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June 25, 2018

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

Re: Proposed Adoption of Stress Buffers and Related Revisions to the Regulatory Capital, Capital Plan and Stress Test Rules (Docket No. R-1603, RIN 7100-AF 02)

Ladies and Gentlemen:

The Institute of International Bankers ("IIB") appreciates the opportunity to provide comments on the recent proposal[1] by the Board of Governors of the Federal Reserve System (the "Board") to revise the regulatory capital, capital plan and stress test rules applicable to bank holding companies ("BHCs") with $50 billion or more in total consolidated assets and U.S. intermediate holding companies ("IHCs") of foreign banking organizations ("FBOs").[2]

The proposal contains two parts. The first part—simplifying the supervisory stress testing assumptions—we strongly support. However, the second—the introduction of stress buffers—is premature. First, the proposal would revise certain assumptions in the Board's annual Comprehensive Capital Analysis and Review ("CCAR") (the "CCAR Proposal") to narrow the set of assumed capital actions under stress and to revise the counterintuitive assumption that firms will expand their balance sheets during times of stress.

Second, the proposal would introduce "stress buffers" that would change annually based on (i) a firm's maximum projected regulatory capital declines under the severely adverse stress scenario of the Board's CCAR supervisory stress tests and (ii) one year of the firm's planned common stock dividends (the "Stress Buffers Proposal"). The Stress Buffers Proposal would replace the current fixed 2.5% capital conservation buffer[3] with a dynamic "standardized

1 83 Fed. Reg. 18,160 (April 25, 2018).

2 12 C.F.R. Parts 217, 225, and 252. BHCs with $50 billion or more in total consolidated assets and IHCs are currently subject to the Board's annual Comprehensive Capital Analysis and Review exercise ("CCAR") and are referred to collectively in this letter as "CCAR firms".

3 We note that the capital conservation buffer will not be fully phased in until January 1, 2019.

approach capital conservation buffer" ("Standardized CCB"). The Standardized CCB would incorporate several fluid buffer components: (i) a bespoke "stress capital buffer" ("SCB"), as described above, subject to a 2.5% floor; (ii) any countercyclical capital buffer ("CCyB") that may be in effect; and (iii) any surcharge that may apply to global systemically important BHCs ("GSIBs") under the Board's capital regulations. The Stress Buffers Proposal would also introduce a new stress leverage buffer ("SLB") as an add-on to a CCAR firm's minimum required Tier 1 leverage ratio that would consist of the maximum projected decline in its Tier 1 leverage ratio plus one year of its planned common stock dividends.

**We strongly support the CCAR Proposal and urge the Board to adopt without delay its simplifications to the CCAR assumptions to better align these assumptions with a firm's expected actions under stress.** The CCAR Proposal's revisions to the assumptions about a firm's capital distributions are necessary to make the CCAR consistent with real-world actions, because, under the current CCAR assumptions, a firm is required to assume that it will engage in capital distributions even when such distributions would in fact be prohibited under the capital conservation buffer. Similarly, the CCAR Proposal would correct the unrealistic assumption of balance sheet growth during a sharp economic downturn. These revisions are an important first step in simplifying the supervisory stress testing framework and ensuring that the Board's supervisory stress tests provide useful and accurate projections of expected losses in stress scenarios. We note that these simplifications to the CCAR assumptions were recommended by the U.S. Department of the Treasury in its 2017 report examining the regulatory changes that can be immediately undertaken to make regulation more efficient, effective and appropriately tailored.[4] The CCAR Proposal is a natural extension of the Board's recent package of proposals to increase transparency with respect to CCAR, which we also support as important initial step in strengthening the supervisory stress testing framework.[5] The CCAR Proposal is a logical next step in improving the quality and reliability of supervisory stress testing results before moving forward with the integration of the stress testing framework and the capital rules as contemplated by the Stress Buffers Proposal.

**However, the Stress Buffers Proposal is premature, and any reconsideration of the Stress Buffers Proposal needs to be sequenced properly after other pre-requisites are completed, especially with respect to IHCs.** The Stress Buffers Proposal should be tabled for reconsideration, for all CCAR firms, until after:

i. the stress testing framework has been appropriately revised to reflect (a) the Economic Growth, Regulatory Relief and Consumer Protection Act,[6] (b) the

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4 U.S. Department of the Treasury, A Financial System that Creates Economic Opportunities: Banks and Credit Unions (Oct. 2017) (the "Treasury Report"), p. 53.

5 82 Fed. Reg. 59547 (Dec. 15, 2017) (Enhanced Disclosure of the Models Used in the Board's Supervisory Stress Test); 82 Fed. Reg. 59533 (Dec. 15, 2017) (Policy Statement on the Scenario Design Framework for Stress Testing); and 82 Fed. Reg. 59528 (Dec. 15, 2017) (Stress Testing Policy Statement).

6 P.L. 115-174, S. 2155 ("Regulatory Relief Act").

recommendations highlighted in the Treasury Report and (c) the promised increase in transparency of the Board's stress testing models;

ii. the Board can conduct and disclose the results of an appropriate quantitative analysis of the Stress Buffers Proposal's impact on IHCs under the revised stress testing framework,[7] based on a robust IHC data set comparable to the BHC data set described in the Board's impact analysis of the Stress Buffers Proposal;[8] and

iii. the Board remedies the weaknesses in the Stress Buffers Proposal that we highlight below.

