



November 20, 2020

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

Re: SIFMA Comment on Capital Planning and Stress Testing Requirements for Large Bank Holding Companies, Intermediate Holding Companies, and Savings and Loan Holding Companies (Docket No. R-1724, RIN 7100-AF95)

Dear Sirs and Madams:

The Securities Industry and Financial Markets Association (“SIFMA”)¹ appreciates the opportunity to comment on the notice of proposed rulemaking (the “Proposal”) issued by the Board of Governors of the Federal Reserve System (the “Board”) to conform its capital plan rule, stress capital buffer requirements, and Stress Testing Policy Statement by modifying them to be consistent with its tailoring framework.² The Proposal also requests comment on all aspects of the Board’s guidance on capital planning for firms of all sizes.

SIFMA is encouraged by the Board’s efforts to create a more consistent and risk-sensitive capital planning and stress testing framework, and appreciates the Board’s practice of reviewing its policies and guidance to ensure that they are having their intended effect, particularly during the COVID-19 pandemic. Given the close integration of capital planning requirements and stress testing, the Proposal represents an important opportunity to review and revise both of these key elements of the framework in tandem. Effective capital planning is an essential component of sound risk management at both the firm and systemic levels, and as such, our member firms share the Board’s interest in ensuring a well-designed and transparent capital planning and stress testing framework. However, at present, certain aspects of this framework impede firms’ ability to engage in effective capital planning internally, and addressing

¹ SIFMA is the leading trade association for broker-dealers, investment banks, and asset managers operating in the U.S. and global capital markets. On behalf of our industry’s nearly 1 million employees, we advocate on legislation, regulation, and business policy affecting retail and institutional investors, equity and fixed income markets, and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (“GFMA”).

² 85 Fed. Reg. 63,222 (Oct. 7, 2020).

these shortcomings should therefore be part of the Board's current efforts to reform its capital planning requirements.

Consistent with SIFMA's membership and organizational focus, our comments in this letter are largely focused on enhancing the design and transparency of the Board's models and methodologies as applied to capital markets products, and are not intended to serve as a recommendation to decrease aggregate stress losses and, by extension, capital needs. Instead, we support the Board's objective of improving its capital planning and stress testing framework to increase the accuracy and usefulness of capital stress testing for both firms and the Board.³

In section I, we recommend that the Board adjust elements of the supervisory stress testing framework, including pre-provision net revenue ("PPNR") modeling, the global market shock ("GMS") component, and the large counterparty default ("LCD") component, to address structural and methodological issues that have a disproportionate impact on firms providing capital markets products and unduly complicate the capital planning process at bank holding companies ("BHCs") and U.S. intermediate holding companies ("IHCs") with significant trading activity. Our specific recommendations include that the Board should:

- Revise the PPNR modeling of trading revenues, trading expenses, and unfunded syndicated loan commitments so that the PPNR model bears a closer relationship to real-world stressed market outcomes;
- Address certain design issues to make the GMS component more plausible, and align the applicability of the GMS component to the Board's tailoring framework by applying the GMS to Category I firms only; and
- Revise the methodology underlying the LCD component to reflect more plausible margin periods of risk, and align the applicability of the LCD component to the Board's single-counterparty credit limits ("SCCL") framework by applying the LCD only to "major covered companies" under the SCCL.

In section II, we recommend that the Board enhance the transparency of the assumptions underlying the GMS component and the LCD component to facilitate better capital planning and public understanding of the capital planning and stress testing framework. Specifically, the Board should provide greater transparency with regard to LCD recovery rate modeling, evaluation of GMS plausibility, selection of the GMS and LCD "as of" dates, and GMS-specific information reporting requirements, along the lines of similar advances in transparency in other parts of the stress testing framework.

³ In some cases, our recommendations call for the Board to revise its models using enhanced data that may need to be collected from firms. Most, if not all firms engaged in a material amount of trading activity collect the required data we identify as part of their risk management processes.

In section III, we recommend that the Board harmonize its existing guidance and tailor the applicability of Supervision and Regulation letters 15-18 and 15-19 to align with the regulatory tailoring framework by applying SR 15-18 to Category I firms only and SR 15-19 to Category II and III firms only.

Finally, in section IV, we describe why the Board should refrain from adopting a singular definition of common stock dividend that would unfairly penalize IHCs and their parent companies and have unforeseen consequences on intercompany arrangements.

The remainder of this letter addresses each of these recommendations in turn.

I. The Board should adjust elements of the supervisory stress testing framework, including PPNR modeling, the GMS component, and the LCD component, to address structural and methodological issues that have a disproportionate impact on firms providing capital markets products and unduly complicate the capital planning process at BHCs and IHCs with significant trading activity.

