November 20, 2020

Via Electronic Mail

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Amendments to Capital Planning and Stress Testing Requirements for Large Bank Holding Companies, Intermediate Holding Companies and Savings and Loan Holding Companies (RIN 7100–AF95)

To Whom It May Concern:

The Bank Policy Institute[1] appreciates the opportunity to comment on the notice of proposed rulemaking to tailor the requirements in the Federal Reserve Board's capital plan rule, which applies to bank holding companies ("BHCs") and U.S. intermediate holding companies ("IHCs") of foreign banking organizations ("FBOs") with $100 billion or more in total consolidated assets.[2] The proposal generally would make sensible, conforming changes to the capital planning, regulatory reporting, and stress capital buffer ("SCB") requirements for banking organizations subject to Category IV standards to better align those requirements with the October 2019 tailoring framework.[3] The proposal also seeks comment on, but does not propose any specific changes concerning, all aspects of the Federal Reserve's capital planning guidance for all banking organizations supervised by the Federal Reserve.

Our comments are organized as follows: part I contains an executive summary with our key recommendations; part II responds to the request for comment on the Federal Reserve's guidance on

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1 The Bank Policy Institute ("BPI") is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost two million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

2 Federal Reserve, *Amendments to Capital Planning and Stress Testing Requirements for Large Bank Holding Companies, Intermediate Holding Companies and Savings and Loan Holding Companies*, 85 Fed. Reg. 63222 (Oct. 7, 2020).

3 Throughout this letter, we refer to the "tailoring framework" to include the final rules issued by the Federal Reserve and other banking agencies in November 2019. *See* OCC, Federal Reserve, and FDIC, *Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements*, 84 Fed. Reg. 59230 (Nov. 1, 2019), available at https://www.govinfo.gov/content/pkg/FR-2019-11-01/pdf/2019-23800.pdf; Federal Reserve, *Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies*, 84 Fed. Reg. 59032 (Nov. 1, 2019), available at https://www.govinfo.gov/content/pkg/FR-2019-11-01/pdf/2019-23662.pdf. Similarly, categories of banking organizations referred to in this letter are defined by the tailoring framework.

capital planning; part III contains recommendations for certain changes to the capital planning rule; and part IV provides our comments on the proposed changes contained in the proposal.

I. Executive Summary and Key Recommendations

This letter is organized as follows:

- Part II identifies the following key recommendations regarding the Federal Reserve's guidance on capital planning, including:

    - As a basic principle, the multiple publications of rules and guidance relating to capital and capital planning should be aligned and made more uniform so as to promote transparency and reduce uncertainty for banking organizations and markets more generally.

    - As a second basic principle, and pervasive theme of this comment letter, important issues that can be determinative of capital ratios and capital distributions should be the subject of formal rules and not guidance that have the practical effect, but not the procedural safeguards, of formal rules.

    - Guidance on capital distributions is no longer needed because the Federal Reserve has established a conservative rule-based framework that effectively governs capital distributions and the existing guidance does not appropriately reflect that guidance is non-binding and otherwise runs counter to the goals of transparency and certainty.

    - The Federal Reserve's existing capital regulations, particularly the rule-based capital buffer framework, should govern capital distributions.

    - The existing guidance on dividends is outdated and inappropriate, particularly in light of the impact of the current expected credit losses accounting standard.

    - There is no need for prescriptive cash flow-based tests in the BHC supervision manual on the common stock cash dividend coverage ratio.

    - The Federal Reserve should publish a specific, updated proposal for notice and comment on other aspects of its capital planning guidance to account for recent regulatory reforms and align the scope of application of the guidance with the tailoring framework.

    - The scope and substance of the Federal Reserve's specific supervisory expectations for capital planning and positions of certain banking organizations should be revised to appropriately reflect the categorization and differentiation established in the tailoring framework, SR 15-18 and SR 15-19 should be revised via notice and comment processes to memorialize those changes, and appropriate successor guidance to SR 09-04 to address capital planning for banking organizations with less than $100 billion in total consolidated assets should be provided.

- The Federal Reserve should seek comment on and update SR 15-18 and SR 15-19 to appropriately update these SR letters for the stress capital buffer final rule.

- The Federal Reserve should work with the other banking agencies to clarify bank-level expectations for capital planning that are appropriately harmonized with holding company guidance.

- The Federal Reserve's Guidance on Model Risk Management, SR 11-7, should be better tailored to the risks of Category III and IV banking organizations and banking organizations with less than $100 billion in total consolidated assets.

➢ Part III describes certain recommendations for changes to the capital plan rule, including:

  - The Federal Reserve should amend the capital plan rule to pre-authorize certain capital distributions in connection with a pending resubmission and impose a reasonable limit on any future prior approval requirements in the context of a resubmission.

  - The Federal Reserve should amend the capital plan rule to make clear which changes are deemed to be "material" such that they would lead to a capital plan resubmission.

➢ Part IV discusses our recommendations on the proposed changes contained in the proposal, including:

  - The Federal Reserve should allow Category IV banking organizations until mid-March to notify the Federal Reserve of the banking organization's decision to participate in a supervisory stress test in any given year.

  - The Federal Reserve should provide clarity on whether there will be public disclosure of Category IV banking organizations' stress capital buffers during an off-cycle year.

  - The materiality of business plan changes should be considered in the requirement for banking organizations to report the effects of business plan changes in Schedule A and Schedule C of the FR Y-14A.

  - Additional memoranda items should be added into the FR Y-14A Summary Schedule for banking organizations to incorporate purchase accounting data after a transaction has been consummated.

  - Any proposal defining "common stock dividend" should take into account the different circumstances of the U.S. IHCs of FBOs.

II. Federal Reserve Guidance on Capital Planning

A. Guidance on capital distributions is no longer needed because the Federal Reserve has established a conservative rule-based framework that effectively governs capital distributions and the existing guidance does not appropriately reflect that guidance is non-binding and otherwise runs counter to the goals of transparency and certainty.

In the proposal, the Federal Reserve seeks comment on all its capital planning guidance, including SR 15-18, SR 15-19, SR 09-4 and its 1985 policy statement. The 1985 policy statement contains prescriptive guidance on capital distributions, providing that a banking organization generally should not maintain its existing rate of common stock cash dividends unless (1) the organization's net income available to common shareholders over the past year has been sufficient to fully fund the dividends and (2) the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition.[4]

SR 09-4, which applies to banking organizations that do not participate in Comprehensive Capital Analysis and Review ("CCAR"), provides direction to supervisory staff and banking organizations on the declaration and payment of dividends, capital redemptions, and capital repurchases by banking organizations in the context of their capital planning processes.[5] Similar to the 1985 policy statement, SR 09-4 provides that the board of directors of a banking organization should inform the Federal Reserve and should eliminate, defer, or significantly reduce the banking organization's dividends if: (1) The banking organization's net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends; (2) The banking organization's prospective rate of earnings retention is not consistent with the banking organization's capital needs and overall current and prospective financial condition; or (3) The banking organization will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.[6] SR 09-04 also directs banking organizations to inform the Federal Reserve reasonably in advance of declaring or paying a dividend that exceeds earnings for the period for which the dividend is being paid. As reflected in Attachment C to SR 09-4, this guidance has been administered as the functional equivalent of a requirement that banking organizations provide notice to the Federal Reserve and obtain the Federal Reserve's non-objection before paying a dividend that exceeds income for the relevant period. SR 09-4 also directs banking organizations to advise Federal Reserve supervisory staff sufficiently in advance of certain share repurchases "to provide reasonable opportunity for supervisory review and possible objection."[7] With respect to both dividends and repurchases, SR 09-4 has the practical effect of imposing prior notice and non-objection requirements even though SR 09-4 is guidance, promulgated without notice and comment, and, in many cases, dividends and repurchases that would be subject to the guidance in SR 09-4 would not be subject to any notice, non-objection or approval requirements under the Federal Reserve's regulations. These aspects of SR 09-4 are, therefore, both fundamentally inconsistent with the critical distinction between guidance (which is non-binding) and regulations (which

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4 Federal Reserve, *UNSOUND BANKING PRACTICES—Cash Dividends Not Fully Covered by Earnings* (Nov. 14, 1985), available at https://www.federalreserve.gov/boarddocs/srletters/2009/sr0904a2.pdf (the "1985 policy statement"). The 1985 policy statement appears to apply to all banking organizations supervised by the Federal Reserve. Although it is included as Appendix B to SR 09-4, it is also cross-referenced in SR 15-18 and SR 15-19 and thus seems to still be relevant to larger banking organizations.

5 Federal Reserve, SR letter 09–4, *Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies* (Feb. 24, 2009, revised July 24, 2020), available at https://www.federalreserve.gov/boarddocs/srletters/2009/SR0904.htm.

