CAPITAL ONE FINANCIAL CORPORATION , ROBERT ZIZKA

Proposal and Comment Information

Title: Modifications to the Capital Plan Rule and Stress Capital Buffer Requirement, R-1866

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Submitter Information

Organization Name: Capital One Financial Corporation

Organization Type: Company

Name: Robert Zizka

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Please see attached commment letter from Capital One.

Capital One Financial Corporation
1680 Capital One Drive
McLean, VA 22101

Via Electronic Submission

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

June 23, 2025

Re: Comment Letter Re: Modifications to the Capital Plan Rule and Stress Capital Buffer Requirement (Docket No. R-1866, RIN 7100-AG92)

Ladies and Gentlemen:

Capital One Financial Corporation (**Capital One**)[1] is pleased to submit this comment on the notice of proposed rulemaking (the **Proposed Rule**) issued by the Board of Governors of the Federal Reserve System (the **Federal Reserve Board**) that would amend the calculation of the stress capital buffer (**SCB**) requirements applicable to certain large banking organizations and other covered companies (**Covered Firms**), including Capital One.[2] Capital One appreciates the Federal Reserve Board's commitments to reduce volatility in capital requirements and increase transparency and effectiveness in its supervisory stress test, and welcomes the opportunity to provide our feedback on the Federal Reserve Board's supervisory stress test framework.

This comment letter responds to the Federal Reserve Board's invitation in the Proposed Rule (Question 01) for comments on "other elements of the supervisory stress test framework [that the Federal Reserve Board should] consider amending to improve the transparency and effectiveness of its supervisory stress test." Specifically, Capital One recommends that the Federal Reserve Board refine (i) the assumption under its Stress Testing Policy Statement that each firm's balance sheet would maintain the same level and mix of credit balances across each product type throughout the nine-quarter planning horizon, regardless of the level of projected loan losses (the **Flat Balance Sheet Assumption**), and (ii) the supervisory models for other non-interest expenses to consider more granular sub-categories of such expenses, such as marketing expenses.

Executive Summary

For the reasons discussed in this letter, Capital One believes that the Flat Balance Sheet Assumption is overly simplified, unsupported by empirical data, and ultimately leads to higher borrowing costs and reduced availability of credit for certain consumers, particularly underserved consumers with subprime credit scores.

During stressed economic conditions, loan balances do not stay flat. Instead, they ordinarily fluctuate significantly due to a combination of factors, such as elevated charge-offs and changes in borrower demand. In addition, our observed experience has shown that different asset classes behave differently under stress. For example, during the 2008-2009 financial crisis, we saw credit card balances

[1] Capital One Financial Corporation (www.capitalone.com) is a financial holding company which, along with its subsidiaries, had $367.5 billion in deposits and $493.6 billion in total assets as of March 31, 2025. Headquartered in McLean, Virginia, Capital One offers a broad spectrum of financial products and services to consumers, small businesses and commercial clients through a variety of channels.

[2] *See* Federal Reserve Board, Modifications to the Capital Plan Rule and Stress Capital Buffer Requirement, 90 Fed. Reg. 16843 (Apr. 22, 2025).

shrink while balances for other asset classes increased. We observed a similar dynamic in the 2020 COVID shock period where credit card balances shrank significantly. By assuming that all loan portfolios behave the same and maintain constant balances during stress (regardless of loan type and projected loan losses), the resulting model output is inconsistent with observed experience. This disconnect between the Flat Balance Sheet Assumption and observed experience has significant implications for capital planning and availability of credit.

The flaw of this assumption is particularly pronounced in subprime credit card portfolios, typically borrowers with FICO scores below 650, as the Federal Reserve Board assumes a relatively higher loss rate for these customers. A high loss rate, when combined with the assumption of constant loan balances, necessarily assumes an implausibly high new loan origination rate that is unattainable even during stable economic conditions, let alone in stressed economic conditions. This unrealistic implied new loan origination rate assumption results in overestimation of projected loan balances, total projected losses and expenses for subprime credit card portfolios in stress tests. This, in turn, leads to higher-than-justified capital needs for these customer segments. Unnecessarily high capital needs ultimately lead to higher borrowing costs and/or reduced availability of credit for consumers who rely on these products.

As we discuss further below, to prevent the distortions arising from the Flat Balance Sheet Assumption, Capital One recommends that the Federal Reserve Board revise the oversimplified Flat Balance Sheet Assumption to take into account projected losses and a feasible level of similar new account originations. The Federal Reserve Board could implement this modification through a model that would apply a single, fixed growth rate of new loan balances (e.g., using a 6% growth rate) across all product types[3], with resultant loan balances of each product type being adjusted downward by the product type's specific projected gross loan losses. This modification would better align with observed experience in stress scenarios by differentiating loan types based on projected gross loan losses, while generally preserving a flat balance sheet in aggregate for all Covered Firms. We believe that our recommendation aligns with the Federal Reserve Board's macro-prudential goal of ensuring credit stability during stress while at the same time improving the accuracy and utility of the supervisory stress tests. More importantly, it would help ensure that the supervisory stress test results – through the SCB – do not create incentives for firms to curtail credit in certain business lines due to capital requirements that are not commensurate with the risks of these products.

Finally, in addition to revising the Flat Balance Sheet Assumption, Capital One recommends that the Federal Reserve Board refine its supervisory models for other non-interest expenses to consider more granular sub-categories of such expenses, such as marketing expenses. In addition, as we discuss further below, the Federal Reserve Board should assume a decrease in marketing expenses during stressed conditions based on experience observed during the 2008-2009 financial crisis and the COVID-19 shock period. A more granular modelling of non-interest expenses would better reflect the resilience and capital needs of the Covered Firms.