Section 165(i) of the Dodd-Frank Act requires the Board to conduct supervisory stress tests of covered companies to evaluate whether these firms have the capital necessary to absorb losses as a result of adverse economic conditions. In accordance with 12 C.F.R. part 252, subpart E, the Board conducts its supervisory stress test analysis on an annual or biennial basis (as applicable), and utilizes two different macroeconomic scenarios: a baseline scenario and a severely adverse scenario.⁴ In addition to the macroeconomic scenarios, the Board requires a subset of firms to undergo additional stress testing components that are designed to capture different effects of adverse events on their revenue, losses, and capital. In particular, firms with significant trading activity are subject to the GMS component. In addition, firms with substantial trading or processing and custodian operations are subject to the LCD component.⁵

As we have previously noted,⁶ SIFMA has concerns about the structure of the Board's PPNR modeling, GMS component, and LCD component. These aspects of the stress testing framework are, at times, opaque and volatile, forcing firms to focus on external requirements rather than internally developed risk assessments, which frustrates the purpose of the Board's capital planning guidance. SIFMA respectfully requests that the Board address each of SIFMA's concerns through changes to the Board's PPNR model, GMS component, and LCD component in future stress test cycles. These changes could be made through revisions to the Board's stress testing models, and amendments to requirements and guidance codified in part 252, subpart E of the Board's regulations (including the Policy Statement on the Scenario

⁴ See 12 C.F.R. § 252.44.

⁵ See 12 C.F.R. pt. 252, App. A, § 3.0, 3.2; *id.*, App. B, § 2.5.

⁶ See, e.g., SIFMA, *Global Market Shock and Large Counterparty Default Study* at 34–41 (August 2019), <https://www.sifma.org/wp-content/uploads/2019/09/SIFMA-GMS-LCD-Study-FINAL.pdf> [hereinafter *SIFMA Whitepaper*]; Joseph L. Seidel & Coryann Stefansson, *2020 GMS Moving in the Right Direction But More to be Done*, PENNSYLVANIA + WALL (Feb. 13, 2020), <https://www.sifma.org/resources/news/2020-gms-moving-in-the-right-direction-but-more-to-be-done/>; Coryann Stefansson, *New SIFMA Analysis: The Fed & CCAR 2020 – Stay the Course for the Sake of Economic Recovery*, PENNSYLVANIA + WALL (June 3, 2020), <https://www.sifma.org/resources/news/new-sifma-analysis-the-fed-ccar-2020-stay-the-course-for-the-sake-of-economic-recovery/>.

Design Framework for Stress Testing and the Stress Testing Policy Statement). While we recognize that stress test results are designed to include a degree of unpredictability, the changes we recommend would preserve such outcomes while still reducing unnecessary opacity and volatility that currently reduces the usefulness of some elements of internal capital planning.

A. The PPNR Model under the Severely Adverse Macroeconomic Scenario

For all firms subject to the supervisory stress test requirement, the Board assesses the effect of each macroeconomic scenario on the PPNR of the firm over a forward-looking planning horizon consisting of nine quarters. For firms subject to the GMS and LCD components, the Board's PPNR model results in a double counting of mark-to-market position losses because it relies on trading revenue data that comingles activity-based trading revenue with mark-to-market position losses. Moreover, the Board's trading revenue model is distorted because it is heavily influenced by historical capital markets data that is potentially no longer relevant given regulatory requirements and firms' product offerings. Further, the Board's approach to estimating non-interest expenses from trading activities ignores the strong correlation between trading revenue and trading expenses, resulting in an unsupportable expense estimation. Finally, the Board's PPNR model overstates losses with respect to unfunded syndicated loan commitments by failing to incorporate "price flex" terms. The Board should address each of these concerns with the PPNR model in order to more accurately estimate trading revenues and other income in stress scenarios, which would reduce unnecessary volatility and reflect outcomes that are more complementary to internally developed risk assessments.

- **Doubling counting of mark-to-market position losses due to comingled data.** The Board's trading revenue model demonstrates an inverse relationship between market volatility, as measured through the Chicago Board Option Exchange Volatility Index ("VIX"), and firms' trading revenue. This inverse correlation is not supported through historical experience, including the market patterns observed during the COVID-19 pandemic in the first half of 2020. Historical analysis demonstrates that activity-based trading revenue is, in fact, positively correlated with the VIX. During the COVID-19-related market dislocation, for example, the activity-based trading revenues of large trading firms to which the GMS and LCD components apply increased significantly due to the volume and scale of investor trading activity that those firms facilitated.

