Morgan Stanley

June 25, 2018

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

Re: Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules; Docket No. R-1603; RIN 7100–AF 02.

Ladies and Gentlemen:

We appreciate the opportunity to comment on the notice of proposed rulemaking published by the Board of Governors of the Federal Reserve System (the "**Board**") to integrate the Board's regulatory capital framework and the Board's Comprehensive Capital Analysis and Review ("**CCAR**") and stress test rules through the establishment of a Stress Capital Buffer ("**SCB**") and related changes to capital planning standards and stress testing practices (the "**Proposal**").[1]

Morgan Stanley is a global financial services firm that provides its products and services to a large and diversified group of clients and customers, including corporations, governments, financial institutions and individuals. We are registered as a financial holding company with the Board and are subject to the Board's consolidated regulation and supervision, including the Board's regulatory capital framework, CCAR requirements, capital planning standards and stress testing practices.

We maintain robust capital, liquidity and funding positions to ensure that we can support clients' access to credit and capital markets at all points of the economic cycle, including in severely adverse markets. Over the past ten years, we have more than doubled our capital base while reducing our assets by more than 20 percent.[2] We have a diversified revenue base, with approximately 50 percent of our revenues generated by our wealth management and investment management segments, and our core

[1] 83 Fed. Reg. 18,160 (Apr. 25, 2018).

[2] Morgan Stanley reported common equity of $30.2 billion and total assets of $1,045.4 billion in our Form 10-K for the fiscal year ended Nov. 30, 2007 ("**2007 Form 10-K**"). 2007 Form 10-K, p. 68. At the time, Morgan Stanley's fiscal year ended on Nov. 30 and the firm was not a bank holding company and therefore did not compute or report regulatory capital figures based on the Board's regulatory capital standards. Morgan Stanley reported common equity of $68.9 billion and total assets of $851.7 billion in our Form 10-K for the year ended Dec. 31, 2017 ("**2017 Form 10-K**"), the end of our most recent fiscal year, and $61.1 billion of common equity tier 1 as of the same date, as measured in accordance with the Board's transitional regulatory capital standards for bank holding companies. 2017 Form 10-K, pp. 31, 64.

funding is comprised of deposits, long-term debt borrowings, long-dated secured funding and shareholders' equity.[3]

We strongly support the Board's policy objective of ensuring that large bank holding companies maintain sufficient levels of capital to support the risks associated with their exposures and activities. In addition, we strongly support stress testing and capital planning practices that make the Board's capital framework more forward-looking, risk-sensitive, and firm-specific. We agree with the Board's observation that large U.S. bank holding companies are much more resilient to stress than in the past, and that U.S. firms are among the strongest in the world.[4]

We request the Board to consider comment letters on the Proposal submitted by The Financial Services Forum; The Clearing House Association L.L.C., the Securities Industry and Financial Markets Association, and the Financial Services Roundtable; and the American Bankers Association, which contain many recommendations that would improve the design and operation of the Board's capital framework and stress testing practices. We have submitted this letter to highlight issues of particular concern to Morgan Stanley.

I. Executive Summary

The Proposal places CCAR stress loss analysis at the center of the Board's regulatory capital framework. CCAR is a mature regulatory framework, with nearly ten years of operating history. The Proposal provides an opportunity to identify best practices within CCAR, eliminate redundancies and inefficiencies, and improve the realism and development of supervisory scenarios to most appropriately test firms' exposures and vulnerabilities. While there are elements within the Proposal that represent clear improvements from current practice, the Proposal retains a gold-plated approach that, at best, approximates firms' risk profiles and impedes firms' ability to efficiently allocate capital to business units in order to facilitate client lending activities and capital markets access.

A robust stress testing framework also supports strong capital planning, and one of the primary goals of capital planning is to align, to the greatest extent possible, capital management with risk management.[5] While the Proposal seeks to advance this goal through the integration of the regulatory capital framework with CCAR stress loss results, it also reinforces an existing divergence between firms' risk management and capital management practices. Since supervisory scenario stress losses, rather than firms' independent risk management assessments, drive the SCB, firms are unable to completely align their capital management and risk management practices. While this divergence is inherent in any capital framework that includes supervisory add-ons, it is particularly striking in the Board's regulatory capital framework given the magnitude of supervisory stress loss projections for some firms and the inability of firms to fully understand what is driving such stress losses. For example, in the Board's 2018 severely adverse scenario, the Board estimated projected Morgan Stanley net income before taxes of -$20.8 billion

[3] 2017 Form 10-K, p. 35; Morgan Stanley, "Morgan Stanley Fixed Income Investor Call," (Nov. 3, 2017), pp. 4, 5.
[4] See 83 Fed. Reg. at 18,160-18,161.
[5] See, e.g., Board, Capital Plans, 76 Fed. Reg. 74,631, 74,634 (Dec. 1, 2011) (citing risk management infrastructure as the first criterion for evaluating the robustness of a bank holding company's capital adequacy process).

whereas we estimated net income before taxes of -$15.9 billion in the same scenario.[6] The $4.9 billion difference appears to be largely driven by a $4.1 billion difference in "other" projected losses for which the Board does not provide detailed disclosure.[7]