6 *See id.* at 5.

7 *Id.* at 7-8.

are),[8] and, as discussed below, unnecessary in light of the current conservative and effective rule-based framework governing capital distributions.

In December 2015, SR 09-4 was superseded by SR 15-18 and SR 15-19 for banking organizations that participate in CCAR. In particular, both SR 15-18 and SR 15-19 provide that a banking organization's "capital policy should describe the firm's capital adequacy decision-making process, including the decision-making process for common stock dividend payments or stock repurchases," and that "[c]onsistent with the Board's November 14, 1985, Policy Statement on the Payment of Cash Dividends, the principles of which are incorporated into this guidance, firms should have comprehensive policies on dividend payments that clearly articulate the firm's objectives and approaches for maintaining a strong capital position and achieving the objectives of the policy statement."[9]

The current guidance on dividends does not appropriately reflect the critical distinction between guidance and regulations which results in substantial uncertainty among banking organizations and market participants as to the ability of banking organization to make their own determinations about their common dividend, especially for non-CCAR banking organizations. A banking organization faces a risk of a significant adverse reaction among market participants and other stakeholders if it is, for all practical purposes, required to suddenly and unexpectedly reduce or suspend its dividend through the application of the current guidance. In that event, there is likely to be confusion among market participants as to what the reduction or suspension indicates about the banking organization's financial condition and prospects or supervisory views as to the banking organization's financial condition and prospects, that adversely affect the market price for the banking organization's common stock. Moreover, the very fact that this risk exists results in the current guidance actually detracting from banking organizations' safety and soundness by jeopardizing their access to equity markets and their ability to raise capital, in particular at an appropriate valuation. Furthermore, allowing existing capital rules to govern capital distributions would also be consistent with the Federal Reverse's recognition of the critical distinction between guidance (which is not binding) and regulations (which are).

Both Federal Reserve Chair Powell and Vice Chair for Supervision Quarles have indicated that banks have served as a source of strength during the coronavirus stress event this year and that banks remain well-capitalized and strong.[10] The recent Federal Reserve Supervision and Regulation report also stated that banks have served as "as shock absorbers for the real economy" and noted the strong capital

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[8] *See, e.g.*, OCC, Federal Reserve, FDIC, NCUA and CFPB, *Role of Supervisory Guidance*, 85 Fed. Reg. 70512, 70514 (Nov. 5, 2020), available at https://www.govinfo.gov/content/pkg/FR-2020-11-05/pdf/2020-24484.pdf ("[The agencies] recognize the important distinction between issuances that serve to implement acts of Congress (known as 'regulations' or 'legislative rules') and non-binding supervisory documents. Regulations create binding legal obligations. Supervisory guidance is issued by an agency 'to advise the public prospectively of the manner in which the agency proposes to exercise a discretionary power' and does not create binding legal obligations.") (internal citations omitted).

[9] Federal Reserve, SR letter 15-18, *Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms* (Dec. 18, 2015), at 13 and 13 n.19, available at https://www.federalreserve.gov/supervisionreg/srletters/sr1518.htm; Federal Reserve, SR letter 15-19, *Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms* (Dec. 18, 2015), at 12 and 12 n.19 (Dec. 18, 2015), available at https://www.federalreserve.gov/supervisionreg/srletters/sr1519.htm.

[10] *See* Federal Reserve, *Transcript of Chair Powell's Press Conference* (July 29, 2020), at 27, available at https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20200729.pdf; *see also* Vice Chair for Supervision Randal K. Quarles, *Remarks at the Hoover Institution* (Oct. 14, 2020), available at https://www.federalreserve.gov/newsevents/speech/quarles20201014a.htm; Federal Reserve, Press Release, *Statement by Vice Chair for Supervision Quarles* (June 25, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/quarles-statement-20200625c.htm.

position of the banking system.[11] If a banking organization is required to reduce or suspend its dividend through the application of the current guidance, even though it is well above its regulatory capital buffer requirement, those actions would effectively correspond to an increase in capital requirements. There is significant research demonstrating that increases in capital requirements cause a reduction in credit availability, which would be particularly problematic in an economic downtown.[12] We recommend that the Federal Reserve continue to promote policies that allow banks to continue to serve as a vital source of strength to the U.S. economy during this period of uncertainty and economic recovery.

Our key recommendation is that the Federal Reserve's guidance should focus on capital planning, generally. This guidance should not specifically address capital distributions, should not create prior notice and consultation/non-objection expectation that for all practical purposes are indistinguishable from requirements, and should not provide additional qualitative tests nor present prescriptive quantitative tests and metrics indicating when banking organizations should limit, reduce or suspend those distributions. The Federal Reserve has developed conservative and effective capital rules to govern capital distributions[13] and to promote capital conservation, which render guidance on capital distributions unnecessary, particularly the current guidance, which blurs the distinction between guidance and regulations. Moreover, the Federal Reserve will increase the transparency, simplicity, and predictability around the ability of banking organizations to make their own determinations regarding their capital distributions by eliminating qualitative and quantitative tests and metrics for capital distributions from its capital planning guidance and allowing the capital rules, particularly the capital buffer framework, to function as intended.

1. The Federal Reserve's existing capital regulations, particularly the rule-based capital buffer framework, should govern capital distributions.

In assessing the continued need for capital distribution guidance like the 1985 policy statement, the Federal Reserve should take into account all of the regulatory reforms that it has put in place over the past three and a half decades, particularly the past decade of reforms. These reforms include specific rule-based mechanisms that govern capital distributions. We believe these regulations create a robust framework that is sufficient to achieve the Federal Reserve's objectives with respect to capital distributions and capital conservation.

These reforms include the establishment of risk- and leverage-based minimum capital requirements, and, more recently, reforms that improve the quality and quantity of capital, the

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11 Federal Reserve, *Supervision and Regulation Report* (Nov. 2020), at 3 and 4, available at https://www.federalreserve.gov/publications/files/202011-supervision-and-regulation-report.pdf.

12 Bank for International Settlements, Macroeconomic Assessment Group, *Final Report: Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements* (Dec. 2010), available at https://www.bis.org/publ/othp12.pdf; Martin Brooke et al., *Measuring the macroeconomic costs and benefits of higher UK bank capital requirements*, Bank of England Financial Stability Paper No. 35 (Dec. 1, 2015), available at https://www.bankofengland.co.uk/financial-stability-paper/2015/measuring-the-macroeconomic-costs-and-benefits-of-higher-uk-bank-capital-requirements; Jihad Dagher et al., *Benefits and Costs of Bank Capital*, IMF Staff Discussion Note No. SDN/16/04 (March 2016), available at https://www.imf.org/external/pubs/ft/sdn/2016/sdn1604.pdf; Simon Firestone et al., *An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the United States*, Economic Research Review, Federal Reserve Bank of St. Louis, Third Quarter 2019, Vol. 101, No. 3 (July 12, 2019), available at https://research.stlouisfed.org/publications/review/2019/07/12/an-empirical-economic-assessment-of-the-costs-and-benefits-of-bank-capital-in-the-united-states.

13 We use the term "capital distribution" to refer to dividends and share repurchases throughout this letter. *See* 12 CFR § 225.8(d)(6); *see also* 12 CFR § 217.2 (defining "distribution").

establishment of a minimum common equity tier 1 ("CET1") capital requirement, and a fixed capital conservation buffer ("CCB") equal to 2.5 percent of risk-weighted assets.[14]

According to the Federal Reserve, OCC and FDIC, the main objective of the CCB, adopted in 2013 and fully phased in since 2019, is to govern capital distributions in stress. The CCB was adopted as a response to the last financial crisis in 2007-2009 when "banking organizations continued to pay dividends and substantial discretionary bonuses even as their financial condition weakened," and it "is intended to provide incentives for banking organizations to hold sufficient capital to reduce the risk that their capital levels would fall below their minimum requirements during a period of financial stress."[15]

Large banking organizations in Categories I, II, and III also became subject to a countercyclical capital buffer requirement, which can range from 0 to 2.5 percent of risk-weighted assets, and the largest and most systemically important banking organizations—global systemically important bank holding companies ("GSIBs") that are Category I institutions—became subject to an additional capital buffer based on a measure of their systemic risk, the GSIB surcharge.[16] All of these buffers are added together and sit atop enhanced regulatory capital minimum requirements. Banking organizations generally treat regulatory capital buffers like effective regulatory minimums and seek to stay above them, even during stress, to avoid limitations on capital distributions.