## I. Introduction and Summary

The IIB and its members generally support the goals and process of capital stress testing, capital planning and risk-based capital requirements. We welcome Vice Chairman Randal K. Quarles' recent statements that the Board is seeking to improve the "efficiency, transparency, and simplicity" of the regulatory framework for banking organizations.[9] We were also encouraged by Vice Chairman Quarles' statement that the Board will "consider additional tailoring and flexibility of [its] regulations in light of their impact on [FBOs]"[10] (these statements, the "Reform Principles"). The IIB would support revisions to the Board's regulations that comport with these Reform Principles, which we agree would strengthen the effectiveness of the stress testing and capital planning process.

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7 The supplementary materials issued with the Board's recent proposal to implement single counterparty credit limits ("SCCL") indicate that the Board "is developing a comprehensive proposal on the extent to which it should apply the SCCL and other enhanced prudential standards [("EPS")] to banking organizations with total consolidated assets of $100 billion but less than $250 billion." See Draft SCCL proposal, p. 25. The Board retains discretion under the Regulatory Relief Act to apply EPS, including supervisory stress testing requirements, to banking organizations in this asset range, subject to a determination that such EPS would be appropriate to mitigate risks to U.S. financial stability or to promote safety and soundness. Given a proposal to revise the scope of EPS applicable to a portion of CCAR firms, including presumably IHCs, will be forthcoming, it is logical and reasonable to sequence a quantitative analysis of the impact of the Stress Buffers Proposal on IHCs after the Board has finalized any resulting changes to the stress testing framework.

8 The Board's assessment of the Stress Buffers Proposal's quantitative impact included a review of three years of historical data in relation to BHCs only. 84 Fed. Reg. at 18,167. As discussed in detail below, the Board lacks adequate historical data to conduct a similar impact analysis for IHCs, many of which are participating in publicly disclosed supervisory stress tests for the first time as part of the ongoing 2018 CCAR exercise, the results of which have not yet been disclosed by the Board and will not fully reflect the projected losses for IHCs that are subject to the global market shock ("GMS").

9 Vice Chairman Randal K. Quarles, Early Observations on Improving the Effectiveness of Post-Crisis Regulation (Jan. 19, 2018) ("Early Observations").

10 Vice Chairman Randal K. Quarles, The Federal Reserve's Regulatory Agenda for Foreign Banking Organizations: What Lies Ahead for Enhanced Prudential Standards and the Volcker Rule (March 5, 2018).

The Stress Buffers Proposal, however, raises several concerns when assessed against the Reform Principles.

Rather than simplifying the capital and stress testing rules, the Stress Buffers Proposal would add significant complexity and uncertainty to the capital rules by introducing a variable, firm-specific buffer determined through non-transparent Board models (from which derived projected loss estimates are highly unpredictable). The stress buffers also sharply diverge from the internationally agreed Basel capital framework, and such divergences increase complexity particularly for IHCs, whose parent FBOs must manage their consolidated organizations under home country capital requirements that generally align with the Basel capital framework. IHCs must maintain parallel but distinct bespoke systems, controls, models and data that cannot be used across the consolidated organization even under the Board's current requirements, and the Stress Buffers Proposal would only magnify the resulting challenges presented.

Rather than increasing transparency, the Stress Buffers Proposal would exacerbate the problems with the lack of transparency in the stress testing framework by replacing certain fixed buffers and predictable, internationally agreed capital rules with volatile institution-specific requirements that are reset annually and cannot be determined with any reasonable degree of certainty because they are established pursuant to non-transparent models that are wholly prescribed by the Board.

We welcome Chairman Powell's recent statements that the Board is "committed to increasing the transparency of the stress testing and CCAR processes."[11] Although the Board's recent proposals to modestly increase the transparency of the CCAR process would not, in our view, provide particularly meaningful insight into the Board's models, we were encouraged by Vice Chairman Quarles' statements that these proposals represent "early steps"—suggesting that additional transparency will be forthcoming.[12] Without meaningfully increasing the transparency of the models used in the CCAR process, the supervisory stress testing process provides no ability for CCAR firms to accurately and objectively assess whether the proposed stress buffers would be appropriate or sustainable.

Accordingly, we strongly recommend that, as a first step before integrating the supervisory stress testing framework with the capital rules, the Board should follow the recommendations in the Treasury Report and subject its stress-testing and capital planning review frameworks to public notice and comment, including with respect to its models, economic scenarios, and other material parameters and methodologies.[13]

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[11] Governor Jerome H. Powell, Testimony on the Relationship between Regulation and Economic Growth, Senate Committee on Banking, Housing and Urban Affairs (June 22, 2017).

[12] Early Observations, p. 4.

[13] Treasury Report, p. 53.

Rather than increasing efficiency of the capital and stress testing frameworks, the Stress Buffers Proposal would increase the costs of compliance without a corresponding increase in safety and soundness. The stress buffers would also effectively require CCAR firms to hold operational capital buffers on top of the required stress buffers on an ongoing basis to mitigate the risk of inadvertently dipping into the SCB and SLB, which would trap additional capital within financial firms that could be better deployed growing the U.S. economy through financial intermediation. Imposition of stress buffers would also reduce the efficiency of the financial system by inhibiting capital flows across entities and geographies. The Stress Buffers Proposal is particularly inefficient for IHCs because it exacerbates ring fencing and the balkanization of capital by hindering IHCs from distributing excess capital to their parent organization and by maintaining a Board approval requirement over any increase in capital actions during the annual cycle. The Stress Buffers Proposal could also potentially encourage retaliatory measures by non-U.S. regulators to prevent subsidiaries of U.S. banking organizations located outside the United States from returning excess capital to their U.S. parent organizations.

