BANK POLICY INSTITUTE

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Via Electronic Mail

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
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Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Regulatory Tailoring and DFAST Proposals[1]

Ladies and Gentlemen:

The Bank Policy Institute[2] appreciates the opportunity to comment on (i) the proposal issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the

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1 Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements (FRB Docket No. R–1628 and RIN 7100–AF21; Docket ID OCC–2018–0037 and RIN 1557–AE56; FDIC RIN: 3064–AE96); Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies (FRB Docket No. R–1627 and RIN 7100–AF20); Amendments to the Stress Testing Rules for National Banks and Federal Savings Associations (Docket ID OCC-2018-0035 and RIN 1557-AE55); Amendments to the Company-run and Supervisory Stress Test Rules (FRB Docket No. R-1648 and RIN AF 37); Company-Run Stress Testing Requirements for FDIC-Supervised State Nonmember Banks and State Savings Associations (FDIC RIN 3064–AE84).

2 The Bank Policy Institute 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 2 million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

Comptroller of the Currency regarding the agencies' proposed changes to the applicability thresholds for certain regulatory capital and liquidity requirements[3] and (ii) the proposal issued by the Federal Reserve regarding proposed changes to the enhanced prudential standards for large bank holding companies and savings and loan holding companies.[4] We are submitting one comment letter on both tailoring proposals because they are interrelated and would use the same methodology to assign prudential standards to large banking organizations.[5]

We appreciate the agencies' timely efforts to implement the Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA") and better and further tailor the application of enhanced prudential standards under section 165 of the Dodd-Frank Act, as well as capital and liquidity requirements, for domestic banking organizations. Collectively, the tailoring proposals are an important step forward toward a regulatory framework for these firms that more appropriately aligns prudential regulatory standards and burdens with the diverse activities, business models, and risk profiles of these firms. In particular, the risk-based indicator methodology on which the proposals are based is a promising approach that, if properly calibrated, indexed and deployed, could serve as a simple, transparent, and effective means by which to tailor prudential standards. Subject to several important refinements, we strongly encourage the agencies to adopt the general framework of the risk-based indicator approach as they move forward with implementation of EGRRCPA.

At the same time, both the proposed definition and calibration of the risk-based indicators and the proposed standards for certain categories of firms would inappropriately result in the application of enhanced prudential standards to certain firms when those standards are a poor fit for the firms' activities, business models, and risk profiles. Accordingly, we urge the agencies to revise several key aspects of the proposals to make them fully consistent with both the letter and spirit of EGRRCPA. First, the dollar-based threshold for the cross-jurisdictional activity risk-based indicator should be significantly increased. Second, *all* the risk-based indicators should be adjusted automatically and on an annual basis to account for economic growth so that those indicators retain similar relationships to risk as the U.S. banking industry and the economy expand. Third, the agencies should immediately eliminate several stress testing requirements that we do not believe are appropriate for any firm of *any* size—the qualitative assessment and objection framework, use of an "adverse" scenario, and mid-cycle company-run stress test requirements. Fourth, changes contemplated for capital planning and stress testing requirements applicable to Category III and Category IV firms—specifically, making company-run and supervisory DFAST biennial for Category III and Category IV firms, respectively, and allowing Category IV firms to include estimates based on a forward-looking analysis instead of stress tests in their annual capital plan submissions—should be carefully evaluated to ensure they do not result in unintended and adverse consequences and achieve the intended tailoring of prudential standards. And fifth, the tailoring proposals should use the existing modified LCR and proposed modified NSFR to develop the less stringent LCR and NSFR (if retained) requirements for certain firms rather than subjecting them to entirely new "reduced" LCR and NSFR requirements.

Leaving aside recommended changes to the tailoring proposals, we wish to emphasize that no regulatory tailoring for banking organizations can be effective unless it is consistently and faithfully honored in the examination process.[6] The purpose of EGRRCPA will be defeated if compliance with standards that are removed from the

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[3] 83 Fed. Reg. 66024 (Dec. 21, 2018) (the "interagency tailoring proposal").

[4] 83 Fed. Reg. 61408 (Nov. 29, 2018) (the "Federal Reserve tailoring proposal").

[5] We also appreciate the opportunity to comment on the agencies' recent proposals to amend their DFAST rules to, among other things, remove the "adverse" scenario. We are including comments on that aspect of those proposals in this letter because of the close relationship to the proposed and potential changes to capital planning and stress testing requirements discussed in the Federal Reserve's tailoring proposal. Other comments to the agencies' DFAST proposals, including technical corrections to the language of the proposed rules, will be provided to the agencies under separate cover and at a later date.

[6] With regard to examination, we also recommend that the Federal Reserve revisit the recently adopted rule establishing a new rating system for large financial institutions (the "LFI rating system") to ensure the supervisory practices set forth in the LFI rating system

regulations are nonetheless imposed in the examination process through matters requiring attention, horizontal reviews, or rating decisions, with those requirements instead cast as "best practices" or "supervisory expectations" that are no less binding on firms in practice. Still worse, because the examination process remains confidential, it is not subject to public scrutiny, and banks effectively have no right of appeal.[7] We therefore urge the agencies to also consider and identify what examination reforms should be implemented to ensure that no agency guidance or *ad hoc* examination mandate trumps the final rule.[8]

Finally, we note that the proposals' scope is explicitly limited to domestic banking organizations, with related changes to the framework applicable to the U.S. operations of foreign banking organizations to be proposed at some future date. This is inappropriate and unfortunate, as effective and appropriate tailoring of enhanced prudential standards is best identified and designed on a holistic basis that takes into account the full range of subject firms. This approach also threatens to undermine global regulatory cooperation and consistency. We therefore urge the agencies to issue for public comment, as soon as possible, similar and aligned proposals for the better and further tailoring of enhanced prudential standards for the U.S. operations of FBOs.

I. Executive Summary

- The agencies should adopt the general framework of the risk-based indicator approach set forth in the tailoring proposals, subject to important changes—including changes to the risk-based indicators that would place firms into Category II and inclusion of a mechanism to automatically adjust the applicable dollar-thresholds—that would more appropriately tailor prudential requirements to the risk profiles of applicable firms.

  - The dollar-based threshold for cross-jurisdictional activity should be set at a significantly higher level.

  - The final rules should automatically adjust the dollar-based thresholds used in the risk-based indicators, as well as the $700 billion asset-size threshold for Category II, on an annual basis to account for economic growth.

  - The agencies should clearly identify in the preambles to the final rules the line items in the applicable reporting forms for the risk-based indicators.

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are consistent with the framework contemplated by the tailoring proposals. We expect to file a supplemental letter suggesting changes to the LFI rating system in light of the tailoring proposals.

[7] *See* Julie Andersen Hill, *When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations*, 92 Wash. U. L. Rev. 1101, 1143-1148, 1165-1167 (2015) (noting that there are "few [intra-agency] appeals" by banks, that banks "rarely win" appeals, and that use of financial institution intra-agency appeals processes is limited by the fact that "[s]ome financial institutions believe that appealing is futile [and] [o]thers fear retaliation"). Indeed, although thousands of financial institutions have been examined since the appeals process was put in place in 1995, the Federal Reserve had decided only 25 appeals in the period from 2000 to 2015. (Data from 1995-2000 are unavailable.) *See id.*; *see also* The Clearing House, *Letter Re: Large Financial Institution Rating System* (Docket No. R-1569; RIN 7100-AE82) (Feb. 15, 2018).

[8] An important, perhaps even necessary, step in this direction would be to provide by regulation that matters requiring attention and other quasi-enforcement actions taken by the agencies will be based only on unsafe and unsound banking practices and other violations of law or regulation (including the rules ultimately adopted pursuant to the tailoring proposals). *See* Bank Policy Institute, American Bankers Association, *Petition for Rulemaking on the Role of Supervisory Guidance* (Nov. 5, 2018).

- The agencies should not subject firms and their subsidiaries to Category II requirements on the basis of meeting any single indicator threshold, whether on the basis of the $700 billion asset threshold or the $75 billion cross-jurisdictional activities threshold.

➢ The agencies should immediately eliminate stress testing requirements that would no longer be in effect upon finalization of the proposals, and the Federal Reserve should address aspects of the proposed revisions to capital planning and stress testing requirements applicable to Category III and Category IV firms so the revisions achieve the intended tailoring of prudential standards and do not result in unintended and adverse consequences.

- The agencies should revise their DFAST rules to eliminate the adverse scenario and should not include the adverse scenario in the 2019 DFAST and CCAR stress tests.

- Rather than expand the scope of the CCAR qualitative assessment and objection framework, the Federal Reserve should eliminate the CCAR qualitative assessment and objection framework for all firms, including Category I, II and III firms currently subject to it.

- The Federal Reserve should provide immediate relief from the mid-cycle company-run stress test requirement for all firms currently subject to it, including U.S. IHCs.

- The Federal Reserve should confirm that the internal capital stress test required of Category III firms during the "off" year would be fully aligned with existing CCAR and DFAST stress testing requirements, but with only the capital action assumptions applicable in CCAR and without the public disclosure required under DFAST.

- The Federal Reserve should address potential issues with the implementation of biennial supervisory stress testing for Category IV firms.

- The forward-looking analysis previewed for Category IV firms should not be applied in a manner that would continue to require these firms to run hypothetical stress scenarios.

- The capital plan proposal to be issued by the Federal Reserve should codify key aspects of the guidance that has been provided through the CCAR and DFAST Questions and Answers.

➢ The agencies should revise the proposed liquidity framework, in particular by using the existing modified LCR and proposed modified NSFR to develop the less stringent requirements for Category III firms and further tailoring liquidity requirements for Category II and IV firms.

- The agencies should use the modified LCR and proposed modified NSFR to develop the less stringent LCR and NSFR (if retained) requirements for qualifying Category III firms rather than subjecting those firms to a new "reduced" LCR or NSFR requirement.

- The Federal Reserve should not expand the universe of firms subject to daily FR 2052a reporting requirements.

- For Category IV firms, the Federal Reserve should explicitly confirm that Category IV firms would not be subject to any LCR-based requirements or supervisory expectations as a result of any continuing FR 2052a reporting obligations and should take steps to appropriately reduce reporting burdens for those firms.

- Without delaying the implementation of the general framework contemplated by the tailoring proposals, the agencies should provide more information on how they intend to implement EGRRCPA and the broader tailoring of the regulatory requirements that are previewed in the tailoring proposals, but not described with any specificity or detail, and should explain how the various proposals will relate to one another.

- The Federal Reserve should issue and implement a tailoring proposal applicable to FBOs and their U.S. IHCs as soon as possible.

  - To the extent the tailoring proposal applicable to FBOs will parallel the structure of the tailoring proposals, the FBO-specific proposal should limit the Federal Reserve's consideration of size and other risk-based indicators to the characteristics of the FBO's U.S. IHC on a standalone basis.