Our recommendations would improve CCAR and capital planning by making them more forward-looking, risk-sensitive and tailored to firms' individual risk profiles. These recommendations would scale supervisory losses based on plausible, if remote, shock scenarios; avoid layers of duplication and imprecision in stress loss analysis; and incorporate stress loss parameters that appropriately capture the range of business unit exposures and vulnerabilities within each firm. These comments focus on the following four principal areas of the Proposal:

- **GSIB surcharge (II.A)**: The SCB framework should combine the stress loss-based SCB with GSIB Method 1 requirements, not GSIB Method 2. The SCB framework should be subject to a floor comprised of the Capital Conservation Buffer ("**CCB**"), Countercyclical Capital Buffer ("**CCyB**") and GSIB Method 2 surcharge. This approach would ensure that U.S. GSIBs' regulatory capital requirements remain at least equal to current requirements, align with global standards, and avoid the conceptual and operational duplication resulting from combining CCAR stress loss results and GSIB Method 2 together. In addition, the Board should reopen GSIB Method 2 for comment, as it was designed and calibrated based on 2012-14 data and does not account for recent enhancements to systemic risk regulations that reduce firms' probability of default, loss given default and expected loss.

- **CCAR practices (II.B):** Adoption of the SCB increases the centrality of the Board's stress loss analysis in the regulatory capital framework. Reasonable "guardrails" on the content and severity of supervisory stress scenarios, improvements to risk sensitivity in stress loss assumptions and enhancements to CCAR transparency would, in combination, enable firms to better align their risk management and capital management practices. CCAR should test firms' vulnerabilities to hypothetical but plausible tail risks, rather than to very severe stress scenarios in which market variables fail to align with reasonable guideposts from financial history and economic theory. To improve realism and restore the alignment of risk management and capital management, CCAR should let the value of trading assets "float" in the projection period in response to the global market shock and the macroeconomic scenario.

- **Capital planning process (II.C):** The SCB framework would require firms to meet, on an ongoing basis, a firm-specific SCB based on stress loss results in the supervisory

[6] Board, "Dodd-Frank Stress Test 2018: Supervisory Stress Test Methodology and Results" (Jun. 2018) ("**2018 DFAST Results**"), Table C.23.A; Morgan Stanley, "2018 Dodd-Frank Act Annual Stress Test (DFAST)" (Apr. 2018) ("**2018 MS DFAST Disclosure**"), p. 8.

[7] The Board's loss estimates include $6.1 billion in "other losses/gains" and $1.8 billion in losses related to "other loans," for $7.9 billion total. The Morgan Stanley DFAST loss estimates include $3.2 billion in "other gains/losses" and $0.6 billion in losses related to "other loans," for $3.8 billion, which is $4.1 billion lower than the Board's estimated projected losses for these two categories. 2018 DFAST Results, Table C.23.A; 2018 MS DFAST Disclosure, pp. 8-9.

severely adverse scenario, as calculated by the Board. Firms should be permitted to take capital actions at their discretion, without prior review and non-objection by the Board, provided that they would continue to meet the SCB buffer, and all other point-in-time capital standards, after taking the capital actions.

- **Volatility and *de minimis* breaches (II.D)**. While the Proposal simplifies the capital framework in many respects, it introduces new volatility in both year-over-year SCB calibrations, which may be driven by changes in supervisory scenario assumptions or models rather than by changes in firms' risk profiles, as well as intra-year capital management resulting from normal course capital ratio fluctuations. Firms' ability to provide credit to the real economy and to facilitate clients' access to capital markets would be impaired if they are forced to hold buffers-on-buffers to avoid any risk of a *de minimis* breach that could harm shareholders. To address these volatility challenges, we recommend that the SCB framework incorporate a *de minimis* exception safe harbor, scaled to the size of a firm's pre-funded dividends, where SCB breach restrictions would not apply.

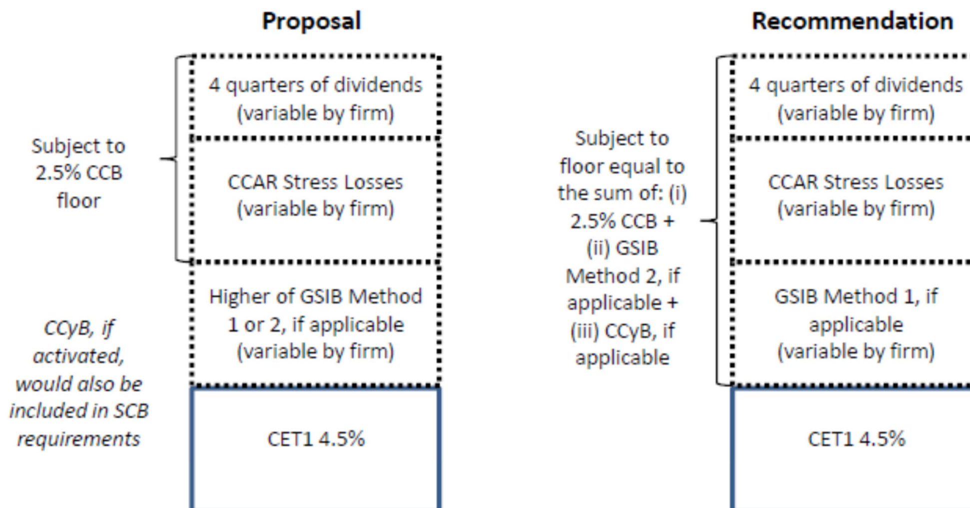
II. Discussion

A. The SCB framework should utilize GSIB Surcharge Method 1, but Method 2 together with the CCB and the CCyB should serve as a floor to SCB requirements