Moreover, considering how best to revise the supervisory stress testing framework consistent with Reform Principles, there are several important steps the Board should take to improve the supervisory stress testing framework before considering full integration of the supervisory stress testing framework into daily capital adequacy compliance through the Stress Buffers Proposal.

First, the Stress Buffers Proposal is premature in light of the recently enacted Regulatory Relief Act, and the changes it prescribes for the application of enhanced prudential standards. The Board will have to consider the implications of the Act's changes to the applicability thresholds for CCAR and the Board's capital plan rule for BHCs and IHCs. Any resulting adjustment to CCAR and the capital plan rule should be fully implemented through a public rulemaking procedure before consideration of the Stress Buffers Proposal because it would be highly inefficient and burdensome to impose stress buffers on banking organizations that would later be irrelevant if the application threshold is modified. Moreover, the Board should provide CCAR firms with clarity on how it intends to administer "periodic" DFAST stress tests under fewer stress scenarios, consistent with the Regulatory Relief Act, before attempting to integrate the stress testing framework with the capital rules.

Second, the Treasury Report's recommendations to improve the Board's supervisory stress testing framework should be fully implemented before the Board considers an initiative such as the Stress Buffers Proposal. The CCAR Proposal is a welcome, although partial, first step in this direction because it would implement the Treasury Report's recommendation that the Board adjust the unrealistically conservative assumption that CCAR firms will continue to make all planned capital distributions and grow their balance sheets during periods of severe stress. However, the Board should also prioritize implementation of the Treasury Report's companion recommendations to:

i. improve supervisory modeling practices by better recognizing firms' unique risk profiles;

ii. subject its stress-testing and capital planning review frameworks to public notice and comment, including with respect to its models, economic scenarios, and other material parameters and methodologies;[14]

iii. adjust the CCAR stress test to a two-year cycle, which would not compromise quality because stress-testing results are forecast over a nine-quarter cycle;[15] and

iv. eliminate public disclosure of the Board's qualitative assessment of CCAR firms' capital plans and adjust the qualitative assessment in all cases in favor of supervisory review as the Board has already done for large and noncomplex CCAR firms.[16]

These reforms to CCAR would represent a more effective approach to simplification than the Stress Buffers Proposal which would increase complexity and volatility for CCAR firms. Many of the Treasury Report's other recommendations regarding stress testing have been enacted by Congress in the Regulatory Relief Act, including upwardly adjusting the applicability thresholds for stress testing, reducing the number of scenarios and eliminating the mid-year cycle. The Board should first implement these revisions to the stress testing framework before embarking on a reconsideration of the Stress Buffers Proposal.

Not only is the Stress Buffers Proposal inconsistent with the Reform Principles and premature in light of the need to first implement the Regulatory Relief Act and Treasury Report recommendations, but more troublingly, it has been put forward without adequate analysis or understanding of the impact on IHCs. Below we discuss why the Board should reconsider the Stress Buffers Proposal in its entirety and suspend application of the Stress Buffers Proposal until it can conduct a comprehensive review of the impact of the stress buffers on IHCs and disclose the results of this review. We also highlight several concerns that should be remedied before stress buffers should be imposed on IHCs and alternative approaches to increase efficiency and transparency that the Board should first pursue before considering adoption of the Stress Buffers Proposal.

## II. The Proposed Stress Buffers Should Only Be Implemented After the Board Assesses Their Impact on IHCs and Obtains Data to Conduct an Appropriate Impact Analysis

### A. The *Board's* Economic Analysis of the Impact of the Stress Buffers Specifically Excluded IHCs

The Board has not analyzed the impact the stress buffers would have on IHCs, and has acknowledged that it does not currently have adequate data to conduct an appropriate

14 Treasury Report, pp. 53, 125, 131.

15 Id.

16 Treasury Report, pp. 12, 50, 53-54, 125.

analysis. The stress buffers would be calibrated primarily based on a CCAR firm's projected losses under the severely adverse scenario in the Board's annual supervisory stress tests. The largest domestic BHCs, and all of the U.S. GSIBs, have been subject to such supervisory stress tests for almost a decade.[17] By contrast, many IHCs are participating in publicly disclosed supervisory stress tests for the first time as part of the ongoing 2018 CCAR exercise, the results of which have not yet been disclosed by the Board[18] and will not fully reflect the projected losses for IHCs that are subject to the GMS component of CCAR.[19]

The Board conducted an economic analysis of the Stress Buffers Proposal's impact on required levels of capital and resulting capital distributions, but this analysis was based on supervisory stress test results from the 2015 through 2017 CCAR cycles and focused exclusively on domestic BHCs. The Board acknowledges that IHCs were not subject to supervisory stress testing as part of CCAR for this period, and the Stress Buffers Proposal notes that, as a result of this data deficiency, IHCs "were excluded from this quantitative analysis."[20] The Board offers post hoc rationalization of this omission by indicating that "all would benefit" from certain elements of the Stress Buffers Proposal. As we discuss in this letter, however, certain unique attributes of IHCs require that the Board fully analyze and reconsider how and whether the Stress Buffers Proposal should be applied to IHCs.

