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Proposal and Comment Information

Title: LFI -Revisions to the Large Financial Institution Rating System and Framework for the Supervision of Insurance Organizations, OP-1868

Comment ID: FR-2025-0042-01-C03

Submitter Information

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See attachment

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Submitted via Electronic Mail

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

Re: Revisions to the Large Financial Institution Rating System and Framework for the Supervision of Insurance Organizations (Docket No. OP-1868)

To Whom It May Concern:

I appreciate the opportunity to submit comments concerning the above-captioned proposed rulemaking (Proposal) of Board of Governors of the Federal Reserve System (Board).[1] I am an Assistant Professor of Legal Studies at the J. Mack Robinson College of Business at Georgia State University. I submit these comments in my personal capacity.

I. Summary of Comments

The Board's Proposal is contrary to the provisions of the Bank Holding Company Act ("BHC Act") and Congressional intent. In addition, it is unnecessary to adopt a composite score for the Large Financial Institution Rating System ("LFI Framework").

II. Background

The BHC Act grants certain privileges to bank holding companies that (1) are considered "well capitalized" and "well managed" and (2) only have depository institution subsidiaries that are "well capitalized" and "well managed."[2] In particular, these institutions may apply to become "financial holding companies," which authorizes them to engage in, or own shares in companies that engage in, nonbanking activities that are "financial in nature or incidental to such financial activity" or are "complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."[3] These activities include insurance underwriting, securities underwriting and dealing, and merchant banking. The BHC Act provides that bank holding companies are "well managed," and therefore eligible to become financial holding companies, if they maintain "a CAMEL[S] composite rating of 1 or 2" and "at least a satisfactory rating for management."[4] The Act authorizes the Board to use equivalent ratings under an equivalent rating system.[5]

The Board evaluates bank holding companies with total consolidated assets of $100 billion or more and foreign banks' intermediate holding companies with consolidated assets of

[1] 90 Fed. Reg. 31641 (July 15, 2025).
[2] *See* 12 U.S.C. § 1843(l)
[3] *Id*. § 1843(k).
[4] *Id*. § 1841(o)(9)
[5] *Id*.

$50 billion or more established under the LFI Framework.[6] The LFI Framework has three components: Capital Planning and Positions; Liquidity Risk Management and Positions; and Governance and Controls. Each component is rated based on a four-point, non-numeric scale: Broadly Meets Expectations, Conditionally Meets Expectations, Deficient-1, and Deficient-2. Under the Board's existing policy, it considers a bank holding company to be "well managed" if it is rated "Broadly Meets Expectations" or "Conditionally Meets Expectations" for each of the three component ratings.[7] That is, it considers a "Conditionally Meets Expectations" rating to be equivalent to a CAMELS rating of 2 or to a "satisfactory" rating.

The Proposal, if codified, would amend the LFI Framework so that a firm with at least two "Broadly Meets Expectations" or "Conditionally Meets Expectations" component ratings and no more than one "Deficient-1" component rating would be considered "well managed."[8]

III. Legal Considerations

If codified, the Proposal would most likely violate the BHC Act. When Congress enacted applicable provisions of the Act in 2010, the Uniform Financial Institutions Rating System (UFIRS) provided that a CAMEL (now CAMELS) composite of 1 or 2 meant that, at minimum,

> Financial institutions in this group are fundamentally sound. … Only moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.[9]

Similarly, a "Management" rating of 2 was considered "satisfactory." The Management component evaluates "The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations."[10] The UFIRS guidance explained that a rating of 2 "indicates *satisfactory* management and board performance and risk management practices relative to the institution's size, complexity, and risk profile."[11] A rating of 3 was "less than satisfactory."[12]

By explicitly referring to the UFIRS ratings in effect at the time the Dodd-Frank Act was enacted, Congress endeavored to incorporate these principles into law. To the extent that the

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[6] *See* SR Letter 19-3/CA Letter 19-2, *Large Financial Institution (LFI) Rating System* (Feb. 26, 2019), https://www.federalreserve.gov/supervisionreg/srletters/sr1903.htm.

[7] *Id*. at 4.

[8] 90 Fed. Reg. at 31643.

[9] *Federal Financial Institutions Examination Council, Uniform Financial Institutions Rating System*, 61 Fed. Reg. 67021, 67026 (Dec. 19, 1996).