Additionally, for CCAR banking organizations in Categories I-IV, the Federal Reserve recently adopted a stress capital buffer final rule ("SCB rule") that first began to apply on October 1 and integrates the Federal Reserve's regulatory capital rule with the stress-based capital requirements established through CCAR.[17] Under the SCB rule, large holding companies are subject to an SCB based on the results of the supervisory stress test and four quarters of planned common stock dividends that is floored at the CCB level of 2.5 percent and can range much higher based on stress losses (*e.g.*, up to nearly 8 percent).[18] The SCB requirement thus replaces the fixed 2.5 percent component of a banking organization's capital conservation buffer requirement at the holding company level with a buffer determined based on a banking organization's stress losses plus four quarters of pre-funded dividends.[19] Non-CCAR banking organizations (*i.e.*, those not in Categories I-IV and, therefore, not subject to SCB) continue to be subject to the 2.5 percent CCB.

The SCB is a banking organization-specific and extremely conservative constraint on capital distributions set through the supervisory stress test and supervisory models which are already

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14 *See generally* 12 CFR § 217.

15 OCC and Federal Reserve, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches to Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 Fed. Reg. 62018, 62033 (Oct. 11, 2013), available at https://www.govinfo.gov/content/pkg/FR-2013-10-11/pdf/2013-21653.pdf.

16 *See* Federal Reserve, *Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Globally Systemically Important Bank Holding Companies*, 80 Fed. Reg. 49082 (Aug. 14, 2015), available at https://www.govinfo.gov/content/pkg/FR-2015-08-14/pdf/2015-18702.pdf.

17 Federal Reserve, *Regulations Q, Y, and YY: Regulatory Capital, Capital Plan, and Stress Test Rules*, 85 Fed. Reg. 15576 (March 18, 2020), available at https://www.govinfo.gov/content/pkg/FR-2020-03-18/pdf/2020-04838.pdf.

18 Federal Reserve, Press Release, *Federal Reserve Board announces individual large bank capital requirements, which will be effective on October 1* (Aug. 10, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200810a.htm.

19 Notably, the dividend add-on was explicitly adopted to promote forward-looking capital planning and address how during the last financial crisis in 2007-2009 banking organizations paid dividends without regard to the impact of a prolonged economic downturn on their capital adequacy. *See* 85 Fed. Reg. at 15579.

conservative (*e.g.*, given elements like projections for trading and counterparty losses, projections for loan losses based on industry data). The SCB, in particular, reflected a shift from tests tied to payout ratios toward distribution limitations based on measures of capital adequacy and capital levels, which is notably reflected in the removal of the guidance on dividend payout ratios exceeding 30 percent.[20] Similar considerations apply for non-CCAR banks in light of the CCB.

When a banking organization has a regulatory capital ratio that is less than the applicable minimum and buffer requirement, taken together, the banking organization's maximum payout ratio cannot exceed a certain percentage of eligible retained income (*i.e.*, average net income over the prior four quarters). The constraints are graduated, with increasingly stringent limitations based on the extent of the shortfall. Importantly, when a banking organization's eligible retained earnings is zero or negative and it does not satisfy its buffer requirements in full, shareholder payouts generally are not permitted without prior approval, regardless of how much buffer capacity a banking organization has available within its buffer and irrespective of whether the lack of eligible retained earnings is due to an idiosyncratic event.[21]

The capital rule's buffer requirements thus impose increasingly strict automatic limits on capital distributions as a banking organization's capital ratios decline toward the minimum requirements and as a banking organization's eligible retained income declines. The entire point of these buffers—which have been subject to notice and comment rulemaking—is to govern capital distributions and require prudent capital conservation, including during stress.

As a general matter, therefore, we believe the rule-based buffer framework is sufficient and effective to govern capital distributions as intended. Applicable capital buffers—*i.e.*, the CCB for non-CCAR banking organizations and the SCB for CCAR banking organizations—are a sufficient (indeed, more than sufficient) mechanism to promote capital conservation and limit capital distributions as capital ratios decline, including during stress. For CCAR banking organizations, BPI research has recently demonstrated that the rule-based capital buffer framework is an effective constraint on dividends.[22] These buffers should be allowed to function as intended without layering on guidance with additional quantitative tests on top of rule-based constraints.

Using prescriptive guidance on top of these rule based-buffers and earnings tests to further limit capital distributions has the practical effect of imposing an additional buffer—but doing it through guidance instead of a rule. Capital distribution limits in the form of guidance including numerical, prescriptive earnings tests to limit dividends is not appropriate and is no longer necessary. It is also inconsistent with the Federal Reserve's recognition of the appropriate role of guidance.[23] It would also substantially improve transparency, predictability, and simplicity of the regulatory capital framework to

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20 *See* 85 Fed. Reg. at 15579 ("A dividend payout ratio criterion is no longer necessary because the final rule's automatic distribution limitations, combined with the perceived market signaling effect of dividend cuts, will sufficiently restrict dividend increases in the future."); Federal Reserve, *Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules*, 83 Fed. Reg. 18160, 18166 (Apr. 25, 2018), available at https://www.govinfo.gov/content/pkg/FR-2018-04-25/pdf/2018-08006.pdf .

21 *See* 12 § CFR 217.11(a)(4) and (c)((1)(v).

22 *See* Francisco Covas and Anna Harrington, *The Federal Reserve's Capital Buffer Framework Effectively Constrains Bank Dividends in Stress*, Bank Policy Institute (Oct. 26, 2020), available at https://bpi.com/the-federal-reserves-capital-buffer-framework-effectively-constrains-bank-dividends-in-stress/.

23 *See* Federal Reserve, CFPB, FDIC, NCUA, and OCC, *Interagency Statement Clarifying the Role of Supervisory Guidance* (Sept. 12, 2018), available at https://www.federalreserve.gov/supervisionreg/srletters/sr1805.pdf (hereinafter "Guidance on Guidance"). *See also* 85 Fed. Reg. at 70514-15.

not have rule-like guidance layered on top of rule-based constraints for capital distributions.[24] We believe that, in turn, the market receptivity for the stock of all banking organizations would be enhanced.

2. The existing guidance on dividends is outdated and inappropriate, particularly in light of the impact of the current expected credit losses accounting standard.

Last year, the Federal Reserve and other banking agencies adopted a rule to address the implementation of the current expected credit losses methodology ("CECL"), which has generally been made applicable this year to all banking organizations that are SEC filers.[25] In 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update (ASU) No. 2016-13, Financial Instruments—Credit Losses, Topic 326, Measurement of Credit Losses on Financial Instruments. This purported "update" resulted in a fundamental and conceptual change to credit loss accounting under U.S. generally accepted accounting principles ("GAAP"). The revisions to credit loss accounting under GAAP included the introduction of the CECL, which replaces the incurred loss methodology for financial assets measured at amortized cost. For these assets, CECL requires banking organizations to recognize immediately lifetime expected credit losses and to incorporate reasonable and supportable forecasts in developing the estimate of lifetime expected credit losses, while also maintaining the current requirement that banking organizations consider past events and current conditions. As a result of this standard, banking organizations hold substantial additional reserves against potential losses, further increasing the conservatism of reported regulatory capital positions of banking organizations and potentially forcing banking organizations to reserve additional capital that could otherwise be deployed to the economy and consumers.[26]

As seen in the current coronavirus event, CECL forced banking organizations to accelerate the recognition of potential credit losses and ramp up their allowances for credit losses on an immediate basis. Prior to the coronavirus event, we expected the increase in loan loss provisions to be recorded in downturns because it is very difficult to accurately forecast turning points in the business cycle.[27] Not only were our assumptions proved to be correct, but the coronavirus event reinforced those concerns. Because the allowances for credit losses rose so quickly, net income declined appreciably at banking organizations applying CECL at the start of the downturn. CECL accelerates the recognition of credit losses in a deteriorating macroeconomic environment, which accelerates the reduction of net income

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24 In this sense, eliminating capital distribution guidance on top of capital distribution rules would be consistent with the principles articulated by the Federal Reserve's Vice Chair for Supervision. *See* Randal K. Quarles, Vice Chairman for Supervision, *Early Observations on Improving the Effectiveness of Post-Crisis Regulation*, American Bar Association Banking Law Committee Annual Meeting (Jan. 19, 2018), at 2 (hereinafter "Early Observations") (suggesting "we have an opportunity to improve the efficiency, transparency, and simplicity of regulation."), available at https://www.federalreserve.gov/newsevents/speech/quarles20180119a.htm.

25 *See* OCC, Federal Reserve, and FDIC, *Regulatory Capital Rule: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rule and Conforming Amendments to Other Regulations*, 84 Fed. Reg. 4222 (Feb. 14, 2019), available at https://www.govinfo.gov/content/pkg/FR-2019-02-14/pdf/2018-28281.pdf. Banking organizations that are SEC reporting companies (other than smaller reporting companies and, generally, emerging growth companies) were required to adopt CECL in 2020, unless they opted to apply the relief in the CARES Act.