We believe that the counterfactual relationship between the Board's model and real-world outcomes arises because the Board's trading revenue model was trained on data drawn from the FR Y-9C trading revenue line item, which combines activity-based trading revenue with mark-to-market position losses. As a result, the trading revenue model underestimates trading revenue and replicates positional losses that are also generated by the GMS component. In addition, the use of comingled activity-based trading revenue data and mark-to-market position losses is inconsistent with the Board's approach to banking book credit products, which separates

revenues from credit losses.⁷ SIFMA recommends that the Board alter its trading revenue model using data that is fit for purpose. Going forward, the Board could rely on data from amended reporting schedules that would separately capture activity-based trading revenues and mark-to-market position gains or losses. For historical periods, the Board could draw trading revenue data from alternative sources, such as data reported in connection with the Volcker Rule and in securities disclosures, that more accurately represent firms' activity-based trading revenues, and/or could conduct a quantitative impact study to obtain this data. By using such data, the Board's trading revenue model would more accurately reflect the relationship between trading revenues and volatility, resulting in an approach that would complement rather than contradict how firms assess risk and manage capital in connection with trading activities.

- **Potentially obsolete historical trading data.** SIFMA understands that the Board's trading revenue model is heavily weighted by the positional losses experienced during the 2008-2009 financial crisis. Financial crisis-era losses were driven largely by certain structured mortgage products that banking organizations no longer offer due to regulatory changes and lack of investor demand. Consequently, the historical trading revenue data employed to train the model may no longer be relevant to BHCs' and IHCs' present-day market offerings or risk exposures.

SIFMA understands that the Board uses a median regression approach to minimize the impact of extreme movements in trading revenue on its trading revenue model. However, this approach fails to address the potential irrelevance of certain historical trading revenue data to firms' current product offerings. SIFMA recommends that the Board solicit information from firms in order to validate that its trading revenue model reflects current market offerings. If the Board's model relies on historical trading data for products that are no longer offered, then the Board should remove such data from its model. A more permanent and accurate solution would be for the Board to make its trading revenue model more granular to capture activity-based trading revenues that materialized in particular asset classes – including across equities, credit and mortgage products, interest rates, foreign exchange, and commodities – and apply those asset class-specific activity-based trading revenues to a firm's current trading mix. This approach would improve the overall accuracy of the Board's trading revenue model, resulting in outcomes that more closely match firms' internal trading revenue models.

- **Unmatched trading expenses.** SIFMA understands that the Board's approach to modeling non-interest expenses involves a high-level segmentation of expense types that captures trading expenses – such as costs related to execution, clearing, distribution, and brokerage – in the model's catch-all expense category. The Board then applies macroeconomic variables, such as GDP growth, to project non-interest expenses in stress scenarios. When applied to trading

⁷ We further note that the Board has taken steps to avoid the double counting of losses in other contexts within the stress test. See, e.g., Board of Governors of the Federal Reserve System, Dodd-Frank Act Stress Test 2020: Supervisory Stress Test Methodology at 19 n.31 (March 2020), <https://www.federalreserve.gov/publications/files/2020-march-supervisory-stress-test-methodology.pdf>.

expenses, this approach is inappropriate because trading expenses are less strongly correlated with macroeconomic factors, but are closely related to the volume of trading activity, and by extension, trading revenues. The Board should enhance its expense modeling by providing for a corresponding decrease in trading expenses whenever there is a modeled decrease in trading revenues.

- **PPNR treatment of committed unfunded syndicated loan commitments.** The Board’s PPNR models overestimate losses on committed unfunded syndicated loans when those commitments include risk-mitigating “price flex” terms as part of the underwriting. Price flex terms are a risk mitigation tool that protects lenders against the widening of credit spreads by allowing firms to modify the coupon, original issue discount, or underwriting fees. The purpose of this “flex” feature is to provide protection to lenders against market dislocation and permit firms to alter terms in stressed markets to clear the underwriting. Most recently, firms used these risk mitigation tools widely at the peak of the market volatility triggered by the COVID-19 pandemic in the second quarter of 2020. SIFMA understands that the Board’s approach to estimating PPNR for committed unfunded loan commitments does not discern which facilities contain price flex terms. Consequently, the Board’s approach overestimates losses because it does not account for adjustments to pricing that increase firms’ revenues and decrease interest rate risk. The Board should enhance loss estimation for syndicated loan underwritings to account for price flex terms, which would align regulatory capital planning more closely with market standard risk management practices. To pursue this enhancement, the Board should request information regarding firms’ use of price flex terms, along with the extent of those terms’ coverage across firms’ committed unfunded syndicated loan commitments portfolios, on the FR Y-14Q, and revise its PPNR model for these exposure types on the basis of that data.

Addressing the concerns described above would improve supervisory stress testing practices, resulting in more meaningful and accurate estimations, which would reduce the current disconnect between firms’ internal capital planning outcomes and regulatory capital requirements driven by the stress capital buffer.

B. GMS Component

Firms with significant trading activity – defined as firms with aggregate trading assets and liabilities of \$50 billion or more, or aggregate trading assets and liabilities equal to 10 percent or more of their total consolidated assets, that are not Large and Noncomplex Firms – are subject to the GMS component as an add-on to the severely adverse macroeconomic scenario⁸ and static regulatory capital requirements that already impose conservative capital requirements on trading assets.⁹ The GMS component consists

⁸ See 12 C.F.R. § 252.54(b)(2)(i).