[10] *Id*. at 67027.

[11] *Id*. at 67028 (emphasis added).

[12] *Id*.

Board uses any other rating system, its application must align with these principles.

Aligning these principles to the LFI Framework is not a 1:1 exercise. The Board does not offer a composite rating under the LFI Framework, and its four-point, non-numeric scale does not map easily on to UFIRS' five-point numeric scale.

It is clear that a Deficient-1 or -2 on the Governance and Controls component means that the firm's management is less than satisfactory. This component evaluates a firm's "effectiveness in aligning strategic business objectives with the firm's risk appetite and risk management capabilities; maintaining effective and independent risk management and control functions, including internal audit; [and] promoting compliance with laws and regulations."[13] This maps directly onto the UFIRS Management component, which evaluates "The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations."[14] To that end, a Deficient-1 rating on the Governance and Controls component means that "a firm's governance and controls put the firm's prospects for remaining safe and sound through a range of conditions at significant risk."[15] It is inconceivable that this "significant risk" is equivalent to a Management component rating of 2, which would require that "[m]inor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed" and that "significant risks and problems are effectively identified, measured, monitored, and controlled."[16]

In addition, it is difficult to imagine (though harder to demonstrate) that a bank holding company could receive a Deficient-1 on any component while being equivalent to a UFIRS composite score of 1 or 2. At minimum, because a Deficient-1 rating signifies "a strong presumption that a firm … will be subject to an informal or formal enforcement action,"[17] it is contrary to the UFIRS composite 2 assertion that the institution is "in substantial compliance with laws and regulations"[18]—it cannot be the case that an institution is in substantial compliance with the law if it will presumptively be subject to enforcement actions. Moreover, a Deficient-1 rating, which signifies that a holding company "is unable to remediate [its financial or operational] deficiencies in the normal course of business," violates the UFIRS composite 2 holding that only "moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct."[19] As above, it cannot be the case that a firm's board and management are capable of correcting deficiencies if it is also unable to remediate those deficiencies without significant operational changes.

Theoretically, the Board could amend the LFI Framework to add a composite score to

[13] SR Letter 19-3/CA Letter 19-2 at 12.
[14] 61 Fed. Reg. at 67027.
[15] SR Letter 19-3/CA Letter 19-2 at 14.
[16] 61 Fed. Reg. at 67028.
[17] SR Letter 19-3/CA Letter 19-2 at 4.
[18] 61 Fed. Reg. at 67026.
[19] SR Letter 19-3/CA Letter 19-2 at 14.

which it may give a rating, and it has asked for comment about whether it should.[20] However, doing so appears unnecessary. The Board explains in its Proposal that the purpose of the change is because it believes the receipt of "a single Deficient-1 component rating can be indicative of a discrete deficiency that does not necessarily reflect the overall condition of a firm."[21] But given that this Framework applies only to large holding companies with over $50 billion or $100 billion in total consolidated assets, it is implausible that examiners would give a Deficient-1 rating based on a single deficiency among all the activities of the firm. To the extent it is possible that a bank will receive a Deficient-1 rating on the basis of a single deficiency, that deficiency would be so egregious as to fundamentally undermine an assertion that the bank is "fundamentally sound" and with "[o]nly moderate weaknesses," as the UFIRS requires of a bank receiving a composite 2 rating.[22] The Board asserts that a holding company may have "an idiosyncratic deficiency that results in a rating of Deficient-1 in an individual component" while having "overall robustness."[23] Although that may be the case with the UFIRS, given its six components, it necessarily cannot be with the LFI Framework's three.

IV. Policy Considerations

When Congress enacted the Gramm-Leach-Bliley Act and authorized bank holding companies to engage in nonbank activities in 1999, it only required insured-depository institution ("IDI") subsidiaries to be "well capitalized" and "well managed."[24] This would, in theory, ensure those deposit-taking subsidiaries were sufficiently strong enough to withstand "any potential risks that might arise from the expanded range of financial activities in which the other subsidiaries of the financial holding company might engage."[25]

In the wake of the Global Financial Crisis, however, it was apparent that many of these holding companies were not themselves being held to the highest regulatory standards even as they "came to dominate markets in complex financial products."[26] In the Dodd-Frank Act, Congress added the requirement that financial holding companies themselves be "well capitalized" and "well managed."[27] Doing so ensured that these firms' nonbanking activities do not harm their IDI subsidiaries, and made clear that Congress did not wish that less-than-well-capitalized and -well-managed holding companies receive the benefits of IDI subsidiaries.