  - Transactions between the FBO's U.S. IHC and the FBO's non-U.S. operations should not count toward any proposed cross-jurisdictional activity or any other risk-based indicator.

- In addition to implementing the general framework contemplated by the tailoring proposals, the agencies should address related aspects of the broader regulatory framework that would remain in place after the tailoring proposals are implemented.

  - The AOCI filter should be available for all firms, not just firms subject to Category III and Category IV requirements.

  - The Federal Reserve should amend SR 09-4 to make it expressly applicable to firms with less than $100 billion in assets that will no longer be subject to CCAR.

  - The Federal Reserve should notify BHCs and U.S. IHCs of the applicability of additional scenario components for an upcoming CCAR/DFAST cycle by June 30 of the calendar year before the relevant stress test.

  - The Federal Reserve should amend Regulation YY to permit the risk committee of the board of directors to review and approve all matters relating to liquidity risk, rather than require full board action for such matters.

  - The agencies should reconsider and revisit of other aspects of the existing regulatory framework underlying the tailoring proposals.

II. The agencies should adopt the general framework of the risk-based indicator approach set forth in the tailoring proposals, subject to important changes—including changes to the risk-based indicators that would place firms into Category II and inclusion of a mechanism to automatically adjust the applicable dollar-thresholds—that would more appropriately tailor prudential requirements to the risk profiles of applicable firms.

The tailoring proposals would assign all U.S. bank holding companies and certain covered savings and loan holding companies with $100 billion or more in total consolidated assets to one of four categories based on their size and other "risk-based indicators," with all U.S. GSIBs being automatically assigned to Category I. The proposals would also assign the same category to both top-tier holding companies and their respective subsidiary depository institutions. For purposes of assigning non-Category I firms to one of the other three categories, the proposals set a threshold of $75 billion for each of four risk-based indicators (other than size): cross-jurisdictional activity, weighted

short-term wholesale funding, nonbank assets, and off-balance-sheet exposure. Non-Category I firms would also be assigned to Category II if they have $700 billion or more in total consolidated assets.

BPI continues to support strongly the principle that prudential regulation should be appropriately tailored to the business model and risk profile of each type of bank, without reliance on arbitrary size thresholds. In that regard, we generally support the framework proposed by the agencies because it would further the goal of applying prudential standards to firms according to risk-related criteria (and not just asset size) through a simple, transparent and straightforward methodology. However, certain aspects of the tailoring proposals—in particular, the risk-based indicators that would place firms into Category II—should be changed in the final rules so that the stringent requirements of Category II are more appropriately tailored to the risk profiles of applicable firms. Our recommendations with respect to the risk-based indicators set forth in the tailoring proposals are described more fully below.[9]

A. The dollar-based threshold for cross-jurisdictional activity should be set at a significantly higher level.

BPI conducted a quantitative analysis of the tailoring proposals, which demonstrates that the dollar-based threshold for cross-jurisdictional activity should be significantly increased.[10] The analysis uses SRISK, as a proxy for an independent market-based measure of the amount of capital a firm would need to survive a systemic crisis to gauge the degree to which firms pose risk to the financial system.[11] Although any individual measure's estimate of systemic risk, including the SRISK measure used in the BPI analysis, is insufficient by itself and fundamentally flawed, BPI uses SRISK as a proxy for systemic risk here because it uses a consistent metric across banks and it is also readily available, making it straightforward to replicate the results of our analysis.[12] The assessment of the proxy for the degree of complexity and resolvability of a firm is based on linear and nonlinear regression models that relate the market-based measure of losses, *i.e.*, SRISK, to the risk-based indicators included in the tailoring proposals. While the results indicate that cross-jurisdictional claims are positively correlated with SRISK, we find that cross-jurisdictional liabilities are negatively correlated with SRISK across all specifications considered. The negative correlation between cross-jurisdictional liabilities and SRISK holds using both data from U.S. banking organizations and data available for the international banking organizations included in the Basel Committee on Banking Supervision GSIB assessment sample (*i.e.*, we are able to validate the findings based on data from U.S. banking organizations using a much more comprehensive sample). Accordingly, because the current measure includes cross-jurisdictional liabilities, the dollar-based threshold for cross-jurisdictional activity should be set at a significantly higher level than proposed, or, at a minimum, if the $75 billion threshold is retained, cross-jurisdictional liabilities should be excluded. This result is also strongly supported by the quantitative analysis which uses nonlinear (or threshold) models to describe the relationship between SRISK and cross-jurisdictional claims.

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[9] The recommendations with respect to the risk-based indicators described in this section would also apply in the context of the FBO-specific tailoring proposal, which we urge the Federal Reserve to issue as soon as possible as discussed further in Section VI below.

[10] A research note (the "BPI Research Note") summarizing our quantitative analysis is attached to this comment letter as Annex A.

[11] Acharya, Viral V., Robert Engle and Matthew Richardson (2012), Capital Shortfall: A New Approach to Ranking and Regulating Systemic Risks, American Economic Review, 102(3), 59-64.

[12] The fundamental weaknesses of SRISK include: first, SRISK does not capture the spillover effects on the real economy that may arise if a bank were to fail. Second, SRISK is based on a simple model used to estimate the expected equity loss conditional on a single shock to the equity market and also places undue reliance on bank size. Finally, for the avoidance of doubt, measures such as SRISK do not capture the effect of the regulations prescribed to mitigate systemic risk.

There are also several policy and economic reasons that justify the empirical finding for a significantly higher threshold for cross-jurisdictional activity. First, it is desirable for banking organizations to diversify their funding sources. Funding from outside the United States mitigates creditor concentrations and does not present significant risks as firms have expertise in managing foreign exchange risk. Second, for foreign subsidiaries of U.S. firms, raising local funding is a sound asset-liability management and risk-management practice. Finally, cross-border borrowing can be less expensive than other forms of funding.[13]

B. The final rules should automatically adjust the dollar-based thresholds used in the risk-based indicators, as well as the $700 billion asset-size threshold for Category II, on an annual basis to account for economic growth.

The final rules should provide for annual adjustments to the $75 billion dollar risk-based indicators, as well as the $700 billion asset size threshold for Category II (if retained),[14] used to assign firms to different categories to account for economic growth by indexing these dollar thresholds to the growth in domestic banking assets.[15]

Over time, firms' asset size and risk-based indicators may increase as their activities expand in response to growth in the banking sector and the economy more generally. If a firm's asset size and risk-based indicators increase proportionately to increases in domestic banking assets, the firm's relative significance and risk profile within the U.S. banking system—as measured by the framework set forth in the tailoring proposals—generally remains static even though the absolute value of its assets or risk-based indicators is increasing. Those increases would reflect the expansion of the banking sector and the economy more generally, not changes in the firm's risk profile. If, in contrast, a firm's asset size or risk-based indicators increase disproportionately to increases in domestic banking assets, the firm's relative risk profile—as measured by the framework set forth in the tailoring proposals—may be changing such that a different category within the framework created by the proposals could be more appropriate. Annual adjustments to the dollar amount of the risk-based indicators and $700 billion asset size threshold for Category II based on changes in domestic banking assets would help prevent the application of more stringent capital, liquidity and other prudential standards to firms simply because the banking sector in general has grown. To promote transparency and certainty regarding the application of regulatory standards, the final rules should provide that the adjustments occur automatically based on the availability of data on domestic banking assets.

C. The agencies should clearly identify in the preambles to the final rules the line items in the applicable reporting forms for the risk-based indicators.

The tailoring proposals refer to various reporting forms and metrics that would be used to determine the applicable risk-based indicators but do not identify the specific line items that should be used. In order to promote the transparency of the framework and the simplicity and accuracy of determining the category to which a firm would be assigned, the preambles for the final rules should clearly identify the specific line items on the various reporting forms that would be used to determine a firm's size and risk-based indicators. Where a specific line item in the relevant reporting forms would not currently correspond exactly with each risk-based indicator that would be determinative for purposes of assigning firms to different categories, the agencies should either (i) amend the

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13 Ahnert, Toni, Kristin Forbes, Christian Friedrich, and Dennis Reinhardt, *Macroprudential FX Regulations: Shifting the Snowbanks of FX Vulnerability?* NBER Working Paper No. 25083, September 2018.

14 See Section II.D below.

15 The rationale for adjusting the $700 billion asset threshold for Category II, as discussed above, applies equally well to the $100 billion and $250 billion asset thresholds for Category IV and Category III, respectively. However, we recognize that the $100 billion and $250 billion asset thresholds are used to maintain consistency between the proposals and EGRRCPA, which includes these thresholds, but did not provide for indexation of these amounts.

reporting forms or (ii) include in the preamble for the final rules an exact description of the calculation to be used, with cross-references to specific line items.[16]

D. The agencies should not subject firms and their subsidiaries to Category II requirements on the basis of meeting any single indicator threshold, whether on the basis of the $700 billion asset threshold or the $75 billion cross-jurisdictional activities threshold.

EGRRCPA clearly presents Congress' determination that the degree of regulation to which a firm is subject should be based on a comprehensive view of the firm's overall risk profile across multiple indicators rather than any one indicator.[17] The tailoring proposals, however, would do just the opposite, subjecting a firm to Category II standards solely because the firm crosses a single threshold based on either total consolidated assets or cross-jurisdictional activities.

Regarding the proposed $700 billion asset threshold, the tailoring proposals cite a 2018 Federal Reserve staff paper to support the inclusion of size as an indicator of systemic impact and safety and soundness risks of a banking organization.[18] It is well accepted that the failure of a systemically important bank has a disproportionate impact on economic activity relative to a non-systemically important institution; however, the Federal Reserve staff paper—which has never been subject to public comment or peer review—does not in fact show that bank size is a useful determinant of the systemic importance of a bank. Recent BPI research argues that there are several important flaws in the Federal Reserve staff paper.[19] First, the impact of financial stress of large banks on real outcomes is statistically weak even under their baseline specification because the paper fails to correct for heteroskedasticity and autocorrelation in the residuals. As a result, the estimated standard errors are incorrect and lead to an overstatement of the statistical significance of the estimated coefficients. Next, the statistical significance of their findings vanishes when we conduct robustness exercises akin to those performed in a 1983 paper by Ben Bernanke,[20] which the Federal Reserve staff paper claims to build upon. Specifically, when we use the same specification used in the Bernanke paper (which uses the change in deposits of failed banks instead of the natural logarithm) we find that the coefficient on the deposits of failed large banks is almost never statistically different from zero at conventional levels in the regression that explains the growth rate of real GDP. In addition, when we include additional macroeconomic factors to control for the decline in economic activity during recessions the coefficient on

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16 In addition, the tailoring proposals provide that nonbank assets for purposes of the risk-based indicators would be nonbank assets as reported on line item 17 of the PC-B Memoranda of the FR Y-9LP, consistent with the determination of nonbank assets for purposes of the capital plan rule. Although the preambles of the tailoring proposals refer to "nonbank assets" as being "measured as the average amount of equity investments in subsidiaries", line item 17 of the PC-B Memoranda of the FR Y-9LP includes nonbank assets of consolidated nonbank subsidiaries and direct investments in unconsolidated nonbank subsidiaries, associated nonbank companies, and nonbank corporate joint ventures over which the relevant firm exercises significant influence. The agencies should revise the reference to "the average amount of equity investments in subsidiaries" in the preambles to the final rules so that the discussion is consistent with the actual scope of line item 17 of the PC-B Memoranda of the FR Y-9LP.