⁹ For example, VaR-based market risk capital requirements increase risk-weighted assets attributed to trading assets in times of volatility, which most recently led the federal banking agencies to adjust the market risk multiplier to avoid implausible outcomes in the early phase of the COVID-19 pandemic. Such capital requirements, like the GMS component and the macroeconomic scenario of the

of an instantaneous shock to a large number of asset classes that determine the mark-to-market value of a firm's trading assets and liabilities.

The GMS component is designed in part to mimic the effects of a sudden market dislocation or market panic, during which asset prices move rapidly in unexpected directions.¹⁰ However, as designed, the GMS component suffers from certain design issues, including unsupportable calibration assumptions, implausible cross-factor correlations, and unbounded year-over-year volatility in the magnitude of market factor shocks. These design issues undermine the plausibility of the GMS component, creating undue volatility and resulting in capital allocation that is divorced from how firms would otherwise assess risk and manage capital for this type of activity.

1. *Alterations to the Design of the GMS Component*

The Board should address the following structural design issues of the current GMS component:

- **Unsupportable calibration assumptions.** The GMS market factor shocks are calibrated in a manner that produces implausible results. The factor shocks are based on assumed time horizons, which the Board has stated reflect the variation in the speed at which firms could reasonably close out positions or effectively hedge risk exposures in the event of market stress. Positions within more liquid markets (e.g., interest rates, foreign exchange, or public equities) are calibrated to shorter horizons, such as three months, while positions within less liquid markets (e.g., non-agency securitized products, private equities), have longer calibration horizons, such as 12 months.¹¹

SIFMA's research demonstrates that the calibration assumptions underlying the GMS component are not supported by empirical analysis or historical observation.¹² For example, trading volume data across three core bond markets – U.S. Treasuries, agency mortgage-backed securities, and investment-grade and non-investment-grade corporate bonds – during the 2008-2009 financial crisis period suggests that those markets remained sufficiently accessible, as measured by trading volume, immediately following a material event, such as the Lehman Brothers default. In addition, following the June 2016 Brexit referendum, trading volumes of GBP/USD spiked, demonstrating that liquidity as measured by trading volumes remained robust despite the market

supervisory stress tests, can be pro-cyclical and exacerbate the effects of stress on market liquidity at exactly the wrong time. This pro-cyclicality is in tension with capital planning principles that would suggest a firm's capital requirements should not change materially absent a material change in the firm's risk profile.

¹⁰ See 12 C.F.R. pt. 252, App. A, §§ 3.2, 6.

¹¹ See Board of Governors of the Federal Reserve System, *Dodd-Frank Act Stress Test 2020: Supervisory Stress Test Results* at 8 (June 2020), <https://www.federalreserve.gov/publications/files/2020-dfast-results-20200625.pdf> [hereinafter *2020 Supervisory Stress Test Results*].

¹² See *SIFMA Whitepaper* at 34–41.

event. Thus, given that market participants have proven able to quickly close out positions or effectively hedge risk exposures in real-world market stress events, the assumed calibration horizons underlying a number of GMS factor shocks for several asset classes are unsupported because they lead to GMS factor shocks that are of a far greater magnitude than occur in real-world severe stress events. Notably, for instance, SIFMA's research shows that the magnitude of the 2020 GMS factor shocks far exceeded actual market movements during the COVID-19 pandemic across public equity, U.S. Treasury, corporate bond, and foreign exchange markets.¹³ The Board should revise the calibration assumptions underlying the GMS component to be more realistic, which would make the GMS component a more effective capital planning tool.¹⁴

- **Inconsistency between banking book and trading book impacts.** The severity of the GMS market factor shocks also results in significantly different capital treatment of the same economic risks based solely on accounting classification. For example, certain positions appear to be subject to very significant market shocks under the GMS component when held as trading assets, but have much lower loss rates under the macroeconomic scenarios when held as banking book assets. For example, in the 2019 supervisory stress tests, the GMS loss rate for trading AAA prime RMBS whole loans ranged between 27 percent and 37 percent, depending on maturity, while first lien mortgages in the banking book were subject to an average portfolio loss of 1.4 percent – an approximately **20X** difference for assets presenting similar economic risk. SIFMA understands that the stress testing models for trading assets and banking assets are built on different assumptions and frameworks, but such dramatically different capital requirements associated with the same economic risks are not warranted. Moreover, this disconnect disproportionately impacts IHCs, which tend to engage in less commercial banking activity than comparably-sized domestic BHCs. The Board should revise its models to better align risk and capital for market-making and other capital markets activities that are essential to the U.S. financial system, and to be consistent with how firms assess risk and allocate capital to these activities.
- **Implausible cross-factor correlations.** As part of the GMS component, the Board develops a standardized set of market factor shocks that may be based on one or more historical periods, hypothetical but plausible events, or a combination thereof. At present, the Board uses a hybrid approach, incorporating key elements of market developments from particular historical periods

¹³ See SIFMA, *New SIFMA Analysis: The Fed & CCAR 2020 – Stay the Course for the Sake of Economic Recovery* (June 3, 2020), <https://www.sifma.org/resources/news/new-sifma-analysis-the-fed-ccar-2020-stay-the-course-for-the-sake-of-economic-recovery/>.