I. Background on Supervisory Stress Tests and the Flat Balance Sheet Assumption

Covered Firms are subject to the Federal Reserve Board's supervisory stress tests and the related SCB requirement.[4] These requirements help ensure that Covered Firms have sufficient capital to absorb losses and continue lending during economic downturns.[5] The results of the supervisory stress tests directly

[3] Alternatively, the Federal Reserve Board could consider applying product-specific growth rates, calibrated based on recent origination data. *See* Section III for more discussion.

[4] *See* 12 C.F.R. Part 252, Subpart E (supervisory stress test requirement); 12 C.F.R. §225.8 (capital planning and stress capital buffer requirement).

[5] 12 C.F.R. Part 252, Appendix B (*hereinafter*, the "Stress Testing Policy Statement"), ¶2.7(a).

determine the stress capital decline component of the SCB for each Covered Firm,[6] which in turn determines the capital ratios that each Covered Firm must maintain to avoid limitations on capital distributions and executive bonus payments.[7] As a result, the assumptions and methodologies used by the Federal Reserve Board to conduct the supervisory stress tests have a direct impact on the capital requirements applicable to Covered Firms.

The assumptions under the supervisory stress tests are informed by the Federal Reserve Board's Stress Testing Policy Statement. Under Section 2.7(a) of the Stress Testing Policy Statement, the supervisory stress test assumes that "the aggregate credit supply does not contract during the stress period" and "that a balance sheet of consistent magnitude is maintained." Under Section 2.7(b) of the Stress Testing Policy Statement, the Federal Reserve Board also states that "newly originated loans are assumed to have the same risk characteristics as the existing portfolio, where applicable, with the exception of loan age and delinquency status."

The stated policy rationale for this Flat Balance Sheet Assumption is that it "allows supervisors to evaluate the health of the banking sector assuming firms continue to lend during times of stress" and, by "ensur[ing] that covered companies cannot assume they will 'shrink to health,' . . . serves the Federal Reserve Board's goal of helping ensure that major financial firms remain sufficiently capitalized to accommodate credit demand in a severe downturn."[8] If the supervisory stress test instead assumed that "the banking industry as a whole" would "react to rising losses by sharply restricting its lending," such an assumption would entail a "credit crunch [that] would substantially increas[e] the severity and duration of an economic downturn." In addition, the Flat Balance Sheet Assumption avoids "the need to make assumptions about how underwriting standards might tighten or loosen during times of economic stress," consistent with principles of consistency and comparability across Covered Firms.[9]

Under the Flat Balance Sheet Assumption, the Federal Reserve Board projects a flat balance sheet across all loan portfolios, regardless of loan types or their projected loan losses. At the individual Covered Firm level, the Federal Reserve Board assumes that each Covered Firm will maintain a constant mix of loan types in its portfolio and the same market share of aggregate industry-wide loans over time. This leads to individual Covered Firms having constant projected loan balances by type during stressed conditions. In other words, the supervisory stress test assumes that *each* individual Covered Firm will take actions under stressed economic conditions to ensure that it maintains *its* current level and mix of assets over the nine-quarter planning horizon of the supervisory stress test.

This assumption is at odds with historical empirical data that clearly demonstrates significant differences in loan balance behavior during stress depending on the type of loan, and it paradoxically results in a counterintuitive treatment of certain loan products based on their projected loss rates. As demonstrated on pages 6-8 below, observed experiences during the 2008-2009 Global Financial Crisis and the 2020 COVID shock period show that credit card balances shrank due to charge-offs and lower demand while other loan balances increased during those periods.

In addition, to give effect to the Flat Balance Sheet Assumption, Covered Firms are assumed to take more aggressive origination actions to maintain the balances of products with higher projected loss rates than for products with lower loss rates. This implied assumption does in fact require a loosening of underwriting standards for the higher loss-rate products during stressed conditions. It is also worth noting

[6] *See* 12 C.F.R. §225.8(f)(2).

[7] *See* 12 C.F.R. §217.11(c)(1).

[8] Stress Testing Policy Statement, ¶2.7(a).

[9] *Id* at ¶2.7(b).

that, for products with projected high loss rates, the Flat Balance Sheet Assumption implies a new loan origination rate during stress that is implausibly high and at a level that is not attainable even during stable economic conditions. The ultimate effect of the Flat Balance Sheet Assumption is to create the risk of incenting banking organizations to reduce their exposure to these segments, in business-as-usual conditions, due to unnecessarily and unjustified increased capital costs.

II. The Flat Balance Sheet Assumption Is Unrealistic and Inconsistent with Empirical Data

The Flat Balance Sheet Assumption should be reconsidered for several reasons. First, the history of the assumption reveals that it is based on a flawed and stale analysis of historical balance sheet changes during recessions. Second, the Flat Balance Sheet Assumption results in unrealistic balance sheet projections that are inconsistent with empirical data. Third, the Flat Balance Sheet Assumption overstates the capital requirements for consumer loan portfolios, particularly subprime credit card portfolios, and results in an unintended, disproportionate adverse impact on underserved borrowers. By increasing the resulting SCB and thus capital requirements for these products in business-as-usual conditions, the effect of the Flat Balance Sheet Assumption is to increase the cost of capital for providing these products, which Capital One believes unjustifiably and adversely affects underserved consumers.