17 EGRRCPA § 401(a)(1)(B)(iii) Pub.L. 115–147 (2018) (adding a new subparagraph (C) to 12 U.S.C. § 5365(a)(2) requiring that if the Federal Reserve imposes enhanced prudential standards on firms with $100 billion or more of total consolidated assets, it *must* take into consideration such firm's "capital structure, riskiness, complexity, financial activities (including financial activities of subsidiaries), size, *and* any other risk-related factors that the [Federal Reserve] deems appropriate" (emphasis added)).

18 Interagency tailoring proposal, at 83 Fed. Reg. at 66029 n. 24; Federal Reserve tailoring proposal, at 83 Fed. Reg. at 61413 n. 49.

19 *See* Francisco Covas, Robert Lindgren, *Despite claims to the contrary, Fed staff paper does not convincingly show that economic costs of failure rise sharply with bank size* (Oct. 26, 2018), *available at* https://bpi.com/fed-staff-paper-finding-that-economic-costs-of-failure-rise-sharply-with-bank-size-is-flawed/.

20 Ben S. Bernanke, *Non-Monetary Effects of the Financial Crisis in the Propagation of the Great Depression*, The American Economic Review, Vol. 73, No. 3, (June 1983) pp. 257-276.

the deposits of failed large banks is also never statistically different from zero at conventional levels in the explanation of real GDP.

As a result, the Federal Reserve staff paper does not provide compelling evidence that bank size is an important determinant of systemic risk. The agencies should therefore not subject firms and their subsidiaries to Category II requirements on the basis of meeting a $700 billion asset threshold and should eliminate this threshold in the final rules.

The proposed cross-jurisdictional activity risk-based indicator is also flawed and should not be used as a single threshold that, if met, would subject firms to Category II standards. As described in Section II.A, the BPI Research Note demonstrates that the cross-jurisdictional activity risk-based indicator, as proposed, would not be a useful indicator of a firm's systemic risk due to the inclusion of cross-jurisdictional liabilities. Therefore, if the agencies retain the cross-jurisdictional activity risk-based indicator as a single threshold that would place firms in Category II, the dollar-based threshold for cross-jurisdictional activity should be significantly increased.

In addition, the agencies should further tailor the requirements applicable to any firm subject to Category II standards to more closely align with the specific risks associated with the applicable risk-based indicator that caused any such firm to be subject to Category II standards, and the agencies should incorporate this additional tailoring as they develop and issue additional proposed rules for resolution planning, liquidity and capital planning to fully implement the tailoring directives set forth in EGRRCPA.

III. The agencies should immediately eliminate stress testing requirements that would no longer be in effect upon finalization of the proposals, and the Federal Reserve should address aspects of the proposed revisions to capital planning and stress testing requirements applicable to Category III and Category IV firms so the revisions achieve the intended tailoring of prudential standards and do not result in unintended and adverse consequences.

A. The agencies should revise their DFAST rules to eliminate the adverse scenario and should not include the adverse scenario in the 2019 DFAST and CCAR stress tests.

As the agencies recognized, "the 'adverse' stress testing scenario has provided limited incremental information to the [agencies] and market participants beyond what the 'baseline' and 'severely adverse' stress testing scenarios provide"[21] because "the 'baseline' and 'severely adverse' scenarios are designed to cover the full range of expected and stressful conditions."[22] Accordingly, we support the proposed elimination of the adverse scenario, which would implement EGRRCPA and appropriately eliminate unnecessary stress testing, data production and reporting burdens on firms.[23]

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21 OCC, *Amendments to the Stress Testing Rules for National Banks and Federal Savings Associations* (Dec. 18, 2018), at 8; FDIC, *Company-Run Stress Testing Requirements for FDIC-Supervised State Nonmember Banks and State Savings Associations*, 83 Fed. Reg. 67149, 67150 (Dec. 28, 2018).

22 Federal Reserve, *Amendments to the Company-run and Supervisory Stress Test Rules* (Jan. 7, 2019), at 9.

23 CCAR post-stress capital requirements are frequently firms' binding capital constraints. In nearly every case, the severely adverse scenario has been the binding constraint and the determining factor of a firm's regulatory capital requirements. As a result, the adverse scenario has become an unnecessary element in DFAST and CCAR, one which only serves to increase stress testing burdens without producing any recognizable benefit. A more comprehensive reevaluation of DFAST and CCAR, which is beyond the scope of the tailoring proposals and the DFAST proposals, should consider the use of multiple stress testing scenarios, including bank-designed and bank-specific scenarios, in supervisory and company-run stress testing. *See, e.g.*, Greg Baer, *Stress Test Dummies: A Fundamental Problem with CCAR (and how to fix it)* (July 16, 2018), *available at* https://bpi.com/stress-test-dummies-a-fundamental-problem-with-ccar-and-how-to-fix-it/.

Although the agencies' DFAST proposals do not specify an effective date for the change, the implication is that the amendments to the agencies' DFAST rules would not be effective for the 2019 DFAST and CCAR stress tests. The comment period ends on February 19, 2019, but the agencies' DFAST rules require that they notify firms of the scenarios by February 15 of each year.[24] In light of the limited value of the adverse scenario—which the agencies note in their respective proposals—we urge the agencies not to include the adverse scenario in the 2019 DFAST and CCAR stress tests. The agencies could accomplish this through their reservation of authority, which allows them to extend deadlines.[25] Specifically, the agencies could extend the deadline for all requirements relating to the adverse scenario until November 25, 2019 and then eliminate those requirements as of November 24, 2019, which is the 18-month anniversary of the enactment of EGRRCPA and the effective date of the statutory change eliminating the adverse scenario as a required scenario.

An extension of the deadlines until November 25, 2019, together with the elimination of the requirements relating to the adverse scenario effective November 24, 2019, would be consistent with the policy objectives of EGRRCPA and appropriately provide relief for the 2019 stress testing cycle. Such an extension would also be consistent with recent action by the agencies to exempt all banking organizations with less than $100 billion in assets from the company-run stress tests as of the enactment of EGRRCPA, even though the statutory exemption was immediately effective only for BHCs below the $100 billion asset threshold.[26]

B. Rather than expand the scope of the CCAR qualitative assessment and objection framework, the Federal Reserve should eliminate the CCAR qualitative assessment and objection framework for all firms, including Category I, II and III firms currently subject to it.

The Federal Reserve tailoring proposal states that Category I, Category II and Category III firms would be subject to the CCAR qualitative assessment of a firm's capital plan and potential objection on qualitative grounds. Moreover, despite recent statements by the Federal Reserve Vice Chairman for Supervision noting that it would be appropriate to eliminate the CCAR qualitative assessment,[27] the Federal Reserve staff memorandum regarding the tailoring proposals indicates that the scope of the qualitative assessment and objection framework would actually be *expanded* to include, notably, a firm that was treated as "large and noncomplex" and, therefore, not subject to the qualitative assessment for CCAR 2018.[28]

The Federal Reserve should certainly not expand the scope of the CCAR qualitative assessment and objection framework and instead should eliminate the CCAR qualitative assessment and objection framework for all

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24 *See* 12 C.F.R. §252.54(b)(1); 12 C.F.R. §46.5(b); 12 C.F.R. §325.4(b).

25 *See* 12 C.F.R. §252.3(b); 12 C.F.R. §46.4(a)(1); 12 C.F.R. §325.1(c)(1).

26 *See* 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.

27 *See* Vice Chairman for Supervision Randal K. Quarles, *A New Chapter in Stress Testing*, Brookings Institution, Washington, D.C. (Nov. 9, 2018) ("In my view, the time has come to normalize the CCAR qualitative assessment by removing the public objection tool, and continuing to evaluate firms' stress testing practices through normal supervision.").

28 *See* Federal Reserve tailoring proposal, at 83 Fed. Reg. 61418 n. 76 (explaining that "[f]or firms subject to Category II standards that have less than $250 billion in average total consolidated assets and less than $75 billion in average total nonbank assets, the proposal would *increase* the stringency of the capital planning standards by including these firms in the CCAR qualitative assessment.") (emphasis added); Staff Memorandum to the Board of Governors of the Federal Reserve System, *Notices of Proposed Rulemaking to Tailor Prudential Standards* (Oct. 24, 2018), at 16; Federal Reserve, *Comprehensive Capital Analysis and Review 2018: Assessment Framework and Results* (June 2018), at 1 n. 6 (identifying the large and noncomplex firms which were not subject to the CCAR qualitative assessment).

firms beginning with CCAR 2019.[29] As we have previously noted,[30] eliminating the qualitative assessment and objection framework for all CCAR firms would impact only the mechanism by which supervisory expectations for capital planning are enforced, and not the supervisory expectations themselves. There is nothing about the examination process or the Federal Reserve's supervisory authority more generally that would limit its ability to qualitatively assess CCAR firms' capital planning processes through the ordinary examination and supervisory process. Although we can understand why special focus on not only capital but capital planning might have been viewed as necessary immediately following the 2008 financial crisis, there is no reason that this public approach should be continued indefinitely. The Federal Reserve typically evaluates banking organizations, including in areas of importance commensurate with capital planning, through normal supervisory and examination processes without subjecting them to public, binary determinations similar to the CCAR qualitative assessment and objection framework. There is no reason to have the opacity of the CCAR qualitative assessment and the publicity of the objection framework applicable to only one supervisory judgment, particularly such a highly subjective one. Any benefits of the CCAR qualitative assessment and objection framework do not outweigh the related challenges, costs, subjectivity, inconsistency and unnecessary pressure on firm employees, as well as the potential reputational damage. Normal supervisory and examination processes are sufficient to evaluate the capital planning processes of all firms subject to CCAR, including Category I, Category II and Category III firms. The elimination of the qualitative assessment and objection framework would the reduce challenges, costs and inconsistency of the highly subjective and binary determination without any reduction in regulatory effectiveness.

In addition, transitioning qualitative CCAR reviews to the ordinary examination and supervisory process would be consistent with the Federal Reserve's new LFI rating system for large BHCs. Under the new LFI rating system, all firms with more than $100 billion in assets will be subject to regular supervisory qualitative review as part of the capital planning and positions component, making the separate CCAR qualitative assessment unnecessary.