¹⁴ In addition to the implausible magnitude of the factor shocks, we note that the GMS does not provide any offsets to reflect lower variable expenses associated with extreme trading asset value reductions, which is inconsistent with historical experience.

(such as the second half of 2008), and adding hypothetical elements based on market conditions at the time of the supervisory stress test.¹⁵

SIFMA's research demonstrates that the market factor shocks underlying the GMS component fail to meet the Board's plausibility standard because, when viewed at the portfolio level, the market factor movements are highly positively correlated in a way that is historically unprecedented and extremely unlikely.¹⁶ SIFMA's cross-factor historical analysis illustrates how asset classes do not necessarily move together in the same magnitude or even in the same direction. For example, A-, BBB-, and B-rated corporate bonds experienced their most adverse spread movements in three different years, two of which were not during the financial crisis period. Additionally, within the financial crisis period, the most adverse spread movements across asset classes generally occurred at different stages of the crisis. These analyses demonstrate that an instantaneous, simultaneous realization of severe market shocks across all asset classes is extremely unlikely, and thus does not meet the Board's plausibility standard.

- **Application of market shocks to non-trading assets.** The GMS component involves market shocks to a broad range of asset classes that are traditionally considered trading assets, including equities, credit, interest rates, foreign exchange rates, and commodities. However, the Board's illustrative list of risk factors subject to potential market shocks also includes the value of non-trading assets, such as private equity positions, that do not demonstrate the characteristics of more traditional trading exposures.¹⁷ Firms generally hold these assets over long-term horizons, which means that they have time to recover losses on their positions. The GMS component, however, imposes peak-to-trough losses with no recovery, as if firms locked in losses by selling their positions immediately. The application of the GMS market shocks to these asset classes further undermines the plausibility of the GMS component. The Board should exclude these non-trading assets from the GMS component, as it has done previously with fair-value non-trading loans.
- **Unbounded year-over-year volatility in GMS market factor shocks.** In designing the severely adverse macroeconomic scenario, the Board has imposed several controls with respect to the projected unemployment rate and ratio of the nominal house price index to nominal, per capita disposable income ("HPI-DPI ratio") that have the effect of minimizing the year-over-year volatility of these metrics.¹⁸ By contrast, no similar controls are in place with respect to the GMS

¹⁵ See 12 C.F.R. pt. 252, App. A, § 5.2.2. See also *2020 Supervisory Stress Test Results* at 9 (describing the 2020 GMS component scenario).

¹⁶ See *SIFMA Whitepaper* at 21–27.

¹⁷ See 12 C.F.R. pt. 252, App. A, § 3.2. See also *SIFMA Whitepaper* at 57.

¹⁸ Specifically, the Board has adopted a recession approach to developing the severely adverse macroeconomic scenario. Under this approach, the Board begins by setting the path of the unemployment rate, which will generally increase between 3 to 5 percentage points over the planning

component. SIFMA has previously cataloged the high degree of volatility in many of the GMS market factor shocks across stress test cycles, both in severity and direction.¹⁹ While SIFMA appreciates that the Board's stress testing scenarios should vary year over year, the volatility of the GMS factor shocks should be controlled within reasonable bounds so as to promote more predictable capital planning. This result could be accomplished by broadly recalibrating the GMS market factor shocks or by applying the average of multiple years of GMS shock scenarios, rather than a single set of shocks to a single day's balance sheet. Such changes would have the benefit of reducing volatility in GMS results and providing a more plausible outcome, credibly reflecting that certain markets may remain liquid in stress periods.

Improving the plausibility of the GMS component would promote its use as a credible risk management tool for firms, and would reduce the current unintended and distortive effects that the GMS component has on capital planning efforts by firms with significant trading activity.

2. *Applicability Criteria for the GMS Component*

In addition to addressing certain design issues of the current GMS component, the Board should revise the applicability thresholds for the GMS component to conform with the Board's tailoring framework. In particular, only Category I firms should be subject to the GMS component.²⁰ While SIFMA has expressed concerns with the calibration of the risk-based indicators used in the Board's tailoring framework,²¹ the Board has committed itself to that framework to determine the applicability of enhanced prudential standards such as stress testing and the composition of the LISCC portfolio.²² The Board's tailoring framework and LISCC portfolio reflect the fact that only Category I firms present levels of systemic risk that justify the imposition of the most stringent elements of regulation and supervision, including the application of the GMS component in stress testing. Aligning the applicability of the GMS component with the tailoring framework does not require the Board to jettison the trading activity-based criteria that it currently uses to determine the applicability of the GMS component. Instead, the Board could apply the GMS component only to those Category I firms that have aggregate trading assets and liabilities of \$50

horizon, and in all events will reach at least 10 percent. All other variables in the severely adverse macroeconomic scenario are then specified to be consistent with the increase in the unemployment rate. As a matter of exception, the path for housing prices – which do not bear a consistent historical relationship to the unemployment rate – will be set such that the decline in the HPI-DPI ratio will be at least 25 percent. See 12 C.F.R. pt. 252, App. A § 4.2.2(a), 4.2.3(c).

