluate the new funding shock given the lack of information. Based on the preliminary "notice," we have significant concerns that a funding shock through a single supervisory model will further distort the accuracy and predictability of the CCAR and stress testing exercises.

Similarly, the industry lacks sufficient information to evaluate the different impacts of implementing a proposed approach or a proposed alternate guide to determining the unemployment (UE) rate severity. The current approach uses the greater of a 300-500 basis point (bp) increase in the UE or 10% in the Severely Adverse scenario, using a floor of a 10% UE. The proposed approach allows qualitative judgment, using metrics like labor market and credit losses, to increase the rate by less than 400bp in certain instances, while having no cap. Additionally, the alternative guide proposed is purely quantitative, taking the lesser of a 400bp rise and cap of 11%. This alternative quantitative guide makes no mention of maintaining the current 10% UE floor. We urge the Federal Reserve to clarify whether the 10% UE floor will remain in both the proposed approach and the alternative approach and allow the industry an additional chance to comment. It is our belief that maintaining a 10% floor would render the revisions irrelevant in the current macroeconomic environment and could lead to scenarios with severity well in excess of post-war recessions.[4]

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[3] If the objective of the Federal Reserve is to incorporate the impact to capital of an increase in interest expense, it is already doing so as a part of the PPNR [spell out] models. If it is to capture some other liquidity risk, this proposed change does not belong in the capital planning framework.

[4] With UE ~4.1% on December 31, 2017, a floor of 10% would imply that the CCAR 2018 supervisory severely adverse unemployment rate could increase by ~590 bp, a start-to-peak change which significantly exceeds the 450 bp increase in the last recession, as well as over the average of 360 bp for severe recessions generally. Such a

e. Eliminate Qualitative Objection in CCAR

The qualitative assessment, which can prompt objection to a capital plan aside from quantitative conditions, adds a major element of uncertainty for those banks to which the qualitative evaluation still applies. The Federal Reserve recently made a convincing case that the qualitative elements of CCAR add little to no value for banks with less than $250 billion in assets and ratified that change in regulation. The Federal Reserve should conclude that the pilot of eliminating the qualitative tests for banks with less than $250 billion in assets has demonstrated the lack of sufficient supervisory value in continuing to apply the qualitative elements of the stress tests to the larger banks. Qualitative issues are already addressed by supervisors as part of the normal, comprehensive bank examination process.

In discussing the qualitative assessment in a 2016 report, the Government Accountability Office found that the Federal Reserve, "has not disclosed information needed to fully understand its assessment approach or the reasons for decisions to object to a company's capital plan. Transparency is a key feature of accountability and this limited disclosure may hinder understanding of the CCAR program and limit public and market confidence in the program and the extent to which the Federal Reserve can be held accountable for its decisions."[5] Including qualitative elements in stress tests, especially given their inherent reliance on predictions of the future, raises the unwelcome and unnecessary specter of arbitrary regulatory action. The Federal Reserve should remove the potential for a qualitative objection from the CCAR for all banks.

III. Other Recommended Amendments to the Stress Testing Framework

In addition to comments on the Transparency Package, we offer some additional recommendations that we believe will further the goal of improving the value the stress testing framework for supervision and bank management purposes.

a. Allow Greater Flexibility around Capital Actions and Balance Sheet Assumptions

The capital plan rule requires companies to assume that capital actions planned in baseline conditions will be executed throughout the adverse and severely adverse supervisory scenarios. In effect the Federal Reserve assumes that large bank holding companies will not consider cutting dividends or halting share repurchases in a stress period if prudence recommends doing so. However, this requirement does not reflect banks' internal capital management policies. In reality, bank practices vary widely, not just from bank to bank but from situation to situation. The CCAR assumption allows for no deviation. Moreover, the CCAR assumption requirement can be inconsistent with regulatory restrictions, such as the capital conservation buffer, that restricts capital distributions.

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significant increase could have significant implications for the availability of credit to the marketplace, depending on firms' and supervisory models' sensitivity to the severity of start-to-peak changes.

[5] U.S. Government Accountability Office. (2016, November), Additional Actions Could Help Ensure the Achievement of Stress Test Goals, Publication No. GAO-17-48, see at https://www.gao.gov/products/GAO-17-48.

Similarly, in the 2014 CCAR cycle, the Federal Reserve replaced banks' balance sheet projections with its own model, which assumed that the supply of loans during the severely adverse scenario would not be restricted. The Federal Reserve's model projects an increase in the balance sheets of the CCAR banks during the severely adverse scenario. This is inconsistent with likely bank behavior, which would be to slow balance sheet growth or incur portfolio runoff in the face of declining capital levels. Moreover, even if a bank wanted to grow its balance sheets in stress conditions there may not be sufficient loan demand; some decline in demand by creditworthy borrowers for loans is inevitable in a serious recession. Recognizing this deficiency in the model, then Governor Daniel Tarullo discussed in a public speech the possibility of a "constant balance sheet" assumption. While a "constant balance sheet" assumption would be an improvement over the current model that projects balance sheet growth, a "constant balance sheet" assumption still would not reflect realistic assumptions, failing to capture likely bank behavior or its likely varieties.[6]

The CCAR stress testing framework should recognize banks' likely responsive behavior in the hypothetical scenarios, including the recognition that banks will react in a variety of manners consistent with their business models and with safe and sound operation of their firms. The Federal Reserve should remove the mandatory distribution assumptions, recognizing that actions to address investor concerns and interests can be conducted in ways to reinforce safe and sound operation of the bank, a key element of which can be preserving investor commitment to the bank.

We also recommend that the Federal Reserve revisit unrealistic balance sheet assumptions and allow banks to make the case that their balance sheets will not automatically grow under stress conditions, indeed recognize the economic and business reality that some retrenchment may be reasonable as well as appropriate for safety and soundness and economic reasons.

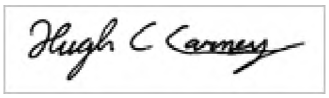
b. More Realistic, Tailored Tax Assumptions

We recommend that the stress test calculations use base case tax calculations as a starting point as these calculations are prepared in accordance with Generally Accepted Accounting Principles (GAAP). Starting with this base, the Federal Reserve can then calculate the tax effects of changes in pre-tax income generated in the Federal Reserve independent calculations and apply those effects to the existing base tax information. We believe that this would result in a better approximation than using a flat uniform rate.

[6] See, https://www.federalreserve.gov/newsevents/speech/tarullo20160926a.htm.

ABA appreciates the opportunity to comment on the Transparency Package. We view these proposals as an important first step to achieving a more transparent stress testing framework. We encourage the Federal Reserve to take additional steps to improve the overall stress testing framework as recommended in ABA's April 2017 Stress Testing White Paper. If you have any questions about the content of this letter please contact me, Hugh Carney, at (202) 663-5324.

Sincerely,



Hugh C. Carney
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