The Federal Reserve's proposal for the elimination of the qualitative assessment and objection framework for large and noncomplex firms indicated that the rationale for nonetheless retaining the qualitative assessment and objection framework for LISCC and large and complex firms is its view that those firms "engage in more diverse activities and have a larger overall size and geographical scope than large and noncomplex firms."[31] It is unclear, however, why such greater diversity or scope would require a formal, annual qualitative assessment and objection framework *in addition* to those supervisory processes to appropriately oversee capital planning. The Federal Reserve has not provided analysis or evidence that suggests either.

Accordingly, in connection with the anticipated proposal on CCAR and the capital plan rule described by the Federal Reserve in its tailoring proposal, the Federal Reserve should eliminate the CCAR qualitative assessment and objection framework entirely. If it is not feasible to finalize that proposal in time formally to eliminate the CCAR qualitative assessment and objection framework for CCAR 2019, the Federal Reserve should take other action effectively to eliminate that framework for CCAR 2019. The capital plan rule provides that the Federal Reserve "*may*" object to a firm's capital plan on qualitative grounds—the objection is discretionary and not mandatory.[32] The Federal Reserve could therefore effectively eliminate the qualitative assessment and objection framework for CCAR 2019 by

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29 This includes all U.S. BHCs and U.S. IHCs that are not "large and noncomplex" under the Federal Reserve's capital plan rule.

30 *See* The Clearing House Association, *Letter Re: Large Financial Institution Rating System* (Docket No. R-1569; RIN 7100-AE82) (Feb. 15, 2018).

31 Federal Reserve, *Amendments to Capital Plan and Stress Test Rules*, 81 Fed. Reg. 67239, 67245 (Sept. 30, 2016).

32 *See* 12 C.F.R. §225.8(f)(2)(ii)(B)

providing in its annual instructions that it would not object to any firm's capital plan on qualitative grounds and would instead address any concerns through the normal supervisory process.

C. The Federal Reserve should provide immediate relief from the mid-cycle company-run stress test requirement for all firms currently subject to it, including U.S. IHCs.

The Federal Reserve tailoring proposal notes the limited value of the mid-cycle company-run stress test requirement and proposes to eliminate it for the 2020 stress test cycle.[33] The approach of not eliminating mid-cycle company-run stress tests until 2020 appears to reflect that the statutory change to the mid-cycle DFAST requirement will not take effect until November 2019. Given, however, the acknowledged limited value of the requirement, we recommend that the Federal Reserve extend the deadline for the 2019 mid-cycle company-run stress tests pursuant to Section 252.3(b) of Regulation YY until November 25, 2019 and then eliminate the requirement as of November 24, 2019, the 18-month anniversary of the enactment of EGRRCPA and the effective date of the statutory change.

As explained above, an extension of the deadline until November 25, 2019, together with the elimination of the mid-cycle DFAST requirement in Regulation YY effective November 24, 2019, would be consistent with the policy objectives of EGRRCPA and appropriately provide relief for the 2019 stress testing cycle. Such an extension would also be consistent with recent action by the agencies to exempt all banking organizations with less than $100 billion in assets from the company-run stress tests as of the enactment of EGRRCPA, even though the statutory exemption was immediately effective only for BHCs below the $100 billion asset threshold.[34]

Notwithstanding the proposal to eliminate the requirement that large U.S. BHCs conduct mid-cycle company-run stress tests, the proposed revisions to 12 C.F.R. § 252.55 would continue to apply the mid-cycle stress test requirement to U.S. IHCs. The rationale for eliminating this requirement for U.S. BHCs applies with equal force to U.S. IHCs, and there is no reason to continue to subject U.S. IHCs to the mid-cycle stress test when all other entities would have been granted relief from a requirement with "modest risk management benefits and limited incremental information to market participants beyond what the annual company-run stress test provides."[35] Moreover, continuation of the requirement for U.S. IHCs would create inexplicable regulatory disparity. The Federal Reserve should therefore eliminate the requirement that U.S. IHCs conduct mid-cycle stress tests in connection with the current proposal rather than wait for an FBO-specific proposal to do so.

D. The Federal Reserve should confirm that the internal capital stress test required of Category III firms during the "off" year would be fully aligned with existing CCAR and DFAST stress testing requirements, but with only the capital action assumptions applicable in CCAR and without the public disclosure required under DFAST.

For Category III firms, the Federal Reserve notes that it would maintain the annual internal capital stress test requirement under the capital plan rule in Regulation Y, but would reduce the required frequency of company-run stress tests for purposes of DFAST to every other year. The Federal Reserve should explain what the off-cycle internal capital stress test—*i.e.*, the internal capital stress test required to be performed under the capital plan rule during a year in which a company-run stress test under DFAST is not required—applicable to Category III firms would be expected to entail. For example, it is not clear in the Federal Reserve tailoring proposal whether (and, if so, the extent to which) the internal capital stress tests for purposes of CCAR would differ from company-run DFAST in

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33 *See* Federal Reserve tailoring proposal, at 83 Fed. Reg. 61417.

34 *See* 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.

35 Federal Reserve tailoring proposal, at 83 Fed. Reg. 61417.

the "off" years, other than the fact that internal stress tests for purposes of CCAR would use only the capital action assumptions required in CCAR and that those stress tests do not entail public disclosure but company-run DFAST does. In order to minimize the imposition of any additional requirements or processes, the Federal Reserve should clarify and confirm that the internal stress tests during the "off" years should be conducted consistent with the internal stress tests required to be conducted under the capital plan rule.

E. The Federal Reserve should address potential issues with the implementation of biennial supervisory stress testing for Category IV firms.

The Federal Reserve tailoring proposal would reduce the frequency of supervisory stress tests for Category IV firms to every other year.[36] In addition, the Federal Reserve explains that its future capital plan proposal would provide that the stress buffer requirements would be updated annually to reflect a Category IV firm's planned capital distributions, but only biennially to reflect supervisory stress loss projections.[37] We support the proposed two-year cycle for supervisory stress tests, but we are concerned that the two-year cycle could have unintended and adverse consequences, such as the imposition of stress buffer requirements that do not appropriately reflect a firm's activities and/or risk profile or the prevailing macroeconomic conditions. This concern is particularly relevant where a Category IV firm has undergone changes in its activities and/or risk profile or macroeconomic conditions have changed significantly since the last supervisory stress tests and related determination of stress buffer requirements. Accordingly, we recommend that the Federal Reserve consider and address these potential adverse consequences, including by providing additional flexibility for Category IV firms to have their stress buffer requirements refreshed during the biennial period.

F. The forward-looking analysis previewed for Category IV firms should not be applied in a manner that would continue to require these firms to run hypothetical stress scenarios.

The Federal Reserve tailoring proposal indicates that, as part of a separate rulemaking on the capital plan rule and CCAR, the Federal Reserve may propose to allow Category IV firms to include in their annual capital plan submissions estimates of revenues, losses, reserves and capital levels based on a forward-looking analysis, taking into account the firm's idiosyncratic risks under a range of conditions, but would not require those firms to submit the results of company-run stress tests on the FR Y-14A.[38] Category IV firms would also be subject to supervisory stress testing on a biennial basis.

The Federal Reserve should confirm in the capital plan proposal that the requirement that submissions take into account "the firm's idiosyncratic risks under a range of conditions" is intended to be distinct from the current requirement in the capital plan rule that capital plans must include projections "under expected conditions and a range of scenarios"[39] and would not be applied to require Category IV firms to include the results of company-run stress tests in their capital plan submissions. Specifically, the Federal Reserve should clearly state in the capital plan proposal that Category IV firms would not be required to conduct any company-run stress tests as part of the forward-looking analysis in addition to stating that the results of such stress tests are not required to be reported on

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[36] Vice Chairman Quarles indicated that he expected that, in connection with moving to a two-year cycle for supervisory stress testing for Category IV firms, the Federal Reserve would make 2019 an "off-cycle" year. Vice Chairman for Supervision Randal K. Quarles, *Statement on Proposals to Modify Enhanced Prudential Standards for Large Banking Organizations* (Oct. 31, 2018) *available at* https://www.federalreserve.gov/newsevents/pressreleases/quarles-opening-statement-20181031.htm. We support this statement and recommend that the Federal Reserve confirm the approach in the preamble to the final rules.

[37] Federal Reserve tailoring proposal, at 83 Fed. Reg. 61421.

[38] Federal Reserve tailoring proposal, at 83 Fed. Reg. 61421.

[39] 12 C.F.R. § 225.8(e)(2)(i)(A).

the FR Y-14A. This would be consistent with the policy objectives of EGRRCPA and the elimination of company-run DFAST requirements for Category IV firms.

G. The capital plan proposal to be issued by the Federal Reserve should codify key aspects of the guidance that has been provided through the CCAR and DFAST Questions and Answers.

The staff of the Federal Reserve receives questions from and provides answers to firms subject to CCAR and DFAST on an ongoing basis. Those questions and answers are provided directly to the firms subject to CCAR and DFAST and published on the Federal Reserve's website "to facilitate transparency and consistency of interpretation and application of related rules and guidance."[40] In order to further those objectives and make the Federal Reserve's capital planning and stress testing framework more transparent and consistent in application, the Federal Reserve should codify key aspects of this guidance in the capital plan rule in connection with the previewed proposal on the capital plan rule and CCAR. In particular, the Federal Reserve should codify its June 2018 guidance confirming that it is acceptable for a firm to use the Federal Reserve's severely adverse scenario from any prior year's stress test cycle as a benchmark to assess the severity of the BHC stress scenario.[41]

IV. The agencies should revise the proposed liquidity framework, in particular by using the existing modified LCR and proposed modified NSFR to develop the less stringent requirements for Category III firms and further tailoring liquidity requirements for Category II and IV firms.

A. The agencies should use the modified LCR and proposed modified NSFR to develop the less stringent LCR and NSFR (if retained)[42] requirements for qualifying Category III firms rather than subjecting those firms to a new "reduced" LCR or NSFR requirement.

When the Federal Reserve adopted its LCR rule and proposed the NSFR rule, it included a modified, less stringent version to apply to certain BHCs that would not otherwise be subject to the "full" LCR or NSFR requirements. Rather than introduce a new type of LCR or NSFR requirement as contemplated by the interagency tailoring proposal, the agencies should use the existing modified LCR and proposed modified NSFR to develop the less stringent LCR and NSFR requirements for qualifying Category III firms (*i.e.*, those Category III firms that are not subject to the "full" LCR or NSFR requirements on account of not having $75 billion or more in weighted average short-term wholesale funding). Specifically, the modified LCR and NSFR—the standards the Federal Reserve previously developed to apply less stringent LCR and NSFR requirements to firms with risk profiles and characteristics that did not warrant the application of the full LCR or NSFR—is the appropriate starting point for developing the LCR and, if finalized, NSFR requirements that would apply to qualifying Category III firms. Below we provide recommendations for how the agencies should revise the modified LCR and NSFR to apply to qualifying Category III firms.