To impose a regulatory restriction as significant as the stress buffers on IHCs without undertaking appropriate economic analysis risks significant unintended consequences such as resulting stress buffers being too high. These could include increasing systemic risk if the stress buffers impede the free flow of excess capital within cross-border banking organizations and possibly encouraging non-U.S. regulators to increase capital requirements for U.S. banking organizations in host jurisdictions abroad.

B. The Board Should Assemble an Adequate Data Set and Conduct a Meaningful Analysis of the Stress Buffers *Proposal's Impact on IHCs* Before Reconsidering its Application to IHCs

It is inappropriate to assume that three years of domestic BHCs' supervisory stress test data would provide the Board with adequate insight into the Stress Buffers Proposal's impact on IHCs. As subsidiaries, IHCs face fundamentally different structural considerations with respect to their regulatory capital base and planning of capital actions. IHCs also book

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17 The precursor to CCAR, the Supervisory Capital Assessment Program, was launched in February 2009 and included the largest 19 U.S. BHCs. U.S. BHCs with total assets of $50 billion or more that are incorporated at the top-tier in the United States are referred to throughout this letter as "domestic BHCs".

18 Indeed, because the deadline for comments on the Stress Buffers Proposal (June 25) precedes the final announcement of the 2018 CCAR results (June 28), we and our members will not have the opportunity to analyze public data from the 2018 CCAR cycle in preparing these comments.

19 CCAR 2018 Summary Instructions (Feb. 2018), p. 2.

20 83 Fed. Reg. at 18,167 n.39.

assets, risk exposures, and revenue in a manner that is structurally different from domestic BHCs and is often based on tax, accounting or home country legal or regulatory considerations that are not relevant to domestic BHCs.

We understand that the Board had to modify certain of its model assumptions and methodologies with respect to IHCs as part of the 2018 CCAR exercise (which will be the first CCAR exercise to incorporate all IHCs in its public disclosure). The results of this modeling exercise will be published for the first time in June 2018, after the close of the Stress Buffers Proposal's comment period. Given the primacy of the Board's models in determining an IHC's stress buffers, it is impossible for IHCs to assess with any reasonable degree of accuracy at this point how IHC capital requirements would be affected by the Stress Buffers Proposal over time. Moreover, even the 2018 CCAR results will provide limited insight once available because they will not reflect the GMS component of the CCAR stress tests, which can be reliably expected to increase projected losses for the six IHCs that are required to incorporate the GMS.[21]

In addition, no IHC has yet been subject to the counterparty default shock ("CDS") component of CCAR, which may be applied to IHCs in the future.[22] Like the GMS, incorporation of the CDS into a firm's CCAR stress tests drives up its expected losses and therefore would increase its stress buffer requirements. IHCs have not had experience in modeling these additional losses for a CCAR planning exercise, and have no way of predicting how the Board's models will affect their loss profile.

A larger data set is also necessary given the significant volatility that the Stress Buffers Proposal would introduce into a firm's capital planning processes. As discussed further below,[23] projected losses can vary widely for a given firm across CCAR cycles and across firms in a given CCAR cycle. IHCs are at a particular disadvantage to domestic BHCs under the Stress Buffers Proposal in this regard, because many IHCs have no relevant historical data to analyze in order to prepare for and mitigate this volatility (since even results of the 2018 CCAR exercise have not been published as of this submission and will not fully reflect the impact the GMS will have on projected losses that drive the stress buffers' calibration).

Unlike domestic BHCs, which have nearly ten years of supervisory stress test results (including more than five years of results reflecting the impact of the GMS for the six subject BHCs), IHCs simply do not have adequate historical data to reasonably predict and efficiently manage the volatility inherent in the stress buffers' reliance on a single year's CCAR loss projections. Introduction of the stress buffers simultaneous with introduction of the full

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[21] CCAR 2018 Summary Instructions (Feb. 2018), p. 2.

[22] See 82 Fed. Reg. 59533 (Dec. 15, 2017) (Proposal to Revise the Policy Statement on the Scenario Design Framework for Stress Testing).

[23] See Section III below.

GMS in the 2019 CCAR exacerbates this data deficiency and highlights the disproportionate burden the Stress Buffers Proposal will place on IHCs.

Without an adequate calibration period, the Board's modeling of IHC stress losses would, in our view, be materially different than expected and in comparison to domestic BHCs. Without adequate data to predict and manage the volatility the stress buffers will introduce, IHCs may be forced to maintain outsized and inefficient operational buffers in order to ensure they are prepared to meet the potentially sharp increases in the stress buffer requirements that may unexpectedly arise in an unfamiliar adverse stress scenario.

In light of this data deficit and the risks of miscalibration of the stress buffers, the Board should reconsider the Stress Buffers Proposal for IHCs after it (i) assembles an adequately robust historical CCAR data set for IHCs (that reflects all elements of CCAR, including the impact of GMS and CDS on the projected stress losses of IHCs) and (ii) undertakes a comprehensive quantitative impact study of the Stress Buffers Proposal's expected impact on IHCs. The Board has acknowledged that it does not currently have sufficient historical data to accurately assess the impact on IHCs. Until such data is available to understand potential effects of heightened standards, the Stress Buffers Proposal should not be applied to IHCs.