Financial holding companies benefit from their IDI subsidiaries in several ways, and one can easily see why Congress would not want less-than-well-managed holding companies to

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[20] *See* 90 Fed. Reg. at 31646.

[21] *Id*. at 31644.

[22] 61 Fed. Reg. at 67026.

[23] 90 Fed. Reg. at 31644.

[24] *See* Pub. L. No. 106–102 § 103(a), 113 Stat. 1346 (codified as amended at 12 U.S.C. § 1841(l)).

[25] Paul L. Lee, *The Source-of-Strength Doctrine: Revered and Revisited – Part II*, 129 Banking L.J. 867, 878 (2012).

[26] Robert C. Hockett & Saule T. Omarova, *The Finance Franchise*, 102 CORNELL L. REV. 1143, 1193 (2017). *See also* DEPARTMENT OF THE TREASURY, FINANCIAL REGULATORY REFORM 30 (2009) ("The GLB Act does not, however, require an FHC to be 'well-capitalized' or 'well-managed' on a consolidated basis. As a result, many of the BHCs that were most active in volatile capital markets activities were not held to the highest consolidated regulatory capital standard available.").

[27] *See* Pub. L. No. 111–203 § 606, 124 Stat. 1607 (making this change).

receive them. For example, nonbank subsidiaries may obtain funding at a lower cost than their nonbank competitors thanks to their IDI affiliates' deposit franchises and access to the Federal Reserve's discount window.[28] Because IDIs borrow funds at a lower cost than nonbanks, they can lend those funds to their nonbank affiliates at a lower rate than those affiliates could get themselves. It is inappropriate to have institutions that are not well managed to be able to use cheap funding to undercut their competitors. Similarly, financial holding companies' IDIs may have direct access to the System's payment services and can provide those services at cost to their nonbank affiliates.

In addition, financial holding companies can place bad assets from their nonbanks into their banks, benefitting from the Federal Reserve System's discount window and the FDIC's insurance safety net, preserving the health of their nonbank affiliates while allowing their IDIs to receive government support. Although Sections 23A and 23B of the Federal Reserve Act were designed to prevent IDIs from transferring federal subsidies to nonbank affiliates and receiving bad assets in return, they did not work effectively prior to the global financial crisis.[29] To that end, it is easier for regulators to simply prevent IDIs from becoming affiliated with nonbanks if the latter are not going to be well managed, rather than having regulators police all transactions between them.

To that end, a bank holding company with a Deficient-1 on the Capital Planning and Positions and Liquidity Risk Management and Positions components of the LFI Framework are simply inconsistent with the policies Congress was effectuating. Take what constitutes a Deficient-1 rating on the liquidity risk management component. The Board explains that the firm may receive such a rating when its "projected liquidity positions may be insufficient to support its ability to meet prospective obligations and serve as a financial intermediary through a range of conditions."[30] If a holding company is in such a dire condition, it may use its IDIs to obtain liquidity from the discount window that it could push through to its affiliates. Similarly, the Board explains that firms may receive a Deficient-1 rating on the capital planning component "when supervisory issues are identified that place the firm's prospects for maintaining safe-and-sound operations through a range of potentially stressful conditions at significant risk" or "when the firm's inability to resolve supervisory issues in a timely manner indicates that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions."[31] If a holding company is in such a dire position, it may place bad assets from nonbank affiliates onto the balance sheets of their IDIs and place their IDIs into receivership, saving the former at the expense of the latter—and the Deposit Insurance Fund.

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[28] *See* Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1707 (2011) (describing how financial holding companies "were eager to leverage their subsidiary banks' high credit ratings and access to cheap sources of funding to increase profitability of their nonbank subsidiaries").

[29] *See generally* Omarova, *supra* note 28.

[30] SR Letter 19-3/CA Letter 19-2 at 10.

[31] *Id*. at 7.

Thank you for the opportunity to comment on this Proposal.

Sincerely,

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