- The outflow and required stable funding ("RSF") requirements for Category III firms should be set at 70% of the "full" LCR requirements and NSFR requirements (if finalized), respectively, consistent with the scaling factors applied (or proposed to be applied) under the "modified" LCR and NSFR. The

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40 *See* Federal Reserve, Comprehensive Capital and Analysis Review and Dodd-Frank Act Stress Tests: Questions and Answers (last updated Oct. 25, 2018), *available at* https://www.federalreserve.gov/publications/comprehensive-capital-analysis-and-review-questions-and-anwers.htm#xsubsection-1610-3821efa2.

41 *See id.*, Response to Question GEN0195.

42 We have previously questioned the basis for and utility of the NSFR. *See* Bill Nelson, *Six questions about the Net Stable Funding Ratio (NSFR) requirement* (Sept. 21, 2018), *available at* https://bpi.com/six-questions-about-the-net-stable-funding-ratio-nsfr-requirement/.

Federal Reserve previously determined that a 70% scaling factor was appropriate for banking organizations that "are smaller in size, less complex in structure, and less reliant on riskier forms of market funding" than banking organizations subject to the "full" LCR.[43] These criteria apply equally well to Category III firms relative to those firms that would remain subject to the "full" LCR under the interagency tailoring proposal. Moreover, a 70% scaling factor provides a reasonable and gradual differentiation for Category III firms versus other firms.

- Applying the "reduced" LCR to Category III firms as contemplated by the interagency tailoring proposal would make the maturity mismatch add-on applicable to Category III firms. However, as we explain in Section VII.E below, the activities of U.S. firms—including Category III firms—subject to the LCR, the nature of their funding sources and the characteristics of the markets and financial systems within which they operate do not justify the imposition of the maturity mismatch add-on, which represents a significant departure from the Basel Committee standards. Category III firms generally have bank-centric business models and organizational structures, which mitigates liquidity risk. Accordingly, the agencies should apply the "modified" LCR, which does not include the maturity mismatch add-on, to Category III firms, consistent with our recommendation above.[44]

- Qualifying Category III firms should be required to monitor their LCR on each business day. However, consistent with the current modified LCR, qualifying Category III firms should be required to maintain an LCR greater than or equal to 1.0 only on the last business day of the applicable calendar month; the requirement should not apply on each business day. Similarly, and again consistent with the current modified LCR, qualifying Category III firms should be required to consult with their federal supervisor to determine whether they must provide a written remediation plan only if their LCR is below the required minimum on the last day of the month or if the appropriate federal supervisor has determined that the firm is materially noncompliant with the applicable LCR requirement—that is, the supervisory and remediation framework in Section 40 of the LCR rule should apply as it currently does to BHCs subject to the modified LCR.

- Qualifying Category III firms should be permitted to submit their monthly FR 2052a reports on a T+10 basis, the current requirement for firms subject to the modified LCR, instead of T+2 basis, as is currently required for firms subject to the full LCR. The current T+2 deadline creates a substantial strain on these firms' resources on a monthly basis. In light of their liquidity profiles, the supervisory benefits of T+2 reporting does not justify the burdens of producing and submitting the information on that timeline. T+10 reporting would continue to provide the Federal Reserve with appropriately timely information, without adversely affecting supervisory oversight of firms' liquidity risk, while significantly reducing the reporting burdens on firms.

- Public LCR disclosures by qualifying Category III firms should be based on average month-end values, consistent with existing regulatory reporting requirements. Currently, these firms report quantitative information about their LCR calculations to the Federal Reserve on a monthly basis in their FR 2052a submissions, and the current LCR rule does not require more frequent reporting absent an LCR shortfall. In meeting public disclosure obligations, qualifying Category III firms should be permitted to

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[43] Federal Reserve, FDIC and OCC, *Liquidity Coverage Ratio: Liquidity Risk Measurement Standards*, 79 Fed. Reg. 61439, 61520 (Oct. 10, 2014); Federal Reserve, FDIC and OCC, *Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements*, 81 Fed. Reg. 315124, 35157-58 (Jun. 1, 2016).

[44] As discussed further in Section VII.E below, the maturity mismatch add-on is a significant difference from the Basel Committee standard and should be eliminated for all U.S. firms subject to the LCR.

present data calculated in the same manner and with the same frequency as the data that is reported to the Federal Reserve on FR 2052a.

The interagency tailoring proposal notes that, consistent with Section 22(b) of the LCR rule, a Category III firm subject to the proposed reduced LCR requirement would not be permitted to include in its HQLA amount the eligible HQLA of a consolidated subsidiary except up to the amount of net cash outflows of the subsidiary (as adjusted for the factor reducing the stringency of the requirement, such as the proposed factor of between 70% or 85%)[45] plus any amount of assets that would be available for transfer to the top-tier holding company during times of stress without statutory, regulatory, contractual, or other supervisory restrictions. The agencies note that a similar restriction would apply under the proposed NSFR rule. The agencies request comment on whether they should "consider the approach the [Federal Reserve] currently permits for holding companies subject to a modified LCR [whereby] . . . a company may include in its HQLA amount eligible HQLA held at a subsidiary up to 100 percent of the net cash outflows of the subsidiary," without adjusting those net cash outflows for the factor reducing the stringency of the requirement at the holding company level.[46]

Section 22(b) of the LCR rule prevents excess liquidity at a consolidated subsidiary from counting toward the parent company's HQLA where the liquidity may not be able to be used to satisfy liquidity needs elsewhere at the consolidated enterprise. Allowing eligible HQLA held at a consolidated subsidiary up to 100 percent of the subsidiary's net cash outflows (plus any amount of assets that would be available for transfer to the top-tier holding company during times of stress without statutory, regulatory, contractual or other supervisory restrictions) is consistent with that objective. That methodology would appropriately reflect that eligible HQLA held by a consolidated subsidiary are available to satisfy the liquidity needs of that consolidated subsidiary. This treatment would be appropriate and should be applied for either the proposed reduced LCR or the revised version of the modified LCR recommended above. Accordingly, we urge the agencies to allow qualifying Category III firms to include in their HQLA amount eligible HQLA at any consolidated subsidiary up to 100 percent of the net cash outflows of the consolidated subsidiary (plus any amount of assets that would be available for transfer to the top-tier holding company during times of stress without statutory, regulatory, contractual, or other supervisory restrictions).[47]

B. The Federal Reserve should not expand the universe of firms subject to daily FR 2052a reporting requirements.

The Federal Reserve tailoring proposal would revise the FR 2052a reporting requirements to require all firms subject to Category II standards to report the FR 2052a on a daily basis. As noted in the Federal Reserve tailoring proposal, for firms subject to Category II standards that have less than $700 billion in total consolidated assets and less than $10 trillion in assets under custody, the proposal would increase the frequency of FR 2052a reporting from monthly to daily. The Federal Reserve states that reporting of daily liquidity data would facilitate greater supervisory monitoring based on these firms' liquidity risk profiles, as indicated by their size and cross-

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[45] For example, if the proposed reduced LCR requirement were calibrated at 70% and a firm's consolidated subsidiary had HQLA of 150 and net cash outflows of 100, the interagency tailoring proposal would allow the firm to include in its HQLA amount 70 (instead of 100), plus amounts that are available for transfer.

[46] *See* Interagency tailoring proposal, at 83 Fed. Reg. 66037.

[47] The same principles apply for purposes of the proposed reduced NSFR, and the agencies should permit qualifying Category III firms to include the available stable funding ("ASF") of consolidated subsidiaries up to (i) the RSF amount of the consolidated subsidiary plus (ii) any amounts in excess of that to the extent the consolidated subsidiary may transfer assets to the banking entity subject to the NSFR requirement, taking into account statutory, regulatory, contractual or supervisory restrictions. For purposes of any reduced NSFR requirement applicable to Category III firms, the RSF amount for a consolidated subsidiary should not be adjusted for the factor reducing the stringency of the NSFR requirement—that is, up to 100 percent of a consolidated subsidiary's RSF amount should be eligible for inclusion in a Category III firm's ASF, along with amounts that are freely transferrable.

jurisdictional activity. However, the relative benefit of significantly increasing the frequency of this reporting requirement is, for the proposed population of Category II firms, comparatively low and does not justify the increased burden on such firms' systems and resources.

Indeed, the only firm that would currently be subject to Category II standards has total consolidated assets substantially below the $700 billion threshold and cross-jurisdictional activity that primarily relates to custody activities and custodial deposits, which do not present liquidity risk warranting daily FR 2052a reporting.[48] Custody banks provide institutional clients with deposit and cash management services as a matter of course, and these services grow with organic growth in the custody business. For this reason, the balance sheet of a custody bank is liability-driven. During macroeconomic stress, custody banks typically see an inflow of client deposits and the balance sheet, capital and liquidity are managed to service clients optimally through economic cycles. By its very nature, the asset side of a typical custody bank balance sheet is required to be liquid to provide its clients the safety and security that they desire from a custody bank, weighting its asset base towards central bank deposits and high quality liquid securities. This highly liquid asset base and the ability to efficiently size assets in response to movements in liabilities distinguishes custody banks from traditional asset generating institutions.

C. For Category IV firms, the Federal Reserve should explicitly confirm that Category IV firms would not be subject to any LCR-based requirements or supervisory expectations as a result of any continuing FR 2052a reporting obligations and should take steps to appropriately reduce reporting burdens for those firms.

Under the Federal Reserve tailoring proposal, Category IV firms would no longer be subject to the LCR but would remain subject to FR 2052a reporting requirements.[49] The FR 2052a report collects quantitative information on selected assets, liabilities, funding activities, and contingent liabilities and uses the information to monitor an organization's overall liquidity profile. Notably, Appendix VI to FR 2052a is intended to assist firms subject to the LCR in mapping the provisions of the LCR rule to the unique data identifiers reported on FR 2052a. In light of the close relationship between the FR 2052a and the LCR rule, the Federal Reserve should explicitly confirm that Category IV firms would not be subject to any LCR-based requirements or supervisory expectations as a result of any continuing FR 2052a reporting obligations and should take steps, described further below, to appropriately reduce reporting burdens for those firms so that liquidity reporting obligations are commensurate with their liquidity risk profiles.