### C. The Stress Buffers Proposal Should Not Be Adopted Unless the Dividend Prefunding Component Is Eliminated

The Stress Buffers Proposal would require CCAR firms to "pre-fund" one year of planned dividends by incorporating four quarters of planned common stock dividend payments into the stress buffer calculations. The Stress Buffers Proposal notes that this requirement is based on the Board's experience with domestic BHCs' capital distribution practices during the financial crisis and cites economic analyses that are focused on publicly-traded domestic firms. There is no discussion in the Stress Buffers Proposal of the dividend practices of IHCs, as subsidiaries of non-U.S. parent companies, and no acknowledgement that an IHC's "subsidiary dividends" differ significantly from the "corporate dividends" of publicly traded corporations.

Dividends paid by IHCs to their parents do not resemble dividends paid by domestic BHCs to public shareholders. The "corporate dividends" of domestic BHCs are generally regular, predictable payments to a group of diversified public shareholders. Domestic BHCs only reluctantly reduce such payments since a reduction could be interpreted by market participants as an indication of long-term deterioration in the firm's profitability, with attendant adverse effects on the firm's stock price. By contrast, "subsidiary dividends" are highly variable payments to a parent company and not intended to publicly demonstrate the firm's profitability but rather are flexibly deployed to return capital to the parent to maximize the efficiency of the consolidated organization. There is no similar market expectation associated with such "subsidiary dividends", which are not publicly announced to market participants in the same manner as "corporate dividends." Accordingly, IHCs are simply not subject to the "public pressure and competition that may deter [domestic BHCs] from reducing dividend payments"[24] that the Board cites as the basis for the dividend pre-funding component of the proposed stress buffers.

The Stress Buffers Proposal distinguishes between corporate dividends and share repurchases, noting that share repurchases are more flexible and less commonly viewed as indicative of a firm's financial condition. In fact, the effect of the Stress Buffers Proposal is to favor share repurchases, as these capital actions would not need to be "pre-funded". The Stress Buffers Proposal, however, evinces no awareness of the fact that many IHCs deploy dividends in the same flexible manner in which domestic BHCs engage in share repurchases. Indeed, given the often limited amount of actual common shares issued by a subsidiary organization (relative to its capital), IHCs rarely engage in actual share repurchases from their parent.[25] As a result, an IHC's planned "subsidiary dividends" may be significantly larger relative to its capital base over a one-year horizon than a domestic BHC's planned "corporate dividends" for the same period, because the Stress Buffers Proposal would require IHCs to pre-fund these "subsidiary dividends" even though they are deployed in the same manner as a domestic BHC may engage in a combination of dividends and share repurchases, which need not be pre-funded under the Stress Buffers Proposal.

If left unchanged, this requirement would arbitrarily incentivize IHCs to avoid "subsidiary dividends" that would artificially inflate its publicly disclosed stress buffers. This inflation of the stress buffers as a result of the dividend pre-funding component could also present a distorted picture of the IHC's financial condition—an IHC's publicly disclosed stress buffers may be much larger than a peer domestic BHC, which would not be required to reflect its share repurchases in its stress buffer and could appear to have a lower risk profile, as illustrated by its stress buffers, than competitor IHCs.

Boards of directors of IHCs should be able to determine the size and form of capital distributions as part of their duty to maximize benefits to the consolidated organization. This approach would recognize that as sole shareholders of their IHCs, FBOs have discretion over corporate governance matters of their subsidiaries within regulatory boundaries. It does not promote safety and soundness to discourage an IHC from employing subsidiary dividends as a method for redistributing capital to its parent, when there may be tax, accounting, or home country legal and regulatory considerations motivating the use of a dividend as opposed to a share repurchase or return of capital action. Accordingly, the Board should eliminate the pre-

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24 84 Fed. Reg. 18,166.

25 Share amounts issued by subsidiary organizations also tend not to fluctuate in the way a publicly traded corporation's outstanding shares may fluctuate, because shares of the subsidiary are not issued as employee compensation and may not even be issued when receiving a contribution from its parent (as a parent can contribute capital on existing shares). For these reasons, the share repurchase is not typically an effective capital management tool for a subsidiary, such as an IHC.

funding component if it determines to move forward with consideration of the Stress Buffers Proposal.

D. The *"Stress Leverage Buffer" Is* Unnecessary, Inconsistent with the Role of Leverage Requirements as a Backstop to Risk-Based Requirements and Should Not Be Adopted

The Board also has not analyzed the impact of the SLB on IHCs in the Stress Buffers Proposal, and it does not currently have adequate data to do so. The Board lacks data generally regarding the levels of stress leverage capital requirements because the supplementary leverage ratio ("SLR") was incorporated into the CCAR supervisory stress tests for the first time as part of the ongoing 2018 cycle. This deficiency underscores the Board's inability to assess the impact of the SLB generally, and specifically whether the SLB could function as the binding capital constraint for IHCs or other CCAR firms.

Although no data is currently available regarding the impact on the SLB, it is reasonable to anticipate that the SLB would increase effective leverage capital requirements for IHCs since IHCs would need to satisfy the SLB on a daily basis. Such an increase is inconsistent with the Board's statements in its companion proposal to revise the enhanced supplementary leverage ratio, in which the Board acknowledged that "[l]everage capital requirements should generally act as a backstop to the risk-based requirements" and "if a leverage ratio is calibrated at a level that makes it generally a binding constraint through the economic and credit cycle, it can create incentives for firms to reduce participation in or increase costs for low-risk, low-return businesses."[26] The SLB could become the binding capital constraint for certain IHCs, which tend to have higher total assets relative to total risk-weighted assets compared to domestic BHCs.[27] The Board does not appear to have considered differences in the balance sheet compositions of IHCs and domestic BHCs, and the heightened risk that the SLB could be a binding constraint rather than a backstop for IHCs.