26 Under the SCB rule, a higher level of reserves would in principle result in a lower buffer requirement unless the banking organization is already subject to the 2.5 percent floor.

27 *See* Francisco Covas and Bill Nelson, *Current Expected Credit Loss: Lessons from 2007-2009*, Bank Policy Institute, Staff Working Paper 2018-1 (July 12, 2018), available at http://bpi.com/wp-content/uploads/2018/07/CECL-Lessons-2007-2009-WP-July-12-2018.pdf (hereinafter "Covas and Nelson (2018)").

and shifts loss-absorbing capacity from shareholders' equity to the allowance for credit losses. In other words, CECL reduces net income in deteriorating environments but with a different relationship to loss-absorbing capacity than under the incurred-loss methodology.

CECL's fundamental difference from incurred-loss methodology makes it inappropriate to continue to have guidance with prescriptive quantitative tests and metrics tied to recent earnings that were created when a fundamentally different loss-recognition standard was in effect. CECL provisions reduce net income by simply moving the location of loss-absorbing capacity on the balance sheet. Although we believe there should not be any guidance on capital distributions, if there is guidance on the relationship between dividends and recent earnings, this guidance should reflect the fact that CECL has a fundamentally different relationship to capital/earnings than the incurred-loss methodology. Having dividends exceed recent income in a deteriorating macroeconomic environment has vastly different implications depending on which accounting standard is used. Therefore, should the Federal Reserve determine not to eliminate all guidance on capital distributions, the Federal Reserve's capital planning guidance should be updated to appropriately reflect the differences resulting from the implementation of CECL. The CECL example illustrates more generally the susceptibility of capital distribution guidance to idiosyncratic and external events which, in turn, can produce random results.

3. There is no need for prescriptive cash flow-based tests in the BHC supervision manual on the common stock cash dividend coverage ratio.

Although the proposal did not cite the guidance in the BHC supervision manual on the common stock cash dividend coverage ratio ("CSCDCR") (Section 4010) as among the "key" capital planning guidance, the same rationale for eliminating capital distribution guidance applies to the CSCDCR.[28] This ratio is analogous to the earnings-related tests in the 1985 policy statement, though in the context of cash flow/liquidity.

Similar to the rationales discussed above, we believe there is no need for the Federal Reserve to focus on cash flow analyses now in such a prescriptive manner given the ways in which banking organizations manage their liquidity. For banking organizations subject to the liquidity coverage ratio ("LCR"), just as the SCB represented the move away from focusing on payout ratios to focusing on capital adequacy/capital levels, the LCR represents a shift from traditional cash flow analyses to a focus on having sufficient liquidity resources to fund anticipated outflows. The Regulation YY liquidity buffer requirement reinforces this. For banking organizations that are not subject to the LCR (or net stable funding ratio or NSFR, or Regulation YY liquidity requirements), many banking organizations now manage liquidity by having a stock of liquidity resources, instead of relying solely on cash flow analyses.

If a banking organization prefunds the liquidity needs for its dividends, there is no obvious reason why a cash flow shortfall should result in a supervisory expectation of lower or suspended dividends—the banking organization's liquidity management practices are designed to maintain dividends while having a cash flow shortfall. In other words, all the guidance on dividends relating to recent earnings and cash flows needs to be updated to reflect how banking organizations now actually manage their capital and liquidity. Thus, in 2020 and beyond, focusing on a cash flow coverage ratio is generally an inappropriate and outdated way to measure whether a banking organization has enough liquidity to pay its dividend.

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28 Federal Reserve, *Bank Holding Company Supervision Manual*, Section 4010 (Feb. 2020), available at https://www.federalreserve.gov/publications/files/bhc-4000-202002.pdf.

B. The Federal Reserve should publish a specific, updated proposal for notice and comment on other aspects of its capital planning guidance to account for recent regulatory reforms and align the scope of application of the guidance with the tailoring framework.

Beyond removing prescriptive quantitative metrics and tests for capital distributions from its guidance, the Federal Reserve should consider appropriate updates, through notice and comment, on other aspects of its capital planning guidance to account for recent regulatory reforms and align the scope of application of its guidance with the tailoring framework.

SR 15-18 and SR 15-19 are detailed and complex documents that cover capital planning in a number of areas including governance, risk management, internal controls, capital policy, incorporating stressful conditions and events and estimating impact on capital positions. Given their central role in how supervisors assess the capital planning processes of individual banking organizations, and the fact that they establish a wide range of standards that appear to be binding on their face,[29] these documents can and should be subject to a notice and comment process—both because these SR letters have never been subject to notice and comment before, and to appropriately update them with specific changes needed in light of recent developments (*i.e.*, the tailoring framework and SCB rule). The same would be true for any successor guidance to SR 09-4 released by the Federal Reserve to address capital planning for banking organizations that are not subject to CCAR.

1. The scope and substance of the Federal Reserve's specific supervisory expectations for capital planning and positions of certain banking organizations should be revised to appropriately reflect the categorization and differentiation established in the tailoring framework, SR 15-18 and SR 15-19 should be revised via notice and comment processes to memorialize those changes, and appropriate successor guidance to SR 09-04 to address capital planning for banking organizations with less than $100 billion in total consolidated assets should be provided.

In the proposal, the Federal Reserve notes that key capital planning guidance includes SR 15-18 and SR 15-19. SR 15-18 describes the Federal Reserve's supervisory expectations for capital planning for banking organizations that are either (i) subject to the Large Institution Supervision Coordinating Committee ("LISCC") framework; or (ii) have total consolidated assets of $250 billion or more or consolidated total on-balance sheet foreign exposure of $10 billion or more. SR 15-19 describes the Federal Reserve's supervisory expectations for capital planning for BHCs and U.S. IHCs that are considered "large and noncomplex firms," which is stated to include those that have total consolidated assets of at least $50 billion but less than $250 billion, have consolidated total on-balance sheet foreign exposure of less than $10 billion, and are not otherwise subject to the LISCC framework.

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29 *See, e.g.*, SR letter 15-18, Appendix G at 36 ("The firm's stress scenario should be at least as severe as the Federal Reserve's severely adverse supervisory scenario, measured in terms of its effect on net income and other elements that affect capital."). We note this is inconsistent with the Federal Reserve's statement on the role of supervisory guidance.

Last year, BPI submitted a comment letter recommending that the Federal Reserve should modify the scope of SR 15-18 and SR 15-19 in light of the tailoring framework.[30] Since those comments have not been addressed, we repeat them herein.

As we recommended previously, the Federal Reserve should revise the applicability thresholds for SR 15-18 and SR 15-19, and any supervisory expectations set forth in those guidance documents, to align them with the categories established in the tailoring framework. Furthermore, the Federal Reserve should implement such revisions through a notice and comment process that includes proposed revisions. For example, as we previously recommended, the Federal Reserve should remove references to the $10 billion threshold for on-balance sheet foreign exposure in order to be consistent with the categories established by the tailoring framework.

Specifically, SR 15-18 (updated as we recommend below) should apply to Category I banking organizations, while an appropriately tailored version of SR 15-19 should apply to banking organizations in Categories II to IV on the basis of risk and other relevant characteristics. This would align the SR letters so that SR 15-18 applies to banking organizations in the LISCC portfolio as recently redefined by the Federal Reserve to include only Category I banking organizations,[31] and SR 15-19 would apply to banking organizations in other categories.

Currently, the applicability threshold for SR 15-18 is tied to the prior advanced approaches thresholds applicable before the final tailoring rules as well as to being within the LISCC portfolio, a supervisory category which was recently realigned to appropriately tailor supervisory expectations to risk.[32] The tailoring framework provides that Category III banking organizations are not advanced approaches banking organizations and reflects a supervisory view that prudential supervision and regulation as applied to all banking organizations, including those in Categories II and III, should be appropriately tailored. Similarly, as a result of the Federal Reserve's recent clarification of the LISCC portfolio, no Category II or III banking organization is in the LISCC portfolio and this change was explicitly made to "align the Board's supervisory framework with the new regulatory framework that took effect earlier this year."[33] Accordingly, we continue to urge the Federal Reserve to modify SR 15-18 and SR 15-19 to better align with the tailoring framework and expressly clarify that Category II and III banking organizations are subject only to the expectations set forth in SR 15-19 on a basis appropriately tailored to each risk category. In Appendices A and B, we provide some examples of why SR 15-18 is disproportionate on the basis of risk for Category II and Category III banking organizations, respectively.