¹⁹ See *SIFMA Whitepaper* at 28–33.

²⁰ Category I firms include BHCs identified as global systemically important. See 12 C.F.R. § 252.5(b).

²¹ See SIFMA, *SIFMA Comment on Proposals Revising Applicability of Enhanced Prudential Standards for Foreign Banking Organizations* (June 21, 2019), <https://www.sifma.org/wp-content/uploads/2019/06/SIFMA-FBO-Comment-Letter-6.21.19-1.pdf>.

²² See SR 20-XX, *Firms Subject to the LISCC Supervisory Program* (draft released Nov. 6, 2020) (generally aligning the applicability of the Board's LISCC supervisory program to Category I firms and firms designated as systemically important).

billion or more or aggregate trading assets and liabilities equal to 10 percent or more of their total consolidated assets.

As an alternative to aligning the applicability criteria of the GMS component with the Board's tailoring framework, the Board could modify the existing criteria to use a definition of trading assets and liabilities that exclude assets that present minimal credit and liquidity risk, such as U.S. Treasury securities and agency mortgage-backed securities.²³ This change would have the effect of tailoring the applicability of the GMS to exclude firms the trading activities of which do not represent a significant risk to their operations.

C. LCD Component

Firms with substantial trading or processing and custodian operations are subject to the LCD component as an add-on to the severely adverse macroeconomic scenario. The LCD component assumes the default of the single counterparty to which a firm is most exposed in the GMS event. The LCD component reflects the Board's view that factors not directly correlated to macroeconomic or financial assumptions, such as the unexpected default of a major counterparty, can materially affect a firm's risks.²⁴

1. *Alterations to the Design of the LCD Component*

As designed, the Board's supervisory methodology underlying the LCD component relies on the GMS market factor shocks to generate counterparty losses. We believe that the use of the GMS factor shocks – which, as discussed above, have unrealistically lengthy calibration horizons – result in implausible assumptions regarding margin periods of risk (“MPoR”) across most asset classes. Thus, the Board's approach overestimates counterparty default losses and is inconsistent with the goal of risk sensitivity in stress testing.

Furthermore, the continued use of the Board's current methodology can lead to multiple unintended consequences, such as disincentivizing certain forms of market intermediation, and reducing balance sheet capacity. Recognizing the importance of a risk-sensitive MPoR, other central banks have adopted approaches for stress testing large counterparty defaults that are more reflective of stress market conditions and experience. For example, the UK Prudential Regulatory Authority uses a five-day shock for bilateral SFTs, prime brokerage exposures, and exposures governed by global netting agreements and a ten day shock for OTC derivatives.

SIFMA recommends that the Board apply scalars to the GMS market factor shocks to reflect more plausible implied close-out periods for different asset classes, and particularly the most liquid asset

²³ For similar policy reasons, these assets are excluded from scoping criteria that are based on trading assets and liabilities in other areas of the regulatory framework. See 12 C.F.R. § 248.2(u), (s), (ee).

²⁴ See 12 C.F.R. pt. 252, App. B, § 2.5; *id.*, App. A, § 3(b).

classes. These scalars should reduce the MPoR to five to seven days, which would still be severe, but would be more plausible than the current approach.

SIFMA acknowledges that, in certain areas, the Board has modified its GMS assumptions to more closely reflect realistic counterparty default scenarios. For example, in the 2020 stress test exercise, the Board's LCD scenario assumed modest volatility in FX rates, which better reflected the depth and liquidity of FX markets than in prior stress test cycles. The 2019 stress test exercise, by contrast, assumed much wider spreads in FX rates. The Board should expand its efforts to improve the risk sensitivity of FX assumptions in the LCD component into other areas of the LCD component.

2. *Applicability Criteria for the LCD Component*

Currently, the Board applies the LCD component to all firms subject to the GMS component, plus certain additional firms with significant trading or processing and custody operations. Unlike with respect to the GMS component, the Board has not articulated how it determines which firms meet the LCD component's applicability standard, and whether any objective indicators are part of this determination.

To improve transparency, the Board should articulate objective metrics on which the applicability of the LCD component is based. SIFMA recommends that the Board should revise the applicability of the LCD component to align with the SCCL framework, which serves similar policy purposes as the LCD component. Specifically, only BHCs that are "major covered companies" under the SCCL framework – that is, Category I BHCs – should be subject to the LCD component.²⁵ This change would provide greater coherence to the Board's overall approach to regulating large counterparty risk. If the Board does not align the applicability of the LCD component with the SCCL framework, then the Board should at least make more transparent its process for selecting which firms will be subject to the LCD component.