The Proposal includes a CCB-based floor to ensure that firms' SCB surcharges are at least equal to 2.5 percent. We recommend that the SCB framework incorporate only GSIB Method 1 surcharges, but that the floor be expanded to include the 2.5 percent CCB, firm-specific GSIB Method 2 surcharges and any CCyB. Revising the SCB and the floor in this manner would avoid substantial overlap in trading asset-focused Method 2 charges with trading asset-focused CCAR stress losses, ensure that firms' capital requirements remain at least equal to current levels, and promote harmonization with international standards.

While there are valid reasons for excluding any GSIB surcharge requirement from post-stress loss capital requirements, revising the design of the SCB and its floor in the manner described below would balance the policy goals of CCAR with those of the GSIB surcharge:

Recommended Design of SCB Framework



This approach would ensure that regulatory capital requirements would not decline for any firm relative to current standards, since the existing 2.5 percent CCB and firm-specific GSIB Method 2 surcharge would remain as a floor to SCB requirements. In addition, if the Board activates the CCyB, its inclusion in the floor would ensure that the CCyB retains a central role in the regulatory capital framework without duplicating CCAR stress loss analysis. More importantly, this approach would resolve the "double count" problem that would arise from combining CCAR stress losses and GSIB Method 2.

1. The SCB should be combined with GSIB Method 1, not GSIB Method 2

The Board provided its rationale for adopting GSIB Method 2 in a 2015 white paper (the "**GSIB White Paper**").[8] The GSIB White Paper explains that when developing the GSIB surcharge, the Board utilized an "expected impact" framework, which considers probability of default and loss given default to calculate an expected loss for firms. As explained in the GSIB White Paper, "the goal of the GSIB surcharge is to equalize the expected loss from a GSIB's failure to the expected loss from the failure of a non-GSIB reference BHC."[9] The explanation of GSIB Method 2 in the GSIB White Paper is particularly significant, since this methodology is not based on international standards and was, instead, developed independently by the Board. The "expected impact" analysis in the GSIB White Paper does not support inclusion of GSIB Method 2 in combination with the SCB.

Combining the SCB with GSIB Method 2 would introduce substantial duplication into the regulatory capital framework. The Board adopted GSIB Method 2 to reduce firms' probability of default, and thereby reduce firms' expected losses; similarly, CCAR is designed to determine whether firms "are sufficiently capitalized to absorb losses during stressful conditions."[10] While the standards rely on different measurements—Method 2 focuses on short-term wholesale funding ("**STWF**"), whereas CCAR stress losses are driven by a hypothetical global market shock and macroeconomic scenario—in practice

[8] Board, "Calibrating the GSIB Surcharge" (Jul. 20, 2015).
[9] GSIB White Paper, p. 3.
[10] 2018 DFAST Results, p. iii.

there is substantial overlap, since STWF typically supports trading assets that are a primary focus of the CCAR global market shock. This overlap and inefficiency are further reinforced by the Board's announcement that it may modify CCAR stress loss assumptions to account for funding risks, which would directly duplicate the defining feature of GSIB Method 2 in CCAR.[11] In addition, the Board has not revisited Method 2 since its adoption in 2015, rendering it an increasingly inefficient regulatory tool for imposing capital requirements on top of the stress loss-based SCB, which would be dynamic and updated annually.

Combining the SCB with GSIB Method 2 would also add unnecessary complexity to the regulatory capital framework. The STWF component of Method 2 is based on estimates of the gross unwind of a firm's funding sources under stress conditions. It should be calculated on a net basis, measuring both anticipated inflows and outflows, similar to the U.S. Liquidity Coverage Ratio ("**LCR**"). In addition, Method 2 uses firms' risk-weighted assets ("**RWAs**") in the denominator of its STWF formula, which results in firms with higher RWA density (and by definition greater risk) achieving a lower Method 2 requirement. Combining GSIB Method 2 with the SCB would result in a capital framework that relies on measurements of gross funding risk, risk-adjusted stress losses, and preferential treatment for large RWAs—weakening the goal of simplicity and appropriately tailored supervision.

Incorporating Method 1 into the SCB framework would better advance the principles of efficiency, transparency and simplicity, and would better align with global capital standards. Method 1 is conceptually and operationally separate from CCAR stress loss analysis, permitting the distinct goals of the GSIB surcharge framework to work in tandem with those of CCAR. Method 1 is subject to periodic review by the Basel Committee on Banking Supervision (the "**Basel Committee**"), providing transparency and an opportunity to correct imbalances in its design on a periodic basis.[12] Reliance on Method 1 in the SCB framework would also achieve simplicity, with large U.S. bank holding companies required to meet globally consistent capital buffers on a post-stress loss basis, avoiding overlaps between trading asset-focused STWF measurements and CCAR stress losses. This approach would also avoid buffers-on-buffers that, in practice, would require further internal management buffers that distort the efficient allocation of capital to client lending activities and capital markets access.