The SLB also represents a further departure from the Reform Principle of simplicity. The Tier 1 leverage ratio is intended to be a simple measure, in contrast to risk-based capital requirements. By transforming the Tier 1 leverage capital requirement into a dynamic measure calibrated based on projected stress losses, the SLB would become a risk-based measure itself, would add complexity and would undermine the Tier 1 leverage ratio's purpose as a simple backstop. The addition of a new leverage based buffer requirement also contradicts the Stress Buffers Proposal's stated objective of reducing the total number of capital requirements to

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[26] 83 Fed. Reg. 17317, 17319 (Apr. 19, 2018).

[27] As of December 31, 2017, under the U.S. standardized approach applicable to both IHCs and domestic BHCs, the average percentage of risk-weighted assets to total assets for the 12 IHCs is more than 8 percentage points less than that of the domestic BHCs that participate in CCAR. Eight of the 12 IHCs have a ratio lower than the average percentage for the 23 domestic BHCs, and the ratios for the other 4 IHCs are lower than those for more than half (13) of the domestic BHCs. One-third of the IHCs have a ratio less than 50%, compared to less than one-fifth of the domestic BHCs.

which a CCAR firm is subject.[28] Furthermore, the U.S.-specific nature of this Tier 1 leverage ratio requirement already causes a divergence from internationally agreed norms—the SLB can only exacerbate that divergence by making more complex and burdensome a calculation that is not required for the FBO parent. A more appropriate simplification would be elimination of the SLB.

## III. The Board Should Meaningfully Increase the Transparency of Supervisory Stress Testing Before Reconsidering How and Whether to Implement the Stress Buffers Proposal

The CCAR supervisory stress tests effectively determine the binding capital requirements for IHCs and other CCAR firms. While the stress buffers would formalize the supervisory expectations to maintain significant additional capital above the regulatory minimum requirements by integrating them into the Board's "pillar 1" capital rules, the Stress Buffers Proposal would do nothing to reduce the primacy of the Board's supervisory models and stress scenarios in determining effective capital requirements or to increase transparency of the supervisory stress testing process. However, we were encouraged to see that the Stress Buffers Proposal does request feedback on whether the Board should publish for notice and comment the severely adverse scenario used in calculating a CCAR firm's stress buffers.[29] We not only strongly support the release of the severely adverse scenario for notice and comment, but we also urge the Board to submit all of the economic assumptions and supervisory models intended for use in CCAR for notice and comment before their incorporation into each annual CCAR exercise. The Board should move forward with these changes to increase transparency independent of, and in advance of, reconsidering the implementation of the Stress Buffers Proposal.

Clear and consistent regulatory capital standards are necessary for effective capital planning. Currently, the supervisory stress testing process provides no ability for CCAR firms to predict their effective capital requirements with even relative accuracy. As a result, CCAR firms also cannot accurately and objectively assess whether the proposed stress buffers would be appropriate or sustainable. The Board models used for stress testing are opaque, notwithstanding the recent proposals that would disclose marginally more information about the data supporting the models.

This lack of transparency compounds the difficulty for IHCs in assessing the impact of the Stress Buffers Proposal. Even if IHCs had a longer track record of supervisory stress testing, without additional insight into the Board's models, capital planning would still be more complex for FBOs than for BHCs under the rule. For example, IHCs do not know whether they are treated under the Board's models differently from other organizations, and in particular,

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28 Board Staff Memo re: Proposed Rule regarding Stress Buffer Requirements (Apr. 5, 2018), p. 2 and Appendix 1.

29 83 Fed. Reg. 18171 (Question 23(ii)).

whether the relationship between an IHC and its parent is modeled differently from that of a top-tier domestic organization. Adhering to the principles of national treatment, comparability and equality of competitive opportunity, and consistent with Section 165 of the Dodd Frank Act, the Board should investigate whether the Stress Buffers Proposal would have a differential effect going forward for IHCs before imposing any additional requirements that could have a substantial effect on capital planning. Without additional transparency, the Stress Buffers Proposal would not simplify the capital requirements applicable to IHCs. Instead, it would add complexity and amplify uncertainty.

Aside from fairness concerns, the stress buffers can only achieve their intended goal of calibrating capital requirements if the severely adverse scenario designed by the Board each year both: (1) sets an appropriate level of stress across the industry and asset classes and (2) is tailored to individual firms. The Board's modeling suite was developed to model industry-wide portfolios, rather than to capture the idiosyncrasies of individual firm portfolios. Similarly, the supervisory quantitative assessment was designed to evaluate the appropriateness of capital distributions rather than as a mechanism to set effective capital requirements at individual firms. Accordingly, we are concerned that continuing an approach that achieves the goal of facilitating a horizontal assessment of firms' performances during times of macroeconomic stress would simultaneously undermine the stated aim of the Stress Buffers Proposal of calibrating appropriate firm-specific capital requirements.