II. **The Board should enhance the transparency of the assumptions underlying the GMS component and the LCD component to facilitate better capital planning and public understanding of the capital planning and stress testing framework.**

In addition to reconsidering the structural design issues with the GMS component and the LCD component described above, the Board should improve the transparency of its design of these components. SIFMA acknowledges that the Board has increased transparency with respect to certain aspects of the GMS and LCD components, but these advances have mostly occurred with respect to non-capital markets models and processes. This relative lack of transparency creates significant capital planning challenges for firms subject to these add-on components, and reduces the usefulness of the stress test outputs as a risk management tool.

In particular, the Board should provide further clarity and transparency regarding the following aspects of the GMS and LCD components:

²⁵ See 12 C.F.R. §§ 252.70(a)(ii), 252.72(b).

- **Recovery rate modeling.** The Board has disclosed little with respect to the modeling approaches, assumptions, and data it uses to estimate recovery rates under the LCD component. In addition, it is not clear that the Board's recovery rate models account for meaningful differences between asset classes and counterparty types.²⁶ Further transparency from the Board would provide clarity and facilitate better capital planning and self-assessment by BHCs and IHCs.
- **Evaluation of plausibility.** The Board has stated that plausibility is an important touchstone for its design of the macroeconomic scenarios and of the add-on GMS component. However, SIFMA understands that the plausibility of the portfolio of the GMS market factor shocks is evaluated on a qualitative basis, without the benefit of any defined policy of which we are aware. The adoption of a policy or framework to guide plausibility determinations should help address many of the structural design issues described above, including the year-over-year volatility of the GMS market factor shocks and the extended calibration horizons of those shocks.
- **Selection of the "as of" date.** Both the GMS market factor shocks and the LCD component's assumed counterparty default occur on a particular date selected by the Board. Consistent with the Board's efforts to improve transparency with respect to other aspects of the stress testing framework, the Board should make public its process for selecting the "as of" date of the GMS and LCD components through an addition to the Board's Stress Testing Policy Statement.
- **Information reporting.** Any GMS-specific information reporting requirements (e.g., supplemental schedules) that the Board imposes in addition to FR Y-14 reporting forms should be formalized and published to improve public disclosure surrounding the stress testing framework.

III. The Board should harmonize existing guidance and tailor the applicability of Supervision and Regulation letters 15-18 and 15-19, to align with the regulatory tailoring framework.

A. Harmonization of Existing Guidance

SIFMA welcomes the Board's recently renewed commitment to improving its approach to supervisory guidance, including by reducing multiple issuances of supervisory guidance on the same topic.²⁷ SIFMA encourages the Board to apply this approach to the capital planning area. Currently, the Board's supervisory expectations with respect to capital planning and stress testing are described in numerous documents, including published reports (such as past stress test results), FAQs, reporting forms, instructions, and Supervision and Regulation letters, in addition to codified regulations. We believe that

²⁶ See *SIFMA Whitepaper* at 50.

²⁷ See Interagency Statement Clarifying the Role of Supervisory Guidance (September 11, 2018). The agencies recently proposed to codify this Interagency Statement into regulation. See *also* Role of Supervisory Guidance, 85 Fed. Reg. 70,512 (proposed Nov. 5, 2020).

there is a significant opportunity to harmonize the Board's existing capital planning guidance to ensure consistency across these documents and the Board's capital planning and stress testing regulations.

B. Scoping of SR Letters 15-18 and 15-19

The Board's key capital planning guidance applicable to large firms are SR letters 15-18 and 15-19. SR 15-18 applies to BHCs and IHCs that are either LISCC Portfolio Firms or Large and Complex Firms.²⁸ SR 15-19 applies to BHCs and IHCs that are Large and Noncomplex Firms.²⁹ As a general matter, SR 15-18 imposes more significant requirements on and expectations of covered firms relative to SR 15-19.

The Board should revise the applicability thresholds for SR letters 15-18 and 15-19 (or any successor guidance documents setting forth comparable expectations) to conform to the Board's tailoring framework and to expressly remove IHCs from the scope of applicability now that foreign banking organizations have been removed from the Board's LISCC portfolio.³⁰ The enhanced requirements of SR 15-18 are most appropriate for Category I firms, which the tailoring framework assumes to present greater risk to the U.S. financial system. The requirements of SR 15-19 should apply to Category II and III firms, and Category IV firms should not be subject to the requirements of either capital planning guidance document. This approach would align supervisory expectations with firms' risk profiles.³¹

Additionally, revising the scope of application along these lines would avoid disproportionately adversely impacting the U.S. capital markets, which has been a result of subjecting IHCs that focus their U.S. business models on capital markets activities to the same supervisory standards that apply to BHCs that are multiples of their size and systemic footprint.