2. Method 2 should be reopened for comment to account for significant regulatory changes since its adoption in 2015

The Board adopted Method 2 in 2015 based on 2012-14 data.[13] The GSIB White Paper includes detailed mathematical calculations explaining how the Board designed and calibrated Method 2 based on this historical data set, including by applying 99 percent confidence intervals and standard deviation

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[11] See Board, Policy Statement on the Scenario Design Framework for Stress Testing, 82 Fed. Reg. 59,533, 59,535 (Dec. 15, 2017) (the "**Scenario Design Proposal**") ("The Board has not historically captured stress to funding markets in the supervisory stress test exercise. However, it is exploring the inclusion of such a stress in the scenarios, given the potential impact that funding shocks could have on firms subject to the supervisory stress test.").

[12] See Basel Committee, *Global systemically important banks - revised assessment framework* (Mar. 2017); see also Basel Committee, *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement* (Jul. 2013).

[13] GSIB White Paper, p. 4.

analysis. The Board applied this analytical framework to underlying U.S. GSIB data sources to arrive at projected Method 2 surcharge ranges for each U.S. GSIB.[14]

While the GSIB White Paper provides a degree of transparency, it also demonstrates that the analysis used to design and calibrate Method 2 is increasingly obsolete. The 2012-14 data sources relied on by the Board did not reflect, among other standards, compliance with variation margin requirements, which took effect for most counterparty relationships in 2016; initial margin requirements, which are subject to phase-in through 2020; the LCR, for which full compliance was required in 2017; Total Loss Absorbing Capacity requirements, which take effect in 2019; or liquidity and funding prepositioning in connection with Recovery and Resolution Planning, which firms implemented based on guidance for their 2017 resolution plans.[15] While the GSIB White Paper may, to some extent, have anticipated some of these post-2015 developments, the quantitative analysis in the paper necessarily excluded any consideration of changes in firms' portfolios, funding practices and risk profiles beyond the 2012-14 data set.

We recommend that the Board reopen Method 2 for comment and, as part of any revised standard, publish an updated white paper to explain its design and calibration in light of recent prudential enhancements. Reconsideration of Method 2 is particularly important in light of the Board's reliance on Method 2 in other regulatory frameworks, such as the enhanced Supplementary Leverage Ratio proposal and existing Total Loss Absorbing Capacity standards.[16]

In addition, we recommend that the Board adopt a formal procedure to review Method 2 on a periodic basis, consistent with the Basel Committee's review process for the global standard that is utilized in Method 1.[17]

B. Enhancements to the efficiency, transparency and simplicity of CCAR should be adopted in parallel with the SCB

Our recommendations below are informed by the severity and design of prior CCAR supervisory scenarios and the opacity of supervisory results. Every year, the CCAR scenarios become more severe and result in greater hurdles for firms, which is inconsistent with actions firms have already taken to improve their safety and soundness. 2018 CCAR, for instance, included an assumption that U.S. equity markets declined sharply even while U.S. Treasury yields remained elevated and flat throughout the projection period. A sharp decline in U.S. equity values would almost certainly result in a classic "flight to quality" in which investors seek safety in U.S. Treasury securities, forcing down yields.

In addition, increasing CCAR stress loss disclosures would improve firms' ability to utilize stress loss analysis in risk management. For example, to the extent that CCAR assumes that loan losses occur, it

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[14] GSIB White Paper, pp. 7-12.

[15] See Board and Federal Deposit Insurance Company, "Guidance for 2017 §165(d) Annual Resolution Plan Submissions By Domestic Covered Companies that Submitted Resolution Plans in July 2015" (Apr. 2016).

[16] See Board, Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies, 83 Fed. Reg. 17,317 (Apr. 19, 2018) (proposing to incorporate Method 2-based calibrations); 12 C.F.R. § 252.62(a)(1) (scaling long-term debt requirements, in part, based on firms' Method 2 scores).

[17] See footnote 12.

is unclear whether and to what extent CCAR stress loss analysis takes into account daily mark-to-market margining requirements, which would mitigate our losses in the event of a gradual decline in equity security values in the macroeconomic scenario, or the extent to which the "stickiness" of our wealth management client relationships would result in more stable advisory revenues during periods of market turmoil.

We offer the recommendations below to improve the realism of supervisory stress loss analysis and improve firms' ability to utilize such analysis as part of their risk management practices.

1. Supervisory Scenario "Guardrails"

In December 2017, the Board published for comment a package of CCAR-related proposals, including the Scenario Design Proposal and a stress testing policy statement proposal (the "**Stress Testing Proposal**") (collectively, the "**Supervisory Scenario Proposals**").[18] The Scenario Design Proposal would, among other things, impose quantitative boundaries on unemployment and house price index ("**HPI**") assumptions in the macroeconomic scenario but no similar limitations in the global market shock. The Stress Testing Proposal describes the principles, policies, and procedures that guide the development, implementation, and validation of the Board's supervisory stress test models, but does not include express quantitative limitations on the Board's modelling assumptions. We recommend that the Board expand the Supervisory Scenario Proposals to include "guardrails" in the development of the global market shock and in the interaction of the global market shock and macroeconomic scenario.