In particular, the Federal Reserve should confirm that the monthly FR 2052a reporting requirements and the liquidity stress testing, risk management and buffer requirements under Regulation YY will not effectively bind Category IV firms to the quantitative limits of the LCR rule. This confirmation is particularly important with respect to the HQLA eligibility requirements and subsidiary-level net outflows. FR 2052a reporting requirements should not result in additional limits on the types of assets that qualify as "highly liquid assets" for purposes of the Regulation YY liquidity buffer, nor should they result in the LCR's prescriptive treatment of subsidiary-level outflows applying for purposes of Regulation YY liquidity stress tests. In addition, if the Federal Reserve continues to require Category IV firms to report information on FR 2052a, it should explain its expected use of FR 2052a data collected from Category IV firms given that these firms will no longer be subject to the LCR.

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[48] As discussed in Section II above, neither the $700 billion asset threshold nor the current dollar-based threshold for the cross-jurisdictional activity risk-based indicator reflect a risk profile that would subject the appropriate subsection of firms to the stringent standards of Category II.

[49] Although the tailoring proposals explicitly eliminate the LCR requirement for Category IV firms, the Federal Reserve's LCR disclosure requirements, codified in Subpart J of Regulation WW, would require Category IV firms to make their first public disclosures regarding their LCR on or before March 1, 2019. As discussed further in Section VII.E, the Federal Reserve should correct this discrepancy as soon as possible.

Continuing to subject Category IV firms to monthly FR 2052a reporting requirements would impose undue burdens: Category IV firms would be required to report granular quantitative liquidity-related information on a form that is closely related to a regulatory requirement that, under the Federal Reserve tailoring proposal, would no longer apply to Category IV firms in light of their low liquidity risk profiles. Accordingly, we recommend that the Federal Reserve eliminate the FR 2052a reporting obligation for Category IV firms to reflect the elimination of LCR requirements for those firms. Alternatively, if some form of liquidity reporting is nevertheless required for Category IV firms, the Federal Reserve should reinstate the FR 2052b for Category IV firms. Finally, *any* liquidity reporting obligation applicable to Category IV firms—whether such reporting is effected through the FR 2052a or the FRB 2052b—should be on a quarterly, rather than monthly, basis, consistent with the reduction in frequency of Regulation YY liquidity stress tests contemplated by the tailoring proposals.

V. Without delaying the implementation of the general framework contemplated by the tailoring proposals, the agencies should provide more information on how they intend to implement EGRRCPA and the broader tailoring of the regulatory requirements that are previewed in the tailoring proposals, but not described with any specificity or detail, and should explain how the various proposals will relate to one another.

We support the agencies' objective of tailoring the post-crisis regulatory framework, as contemplated by EGRRCPA, and implementing such tailoring promptly, taking into account the important refinements we recommend in this letter. However, it is difficult to comment fully on the tailoring proposals and the framework that will be used to apply prudential requirements to different firms because the proposals only briefly refer to future related proposals that are anticipated, without clearly or completely describing the agencies' overall plan for implementing EGRRCPA. For example, the Federal Reserve briefly describes matters it expects to address in a future capital plan proposal, but there is not sufficient information on the potential revisions to the capital plan rule and CCAR to fully comment on the implications of the categories presented in the Federal Reserve tailoring proposal.[50] Further, although the tailoring proposals represent a substantial improvement over the current regulatory regime, as discussed in Section VII.E below, the tailoring proposals do not resolve significant problems with the underlying rules that are proposed to be tailored, such as the LCR rule and the GSIB surcharge framework. In addition, as discussed further in Section VI below, the tailoring proposals delay entirely any consideration of reform for FBOs and their U.S. IHCs.

We are not recommending that the agencies wait to provide a single comprehensive proposal that addresses all aspects of the implementation of EGRRCPA. We appreciate that implementing EGRRCPA and achieving a more tailored regulatory framework through multiple rulemakings allows the agencies to implement certain aspects of EGRRCPA more quickly and achieve the tailoring and regulatory relief contemplated by the statute sooner, which we support. Rather, we urge the agencies to provide more information on how they intend to implement EGRRCPA and the broader tailoring of the regulatory requirements that are alluded to in the tailoring proposals, but not described with any specificity or detail, and to explain how the various proposals will relate to each other. In addition, as discussed further in Section VI below, we urge the Federal Reserve to issue a tailoring proposal applicable to FBOs and their U.S. IHCs as soon as possible so that it can be implemented for FBOs and their U.S. IHCs on the same timeframe as the proposed tailoring for U.S. organizations.

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[50] *See, e.g.*, *id.*, at 61421 n. 93 ("The Board plans to separately propose reductions to FR Y-14 reporting requirements for firms subject to Category IV standards as part of the capital plan proposal at a later date, to align with changes the Board would propose to the capital plan rule."); *id.* at 61421 ("The Board also intends at a future date to revise its guidance relating to capital planning to align with the proposed categories of standards and to allow more flexibility in how firms subject to Category IV standards perform capital planning.").

VI. The Federal Reserve should issue and implement a tailoring proposal applicable to FBOs and their U.S. IHCs as soon as possible.

The tailoring proposals represent an important step toward a regulatory framework that more appropriately aligns prudential regulatory standards and burdens with the diverse activities, business models, and risk profiles of covered firms. Accordingly, it is imperative that the Federal Reserve issue a tailoring proposal applicable to FBOs and their U.S. IHCs as soon as possible so that it can be implemented for FBOs and their U.S. IHCs on the same timeframe as the proposed tailoring for U.S. organizations without delaying the implementation of the tailoring contemplated by the tailoring proposals.[51] Below, we offer recommendations in anticipation of an FBO-specific proposal being issued in the near future.

A. To the extent the tailoring proposal applicable to FBOs will parallel the structure of the tailoring proposals, the FBO-specific proposal should limit the Federal Reserve's consideration of size and other risk-based indicators to the characteristics of the FBO's U.S. IHC on a standalone basis.

It is critical that any FBO-specific tailoring proposal limit the Federal Reserve's consideration of size and other indicative factors to the characteristics of the FBO's U.S. IHC on a standalone basis. The characteristics of an FBO's U.S. branches and agencies, much less its worldwide operations, should not affect the prudential requirements that apply to its U.S. IHC. This would be consistent with footnote 27 to the Federal Reserve tailoring proposal, which notes the Dodd-Frank Act requirement that FBOs be treated no less favorably than similarly situated U.S. organizations and that FBOs should generally be subject to the same restrictions and obligations in the U.S. as those that apply to the U.S. operations of domestic organizations, as well as the basic principles underlying the imposition of the U.S. IHC requirement itself. The FBO-specific tailoring proposal will also offer a much-needed opportunity to address the conflation of requirements—in particular, requirements relating to liquidity and, in some cases, capital—applicable to U.S. IHCs as opposed to U.S. branches and agencies of FBOs that has occurred in the years since the Federal Reserve's EPS were implemented.

The requirements that apply to the U.S. IHC and the U.S. branches and agencies should be based on their respective characteristics, not the characteristics of the combined U.S. operations. In particular, capital, liquidity and stress testing requirements that apply directly to the U.S. IHC (for example, CCAR, capital requirements, the LCR (if applicable), and DFAST) should be based on the characteristics of the U.S. IHC alone. Similarly, liquidity stress testing and buffer requirements should apply separately to an FBO's U.S. IHC, on the one hand, and its branches and agencies, on the other. Although the U.S. IHC and the U.S. branches and agencies are part of one global organization, the U.S. IHC is a separate legal entity from the U.S. branches and agencies of an FBO, with different obligations, prudential standards, and, depending on the FBO, clients / customers and lines of business. In particular, a U.S. IHC is currently subject to supervisory stress testing in the United States and subject to consolidated capital requirements, whereas U.S. branches and agencies of the U.S. IHC's FBO are not. This is appropriate: capital requirements cannot sensibly be applied to an FBO's U.S. branches and agencies—either on a standalone basis or together with the U.S. IHC—because the branches and agencies are offices of the FBO and not separate legal entities with their own equity capital. For these reasons, and in recognition of home country supervisory regimes applicable to FBOs, the Federal Reserve has long permitted U.S. branches and agencies of FBOs to operate in the United States on the basis of their home country capital requirements.

It would, however, be appropriate for the FBO-specific tailoring proposal to apply qualitative risk management requirements to the combined U.S. operations on that basis, and, importantly, for the tailoring to

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[51] However, this synchronization should not delay finalization of the tailoring proposals.

recognize basic difference in risk-management structures.[52] For example, consistent with the required risk management framework set forth in Regulation YY, some FBOs have U.S. structures and operations that are more suited to having a risk committee of the global board of directors, while others have structures and operations that are more suited to having a risk committee of the U.S. IHC.

B. Transactions between the FBO's U.S. IHC and the FBO's non-U.S. operations should not count toward any proposed cross-jurisdictional activity or any other risk-based indicator.

It is critical that the FBO proposal, when issued, clarify that transactions between the FBO's U.S. IHC, on the one hand, and the FBO's non-U.S. operations, on the other hand, would not count toward the cross-jurisdictional activity or any other risk-based indicator proposed for FBOs. Top-tier BHCs are required to eliminate transactions between the BHC and its consolidated subsidiaries when reporting on the FR Y-15 and other relevant Federal Reserve reporting forms, with the result being that intercompany transactions within the firm's consolidated operations, taken as a whole, are not counted towards the dollar-based thresholds in the reporting forms that inform the risk-based indicators set forth in the tailoring proposals.[53] U.S. IHCs, in contrast, form one part of the top-tier FBO's consolidated operations, and as the reporting entity the U.S. IHC would not be entitled to eliminate transactions between the U.S. IHC, on the one hand, and other subsidiaries of the FBO that are not consolidated with the U.S. IHC, on the other hand. Interaffiliate transactions are therefore treated very differently for U.S. IHCs compared to top-tier U.S. BHCs. Accordingly, in order to subject U.S. IHCs to capital and liquidity requirements that mirror those applicable to top-tier U.S. BHCs with similar risk profiles, the FBO proposal should explicitly carve out from any proposed cross-jurisdictional activity and any other risk-based indicator the transactions within the consolidated FBO and which include the U.S. IHC as a counterparty.[54]

VII. In addition to implementing the general framework contemplated by the tailoring proposals, the agencies should address related aspects of the broader regulatory framework that would remain in place after the tailoring proposals are implemented.

A. The AOCI filter should be available for all firms, not just firms subject to Category III and Category IV requirements.

We support the change set forth in the interagency tailoring proposal that would permit firms subject to Category III and Category IV to not recognize most elements of AOCI in regulatory capital (*i.e.*, they could exercise an opt-out election and continue to apply the AOCI filter). However, the interagency tailoring proposal would continue to require firms subject to Category I and Category II to recognize most elements of AOCI in regulatory

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[52] Importantly, and consistent with the immediately preceding paragraph, quantitative risk management requirements, such as liquidity stress testing and buffer requirements, should not apply to the FBO's U.S. operations on a combined basis but should instead apply to the U.S. IHC, on the one hand, and the U.S. branches and agencies, on the other.