A. History of the Flat Balance Sheet Assumption

The Federal Reserve Board's balance sheet assumptions under the supervisory stress tests have evolved over the last decade. Before 2014, the Federal Reserve Board relied on Covered Firms' own internal projections of balance sheet items for the purposes of conducting the supervisory stress tests. In 2014, the Federal Reserve Board changed its approach, moving to supervisory balance sheet projections. It justified this change in part based on a historical analysis, conducted in 2013, of the changes in total loan balances of the median large bank (among the top 50 bank holding companies) over three historical recessions.[10] The 2013 analysis found that the total loan balances of the median large bank increased by 4.3% in the nine quarters following December 2007, at the onset of the recession triggered by the Global Financial Crisis. The analysis concluded that a projection approach "in which most banks see major contractions in loans or total assets over nine quarters, even in severe recessions, would thus be at odds with historical experience."[11]

As discussed in a paper published by the Committee on Capital Markets Regulation (CCMR),[12] the balance sheet analysis conducted by the Federal Reserve Board in 2013 was flawed for two reasons. First, the analysis did not adjust for the effects of mergers and acquisitions (**M&A**) activity among the 50 largest bank holding companies included in the analysis. Several large commercial banks acquired non-bank financial companies during the Global Financial Crisis, resulting in an inconsistent comparison between the asset amounts at the beginning and end of the nine-quarter period considered in the analysis.

Second, the analysis did not adjust for the effects of new accounting standards implemented after the Global Financial Crisis. These accounting changes had the effect of requiring banks to recognize as on-balance sheet exposures the assets of certain securitization vehicles that had previously been treated

[10] Federal Reserve Board, Federal Reserve Independent Balance Sheet and RWA Projections (Dec. 16, 2013), *available at* https://www.federalreserve.gov/bankinforeg/independent-projections-letter-20131216.pdf. This analysis was conducted in connection with the Federal Reserve Board's 2014 Comprehensive Capital Analysis and Review (**CCAR**) process, as support for the Federal Reserve Board's use, for the first time, of *supervisory* projections of balance sheet items and risk-weighted assets. Prior to CCAR 2014, the Federal Reserve Board had used Covered Firms' internal projections of these items.

[11] *Id*. at 2.

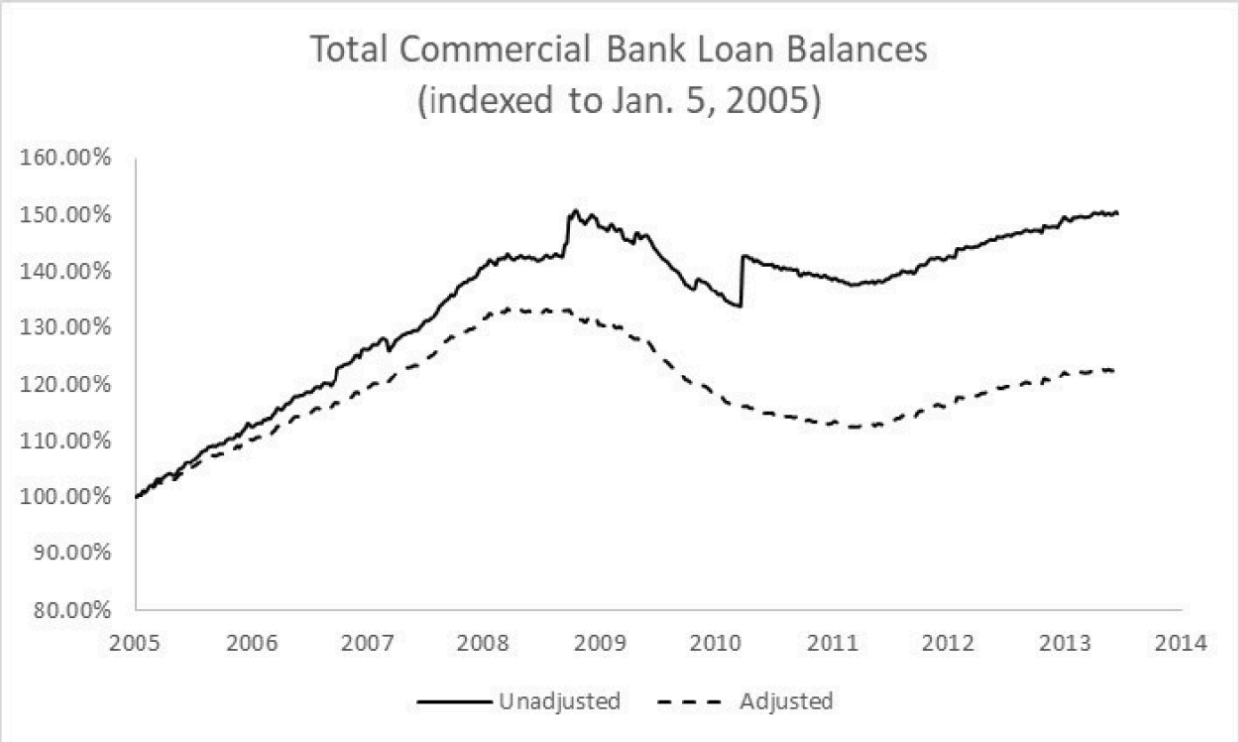
[12] Committee on Capital Markets Regulation (**CCMR**), Bank Stress Testing & Underserved Borrowers (Sep. 2021), *available at* https://capmktsreg.org/wp-content/uploads/2022/11/Bank-Stress-Testing-Underserved-Borrowers-09.01.2021.pdf.

as off-balance sheet exposures. Appropriately adjusting for this accounting change would have reduced the balance sheet growth measured during the period of the analysis.