Global market shock scenario design policy statement

The Board's process for developing the global market shock should be subject to the same procedural requirements and substantive guardrails as the macroeconomic scenario. Similar to the unemployment and HPI guidelines in the Scenario Design Proposal, the Board should propose for notice and comment a global market shock scenario design policy statement that includes quantitative guidelines for each trading asset class. Such quantitative guidelines could be developed with reference to historical loss data supplemented by recent observations of market developments.

Shock severity and rate of decline within and across the global market shock and macroeconomic scenario

The severely adverse supervisory scenario should, as a general principle, not be significantly more severe than recent historical examples of economic distress, and the arc and duration of declines should be based on applicable historical precedents supported by clear economic theory. While the Board will necessarily need to adjust specific components of the shocks each year, these individual components, in the aggregate, should result in a stress scenario that is not significantly more severe than the most severe historical reference periods. Similar to the Board's decision in the Scenario Design Proposal to impose boundaries on unemployment assumptions, limitations on shock severity should apply both within each of the global market shock and macroeconomic scenario and across them, when viewed together.

[18] Board, Stress Testing Policy Statement, 82 Fed. Reg. 59,528 (Dec. 15, 2017); see also Board, "Press Release: Federal Reserve Board requests comment on package of proposals that would increase the transparency of its stress testing program" (Dec. 7, 2017).

Plausibility and coherence within the supervisory scenario

Supervisory stress-testing should examine firms' resiliency in response to remote but plausible scenarios, including severely adverse scenarios. The Board acknowledged this principle, in part, in the Scenario Design Proposal by explaining that, when developing the market shock, "if there is a disagreement between the risk factor movements in the historical event used in the scenario and the hypothetical event, the Board will reconcile the differences by assessing a priori expectation based on financial and economic theory and the importance of the risk factors to the trading positions of the covered companies."[19] The Board should extend this statement to provide that supervisory stress scenarios will be coherent within and across the global market shock and macroeconomic scenario, ensuring that the supervisory scenario is a realistic test of firms' resiliency. Requiring supervisory scenarios to meet a plausibility and coherence standard, for instance, could have resulted in a "flight to quality" assumption accompanying the equity market decline in 2018 CCAR.

Trading assets in the projection period

The Proposal would modify the Stress Testing Proposal to include an assumption that each "firm takes actions to maintain a constant level of assets, including loans, trading assets, and securities over the planning horizon" and that each firm's "risk-weighted assets remain unchanged over the planning horizon."[20] The Proposal justifies this assumption, in part, by explaining that "newly originated loans would be part of a covered company's normal business, even in a stressed economic environment" but includes no rationale to support an assumption that firms would maintain a constant level of trading assets or that trading assets would remain unchanged over the planning horizon.[21] We believe that financial history and economic theory demonstrate that trading assets would decline in value in virtually any stress scenario and that the SCB framework should incorporate such an assumption, potentially by marking down the value of trading assets in projection periods to reflect the global market shock or by allowing trading assets to fluctuate with the changing macroeconomic variables over the nine-quarter projection horizon. To improve realism and restore the alignment of risk management and capital management, CCAR should let the value of trading assets "float" in the projection period in response to the global market shock and the macroeconomic scenario.

2. <u>CCAR stress loss analysis</u>

Avoiding illogical double-counting when calculating deductions in projection period pro forma capital ratios

In its current operation, CCAR imposes capital charges on deduction-eligible assets in two ways. First, firms recognize losses directly stemming from the application of the global market shock and the macroeconomic scenario to their assets, resulting in declining asset values that are reflected in declining capital bases. Second, when firms calculate pro forma capital ratios in the nine-quarter projection period, they calculate capital deductions against the lower post-stress loss capital base, resulting in more deduction-eligible assets over the deduction thresholds. However, CCAR requires firms to use pre-stress

[19] 82 Fed. Reg. at 59,545.
[20] Proposal at 18,187-88 (modifying Stress Testing Proposal §§ 2.7, 3.4).
[21] Proposal at 18,187 (modifying Stress Testing Proposal § 2.7).

loss asset values when calculating post-stress loss capital deductions, introducing a disconnect between stress loss analysis and pro forma capital calculations. We recommend that, as part of the second step of the stress loss analysis, firms calculate deductions in post-stress loss capital ratios using post-stress loss asset values.

To illustrate, consider a firm that, pre-stress loss, has $100 billion of regulatory capital and, among other assets, $8 billion of unconsolidated investments in financial institutions ("**IFI**") that are deduction-eligible. In this example, the firm's IFI positions do not exceed 10 percent of the firm's regulatory capital, meaning that no IFI-related deduction would apply.[22]

This analysis changes in the CCAR severely adverse scenario, which generally imposes heavy losses on IFI positions. For example, suppose that the CCAR shocks resulted in the firm recognizing $6 billion of IFI losses, reducing their value from $8 billion to $2 billion in the projection period. In addition, assume that the $6 billion of IFI losses are part of overall CCAR projected losses of $30 billion, which reduce the firm's post-stress loss regulatory capital from $100 billion to $70 billion.