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30 Bank Policy Institute, Comment Letter, *Tailoring the Federal Reserve's Supervisory Practices and Expectations for Banking Organizations* (Nov. 18, 2019) (hereinafter the "Tailoring Supervision Comment Letter"), available at https://bpi.com/wp-content/uploads/2019/11/Tailoring-the-Federal-Reserve's-Supervisory-Practices-and-Expectations-for-Banking-Organizations.pdf.

31 *See* Federal Reserve, Press Release, *Federal Reserve publishes latest version of its supervision and regulation report* (Nov. 6, 2020) (hereinafter the "LISCC Announcement"), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20201106a.htm.

32 *See* LISCC Announcement; *see also* Vice Chair for Supervision Randal K. Quarles, *Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision*, American Bar Association Banking Law Committee Meeting (Jan. 17, 2020), available at https://www.federalreserve.gov/newsevents/speech/quarles20200117a.htm (noting that "the composition of our supervisory portfolios has not yet been aligned with our recent tailoring rules. For example, the Large Institution Supervision Coordinating Committee (LISCC) portfolio includes all Category I firms, which have the greatest risk profile, along with certain Category II and Category III firms, which are less systemic. Other Category II and Category III firms, on the other hand, are supervised under our large and foreign banking organizations (LFBO) portfolio").

33 LISCC Announcement.

We strongly support the LISCC Announcement that clarified that certain Category III banking organizations would no longer be in the LISCC portfolio. This is an appropriate alignment of the Federal Reserve's supervisory framework with its regulatory framework based on risk. An IHC should only become subject to the LISCC portfolio if its IHC's method 1 score is greater than the 130 designation for GSIBs—*i.e.*, if an IHC becomes a GSIB in the United States. Similarly, we strongly support the decision not to include Category II banking organizations in the LISCC portfolio. A banking organization in Category II should not be in the LISCC portfolio unless and until it becomes subject to Category I standards.

There are other opportunities for the Federal Reserve to align its supervisory framework with its regulatory framework as well. In particular, we believe it is critical for the Federal Reserve to align the scope of the global market shock ("GMS") and large counterparty default ("LCD") components in stress testing with the revised scoping of supervisory tailoring. We estimate that the GMS increases the decline in the aggregate CET1 ratio by an additional percentage point for banking organizations subject to it, which includes a subset of CCAR banking organizations: most Category I banking organizations and some IHCs in Category III. We believe the scoping of GMS and LCD is something that the Federal Reserve should align and propose for comment in a supervisory tailoring proposal to remove the Category III banking organizations from GMS.

The Federal Reserve should also tailor the supervisory expectations set forth in SR 15-19 for Category IV banking organizations in a manner appropriate to the lesser risk profile of these banking organizations. As a general matter, Category IV banking organizations have met the capital planning expectations set forth in SR 15-19, but there are opportunities to appropriately tailor SR 15-19 for Category IV banking organizations. Areas where SR 15-19 could be better tailored for Category IV banking organizations include reducing the frequency and depth of board of director reviews, appropriately tailoring model governance expectations, and removing expectations regarding company-run stress testing that are no longer relevant.

Consistent with the Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA") and action by the banking agencies to modify regulatory standards to reflect the risk profile of banking organizations with less than $100 billion in total consolidated assets (*e.g.*, exempting all banking organizations with less than $100 billion in assets from company-run stress tests),[34] the Federal Reserve should also make clear that banking organizations with less than $100 billion in total consolidated assets that are no longer subject to CCAR are not subject to SR 15-19 and should also, through notice and comment, provide appropriate successor guidance to SR 09-04 on capital planning for these banking organizations.

2. The Federal Reserve should update and seek comment on SR 15-18 and SR 15-19 to appropriately update these SR letters for the stress capital buffer final rule.

Earlier this year, the Federal Reserve finalized the SCB rule, which integrates the regulatory capital rule with stress-based capital requirements established through CCAR and uses the results of the Federal Reserve's supervisory stress test to establish the size of a banking organization's stress capital buffer requirement, which replaces the static 2.5 percent of risk-weighted assets component of a

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[34] *See* Tailoring Supervision Comment Letter (citing Federal Reserve, FDIC and OCC, *Interagency Statement Regarding the Impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)* (July 6, 2018), at 1-2, available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706a1.pdf).

banking organization's capital conservation buffer requirement.[35] The Federal Reserve, however, has not yet updated SR 15-18 or SR 15-19 to account for the SCB rule finalized in March of this year, which became effective for CCAR banking organizations on October 1. We strongly encourage it to do so, including consideration of the following changes designed to better align both guidance documents with the SCB framework.

i. The Federal Reserve should clarify expectations for leverage capital requirements.

SR 15-18 and SR 15-19 provide that a banking organization's capital policy should describe how the banking organization manages, monitors, and makes decisions regarding capital planning, including post-stress capital goals. In particular, the Federal Reserve explained in the preamble to the SCB rule that the rule does not include a stress leverage buffer requirement in order to ensure that leverage ratio requirements serve as a backstop to risk-based requirements and that non-stress leverage ratio requirements continue to apply to all banking organizations.[36] The assertion in the SCB rule that a stress leverage buffer is not required is, however, in conflict with the Federal Reserve publishing stress test results which incorporate leverage ratio projections. For the same reasons, the Federal Reserve should clarify expectations for how banking organizations should internally manage leverage-based requirements, including requirements to define Capital Targets to ensure ratios do not fall below minimum requirements after stress. Additionally, the Federal Reserve should remove the measurement of capital depletion for leverage-based requirements as part of CCAR to avoid asserting a level of leverage depletion.

ii. The Federal Reserve should remove the expectation in SR 15-18 that banking organizations include quantitative payout ratios in their distribution decision-making process.

SR 15-18 currently provides that the Federal Reserve expects a covered banking organization to include quantitative payout ratios in its distribution decision-making process. The Federal Reserve should remove this expectation, as the entire purpose of the SCB is to provide that a banking organization that fails to meet minimum and buffer capital requirements—established through rigorous supervisory stress tests—will be subject to specific, mandatory payout restrictions on capital distributions and discretionary bonus payments, making the quantitative payout ratios described in SR 15-18 duplicative and unnecessary. In this respect, we note that removing the guidance on dividend payout ratios exceeding 30 percent is illustrative of the supervisory shift in focus away from payout

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35 *See* 85 Fed. Reg. 15576.

36 *See* 85 Fed. Reg. at 15582; *see also* Vice Chairman for Supervision Randal K. Quarles, *A New Chapter in Stress Testing*, Brookings Institution (Nov. 9, 2018), available at https://www.federalreserve.gov/newsevents/speech/quarles20181109a.htm ("Last, the SCB proposal would have included a post-stress leverage requirement. As the Federal Reserve has long maintained, leverage requirements are intended to serve as a backstop to the risk-based capital requirements. By definition, they are not intended to be risk-sensitive. Thus, I am concerned that explicitly assigning a leverage buffer requirement to a firm on the basis of risk-sensitive post-stress estimates runs afoul of the intellectual underpinnings of the leverage ratio, and I would advocate removing this element of the stress capital buffer regime. Of course, leverage ratios, including the enhanced supplementary leverage requirements, would remain a critical part of our regulatory capital regime, and we will maintain the supervisory expectation that firms have sufficient capital to meet all minimum regulatory requirements.").

ratios that is in line with this recommendation.[37] Our recommended revision to SR 15-18 is consistent with the elimination of the prior guidance on dividend payout ratios.

iii. The Federal Reserve should clarify if CCAR stress scenarios will continue to be tested by BHCs under planned action assumptions.

The 2020 CCAR instructions prescribed that as part of the capital plan submission, except in the case of the BHC stress scenario, banking organizations should calculate post-stress capital ratios using their planned capital actions over the planning horizon that are described in the BHC baseline scenario.[38] In light of the adoption of the SCB rule, there is no additional value driven by testing the supervisory stress scenario with planned capital actions. Thus, the Federal Reserve should make clear that on a go-forward basis commencing with CCAR 2021 a banking organization should be able to use alternative capital actions in the supervisory stress scenarios.

C. The Federal Reserve should work with the other banking agencies to clarify bank-level expectations for capital planning that are appropriately harmonized with holding company guidance.