In addition to these flaws, the Flat Balance Sheet Assumption contains embedded assumptions about the growth rates for each product type that are unrealistic and inconsistent with empirical data on product-level growth and contraction rates in stressed conditions. These inconsistencies are discussed in Section II.B below.

CCMR has conducted an alternative analysis of the effects of recessions on industry-wide loan portfolios, with and without adjustments for M&A and accounting changes. The unadjusted analysis considers only the reported loan balances of top 50 bank holding companies. The adjusted analysis corrects for the effects of M&A activity and for the accounting change noted above, from 2005 through 2014. As shown in Figure 1 below, the effect of the adjustments is significant, showing that unadjusted loan balances increased by 10% over the Global Financial Crisis recession (January 2008 to June 2013), whereas adjusted loan balances decreased by 9% over the same period.

Figure 1[13]



The 2013 Federal Reserve Board analysis served as the basis for shifting from company-run balance sheet projections to supervisory projections, which remained the supervisory approach for several years. The 2019 Policy Statement on Stress Testing stated that balance sheets would be assumed to be "fixed or growing" under the supervisory stress test, consistent with the 2013 analysis.[14]

[13] *Source:* CCMR, Bank Stress Testing & Underserved Borrowers (Sep. 2021), *available at* https://capmktsreg.org/wp-content/uploads/2022/11/Bank-Stress-Testing-Underserved-Borrowers-09.01.2021.pdf.

[14] 84 Fed. Reg. 6664, 6670 (Feb. 28, 2019).

In 2020, however, in connection with the SCB final rule, the Federal Reserve Board updated its Policy Statement on Stress Testing to implement the Flat Balance Sheet Assumption. In making this change, the Federal Reserve Board acknowledged that "a firm's balance sheet may change in different ways in periods of stress" but justified the Flat Balance Sheet Assumption on the grounds that it "simplifies the Board's stress testing framework, while dissuading firms from planning to reduce credit supply in a stress scenario."[15] Although this change was an improvement relative to the prior approach, which in many cases assumed that Covered Firms' balance sheets would grow under stressed conditions, Capital One believes that the Flat Balance Sheet Assumption remains a flawed approach as it is unrealistic and inconsistent with observed experience, and it overstates projected loan balances and loan losses, particularly for portfolios with higher loss rates in stressed conditions, as discussed in the next section.

B. The Flat Balance Sheet Assumption Results in Unrealistic Balance Sheet Projections that Are Inconsistent with Empirical Data

Under the supervisory stress test, the Federal Reserve Board projects, among other things, the level of loan losses for each loan portfolio. Considered in isolation, these projected loan losses necessarily reduce the projected balances of the affected loan portfolios. The Flat Balance Sheet Assumption simultaneously assumes, for each Covered Firm, that all loan portfolios will generally remain the same size throughout the planning horizon, regardless of the type of loan and the level of loan losses under stressed macroeconomic conditions. Considering these two factors together, the Flat Balance Sheet Assumption effectively assumes that any reduction in the projected loan balance stemming from loan losses in a portfolio would be offset by new extensions of credit by the Covered Firm in that portfolio. In other words, the Flat Balance Sheet Assumption simplistically assumes that each dollar of loan loss in a portfolio would be replaced by a dollar of new loans in that portfolio (the **Simple Replacement Effect**).

The Simple Replacement Effect of the Flat Balance Sheet Assumption is not consistent with real-world outcomes under actual stress conditions and fails to recognize that different asset classes behave differently under stress. The Simple Replacement Effect implicitly assumes that each product type will experience growth in stressed conditions that exactly offsets the gross loan losses in the portfolio. Thus, the Simple Replacement Effect reflects embedded assumptions about product-specific growth rates for each product type. These product-specific growth rates are inconsistent with the real-world growth and contraction rates observed in historical recessions.

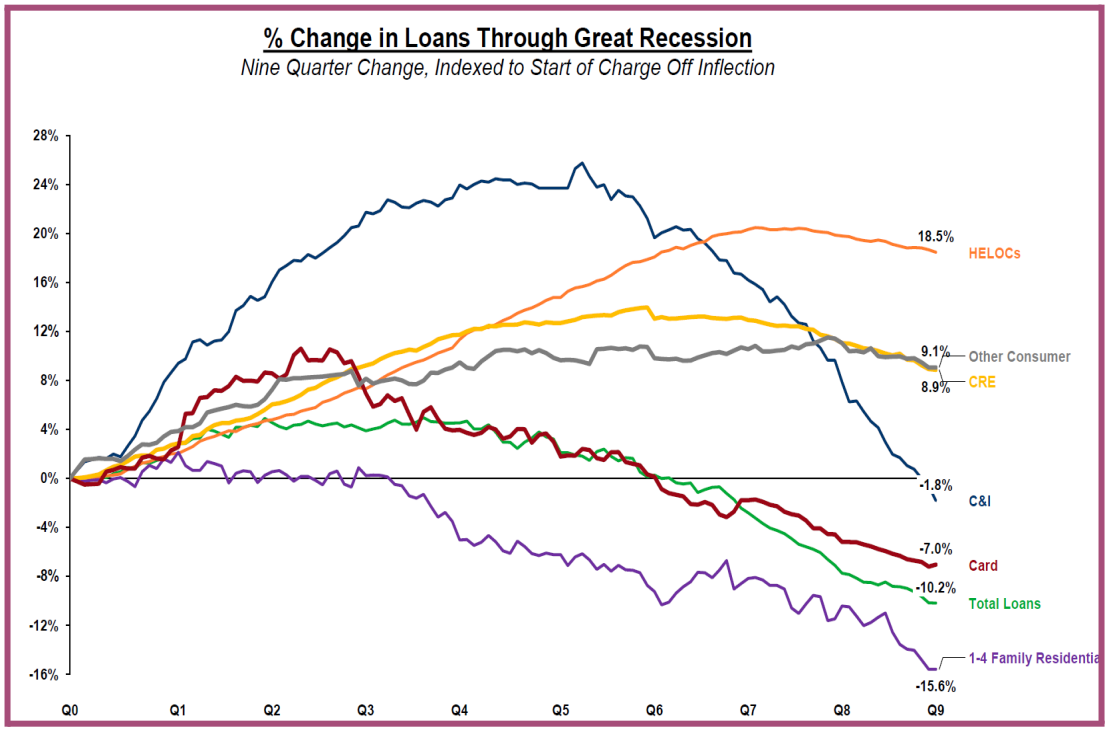
The observed experience during the 2008-2009 Global Financial Crisis and the 2020 COVID shock period shows that credit card balances shrank while other loan balances increased during those periods. Figure 2 below shows the changes in loan balances for all U.S. reporting commercial banks[16] during the Global Financial Crisis by product type, based on data from the Federal Reserve Board's H.8 reports and adjusted for M&A and accounting changes. For each product type, the starting point is indexed to the quarter when loan balances began to experience greater than normal loan losses.[17] As shown in Figure 2, changes in loan balances during the Global Financial Crisis varied greatly depending on the product type, with balances of home equity lines of credit (HELOCs) increasing by 18.5% and credit card balances decreasing by 7%.