The firm's post-stress loss regulatory capital is $70 billion, meaning that the IFI deduction threshold is $7 billion, or 10 percent of the firm's revised capital base. In the current operation of CCAR, the firm would be required to recognize a post-stress loss capital deduction of $1 billion, since the original, pre-stress loss $8 billion IFI position exceeds the post-stress loss deduction threshold by this amount. We believe that post-stress loss capital ratios should be calculated by applying post-stress loss asset values when calculating deductions. In the above example, the firm should evaluate deductions using the post-stress loss $2 billion IFI position, which is well below the deduction threshold of $7 billion in the revised ratio.

Including the original, pre-stress loss asset values when calculating deductions in post-stress loss capital ratios introduces a mismatch between pre- and post-stress loss reference values. It also exaggerates already severe stress losses; in the above example, the CCAR shocks resulted in a 75 percent loss from the original asset value, which is then compounded further by the capital deduction. Depending on the exact circumstances, in some cases the initial stress losses, when paired with the capital deductions, can result in firms suffering losses on securities that exceed the original values of those securities. At a minimum, CCAR analysis should avoid imposing capital requirements, taking into account both stress losses and deductions, that exceed the current value of securities or investments.

Reflecting variation margining arrangements in the largest counterparty default

Firms are required to calculate their largest single counterparty default as part of the global market shock. In current practice, estimates of counterparty defaults do not distinguish between margined and unmargined counterparties. As recognized in the Board's margin rule for uncleared derivatives, counterparty relationships that lack margining arrangements present greater jump-to-default risk. While the global market shock is designed as an instantaneous event, a counterparty default scenario would, in

[22] We have simplified this example by only considering the 10 percent IFI deduction in Section 22(c)(4) of the Board's regulatory capital framework. In practice, the firm in this example would also need to apply the 15 percent deduction threshold in Section 22(d)(2), which applies to IFI positions combined with certain other deduction-eligible assets.

practice, likely arise over several days or weeks of market deterioration where ongoing variation margining would mitigate a firm's counterparty exposure.

Accordingly, the Board should revise the largest counterparty default element of the supervisory scenarios to account for variation margining arrangements since they reduce the scale of losses a firm may suffer if the counterparty defaults. Stress loss analysis could recognize the credit risk benefits of counterparty variation margining arrangements where such arrangements have relatively low posting thresholds (e.g., below $1 million), thereby ensuring that large mark-to-market moves over several days would be collateralized.

Aligning Board calculations with BHC instructions to avoid potential duplication of global market shock and macroeconomic scenario losses

The Board's instructions for the bank holding company ("**BHC**") stress loss scenarios permit firms to eliminate double-count losses where (i) the stress losses arise separately from the global market shock and macroeconomic scenario, (ii) the separate global market shock and macroeconomic scenario stress losses apply to the same firm asset or position and (iii) the firm recognizes the higher of the global market shock or macroeconomic scenario stress loss per asset or position.[23]

In their current form, the CCAR instructions and disclosures do not clarify whether, in the supervisory scenarios, the Board eliminates these double-count losses. We recommend that the Board clarify that, in calculating supervisory scenario stress losses, the Board will rely on the same process as firms follow in the BHC scenario for eliminating such losses. In practice, this may require the Board to modify the FR Y-14A to include a template for the analysis necessary to demonstrate the three conditions above.

3. Improvements to CCAR transparency

Expanding asset class disclosures

The Board's December 2017 CCAR reform package also included an enhanced disclosure proposal (the "**Disclosure Proposal**").[24] The Disclosure Proposal raised the prospect of expanded disclosures relating to both stress loss methodology and stress loss results; although, as proposed, the actual draft disclosure tables were limited to corporate loans. After publication of the Disclosure Proposal, Vice Chair Quarles noted that the Board's CCAR-related disclosures could be further expanded.[25]

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[23] Board, "Comprehensive Capital Analysis and Review 2018 Summary Instructions" (Feb. 2018), p. 9.

[24] Board, Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test, 82 Fed. Reg. 59,547 (Dec. 15, 2017).

[25] See Vice Chair Quarles, "Early Observations on Improving the Effectiveness of Post-Crisis Regulation" (Jan. 19, 2018), p. 9 ("I believe that the disclosure we have provided does not go far enough to provide visibility into the supervisory models that often deliver a firm's binding capital constraint. It is important in any proposal to receive comments, and I can say that I and my colleagues on the Board will be paying particularly close attention to your comments on how we might improve this current proposal.").

We recommend that the Board expand the Disclosure Proposal to include all asset classes, including trading assets.[26] We believe that CCAR disclosures should be asset class-neutral, particularly since CCAR stress losses are generally at least as high for trading assets as corporate loans, making disclosure equally meaningful.