Moreover, the Board's economic scenarios change each year, making a hypothetical idiosyncratic event potentially the largest driver of a banking organization's stress capital buffer. This dynamic could create potential "outlier" years for some organizations, during which they would be required to maintain higher buffers than in prior or later years, without prior notice of the potential spike in their capital requirements. The potential for outlier years is magnified by the lack of transparency with respect to stress testing assumptions because the Board could choose to target one or more sectors or portfolio types in any given year without providing notice or comment to firms who may be adversely affected.[30]

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[30] In addition, we urge the Board to reconsider its application of the GMS in both the context of the Stress Buffers Proposal and in CCAR generally. The GMS is likely to amplify the potential distortions described in this paragraph given that it relies on a randomly chosen, single day's trading positions to make predictions about the amount of capital necessary to cover potential losses for the trading book, which is likely to fluctuate substantially over the course of a year. Having to operate under a daily capital requirement for an entire year based on a potentially non-representative date, and based on a subjective, Federal Reserve-created hypothetical shock, illustrates the weaknesses in the Stress Buffers Proposal as well as in the use of GMS in CCAR. The smaller balance sheets of IHCs in comparison to domestic BHCs only serves to further skew negatively this effect. As of December 31, 2017, under U.S. GAAP, the aggregate total assets of the 6 IHCs subject to the GMS are less than one-tenth of the aggregate for the domestic BHCs subject to the GMS. Furthermore, the total assets of the largest such IHC are less than all but one of the domestic BHCs and less than a quarter of the average of all such BHCs.

The Stress Buffers Proposal would introduce additional challenges into capital planning. As an add-on to the Board's "pillar 1" requirements, the stress buffers would not permit a CCAR firm's capital levels to fluctuate much below the levels it maintains going into each annual CCAR exercise (even if such levels are well above the current regulatory minima). Therefore, the potentially significant volatility in capital requirements caused by model idiosyncrasies, scenario biases, inadvertent punitive impacts on certain asset classes/portfolios and the annual reset of the proposed stress buffers make increased transparency and fixes for potential uncertainty a prerequisite for any reconsideration of the Stress Buffers Proposal.

Accordingly, prior to implementing any stress buffer, the Board should publish its models, supporting documentation, and validation reports in their entirety given that the models would be the key methodology through which the rule sets effective minimum capital requirements for individual firms. In addition, consistent with the Treasury Report, the Board should also be more transparent about how it sets the level of severity of scenarios and how it may target certain portfolios, including by subjecting annual scenarios to the notice and comment procedures to support transparency and public engagement on the appropriateness of the supervisory scenarios. Furthermore, in any reconsideration of the Stress Buffers Proposal, a number of potential modifications should be analyzed, including: (i) limiting increases to a CCAR firm's stress buffer over the prior year, if the increase appears to be model- or scenario-dependent, (ii) averaging two or more years of stress buffers to dampen the impact of an "outlier" year (particularly as the Stress Buffers Proposal would require maintenance of the buffer for the entire year prior to reset), and/or (iii) allowing downward adjustment of a buffer if a CCAR firm has modified its asset mix or reduced a particularly loss-laden portfolio.

## IV. The Board Should Eliminate the Qualitative Assessment from CCAR

The Stress Buffers Proposal would maintain the publicly disclosed qualitative assessment for CCAR firms included in the Large Institution Supervision Coordinating Committee ("LISCC") cohort and for firms deemed "large and complex". The Board recently determined to eliminate the public qualitative assessment for large and noncomplex CCAR firms and instead to incorporate its review of their capital planning processes into the ongoing confidential supervisory process.[31] We encourage the Board to make a conforming change to eliminate the CCAR qualitative assessment for LISCC and large and complex firms.

Qualitative shortcomings in a CCAR firm's capital planning processes are better remediated through the supervisory process, rather than through a "surprise" public qualitative assessment. The Board's newly proposed large financial institution ("LFI") rating system and supervisory framework is focused on four core areas, the first of which is "capital planning and positions". The Board has indicated that findings from CCAR for LISCC firms and certain other large and complex LFIs would represent a material portion of the work that would be conducted to determine the Capital Planning and Positions component rating and CCAR results will be directly reflected within the Capital and Liquidity component rating assignments (in contrast to

[31] 81 Fed. Reg. 9,308 (Feb. 3, 2017).

the current rating system). The LFI framework and rating system is the appropriate supervisory mechanism for determining whether an IHC has satisfied the Board's qualitative expectations with respect to capital planning, and its adoption obviates the need for public disclosure of the qualitative assessment in CCAR.[32]

We note that the U.S. Department of Treasury and the Government Accountability Office have made similar recommendations with respect to eliminating the qualitative assessment,[33] and former Governor Tarullo acknowledged that the qualitative assessment "should be phased out and the supervisory examination work around stress testing and capital planning completely moved into the normal, year-round supervisory process, even for [U.S. GSIBs]."[34]

## V. Public Disclosures

To facilitate assessment of the Stress Buffers Proposal, the Board should provide further clarity around how public disclosures related to CCAR would change under the Stress Buffers Proposal because it is not clear when the stress buffers would be disclosed and what elements would be disclosed at that time. This is particularly the case as the Stress Buffers Proposal did not offer a comparison to the partially confidential, partially public disclosure process at the end of the current CCAR process. More specifically, the Stress Buffers Proposal is not clear on the extent of information that would be disclosed to a CCAR firm and to the public in connection with the two-day adjustment procedure and the new reconsideration procedure.