²⁸ See SR 15-18, *Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms* (Dec. 18, 2015). "LISCC Portfolio Firm" includes any firm designated for enhanced supervision by the Board's Large Institution Supervision Coordinating Committee. "Large and Complex Firm" includes any BHC or IHC with total consolidated assets of \$250 billion or more, or consolidated total on-balance sheet foreign exposure of \$10 billion or more. *Id.*

²⁹ See SR 15-19, *Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms* (Dec. 18, 2015). "Large and Noncomplex Firm" includes any BHC or IHC with total consolidated assets between \$50 billion and \$250 billion and consolidated total on-balance sheet foreign exposures of less than \$10 billion, provided that the company is not a LISCC portfolio firm. *Id.*

³⁰ See SR 20-XX, *Firms Subject to the LISCC Supervisory Program* (draft released Nov. 6, 2020).

³¹ See Randal K. Quarles, Vice Chair for Supervision, Federal Reserve Board, *Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision* (Jan. 17, 2020), <https://www.federalreserve.gov/newsevents/speech/files/quarles20200117a.pdf> (stating that "I believe we should draw the LISCC line to coincide with Category I" and "Category II and III firms would remain subject to heightened supervisory standards that are commensurate with their risk portfolio").

IV. The Board should refrain from adopting a singular definition of common stock dividend that would unfairly penalize IHCs and their parent companies, and have unforeseen consequences on intercompany arrangements.

A firm's stress capital buffer requirement includes a dividend add-on that is based on planned common stock dividends during the projected quarters four through seven of the planning horizon. The stated purpose of this dividend add-on is to reflect the Board's assumption that firms will seek to keep paying common dividends for one year in times of stress in order to avoid sending negative signals to investors.³²

The Board's capital plan rule does not define common stock dividends, and the Board has observed that different firms, especially IHCs, have adopted different approaches to classifying returns of capital to shareholders. The staff memorandum accompanying the Proposal suggests that the Board is considering a definition covering any payment of cash to shareholders in proportion to the number of shares they own, including payments of cash to parent organizations irrespective of whether the amount paid is debited from the firm's retained earnings.

The Proposal's focus on reclassifying IHC capital distributions is misguided, because IHCs pay capital distributions to their parent companies rather than to public shareholders, and IHC capital distributions therefore do not serve as market signals in the same way that BHC dividends do. As a result, IHCs face limited (if any) market pressure to stop paying capital distributions to their parent companies, and IHCs can and will cease these distributions if needed to conserve capital. Furthermore, adopting a singular definition of "common stock dividend" could inhibit an IHC's ability to repatriate capital and liquidity to strengthen its parent foreign banking organization's overall resiliency, which should not be restricted so long as stress capital buffer requirements are met.³³ In addition, an IHC may distribute capital "upstream" within a corporate group for any number of reasons, including payments for intercompany services, tax sharing, and other purposes. The proposed definition contemplated in the Board's staff memorandum would appear to sweep in such payments, which could have a range of unintended negative consequences for the day-to-day operation of foreign banking organizations and IHCs.

We also are aware of no reason why the Board needs to define "common stock dividend" in the context of BHCs. To the contrary, applicable corporate laws and accounting standards appear to supply sufficient guidance to ensure that both IHCs and BHCs characterize capital distributions appropriately. As a result,

³² See Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Department Thoughts* (Apr. 4, 2017), <https://www.federalreserve.gov/newsevents/speech/files/tarullo20170404a.pdf> (stating that "some banks continued to pay dividends in 2007 and 2008 even as their situations became increasingly precarious").

³³ Indeed, after the 2008-2009 financial crisis, a number of jurisdictions imposed restrictions on dividends and capital distributions that applied to intra-group capital transfers as well as external distributions. These restrictions inhibited capital rebalancing within groups, which – contrary to the prudential objective of such restrictions – greatly increased group credit risk in many cases. See, e.g., Wilson Ervin, *Understanding 'Ring-Fencing' and How It Could Make Banking Riskier*, THE BROOKINGS INSTITUTION (Feb. 7, 2018), <https://www.brookings.edu/research/understanding-ring-fencing-and-how-it-could-make-banking-riskier>.

no singular definition of “common stock dividend” is necessary in the capital rule, and firms should retain the ability to characterize distributions to their parent companies in the manner dictated by applicable corporate law and accounting rules in their operative jurisdictions.

* * *

We appreciate the Board’s consideration of our concerns. If you have any questions, please contact Coryann Stefansson at (202) 962-7340 or cstefansson@sifma.org, or Peter Ryan at (202) 962-7452 or pryan@sifma.org.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "K. E. Bentsen, Jr.", with a stylized flourish at the end.

Kenneth E. Bentsen, Jr.
President & CEO
Securities Industry and Financial Markets Association