[15] 85 Fed. Reg. 15576, 15580 (Mar. 18, 2020).

[16] Specifically, as used in this comment letter, "all U.S. reporting commercial banks" means "Domestically-charted Commercial Banks in the United States" as defined for purposes of the Federal Reserve Board's H.8 reporting.

[17] Specifically, the starting point is set as the quarter when the charge off rate exceeds one standard deviation above the average charge off rate from 1Q05 to 2Q07 (referred to in Figure 2 as the charge-off inflection point).

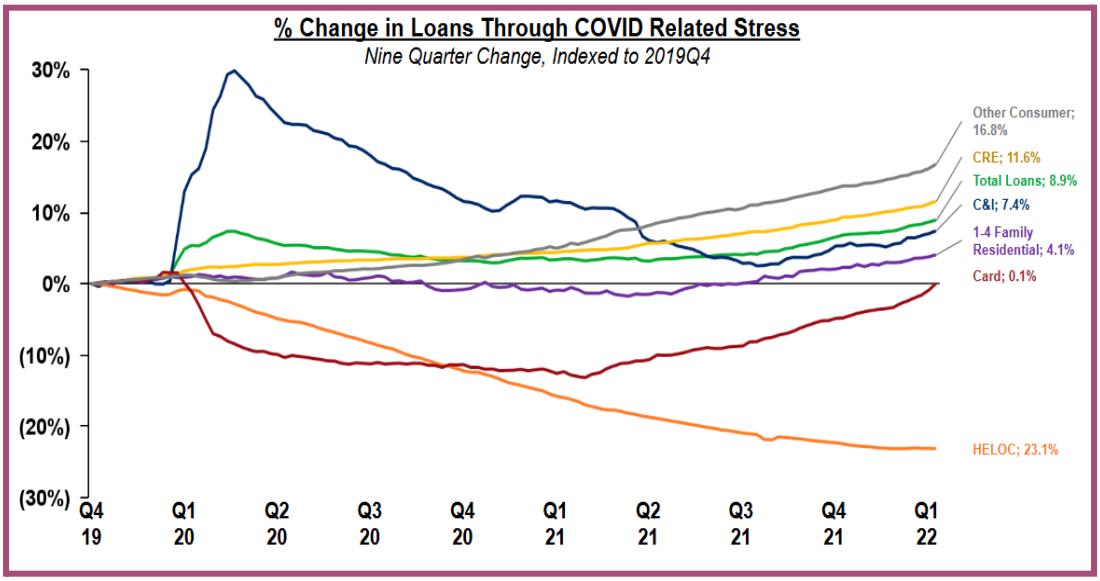
Figure 2



Source: Federal Reserve Board H.8 reports (Domestically Chartered Commercial Banks, Seasonally Adjusted)

Figure 3 below shows the growth in loan balances by product type for all U.S. reporting commercial banks based on data from the Federal Reserve Board H.8 reports for the COVID shock period, measured from the end of 2019 through the first quarter of 2022. Figure 3 again paints a picture of differential changes in loan balances for the COVID shock period as for the Global Financial crisis, in this case showing that commercial loan balances increased dramatically early on in stress while card balances decreased.

Figure 3



Source: Federal Reserve Board H.8 reports (Domestically Chartered Commercial Banks, Seasonally Adjusted). Note that 2019Q4 represents the ending point as of 12/25/2019.

The Flat Balance Sheet Assumption can also inadvertently favor certain loan categories over others, thereby distorting bank lending practices. The differential treatment of loan types under the supervisory stress tests results in variations in SCB results based on a banking organization's mix of loan types. Because the SCB applies in business-as-usual (**BAU**) economic environments as well as under stressed conditions, these distortions affect bank lending practices in BAU, not merely under stressed conditions. As demonstrated by the historical data above, credit card portfolios typically contract while other loan portfolios typically grow during stressed conditions. By requiring all loan balances to stay the same without appropriately distinguishing among various loan types, the Federal Reserve Board is implicitly disadvantaging credit card loans and favoring other loans by requiring more capital than justified for credit card loans and less capital for commercial loans.