This comment letter, like much of the Federal Reserve's "key" capital planning guidance, focuses on holding companies. It is, however, equally important that supervisory guidance on capital planning for banks be updated. In many cases, there is a lack of clarity on supervisory expectations for capital planning at banks, in particular the extent to which supervisory expectations for the holding company may, or may not, apply at the bank level. This lack of clarity is compounded where the bank is a national bank or state nonmember bank and, accordingly, has a different primary federal regulator from its holding company. We recommend that the Federal Reserve coordinate with the OCC and FDIC to develop appropriately tailored interagency capital planning guidance for banks that takes into account a bank's risk profile and other relevant characteristics, including whether the bank is an operating subsidiary of a holding company or the top-tier entity itself. Appropriately tailored interagency guidance for banks would lead to greater transparency and predictability regarding supervisory expectations for the capital planning practices of banks, as distinct from the supervisory expectations uniquely applicable to the holding companies. In terms of timing, we recommend that the Federal Reserve move forward with updating its holding company guidance as soon as possible but also work together with the other banking agencies to provide appropriate bank-level guidance, recognizing that the interagency coordination process might take some time.

D. The Federal Reserve's Guidance on Model Risk Management, SR 11-7, should be better tailored to the risks of Category III and IV banking organizations and banking organizations with less than $100 billion in total consolidated assets.

The Federal Reserve proposal contains a broad request for comment on all aspects of its guidance on capital planning for banking organizations of all sizes, noting that certain aspects of the guidance have not been updated since the 2007–2008 financial crisis. Issued in 2011, SR 11-7 is one such aspect of the Federal Reserve's capital planning guidance which has not been updated in the past decade. We recommend that the Federal Reserve tailor SR 11-7, in particular to distinguish the

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[37] *See* 85 Fed. Reg. at 15579.

[38] Federal Reserve, *Comprehensive Capital Analysis and Review 2020 Summary Instructions* (March 2020), at 12, available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200304a3.pdf.

expectations applicable to Category III and IV banking organizations and banking organizations with less than $100 billion in total consolidated assets.[39]

SR 11-7 is the Federal Reserve's guidance on model risk management, which is intended for use by banking organizations and supervisors as they assess organizations' management of model risk. The guidance is meant to be applied as appropriate to all banking organizations supervised by the Federal Reserve, taking into account each organization's size, nature, and complexity, as well as the extent and sophistication of its use of models.[40] Further, other Federal Reserve capital planning guidance incorporates SR 11-7 by reference for the proposition that a banking organization should independently validate or otherwise conduct effective challenges of models used in internal capital planning, consistent with supervisory guidance on model risk management and that banking organizations should adhere to the supervisory guidance on model risk management in SR 11-7 when using models.[41]

We recommend the Federal Reserve improve the tailoring of SR 11-7, in particular for banking organizations in Categories III and IV and banking organizations with less than $100 billion in total consolidated assets. Areas that the Federal Reserve should consider for tailoring include:

- Model Identification – models whose failure would have an immaterial impact on a banking organization's safety and soundness might be excluded from coverage. As written, SR 11-7 is not risk-based.

- Model Development – recognition that a banking organization may tailor documentation requirements for models using a risk-based approach. SR 11-7, as written, requires that every model be exhaustively documented along seven different dimensions.

Additional discussion from a risk-based view should be provided for validation practices (especially for vendor models), benchmarking expectations, and governance processes, and on-going monitoring, proportionate to risk or supervisory benefits for all banking organizations, especially those in Categories III and IV and those banking organizations with less than $100 billion in total consolidated assets.

III. Recommendations to make certain changes to the capital plan rule

Below we recommend certain changes to the capital plan rule. Although the Federal Reserve did not request comment on these items, our recommendations are related to our comments on the Federal Reserve's guidance on capital distributions.[42]

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[39] GAO, *Board of Governors of the Federal Reserve System—Applicability of the Congressional Review Act to Supervision and Regulation Letter 11-7* (Oct. 22, 2019), available at https://www.gao.gov/assets/710/702190.pdf (determining that SR 11-7 is a rule); *see also* Guidance on Guidance.

[40] Federal Reserve, SR letter 11-7, *Guidance on Model Risk Management* (Apr. 4, 2011), available at https://www.federalreserve.gov/supervisionreg/srletters/sr1107.htm.

[41] *See* SR letter 15-18 at 10 n.12, 19, 23 n.23, 24, and 28; SR letter 15-19 at 2, 4, 17, 20, 21, and 23.

[42] As a procedural matter, this part of the letter is a petition for rulemaking under section 553(e) of the Administrative Procedure Act ("APA"). *See* 5 U.S.C. § 553(e) ("Each agency shall give an interested person the right to petition for the issuance, amendment, or repeal of a rule.").

A. The Federal Reserve should amend the capital plan rule to pre-authorize certain capital distributions in connection with a pending resubmission and impose a reasonable limit on any future prior approval requirements in the context of a resubmission.

We recommend the Federal Reserve amend the provision of the capital rule that requires Federal Reserve prior approval for a banking organization to make capital distributions once a banking organization is required to resubmit its capital plan.[43] This is an extremely broad provision pursuant to which subject banking organizations' capital distributions can be completely restricted, with no clear end point for the prior approval requirement. The Federal Reserve should provide certainty to banking organizations and market participants about a banking organization's ability to make capital distributions when it is required to resubmit its capital plan, through an amendment to the capital plan rule to pre-authorize certain dividends (*e.g.*, an amount equal to a banking organization's average final planned capital distributions in the fourth through seventh quarters). As there is currently ambiguity about how long this provision applies, any such amendment should both provide for a reasonable limit (*e.g.*, two quarters) on the time period for applicability of the prior approval requirement and pre-authorize certain distributions. Such a rule change would promote predictability, certainty, and transparency.[44]

In connection with the 2020 stress tests, the Federal Reserve required all banking organizations participating in CCAR to resubmit their capital plans, which also meant that, without Federal Reserve authorization, they may not make any capital distributions, subject to an exception relating to newly issued capital instruments.[45] In connection with requiring banking organizations to resubmit their capital plans, the Federal Reserve also pre-authorized certain dividends, applying a novel earnings test for determining whether and to what extent dividends may be paid. The Federal Reserve did not permit banking organizations to engage in share repurchases except in relation to employee stock ownership plans.[46]

Notably, this unvariable standard, applied in the exact same way to each and every banking organization participating in CCAR, was wholly indifferent to the capital adequacy or risk profile of any individual banking organization. In light of this uniform application of the prior approval requirement and the imposition of the novel earnings test, going forward it is unclear if the Federal Reserve would use a similar test as a policy matter or adopt a different approach if banking organizations are later required to resubmit their capital plans. To address this substantial uncertainty, we recommend the

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43 *See* 12 CFR § 225.8(k)(1).

44 *See* Early Observations.

45 *See* Federal Reserve, Press Release, *Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event* (June 25, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm; Federal Reserve, Press Release, *Federal Reserve Board announces it will extend for an additional quarter several measures to ensure that large banks maintain a high level of capital resilience* (Sept. 30, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200930b.htm.

46 *See* 12 CFR § 225.8(k); Federal Reserve, *Assessment of Bank Capital during the Recent Coronavirus Event* (June 2020), at 19, available at https://www.federalreserve.gov/publications/files/2020-sensitivity-analysis-20200625.pdf (citing 12 C.F.R § 225.8(e)(4)(i)(B)(3)) (hereinafter the "Federal Reserve Coronavirus Assessment"); *see also* Federal Reserve, Press Release, *Statement of Governor Brainard* (June 25, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20200625c.htm (arguing that the Federal Reserve's actions "implements a novel approach by authorizing third quarter dividends at a level equal to average net income over the prior four quarters").

Federal Reserve establish a predictable, sensible, and above-all transparent approach to pre-authorizing distributions through a notice and comment rulemaking to amend the capital plan rule.

In particular, we recommend the Federal Reserve pre-authorize capital distributions in a manner modeled after the transition provision for capital actions that was supposed to be the constraint on capital distributions in the third quarter of this year and serve as a bridge to the SCB.[47] If this construct is followed, a banking organization subject to prior approval under the capital plan rule would be able to make capital distributions that do not exceed, for any quarter, an amount equal to the average of the banking organization's final planned capital distributions for the fourth through seventh quarters of the planning horizon most recently provided for in section 225.8(h)(3) of the capital plan rule.[48] Banking organizations should also be able to request prior approval to make capital distributions beyond this amount. We recommend further that any rule-based requirements that govern capital distributions be established to avoid detrimental procyclical effects that could dampen bank lending and support for an economic recovery during a period of economic stress.

We also recommend that the Federal Reserve revise the capital plan rule to provide, in addition to the pre-authorization described above, an express authorization for banking organizations to pay de minimis dividends on common stock, such as $0.01 per share, in connection with a capital plan resubmission. This revision would provide greater certainty for banking organizations that they would not be required to cease their common stock dividends entirely in connection with a capital plan resubmission. This revision is important because a cessation of common stock dividends—or the mere possibility of such a cessation—can have a number of adverse effects on banking organizations, such as limiting access to capital markets and increasing the cost of issuing new equity, that would detract from their overall safety and soundness.[49] Indeed, a number of institutional investors will not purchase, or even hold, stocks that pay no dividends whatsoever.