[53] The instructions for the FR Y-15 provide, in relevant part, that all offices, including branches and subsidiaries, "that are within the scope of the consolidated holding company are to be reported on a consolidated basis. . . . As part of the consolidation process, the results of all transactions and all intercompany balances (e.g., outstanding asset/debt relationships) between offices, subsidiaries, and other entities included in the scope of the consolidated holding company are to be eliminated in the consolidation and must be excluded from the FR Y-15". Federal Reserve, Instructions for Preparation of Banking Organization Systemic Risk Report FR Y-15 (Dec. 2016), at GEN-1. The instructions for the FR Y-9C include analogous language. Federal Reserve, Instructions for Preparation of Consolidated Financial Statements for Holding Companies Reporting Form FR Y-9C (Sept. 2018), at GEN-4. The instructions for the FR Y-9LP provide, with respect to line item 17, that reporting holding companies should "[e]xclude balances due to subsidiaries and related institutions." Federal Reserve, Schedule PC to Instructions for Preparation of Parent Company Only Financial Statements for Large Holding Companies Reporting Form FR Y-9LP (March 2013), at PC-7.

[54] The same principle applies to all of the tailoring proposals' risk-based indicators, which are calculated on a consolidated basis for top-tier bank holding companies. *See* footnote 49, *supra*.

capital. We have previously expressed our serious concerns with the requirement that AOCI be included in regulatory capital, and we continue to have those concerns.

In particular, including AOCI in regulatory capital:

- forces the recognition in capital ratios of unrealized gains and losses that are temporary in nature and result principally from movements in interest rates as opposed to changes in credit risk[55] that are unlikely to be realized and that typically result in no effect on the banking organization (therefore raising or lowering regulatory capital regardless of any real change in risk);[56]

- forces firms to maintain ratios of both CET1 to risk-weighted assets and Tier 1 capital to risk-weighted assets substantially above the levels that would otherwise apply after buffers in order to avoid the potentially discontinuous and severe limitations on distributions applicable to banks that fall into the buffer range;[57]

- creates substantial volatility into CET1 and Tier 1 capital as measures of capital;

- discourages firms from engaging in investing activities that are routinely used as an important asset-liability management tool; and

- is inconsistent with liquidity requirements, such as the LCR, and more stringent supervisory expectations regarding resolution planning, which require firms to increase the size of their investment securities portfolios.

Accordingly, we urge that the final rules make the AOCI opt-out election available for all firms (including firms that would be subject to Category I and Category II standards).[58] Such a change would result in a more appropriate measurement of regulatory capital that does not have an adverse impact on firms' asset-liability management activities (indeed, it could have a positive impact) or create inconsistencies with other regulatory regimes that require firms to hold significant amounts of investment securities.

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55 Credit-related losses are recognized in earnings and, therefore, CET1 capital. Currently, U.S. GAAP requires firms to write down the value of their available-for-sale debt securities when they determine that such a security is other-than-temporarily impaired, with the amount of the write-down charged against earnings. Under ASU 2016-13, firms will be required to determine whether a decline in the fair value of an available-for-sale debt security below its amortized cost resulted from credit losses, and to charge any such credit-related decline against earnings. *See* Federal Reserve, FDIC and OCC, *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* (Dec. 21, 2018), at 16. Accordingly, allowing Category I and Category II firms to apply the AOCI filter would not permit them to avoid recognizing credit-related losses in capital.

56 *See*, *e.g.*, The Clearing House, *Letter Re: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996* (Dec. 20, 2017); The Clearing House, *Letter Re: Treatment of Unrealized Gains and Losses Under the Basel III Capital Framework* (Oct. 27, 2011); The Clearing House, *Letter Re: Reform of Capital and Liquidity Regulation as Applied to U.S. Banks* (Nov. 5, 2010); The Clearing House, *Letter Re: Proposals to Strengthen Capital Regulation* (April 16, 2010).

57 Because the definition of "eligible retained earnings" is defined as four quarter trailing net income, net of distributions and tax effects not reflected in net income, a firm that distributes its current income could have no eligible retained income and become subject to a complete prohibition on distributions upon falling into the buffer range by a single basis point.

58 Consistent with statements made elsewhere in this letter, our recommendation that the AOCI filter be made available to all firms should not delay the agencies' finalization of the framework contemplated by the tailoring proposals.

In addition, we note that there is a technical matter the agencies should address to implement the changes to the AOCI filter contemplated by the interagency tailoring proposal. Specifically, although the interagency tailoring proposal would allow Category III firms to elect to exclude most elements of AOCI from regulatory capital, the proposal did not include the necessary amendments to Section __.22(b)(2)(ii) of the agencies' regulatory capital rules that would actually allow these firms to make such an election. The agencies should, accordingly, amend Section __.22(b)(2)(ii) of their capital rules to provide that any firm that is permitted, for the first time, by the interagency tailoring proposal to exercise the AOCI opt-out must do so in its relevant quarterly regulatory report filed for the first reporting period after the effective date of the amendments made by the interagency tailoring proposal.

B. The Federal Reserve should amend SR 09-4 to make it expressly applicable to firms with less than $100 billion in assets that will no longer be subject to CCAR.

Currently, the Federal Reserve's SR 09-4 states that it is "superseded for U.S. bank holding companies or intermediate holding companies of foreign banking organizations with $50 billion or more in total consolidated assets" and presents itself as applicable to BHCs with less than $50 billion in assets. SR 09-4 provides those firms with direction on when to provide notice to supervisors and seek supervisory non-objection in connection with the declaration and payment of dividends, capital redemptions, and share repurchases. In connection with implementing the tailoring proposals, the Federal Reserve should simultaneously amend SR 09-4 to make it applicable to firms with less than $100 billion in assets that will no longer be subject to CCAR and should take the opportunity to confirm which portions of SR 09-4—including the addendum, the attachments and the FAQs—remain in force.[59] The Federal Reserve should also confirm that the bank holding companies with $50 to $100 billion in assets could seek approval for stock repurchases under Section 20(b)(1)(iii) of Regulation Q concurrently with seeking non-objection for those repurchases under SR 09-4.

C. The Federal Reserve should notify BHCs and U.S. IHCs of the applicability of additional scenario components for an upcoming CCAR/DFAST cycle by June 30 of the calendar year before the relevant stress test.

Under the Federal Reserve's DFAST rules, the Federal Reserve can subject any BHC or U.S. IHC to an additional component, such as the counterparty default scenario component, by providing notice to the firm by December 31 of the calendar year before the relevant stress test (*e.g.*, by December 31, 2018 for the 2019 CCAR/DFAST cycle). Becoming newly subject to an additional component such as the counterparty default scenario component could have a material effect on a firm's stressed losses and post-stress capital adequacy. This timeframe does not give firms adequate time to prepare for the upcoming stress testing cycle if they learn they will become subject to a new component only a few months before their capital plan submissions are due. The Federal Reserve should formally notify BHCs and U.S. IHCs that they will be subject to additional scenario components for the upcoming cycle by June 30 of the calendar year before the relevant stress test (and if additional scenario components will be applicable, such components should be identified).

D. The Federal Reserve should amend Regulation YY to permit the risk committee of the board of directors to review and approve all matters relating to liquidity risk, rather than require full board action for such matters.

The Federal Reserve tailoring proposal makes several changes to Regulation YY, including the liquidity risk management provisions of Regulation YY. In connection with these changes, the Federal Reserve should also modify the provisions of Regulation YY, which are described further below, that result in the unnecessary bifurcation

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[59] The addendum to SR 09-4 was stated to be temporary and was addressed to the original 19 Supervisory Capital Assessment Program bank holding companies, but it remains listed as an addendum to SR 09-4 on the Federal Reserve's website.

of liquidity risk management responsibilities between the board of directors of a covered BHC and the board's risk committee.

Currently, the Federal Reserve's Regulation YY requires reports to and approvals by the full board of directors for certain matters relating to liquidity risk management. For example, the full board is required to (i) approve the BHC's liquidity risk tolerance, (ii) receive and review at least semi-annually information to determine if the BHC is operating in accordance with its established liquidity risk tolerance and (iii) approve and periodically review the BHC's liquidity risk-management strategies, policies and procedures.[60] For other matters, it is sufficient for the necessary review or approval to be provided by the risk committee of the board. For example, the risk committee is required or permitted, as applicable, to (i) approve the BHC's contingency funding plan, (ii) receive quarterly reports on the BHC's liquidity risk profile and liquidity risk tolerance and (iii) receive reports on material liquidity risk management issues.[61]

None of those matters should require the attention of the full board of directors; delegation to the board's risk committee should be permitted for all of them. For certain of the above items requiring full board attention, such as the requirement that the board receive and review information to determine if the BHC is operating in accordance with its established liquidity risk tolerance, it would seem equally, if not more, appropriate for the risk committee to undertake such reviews in light of the fact that the risk committee already receives quarterly reports on the BHC's liquidity risk tolerance. Indeed, where BHCs have determined that matters such as approval of liquidity risk tolerances and liquidity risk-management strategies, policies and procedures should be within the purview of the risk committee, satisfying Regulation YY's requirements results in duplicative board processes and devotion of the time and attention of the full board of directors to matters that are otherwise subject to appropriate risk committee oversight. In addition, permitting delegation of liquidity risk management oversight to the board's risk committee would be wholly consistent with the Federal Reserve's stated objective of reducing unnecessary burdens on boards of directors of banking institutions.[62] We therefore recommend that the Federal Reserve amend Regulation YY to permit the risk committee of the board of directors to review and approve all matters relating to liquidity risk. Doing so would also better align liquidity and capital governance requirements, as the Federal Reserve's capital plan rule already permits the risk committee of a covered BHC's board of directors to review and approve the firm's capital plan and stress testing results.[63]

E. The agencies should reconsider and revisit of other aspects of the existing regulatory framework underlying the tailoring proposals.

The tailoring proposals would apply the most stringent standards to U.S. GSIBs, which would be subject to Category I standards, and apply less stringent LCR and NSFR requirements for certain other firms, which would be subject to Category III standards. The tailoring proposals thus pre-suppose (i) that the existing U.S. GSIB surcharge framework is appropriate to identify those firms that should be subject to the most stringent standards and, with

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60 *See* 12 C.F.R. 252.34(a).

61 *See* 12 C.F.R. 252.34(b), (c)(2), (d)(2)(iii).

62 *See* Federal Reserve, *Proposed Guidance on Supervisory Expectations for Boards of Directors*, 82 Fed. Reg. 37219 (Aug. 9, 2017). As noted in our comment letter to the Federal Reserve's proposal, we support the proposal's objective of eliminating unnecessary regulatory requirements for board approval, action or review so that the board can focus on oversight of the execution of the company's strategy and its other principal responsibilities. *See* The Clearing House, *Letter Re: Proposed Guidance on Supervisory Expectations for Boards of Directors (Docket No. OP-1570)* (Feb. 15, 2018).