This disclosure is particularly important in stress loss categories where the Board currently provides minimal information. For example, as noted earlier in this letter, the Board's stress loss analysis in the 2018 supervisory severely adverse scenario included, without elaboration, "other" losses that are $4.1 billion higher than Morgan Stanley's estimates of those same line items. This $4.1 billion difference was the primary driver in the aggregate $4.9 billion loss estimate difference between the Board's and Morgan Stanley's analysis of the same scenario.[27]

Expanding disclosures to include Pre-Provision Net Revenue (PPNR)

We also recommend that the Board expand the Disclosure Proposal to include summary information on the components of Pre-Provision Net Revenue ("**PPNR**") estimates for each firm, including net interest income, non-interest income, non-interest expense, and operational risk losses.[28] Disclosing PPNR projections would permit firms to better align their risk and capital management practices with the Board's stress loss analysis. PPNR disclosures would be particularly meaningful for business units, such as our wealth management franchise that accounts for approximately 45 percent of our revenues, which are driven more by recurring, fee-based advisory revenues rather than by trading, mark-to-market gains or losses or net interest income earned on loans and securities. Expanding CCAR disclosures to include PPNR components would result in equivalent disclosures across asset-focused and advisory-based business units.

C. *Firms should be permitted to take any capital action if, after taking such action, they continue to meet SCB requirements and all other applicable capital ratios*

By design and operation, the SCB requires firms to capitalize against stress losses at all points in time. In recognition of this fact, the Proposal would eliminate the quantitative objection feature of the Board's capital planning rule.[29] In practice, however, a form of the quantitative objection would still remain, because firms would be required to submit to the Board, as part of each capital planning annual cycle, proposed quarter-by-quarter capital actions and associated post-stress loss capital ratios. We recommend that the Board further simplify the capital planning process by permitting firms with discretion throughout the year to independently determine appropriate capital actions, provided that all capital buffers, including the SCB, are being met.[30] Firms would still prepare and submit to the Board

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[26] Depending on the level of granularity in asset class disclosures, the Board may consider providing this information on a confidential basis to each firm.
[27] See footnotes 6 & 7.
[28] Depending on the level of granularity in PPNR disclosures, the Board may consider providing this information on a confidential basis to each firm.
[29] 83 Fed. Reg. at 18,167.
[30] To qualify as a capital instrument, Regulation Q requires that the Board must provide its prior approval before a bank holding company is permitted to repurchase such instrument. 12 C.F.R. § 217.20(b)(1)(iii), (c)(1)(vi), (d)(1)(x). The Board's notification to a firm of its SCB each year should be treated as a prior approval, for

capital plans as part of their normal course capital planning process, but the Board would rely on the SCB and other point-in-time capital standards as the exclusive quantitative metric for assessing capital adequacy.

The Board's capital plan rule, adopted in 2011, created a regulatory structure for the Board to review, and potentially object to, each firm's anticipated quarter-by-quarter capital actions through the nine-quarter projection period. When adopting the capital plan rule, the Board recognized that "the board of directors and senior management of a large bank holding company bear the primary responsibility for developing, implementing, and monitoring the bank holding company's capital planning strategies and internal capital adequacy process" and that the Board's "review of capital plans is intended to ensure that large bank holding companies have sufficient capital to weather stressful economic conditions and help to mitigate any systemic risks posed by the firms."[31] "The Board intends to strike a balance between maintaining the board of directors and senior management's primary responsibility in capital planning and ensuring that these firms have sufficient capital to operate in a manner that is safe and sound and does not pose material risk to the financial system."[32]

The SCB restrikes this balance. With stress loss-based capital requirements applicable at all times throughout the year, the original purpose of the Board's quantitative review—to ensure that firms have sufficient capital to weather stressful economic conditions, as measured in each CCAR cycle, and mitigate systemic risks posed by firms—will be hardwired directly into each firm's capital requirements. As a result, each firm's board of directors and senior management should be able to exercise their primary responsibility for determining capital actions within the confines of the SCB framework. To the extent that the Board believes that the SCB framework by itself is insufficient, the Board retains other supervisory powers to ensure prudent capital planning and management. The Board's proposed supervisory guidance for board of directors' effectiveness highlights each board of directors' central role in maintaining the resiliency, including capital governance, of the firm, and the proposed Large Financial Institution rating program would elevate the Board's assessment of each firm's capital planning and positions to one of three supervisory pillars.[33]

Accordingly, we recommend, in connection with each CCAR cycle, that firms submit capital plans, including the four quarters of planned dividends utilized in the SCB, and associated stress loss data to the Board on April 5 each year in the manner contemplated by the Proposal, but that the Board limit its actions in response to providing firms with their SCB ratio for the coming year. In particular, we recommend that the Board eliminate its current practice of reviewing prospective quarter-by-quarter capital actions and associated projection period post-stress loss capital ratios and permit firms with discretion to independently determine the size, type and timing of any capital actions after receiving their SCB ratios from the Board, provided that the firm meets its SCB requirements and all other point-in-time

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Regulation Q purposes, for the firm to repurchase capital instruments in any amount, provided that the firm remains in compliance with its SCB and all other point-in-time regulatory capital requirements.

[31] Board, Capital Plans, 76 Fed. Reg. 74,631, 74,639 (Dec. 1, 2011).

[32] 76 Fed. Reg. at 74,639.