C. The Flat Balance Sheet Assumption Artificially Increases the Capital Requirements for Loans to Underserved Consumers

The flaw of the Flat Balance Sheet Assumption is particularly pronounced for subprime credit card portfolios, typically defined by borrowers having FICO scores below 650, who are generally underserved by the banking industry. During periods of stress, these portfolios historically experienced higher charge-off rates and lower demand for credit. The supervisory stress test model recognizes the higher charge-off rates for these products but counterfactually (through the operation of the Simple Replacement Effect) assumes that the demand for these products during stress would increase to offset the charge-offs. For example, the Federal Reserve Board has disclosed that its average modeled net loss rate for credit card accounts with FICO scores under 650 is about 40% across the nine-quarter planning horizon. Given the recovery rate assumption of approximately 10%, this corresponds to a gross charge-off rate of approximately 45% over the nine quarters. This magnitude of charge-offs cannot be replaced quickly. Even in a healthy economy, replacing such a magnitude of lost balances would be a significant and prolonged challenge, and under stressed economic conditions, it would be nearly impossible. In other words, to assume the loan balances

for these products stay the same while having such a high loan loss rate would imply a new loan origination rate that is implausibly high and unattainable even during stable economic conditions.

This unrealistic new loan origination rate assumption results in overestimation of projected loan balances, total projected losses, projected allowances and expenses for subprime credit card portfolios in stress tests, which in turn leads to higher-than-justified stressed losses for these portfolios under the supervisory stress test. As a result, these portfolios contribute to artificially higher SCB requirements[18], which are binding capital requirements during normal times, for banks that make these loans, which in turn increases the cost of capital and costs to borrowers for these products and reduces the availability of bank credit in this already underserved community, driving them to less regulated lenders. Because the SCB applies to each firm in both stressed conditions and BAU conditions, the Flat Balance Sheet Assumption therefore incentivizes banking organizations to reduce their origination, in all conditions, of products with higher loss rates in stressed conditions.

Credit cards are a particularly important financial product for traditionally underserved groups such as low-income borrowers, borrowers with unfavorable credit histories, and new borrowers with short credit histories. Credit cards provide access to emergency funds for unforeseen needs and serve as a critical tool for financial inclusion as they enable underserved borrowers to build essential credit history. As illustrated in Table 1 below, average credit card debt as a percentage of median annual income is highest for the lowest income groups. For example, the bottom income quintile holds average credit card debt of approximately 23.5% of median annual income, while the highest quintile holds between 4.3% and 6.5%.

Table 1

Income percentile	Avg. credit card debt / median annual income
Less than 20	23.5%
20-39.9	13.1%
40-59.9	8.3%
60-79.9	7.3%
80-89.9	6.5%
90-100	4.3%

Source: Federal Reserve Survey of Consumer Finances

In short, the Flat Balance Sheet Assumption artificially increases the capital requirements for subprime credit card products and has the potential to create unintended consequences of increasing cost of borrowing for, and reducing access to, credit and small-dollar lending for underbanked communities. To

[18] This is because these firms' projected capital ratios at the trough of the stress period are artificially reduced due to compounding effects on both the numerators and denominators of the projected post-stress capital ratios. The denominators of the capital ratios are artificially inflated because RWAs for credit card balances are assumed to be higher than they would be at the trough of the stress scenario if empirically backed projections were used instead. Compounding this effect, the numerators of the post-stress capital ratios are artificially deflated numerators because, since the loan balances are overstated, the cumulative loan losses on these balances and the associated allowances and expenses are artificially overstated as a result.

avoid this outcome, we recommend that the Federal Reserve Board refine its Flat Balance Sheet Assumption.

III. Recommended Changes to the Flat Balance Sheet Assumption

As illustrated in Section II, the Flat Balance Sheet Assumption is a one-size-fits-none approach that overstates capital needs for products with high loan loss rates in stressed conditions, such as subprime credit cards, which in turn results in unintended and disproportionate adverse impact on underserved borrowers. To avoid that outcome and to enhance the granularity of the stress test assumptions and consistency with real-world outcomes and empirical data, Capital One recommends that the Federal Reserve Board modify the Flat Balance Sheet Assumption to take into account projected losses by determining the size of the projected loan balances net of charge-offs. Below, we suggest two alternative approaches for the Federal Reserve Board's consideration.

Alternative A: A Fixed Growth Rate Calibrated Based on Aggregate, Industry-Level Loan Losses

Under this approach, the Federal Reserve Board would continue to assume that the aggregate loan balances held by all Covered Firms would remain constant over the planning horizon but would allow the mix of loan types of individual Covered Firms to fluctuate based on loan type-specific charge off rates. The Federal Reserve Board would no longer assume that the loan balances of each product type net of loan losses would remain constant. Instead, the Federal Reserve Board would apply a single, fixed growth rate of loan balances to all product types and adjust loan balances for each product type downward based on product type's specific projected gross loan losses. The fixed growth rate of loan balances would be calibrated to approximate the aggregate loan loss rate at the industry level, thereby achieving the intended macro-prudential goal of the Flat Balance Sheet Assumption – i.e., ensuring that Covered Firms maintain sufficient capital to continue to supply the same aggregate level of credit to the economy during stress. By using a fixed growth rate of loan balances to all product types but at the same time differentiating between loan types based on their projected gross loan loss rates, the Federal Reserve Board could better reflect the actual dynamics of various assets under stress without needing to make assumptions about choices made by Covered Firms.