More detail is necessary to assess how this information would be treated under home country disclosure laws applicable to FBO parent companies of IHCs, and IHCs would like the opportunity to comment on what may be permissible or inappropriate under home country laws once a better understanding of the Board's disclosure intentions is obtained.

## VI. The Board Should Eliminate a Number of Duplicative and Overly Burdensome Requirements Before it Reconsiders Implementation of the Stress Buffers Proposal

### A. The Board Should Eliminate the Approval Requirements for Distributions that *Would Not Cause a CCAR Firm to Fall into the "Buffer Zone"*

The Stress Buffers Proposal would continue to require CCAR firms to obtain approval to exceed planned capital actions. Yet, the Board indicates that key innovation of the Stress Buffers Proposal is a fully integrated approach that is intended to have CCAR firms

32 See 82 Fed. Reg. 39049, 39050, 39052 (Aug. 17, 2017).

33 See Treasury Report; U.S. Government Accountability Office, Additional Actions Could Help Ensure the Achievement of Stress Test Goals, Publication No. GAO-17-48 (Nov. 2016).

34 Gov. Daniel K. Tarullo, Departing Remarks (Apr. 4, 2017).

operate with the stress buffers on a business-as-usual daily basis. Evidence also suggests that the Stress Buffers Proposal would yield a significantly higher buffer than the current capital conservation buffer. Therefore, the Board should not need to continue individual approval over each CCAR firms' capital. If a banking organization maintains capital levels above its stress buffer requirements on a continuous basis, it should be able to freely determine whether to increase its capital distributions so long as its planned capital actions would not cause its capital ratios to decline below these new buffer requirements. To maintain an approval requirement is inconsistent with the Reform Principles of simplification and efficiency.

### B. Submission of a *"Material Change" to a CCAR Firm's Capital Plan Should Not* Trigger Additional Supervisory Stress Tests

If a CCAR firm were to submit a "material change" to its capital plan, the Stress Buffers Proposal indicates that the Board would undertake new and likely different stress tests to determine new stress buffers for the banking organization and a new qualitative review of its capital planning process.[35] The resulting stress buffers could significantly diverge from the buffer determined to apply prior to the CCAR firm's change or resubmission. There does not appear to be any additional benefit to changing the supervisory stress test from the one that the CCAR firm recently went through, and there does not appear to be any justification for running the qualitative review again.[36] Such action on a resubmission is inconsistent with the Reform Principles, and would in fact reduce efficiency, transparency and simplicity. The Board should run changes through the models used for the past year, and not reiterate its qualitative review. Without these changes, the Stress Buffers Proposal would only serve to hinder strategic planning. We expect firms would be reluctant to submit a material change because, having made changes to their balance sheets or operations in reliance on one set of models, the risk of an unintended result could be too significant to justify.

## VII. If the Stress Buffers Proposal is Adopted, the Board Should Permit IHCs to Count Internal TLAC-eligible Long-term Debt Toward the SCB and SLB

The Stress Buffers Proposal would require IHCs to satisfy the SCB with common equity tier 1 capital ("CET1") and the SLB with tier 1 capital. These restrictions should be revised to recognize the ability of internal long-term debt ("LTD") issued by IHCs to absorb losses in the same manner as CET1. Internal LTD issued by an IHC to its parent FBO to satisfy minimum requirements under the Board's total loss absorbing capacity ("TLAC") rule is fully convertible into CET1 at the Board's discretion if the IHC is in default or in danger of default. Given this conversion feature, internal LTD is effectively indistinguishable from CET1 in a stress scenario since the sole holder of each instrument is the IHC's parent FBO, and the supervisory expectation is that the LTD would be converted to CET1 in the event that the IHC is

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35 83 Fed. Reg. 18,171 (text and Question 22) ("conduct an updated supervisory stress test" and "[a]ccordingly, the Board also would recalculate the firm's stress buffer requirement using an updated severely adverse scenario") (emphasis added).

36 Above we have urged the Board to eliminate the qualitative assessment altogether.

in default or in danger of default. This conversion mechanism is incorporated directly into the internal LTD in contrast to external LTD, which may not be contractually converted into equity. Moreover, external LTD is generally widely held by a diverse set investors that do not acquire the debt with an expectation of its conversion into CET1 unlike an IHC's parent FBO. Accordingly, we request that the Board permit IHCs to count internal TLAC-eligible LTD toward both the SCB and SLB buffers. If necessary to maintain consistency with the Basel capital framework, this recognition of internal LTD to satisfy the stress capital buffer could be limited to the amount of the buffer that exceeds the initial 2.5% (which would be CET1 consistent with the capital conservation buffer). However, we also recommend that, given the unique characteristics of internal TLAC, the Board should more broadly consider the interchangeability of internal TLAC and CET1 in the overall supervisory program for IHCs.

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We appreciate your consideration of our comments. Please contact the undersigned (646-213-1147; bpolichene@iib.org) or our General Counsel, Richard Coffman (646-213-1149; rcoffman@iib.org), if we can provide any additional information.

Sincerely,

Briget Polichene

Briget Polichene
Chief Executive Officer

cc: Chairman Jerome H. Powell
Vice Chairman Randal K. Quarles
Governor Lael Brainard
Michael S. Gibson
Mark E. Van Der Weide
(Board of Governors of the Federal Reserve System)