B. The Federal Reserve should amend the capital plan rule to make clear what changes are deemed to be "material" such that they would lead to a capital plan resubmission.

The capital plan rule contains a few provisions that allow the Federal Reserve to direct a banking organization to revise and resubmit its capital plan, including where there has been, or will likely be, a "material change" in the banking organization's risk profile or changes in financial markets or the macro-economic outlook that could have a "material" impact on a banking organization's risk profile and financial condition that require the use of updated scenarios.[50] The latter provision was used this year in connection with the Federal Reserve's stress test results to require all banking organizations subject to CCAR to resubmit their capital plans.[51] The Federal Reserve, however, has not provided any clarity or details around what would constitute a "material" change or "material" impact for purposes of a capital plan resubmission. We therefore recommend that the Federal Reserve propose and seek comment on clear criteria and standards that will be used when determining if material changes have occurred for

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47 *See* 12 CFR § 225.8(k)(1)(ii).

48 *See* 12 CFR § 225.8(h)(3).

49 We recognize the Federal Reserve has addressed this issue by FAQ in the context of SR 09-4 but we continue to believe clarity in the capital plan rule would be helpful. *See* Federal Reserve, *Frequently Asked Questions re: SR letter 09-4*, Q6, available at https://www.federalreserve.gov/boarddocs/srletters/2009/sr0904a3.pdf. While the Federal Reserve can always choose to impose zero dividends our recommendation would support a presumption of de minimis dividend without a specific Federal Reserve decision otherwise.

50 *See* 12 CFR § 225.8(e)(4)(B)(2)-(3).

51 *See* Federal Reserve Coronavirus Assessment at 19.

purposes of a capital plan resubmission. This would provide better clarity about when to expect the very significant event of a capital plan resubmission.

IV. Comments on the proposed changes contained in the proposal

The proposal would make conforming changes to the capital planning, regulatory reporting, and stress capital buffer requirements for banking organizations subject to Category IV standards to be consistent with the tailoring framework. Among other changes, the proposal also would update the FR Y–14 reporting requirements for banking organizations subject to Category I–IV standards to conform with changes made to the stress test rules. The proposal also seeks comment on, but does not propose, a definition of "common stock dividend" for purposes of the capital plan rule.

A. The Federal Reserve should allow Category IV banking organizations until mid-March to notify the Federal Reserve of its decision to participate in a supervisory stress test in any given year.

Banking organizations subject to Category IV standards are currently subject to supervisory stress testing on a two-year cycle. In order to provide flexibility, the proposal would allow a banking organization subject to Category IV standards to elect to participate in the supervisory stress test in a year in which the banking organization would not normally be subject to the supervisory stress test. Under the proposal, a banking organization would need to make its election by December 31 of the year preceding the year in which it seeks to opt into the supervisory stress test by providing written notice to the Federal Reserve.[52] For this upcoming cycle, for a banking organization subject to Category IV standards that elects to participate in the 2021 supervisory stress test, the proposal includes transitional procedures such that the banking organization could notify the Federal Reserve until February 15, 2021 for purposes of calculating the stress capital buffer requirement in 2021.

In question 8, the proposal seeks comment on February 15, 2021 as the deadline for a banking organization subject to Category IV standards to notify the Federal Reserve of its intention to participate in the 2021 supervisory stress test and asks about the advantages and disadvantages of including April 5, 2021, the date on which these banking organizations must submit their capital plans to the Federal Reserve, as the deadline for notification to participate in the 2021 supervisory stress test.

We recommend that the Federal Reserve allow Category IV banking organizations until mid-March to notify the Federal Reserve of its decision to participate in a supervisory stress test next year and for any subsequent year. A mid-March date would allow banking organizations more time to engage in better capital planning and allow more time for internal governance processes related to the decision of whether to participate in a supervisory stress test. It would also give the Federal Reserve enough time in advance of the April 5 capital plan submission date for its planning purposes as well.

B. The Federal Reserve should provide clarity on whether there will be public disclosure of Category IV banking organizations' stress capital buffers during an off-cycle year.

Banking organizations subject to Category IV standards are currently subject to supervisory stress testing on a two-year cycle. During a year in which a banking organization subject to Category IV standards does not undergo a supervisory stress test ("off-cycle year"), the banking organization would receive an updated stress capital buffer requirement that reflects the banking organization's updated

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[52] *See* 85 Fed. Reg. at 63225.

planned common stock dividends.[53] The Federal Reserve does not, however, address whether the updated stress capital buffer would be disclosed during an off-cycle year and what such disclosure would look like. We recommend that the Federal Reserve make clear it would disclose the SCB in an off-cycle year for Category IV banking organizations and identify which banking organizations did not participate in the supervisory stress test. Consistent with the disclosures in 2020, the Federal Reserve should continue not to break down the components of the SCB, by separately identifying the amount attributable to the results of the supervisory stress tests and the amount attributable to planned capital actions.

C. Reporting Changes

1. The materiality of business plan changes should be considered in the requirement for banking organizations to report the effects of business plan changes in Schedule A and Schedule C of the FR Y-14A.

The proposal would require all banking organizations subject to Category I to III standards to produce two new sub-schedules for the FR Y-14A Schedule A – Summary, and all banking organizations to prepare two new sub-schedules for all items on the FR Y-14A Schedule C – Regulatory Capital Instruments. For both Schedule A and Schedule C, one sub-schedule would incorporate the effects of business plan changes and the other would exclude the effects of business plan changes. We appreciate the Federal Reserve's need to collect data on banking organizations' planned business changes for the purpose of capital planning as they can have "a material impact on the firm's capital adequacy or liquidity."[54] Appropriately, throughout the proposal, the Federal Reserve includes the qualifier "material" to describe the business plan changes on which it is seeking information. However, the sections of the proposal describing the applicable revisions to the FR Y-14A and the new sub-sections devoted to reporting data with the effects of business plan changes do not explicitly state that these sub-sections would be limited to effects of *material* business plan changes.[55] Instead, the proposal states that banking organizations are to submit one version of the schedules "that incorporates the effects of business plan changes, as well as a version of these schedules and items that does not incorporate these effects."[56] Further, draft reporting instructions or forms have not yet been issued that would help clarify whether the materiality of business plan changes would be considered in the application of the proposed reporting revisions.

As noted in the proposal, "[p]rior to the implementation of the stress capital buffer rule, the impact of expected material changes to a firm's business plan were incorporated into a firm's CCAR results."[57] However, as finalized, banking organizations are not to incorporate business plan changes into the calculation of the SCB. Since business plan changes are not being used for purposes of calculating the SCB, it would follow that only *material* business plan changes should be reported on the accompanying CCAR schedules. Absent a materiality qualifier, there would be an unnecessary burden for respondent banking organizations by virtue of these proposed changes. Specifically, implementing this proposed requirement to provide two separate versions of these Schedules, even if the planned business changes are immaterial and therefore would have little to no effect on capital adequacy or

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53 *See id.* at 63225.
54 *Id.* at 63226.
55 *See id.* at 63229.
56 *Id.*
57 *Id.* at 63223.

liquidity, would prove challenging for banking organizations as they would need to establish new systems to capture the required data in order to produce each schedule in its entirety twice.

We therefore recommend that the Federal Reserve clarify that the newly proposed sub-schedules that would incorporate the effects of business plan changes in Schedules A and C of the FR Y-14 would only incorporate the effects of material changes to business plans and that the finalized reporting forms and instructions explicitly indicate the same. At the very least, if the Federal Reserve does not clarify that only material business changes are to be included in the new sub-schedules, we would recommend a one-year delay in effectiveness providing banking organizations until the FR Y-14A as of December 31, 2021, for implementation of these new sub-schedules.

2. Additional memoranda items should be added into the FR Y-14A Summary Schedule for banking organizations to incorporate purchase accounting data after a transaction has been consummated.

The proposal would remove the FR Y-14A Business Plan Changes Schedule and exclude the impact of merger and acquisition activities from the calculation of the SCB before the consummation of such a transaction and "instead, material changes to a firm's business plan resulting from a merger or acquisition are incorporated into a firm's capital and risk-weighted assets upon consummation of the transaction."[58] However, this proposed revision would remove any information related to purchase accounting adjustments from the FR Y-14A schedule after the required day-one calculation of fair value marked assets and liabilities. Purchase accounting can be impactful to financial results <u>after</u> a deal closes not just at the time the deal is consummated. Specifically, at day-one, banking organizations recognize fair value marks, which can lower capital levels through reflecting expected future losses on acquired assets. However, after day-one accounting and moving forward throughout the life of the asset or liability, banking organizations can either accrete the fair value into interest income or reduce the impact of relevant provision expenses. We therefore recommend that the Federal Reserve add memoranda items to the Summary Schedule so that banking organizations can incorporate this relevant purchase accounting data after a transaction has been consummated in the proposed version of the Summary Schedule where business plan changes are reflected. Adding memoranda items would capture the aggregate impact of accretion in the mark to fair value on assets and liabilities, so that the Federal Reserve has context as to the impact of fair value accounting on assets and liabilities and the relevant level of any losses of banking organizations' CET1 capital.