[33] See Board, Proposed Guidance on Supervisory Expectation for Boards of Directors, 82 Fed. Reg. 37,219, 37,224 & n.10 (Aug. 9, 2017); Board, Large Financial Institution Rating System; Regulations K and LL, 82 Fed. Reg. 39,049, 39,050 (Aug. 17, 2017).

capital requirements after taking the capital action. This approach would improve the efficiency and simplicity of the Board's capital regime by completing the integration of capital planning and stress-testing, while ensuring that the Board has sufficient supervisory tools to enforce prudent capital planning and capital management.

D. Minor SCB breaches resulting from normal course volatility should be addressed through a de minimis *exception safe harbor*

1. *De minimis* exception safe harbor

The SCB framework potentially increases regulatory capital volatility in two ways. First, firms' regulatory capital requirements will change every year in response to revised CCAR stress loss results, with only a three-month window to come into compliance with the revised SCB requirement. Stress loss results may change year-to-year based on changes in the Board's stress loss models even where the firm has not changed its risk profile during the same period. Second, for some firms, the SCB significantly increases point-in-time capital requirements by combining the GSIB surcharge with stress loss results. As a result, these firms will be required to meet much higher point-in-time ratios throughout the year, magnifying the consequences of normal course intra-year volatility in capital ratios resulting from temporary RWA spikes, accounting developments, and similar events.

To address these volatility challenges, we recommend that the SCB framework include a *de minimis* exception safe harbor, scaled to the size of the firm's prefunded dividends. When a firm falls into the exception safe harbor, it would receive a 90-day grace period during which capital action restrictions would not apply. If the firm's capital ratios decline below the exception safe harbor during the 90-day period, capital action restrictions would apply, as contemplated by the Proposal. The exception safe harbor would only apply to the extent a firm's SCB exceeds 2.5 percent, ensuring that there is no relaxation of existing buffer requirements, and would remain constant throughout each annual SCB cycle.

An exception safe harbor designed in this manner would mitigate the challenges posed by both year-to-year and intra-year volatility and avoid the potentially damaging market signaling effects of missing a dividend payment because of a *de minimis* and temporary fall in capital ratios. While the Board's existing buffers, including the GSIB surcharge and CCB, do not include a similar exception safe harbor, the need for an exception safe harbor is manifestly greater after adoption of the SCB given the significant projected increases in certain firms' point-time-time capital ratios, which increases the possibility of a *de minimis* and temporary breach.

2. Clarifying the treatment of Additional Tier 1 (AT1) capital instruments

Adoption of a *de minimis* exception safe harbor would also provide the Board with an opportunity to clarify an ambiguity in the Proposal related to potential restrictions on the payment of dividends on Additional Tier 1 ("**AT1**") capital instruments, such as preferred stock.

A firm that fails to meet its SCB would be subject to restrictions on capital distributions, which are defined in the Board's capital and capital planning rules as including payment of dividends on both

common and preferred stock.[34] Neither the Proposal preamble nor the accompanying Board staff memo indicates, however, whether the Board intends for SCB breaches to result in restrictions on preferred stock or other AT1 dividends; in each case, the guidance is limited to a discussion of common stock dividend restrictions.[35] The Proposal, however, indicates that SCB stress loss results will assume full payment of AT1 dividends throughout the nine-quarter projection period.[36]

If the Board intends for planned preferred stock dividend payments to be reflected as expenses in planning period projections, then we recommend that the Board clarify that an SCB breach would not result in restrictions on preferred stock dividend payments. This approach would avoid an anomaly in which firms have effectively pre-funded nine quarters of preferred stock dividends as an expense line item but then become subject to SCB restrictions on the payment of such dividends.

Alternatively, the Board could achieve a similar result by including all pre-funded preferred stock dividends together with four quarters of common stock dividends as the dividend component within the SCB, but then expanding the *de minimis* exception safe harbor to include the full quantum of pre-funded dividends.

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[34] See 12 C.F.R. §§ 217.2, 225.8(c)(2) (definitions of "distribution and "capital distribution," respectively).

[35] See Proposal at 18,163 ("the stress buffer requirements would include only four quarters of planned common stock dividends"); Memo to the Board from Board Staff (Apr. 5, 2018), p. 3 (stating that the Proposal would "remove the current assumption in CCAR that a firm will carry out all nine quarters of its planned capital actions (e.g., dividends, repurchases, and issuances) in the stress test and instead require firms to prefund only four quarters of planned common stock dividends" without clarifying the treatment of preferred stock dividends).

[36] Proposal at 18,116 ("As in the current supervisory post-stress capital assessment, the Board would continue to assume in the supervisory stress test that a firm would make payments on any instrument that qualifies as additional tier 1 capital or tier 2 capital equal to the stated dividend, or contractual interest or principal due on such instrument during the quarter.").

III. Conclusion

We believe that large banking organizations must maintain robust capital, liquidity and funding positions and align, to the greatest extent possible, their capital management and risk management practices. Our comments on the Proposal would improve both the capital planning and stress-testing processes, by improving transparency and making CCAR more forward-looking, risk-sensitive and tailored to firms' individual risk profiles, while advancing the Board's goal of integrating the regulatory capital framework with CCAR stress loss results.

We appreciate the opportunity to provide comments on this significant rulemaking. Please contact us if discussion of any of the points from our letter would be helpful.

Respectfully submitted,

Jonathan Pruzan
Chief Financial Officer