To illustrate how this approach could work in practice, consider the following steps for a simplified hypothetical scenario where the Covered Firms have only two loan types – $7T of commercial loans and $1T of consumer loans:

- First, the Federal Reserve Board would estimate the cumulative gross loan loss rates over the supervisory severely adverse scenario for each product type.

  Example:

  - Commercial loans: 4% cumulative gross loan losses
  - Consumer loans: 20% cumulative gross loan losses

- Second, the Federal Reserve Board would calculate the aggregate cumulative gross loan loss rate over the supervisory severely adverse scenario for the aggregate balance sheet of all Covered Firms.

  Example:

- $7T of commercial loans x 4% loan loss rate = $280B of gross loan losses
- $1T of consumer loans x 20% loan loss rate = $200B of gross loan losses
- Aggregate loss rate: $480B of total gross loan losses / $8T of total loans = 6.00%.

- Third, in order to implement the modified version of the Flat Balance Sheet Assumption, the Federal Reserve Board could assume that both commercial loans and consumer loans grow by a fixed 6% growth rate, offsetting the gross loan losses on the aggregate balance sheet.

- Fourth, at the individual Covered Firm level, the Federal Reserve Board would estimate the projected loan balance for each loan type by applying the fixed 6% growth rate across all product types and then reduce the loan balance of each product type based on the product's specific projected gross loan loss rate (4% for commercial loans and 20% for consumer loans).
    - For example, Covered Firm A has $100B of consumer loans and $100B of commercial loans.
        - The consumer loan portfolio would grow by $6B and then decrease by $20B, resulting in a net decrease of $14B in consumer loan balances.
        - The commercial loan portfolio would similarly grow by $6B and then decrease by $4B, resulting in a net increase of $2B in commercial loan balances.

Our proposed approach would make the loan projections more realistic. By taking into account the effect of net charge-offs on loan balances, the supervisory stress tests would appropriately recognize that balances for different products react differently during periods of stress, while preserving the assumption that the aggregate supply of credit by the Covered Firms remains constant over the planning horizon. This approach would be consistent with the benchmarking aim of the stress tests by facilitating better firm-by-firm comparisons than the current Flat Balance Sheet Assumption. In addition, this approach would maintain the simplicity of the existing approach and would apply consistent assumptions to all Covered Firms, but would refine these assumptions to better reflect the actual balance sheet composition of Covered Firms.

We believe our proposed approach would improve the accuracy and utility of the supervisory stress tests and thus promote financial stability. Importantly, this approach would remove the unintended adverse impact of the Flat Balance Sheet Assumption on subprime credit card products. By removing the unintended adverse impact, this approach would prevent disincentives to lend in those markets and avoid distorting business choices during BAU conditions. Finally, our proposed approach would also be consistent with other refinements the Federal Reserve Board has made to its supervisory models, including adjustments to the 2020 CCAR results to correct an overestimation of hypothetical losses for certain public welfare investments.

Alternative B: Product-Specific Growth Rates Calibrated Based on Recent Origination Data

This approach is similar to Alternative A, except that instead of applying a single, fixed growth rate across all products, the Federal Reserve Board would apply product-specific growth rates (breaking down by FICO band for consumer products and relevant segmentation for commercial products). These product-specific growth rates would be calibrated based on recent new loan origination data already provided in firms' FR Y-14 reports (e.g., average growth rates for each product type based on new loan originations or draws on unused lines over the last 9-quarter period immediately preceding the stress test jump-off date). Under this approach, the Federal Reserve Board would apply a growth rate tailored to each product type, and then adjust loan balances for the product type downward based on the product type's specific projected gross loan losses. Like Alternative A, this approach would appropriately differentiate among product types and provide conservative projections for stress scenarios. This approach would also achieve the Federal Reserve Board's goals of consistency and comparability across Covered Firms because each firm would be subject to the same assumed growth rates for the product types applicable to its balance sheet. To achieve transparency goals, the growth rates by product type could be published for each stress testing cycle along with the details of the supervisory scenarios. While this approach would be modestly more complex than Alternative A, it results in a more grounded growth rate, supported by recent data, without sacrificing the goals of consistency and comparability across firms.

IV. Recommended Changes to the Modeling of Non-Interest Expenses

Greater alignment between the Federal Reserve Board's stress testing assumptions and observed patterns and business models of Covered Firms would similarly improve the accuracy and rigor of the supervisory stress tests. In particular, Capital One recommends that the Federal Reserve Board model more granular categories of non-interest expenses under the supervisory stress test, including a new sub-category for marketing expenses, which will decline significantly in stressed conditions.