D. Any proposal defining "common stock dividend" should take into account the different circumstances of the U.S. IHCs of FBOs.

In the proposal, the Federal Reserve seeks comment on, but does not propose, a definition for common stock dividends in the capital plan rule, noting that the definition of common stock dividend could be aligned with the definition on the FR Y–9C and could include payments of cash to parent organizations irrespective of whether the amount paid is debited from the banking organization's retained earnings. As an example, the Federal Reserve explains that a definition of common stock dividend could be any payment of cash to shareholders in proportion to the number of shares they own.[59] This definition is important because a component of a banking organization's SCB is the dividend

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[58] *Id.*

[59] *Id.* at 63227.

add-on, which is based on planned dividends during projection quarters four through seven of the planning horizon.

The Federal Reserve also notes in the preamble to the proposal that it has observed different practices regarding the classification of dividends and share repurchases. For example, certain U.S. IHCs have classified distributions to their parent companies as dividends, while other U.S. IHCs have classified similar distributions as non-dividend payouts. According to the Federal Reserve, decisions by banking organizations regarding classifications may depend on, among other things, whether the distribution is paid out of the banking organization's retained earnings. Question 14 of the proposal asks whether there are any special considerations the Federal Reserve should consider with regards to U.S. IHCs.

With respect to any proposal defining common stock dividend in the future, we urge the Federal Reserve to take into account our comments made previously with respect to the SCB rule for IHCs.[60] In our SCB comment letter, we explained that the U.S. IHCs of FBOs, unlike the top-tier BHCs of their U.S. peers, generally are not publicly traded and generally do not have public shareholders; their equity generally is owned entirely by their parent FBOs.

As a result, the U.S. IHCs of FBOs generally do not face the possibility of public market pressure to continue to pay dividends. This justification offered by the Federal Reserve as one of the primary reasons for the dividend add-on in the SCB rule is thus entirely inapplicable to the U.S. IHCs of FBOs.[61] Without any appropriate adjustment to the dividend add-on, the SCB rule leads to conceptually inconsistent treatment and an unlevel playing field between U.S. IHCs of FBOs and U.S. banking organizations.

In our SCB comment letter, we recommended that the U.S. IHCs of FBOs should be exempt from the dividend add-on in the calculation of their SCB requirements, and we continue to believe that the Federal Reserve should modify the SCB rule to better account for the business models, risks and exposures of U.S. IHCs of FBOs.[62] The Federal Reserve could, for example, propose for comment a definition of common stock dividend for purposes of the SCB rule that would explicitly provide that payments to parent companies are not included in the dividend add-on component of the SCB regardless of classification.

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60 *See* The Clearing House Association et al., Comment Letter, *Proposed Amendments to the Regulatory Capital, Capital Plan and Stress Test Rules* (June 25, 2018) (hereinafter the "SCB Comment Letter"), available at https://bpi.com/wp-content/uploads/2018/07/f751f6eaf79445b3ae744b6e02816d3d-1.pdf.

61 *See* SCB Comment Letter at 17 (citing 83 Fed. Reg. at 18166).

62 *See* SCB Comment Letter at 17-18 and Annex D, Sections 5 and 6.

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The Bank Policy Institute appreciates the opportunity to provide these comments and would welcome the opportunity to discuss them further with you. If you have any questions, please contact the undersigned by phone at (202) 589-2533 or by email at anna.harrington@bpi.com.

Respectfully submitted,

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Appendix A: Examples of areas where SR 15-18 expectations are disproportionate to the risk profile of Category II banking organizations

1) Quantitative vs. qualitative approaches to loss estimates, PPNR and capital positions

The Federal Reserve expects SR 15-18 banking organizations to rely solely on quantitative approaches in estimating losses and PPNR, whereas SR 15-19 contemplates that banking organizations rely on quantitative and qualitative approaches. Because Category II banking organizations are simpler and have lower risk profiles than Category I banking organizations, Category II banking organizations should be expected – consistent with the expectations in SR 15-19 – to rely on an appropriate mix of quantitative and qualitative approaches to estimating their losses, PPNR and resulting capital positions. While it is appropriate to expect Category II banking organizations to use models and adopt quantitative approaches to reflect the advanced approaches capital requirements applicable to such banking organizations, *e.g.*, in the modeling of operational risk loss events, these expectations should nevertheless recognize the impact of a Category II banking organization's lower risk profile.

2) Model overlays

Under SR 15-18, banking organizations are more limited in their use of model overlays than they are under SR 15-19, including an expectation that banking organizations subject to SR 15-18 use model overlays sparingly, subject model overlays to validation or effective challenge and perform sensitivity analyses before using model overlays. Consistent with the flexibility Category II banking organizations should have to develop and rely on qualitative analyses, Category II banking organizations should also have greater flexibility to deploy model overlays to adjust quantitative models where appropriate.

3) Granularity of loss estimates and PPNR projections

For the same reasons described above with respect to the use of a mixture of quantitative and qualitative approaches to estimating losses, PPNR and resulting capital positions, we believe that a Category II banking organization should not be expected to calculate its estimated losses, PPNR, and capital positions with the same granularity as expected under SR 15-18. SR 15-19 states that a banking organization should estimate losses by type of business activity, *i.e.*, credit risk losses on loans and securities and operational risk losses, and that for non-material portfolios or business lines a banking organization may use simple approaches such as loss or revenue rates during prior periods of stressed conditions. Because of the lower complexity and lower risk profile of Category II banking organizations, we believe that it would be appropriate for Category II banking organizations to be expected to apply a level of granularity consistent with SR 15-19.

4) Use of benchmark models

Appendix C of SR 15-18 specifically states that a banking organization should use a variety of methods, including benchmark or challenger models, to assess the performance of its primary models or to supplement, where appropriate, its primary models. As noted above, in light of their lower complexity and risk profiles, a Category II banking organization should benefit from the expectations as to the use of benchmark models, and the reliance on other model validation methods, as afforded under SR 15-19.

5) Sensitivity analyses

Category II banking organizations should be permitted to conduct sensitivity analyses for material models – *i.e.*, the narrower set of models that more closely fit the banking organization's business model and capture its risk profile – rather than all models, as the expectation would be under SR 15-18.

Appendix B: Examples of areas where SR 15-18 expectations are disproportionate to the risk profile of Category III banking organizations

1) Senior management review of capital planning and risk identification processes

SR 15-18 requires senior management of a subject banking organization to review the capital planning process quarterly and requires the banking organization to establish a formal risk identification process and evaluate material risks at least quarterly. The Federal Reserve should seek comment on modifying the frequency of the senior management review of capital planning and risk identification processes for Category III banking organizations. We believe the quarterly review of capital planning and risk identification processes is unnecessarily frequent for Category III banking organizations based on the risk profile of those banking organizations and the costs of the requirement (in terms of time and resources) are outsized when compared to the minimal benefit provided.

2) Ability to rely on qualitative approaches

Banking organizations subject to SR 15-18 are also expected to rely less on qualitative approaches than banking organizations subject to SR 15-19 (*e.g.*, for loss estimation and PPNR). This imposes additional burdens that are disproportional to Category III risk profiles. For this reason, we recommend that the Federal Reserve seek comment on whether Category III banking organizations subject to SR 15-18 should be able to rely more on qualitative approaches.

3) Model validation requirements

SR 15-18 provides that the Federal Reserve expects subject banking organizations to complete a conceptual soundness review of all models prior to use, maintain comprehensive documentation of its capital planning process, and have compensating controls for known model uncertainties. In contrast, the Federal Reserve expects banking organizations subject to SR 15-19 to make an effort to review its material models prior to use. Further, the Federal Reserve has lower expectations regarding documentation and compensating controls for banking organizations subject to SR 15-19. In addition, the Federal Reserve expects a banking organization subject to SR 15-18 to subject benchmark or challenger models to validation, to the extent the models contribute to post-stress capital estimates, while banking organizations subject to SR 15-19 are not expected to use benchmark models in their capital planning process. SR 15-18 banking organizations also have less ability to rely on model overlays. The coronavirus event has demonstrated the substantial burden these expectations impose on model development, and these expectations are disproportional to the risk of Category III banking organizations.