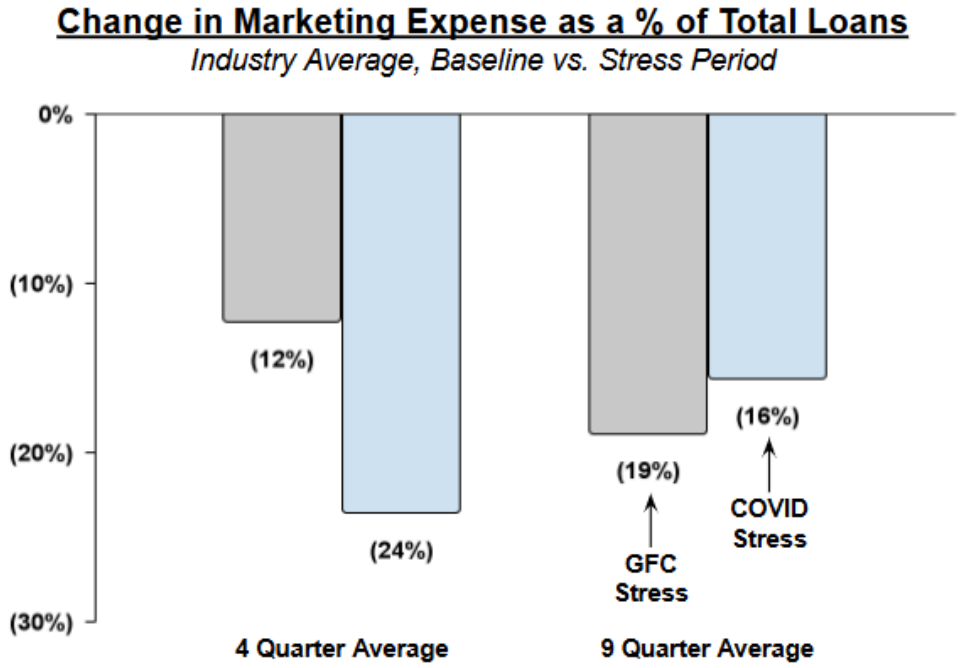
Currently the Federal Reserve Board's supervisory models consider three categories of non-interest expenses: compensation expense, fixed asset expense, and "all other" noninterest expenses (other than operational risk losses and other real estate owned, which are captured by other aspects of the supervisory models). Capital One believes that the "all other" noninterest expenses category is overbroad and should be modelled more granularly. Improved granularity would better reflect resilience and capital needs because the "all other" noninterest expense category includes a variety of costs that behave differently under stress, and therefore can result in material differences in projected expenses under stress. For example, some sub-categories of these expenses will remain flat or increase in stressed conditions, whereas marketing expenses will contract significantly in stressed conditions. Not identifying and accounting for these differences can cause the supervisory models to overestimate projected expenses under stress scenarios.

Marketing budgets are typically more flexible than budgets for other expenses and can be adjusted quickly and significantly at times of stress. As demonstrated in Figure 4, marketing expenses contracted significantly during the 2008-2009 Global Financial Crisis and the 2020 COVID shock period. This is true for most firms, but is especially true for consumer lending firms. Consumer lending firms typically operate with substantially larger marketing budgets, which they drastically cut during economic stress to conserve capital as demand for consumer loans inevitably declines. The Federal Reserve Board's current modelling approach for expenses, therefore, unfairly overstates the projected marketing costs of Covered Firms in stress conditions, especially for Covered Firms with large consumer lending portfolios. Punitive treatment of marketing expenses has the potential to disincentivize the provision of credit to consumer borrowers because marketing and acquisition costs are generally higher for consumer credit than for commercial credit.

Accordingly, Capital One recommends that the Federal Reserve Board model more granular categories of non-interest expenses under the supervisory stress test by including a new sub-category for marketing expenses and assume a decrease in marketing expenses during stressed conditions based on historical data.

Figure 4

Figure 4 shows the reduction in reported marketing expenses as a percentage of total loans during the 2008-2009 Global Financial Crisis and the 2020 COVID shock period, relative to the pre-stress baseline. This is calculated as the average reduction in marketing expense across the industry. In particular, for the Global Financial Crisis, the four-quarter average shows a 12% decrease of marketing expenses as a percentage of total loans while the nine-quarter average shows a 19% decrease. For the 2020 COVID shock period, the four-quarter average shows a 24% decrease of marketing expenses as a percentage of total loans while the nine-quarter average shows a 16% decrease overall.



Note: Baseline for comparison is FY 2007 for GFC stress and FY 2019 for COVID stress; four quarter average is 2008Q1-2008Q4 and 2020Q1-2020Q4 for GFC stress and COVID stress, respectively; nine quarter average is 2008Q1-2010Q1 and 2020Q1-2022Q1 for GFC stress and COVID stress, respectively; GFC stress peer group consists of AXP, BAC, C, COF, FITB, JPM, KEY, PNC, RF, TFC, USB, and WFC; COVID stress peer group consists of ALLY, AXP, BAC, BK, C, CFG, COF, FITB, GS, HBAN, JPM, KEY, MS, MTB, NTRS, PNC, RF, SCHW, TFC, USB, and WFC. Source: SNL, Company Reports.

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V. Conclusion

We appreciate the Federal Reserve Board's efforts to enhance the transparency of its supervisory stress tests and its invitation to submit comments not only on the specific changes proposed in the Proposed Rule, but on its supervisory stress testing framework in general. For the reasons discussed in this letter, Capital One believes that the Flat Balance Sheet Assumption is overly simplified, unsupported by empirical data, and ultimately leads to higher borrowing costs and reduced availability of credit for certain consumer credit products, particularly subprime credit cards. We recommend that the Federal Reserve Board revisit and revise the Flat Balance Sheet Assumption as it continues to evaluate and improve its supervisory stress testing framework. We believe our recommended refinement to the Flat Balance Sheet Assumption preserves the advantages of the existing approach, including simplicity and comparability across Covered Firms, while making the supervisory projections of individual Covered Firms' balance sheets more sensitive to the mix of products comprising each firm's loan portfolio. We also recommend that the Federal Reserve Board revise the "all other" expenses category to more granularly account for how different expenses, particularly marketing expenses, would evolve during a stress period.

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Thank you for considering the recommendations set forth in this letter. If you have any questions, please contact the undersigned at robert.zizka@capitalone.com.

Sincerely,

/s/ Robert Zizka

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Robert Zizka
Executive Vice President,
Capital Markets & Analytics