63 *See* 12 C.F.R. § 225.8(e)(1)(iii).

respect to certain capital requirements, to determine how more stringent standards should apply to them and (ii) that the current LCR requirements and proposed NSFR requirements provide appropriate measures of liquidity risk.

We do not believe that those presuppositions are warranted. As we have consistently noted over many years, both methods utilized in the U.S. GSIB surcharge framework are flawed conceptually and in calibration.[64] The Federal Reserve should conduct a fundamental review of the design and calibration of the U.S. GSIB surcharge framework in light of changes in firms' resiliency and resolvability and address the critical flaws in the U.S. GSIB surcharge framework.

In addition, there are critical issues with the U.S. implementation of the LCR and the proposed implementation of the NSFR. The agencies should reconsider many features of the existing and proposed U.S. liquidity framework, in particular those which represent a deviation from the Basel Committee standards, such as (i) the maturity mismatch add-on, which should be eliminated for all firms subject to the LCR, (ii) the exclusion of deposit balances that result from the provision of custody and other operational services to a non-regulated fund from recognition as operational deposits under the LCR rule and (iii) the eligibility criteria for HQLA. These aspects of the U.S. LCR rule represent significant differences from the Basel Committee standards, with implications for the global competitiveness of the U.S. banking system and U.S. financial stability.[65] The activities of U.S. firms subject to the LCR, the nature of their funding sources and the characteristics of the markets and financial systems within which they operate do not justify the imposition of different or additional standards compared to those of the Basel Committee standards. We would welcome the opportunity to work with the agencies to address these and other critical issues in the U.S. LCR and proposed NSFR.[66]

In addition, we have previously expressed significant concerns regarding the Federal Reserve's LCR disclosure requirements, which are codified in Subpart J of Regulation WW.[67] Currently, there are Category IV firms

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64 *See* The Clearing House, SIFMA, Financial Services Roundtable, *Letter Re: Proposed Amendments to the Regulatory Capital, Capital Plan and Stress Test Rules* (June 25, 2018); Francisco Covas, The Clearing House Blog, *Why Aren't the Largest U.S. Banks Lending More? An Analysis of the Impact of a Reduction in Equity Payouts on the GSIB Surcharge* (Oct. 6, 2017); The Clearing House, *Letter Re: Consultative Document – Global Systemically Important Banks – Revised Assessment Framework* (June 27, 2017); Greg Baer, The Clearing House Blog, *Recent Reports that the Basel Committee Found U.S. Banks to Present More Systemic Risk Are Extremely Misleading* (Nov. 22, 2016); The Clearing House, *Letter Re: Incorporation of the GSIB Surcharge into CCAR* (June 2, 2016); The Clearing House, *Overview and Assessment of the Methodology Used to Calibrate the U.S. GSIB Capital Surcharge* (May 2016); The Clearing House, SIFMA, Financial Services Roundtable, *Letter Re: Risk-Based Capital Guidelines – Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies* (Apr. 2, 2015); The Clearing House, Institute of International Bankers, *Letter Re: Assessment Methodology and Application of Surcharges to Global Systemically Important Banks* (Aug. 26, 2011). *See also* U.S. Department of the Treasury, *A Financial System that Creates Economic Opportunities: Banks and Credit Unions*, at 54–56 (June 2017) (supporting recalibrating the GSIB surcharge, including its focus on short-term wholesale funding reliance, to no longer exceed the international standard).

65 The use of a custodian bank to separate a non-regulated fund's assets from its trading and financing activities has important financial stability benefits, notably a reduction of potential contagion risk.

66 In addition to the concerns raised with respect to the existing U.S. GSIB surcharge framework and the current LCR requirements and proposed NSFR requirements, we would welcome the opportunity to work with the agencies to address other critical issues with respect to the regulatory framework underlying the tailoring proposals. For example, we have previously expressed the need for further changes to the total loss-absorbing capacity requirements applicable to U.S. GSIBs and the U.S. IHCs of non-U.S. GSIBs. *See, e.g.*, The Clearing House, *Letter Re: Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies* (June 25, 2018). These and other aspects of the existing regulatory framework would benefit from reevaluation in light of the experience gained by regulators and the industry in the years since post-crisis requirements were designed and implemented.

67 *See* The Clearing House, *Letter Re: Liquidity Coverage Ratio: Public Disclosure Requirements* (June 2, 2017): The Clearing House, *Letter Re: Liquidity Coverage Ratio Disclosure Standards* (October 11, 2013); The Clearing House, *Letter Re: Notice of Proposed*

that will be required to make their first public disclosures regarding their LCR on or before March 1, 2019 and, as a result, these firms will be required to publish a metric to which they would no longer be subject under the tailoring proposals. Requiring these firms to publish LCR-related information in accordance with the public disclosure requirements is unnecessary in light of the tailoring proposals and, more importantly, potentially confusing to the public and detrimental to the firms: the LCR-related information would not be updated but would linger in the public domain, and the disclosures would provide information about compliance with a regulatory framework that is proposed not to continue to apply to the reporting firms. We therefore urge the Federal Reserve to correct this discrepancy as soon as possible.

Of course, we are not recommending that the agencies delay implementation of the tailoring proposals pending reconsideration and revision of the U.S. GSIB surcharge framework and U.S. implementation of the LCR and proposed implementation of the NSFR. Rather, we urge the agencies to consider on an expedited basis the longstanding issues with the U.S. GSIB framework and U.S. implementation of the LCR and proposed implementation of the NSFR as they continue their implementation of EGRRCPA and tailoring of the post-crisis bank regulatory framework.

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BPI appreciates the opportunity to comment on the proposals. If you have any questions, please contact the undersigned by phone at 202-589-1933 or by email at *greg.baer@bpi.com.*

Respectfully submitted,

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Board of Governors of the Federal Reserve System

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Rulemaking; Comment Request: Liquidity Coverage Ratio: Public Disclosure Requirements; Extension of Compliance Period for Certain Companies to Meet the Liquidity Coverage Ratio Requirements (February 2, 2016).

Annex A

A Quantitative Analysis of the Federal Reserve's Proposal to Tailor Prudential Standards 1.22.2019

BANK POLICY INSTITUTE

I. Executive Summary

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This research note provides an empirical analysis in response to the Federal Reserve's notice of proposed rulemaking to tailor enhanced prudential standards for large banks. The proposal would tailor regulatory capital and liquidity requirements to the risk profiles of U.S. banking organizations with over $100 billion in assets.[1] Specifically, it would create four different categories based on nominal thresholds for a series of proposed risk-based indicators: size, cross-jurisdictional activity, reliance on short-term wholesale funding, nonbank assets, and off-balance-sheet exposure. The main objective of this research note is to assess the empirical importance of the proposed risk-based indicators in explaining SRISK, which we utilize as a proxy for a market-based measure of losses, and the suitability of the corresponding nominal thresholds. This assessment is based on linear and nonlinear regression models that relate SRISK to the proposed risk-based indicators. Before we summarize our main results, we should note that there are important limitations to our analysis. Specifically, any individual measure's estimate of systemic risk, including the SRISK measure used in the analysis, is insufficient by itself and fundamentally flawed. First, SRISK does not capture the spillover effects on the real economy that may arise if a bank were to fail. Second, SRISK is based on a simple model used to estimate the expected equity loss conditional on a single shock to the equity market and also places undue reliance on bank size. Finally, for the avoidance of doubt, measures such as SRISK do not capture the effect of the regulations prescribed to mitigate systemic risk. Nevertheless, we use SRISK as a proxy for systemic risk here because it uses a consistent metric across banks and it is also readily available, making it straightforward to replicate the results of our analysis.

The results of our empirical analysis indicate that of the five risk-based indicators, only cross-jurisdictional activity and reliance on short-term wholesale funding have a strong positive correlation with a market-based measure of losses, i.e. SRISK.[2] That is, after controlling for these two risk-based indicators, bank size, nonbank assets and off-balance-sheet exposures are not important drivers of a bank's SRISK measure. In addition, we decompose cross-jurisdictional activity into its two main components: cross-jurisdictional claims and cross-jurisdictional liabilities. While our results indicate that cross-jurisdictional claims are positively correlated with SRISK (our proxy for systemic risk), we find that cross-jurisdictional liabilities are negatively correlated with SRISK across all specifications considered. The negative

[1] See Federal Reserve System, Notice of Proposed Rulemaking, Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies (31 October 2018).

[2] Note that the proposal provides no empirical analysis demonstrating that cross-jurisdictional activity, reliance on short-term wholesale funding, nonbank assets, and off-balance-sheet exposure are the risk-based indicators that should be used to tailor prudential standards.

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correlation between cross-jurisdictional liabilities and SRISK holds using both data from U.S. banks as well as data available for the international banks that are included in the BCBS GSIB assessment sample and have an SRISK measure. For this reason, our results indicate that the dollar-based threshold for cross-jurisdictional activity should be set at a significantly higher level than proposed, or at a minimum, if kept at the $75 billion level, cross-jurisdictional liabilities should be excluded.

There are several economic reasons to exclude cross-jurisdictional liabilities from the regulatory proxy of global footprint and complexity. First, it is desirable for banks to diversify their funding sources and banks have ample experience in hedging foreign exchange risk. Second, for foreign subsidiaries of U.S. firms, raising local funding is a sound asset-liability management and risk-management practice. Finally, cross-border borrowing can be less expensive than other forms of funding.[3]

With respect to the nominal thresholds, our nonlinear regression analysis sets the thresholds of cross-jurisdictional claims, nonbank assets, short-term wholesale funding and off-balance-sheet exposures at $70 billion, $80 billion, $75 billion and $50 billion, respectively. However, these estimated thresholds are not statistically different from the $75 billion thresholds advanced in the proposal at the 10 percent confidence level.

II. Background

On October 31, 2018, in response to the requirements made by the Economic Growth, Regulatory Relief, and Consumer Protection Act, the Federal Reserve Board, Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation issued a joint notice of proposed rulemaking to tailor prudential standards for large U.S. banking organizations.

The proposal aims to tailor prudential standards to large banks. It would more closely align prudential standards (namely liquidity and capital rules and stress testing requirements) with the risk profiles of U.S. banking organizations with over $100 billion in assets. As proposed, four different categories and applicable thresholds in the manner described below would be created:

- **Category I:** U.S. global systemically important bank holding companies (GSIBs) would remain subject to the most stringent standards.
- **Category II:** Firms of global scale—those with very significant size ($700 billion or more in total assets) or cross-jurisdictional activity ($75 billion or more)— would be subject to more stringent prudential standards (based on global standards developed by the BCBS) and other prudential standards appropriate to very large or internationally active banking organizations.

[3] Ahnert, Toni, Kristin Forbes, Christian Friedrich, and Dennis Reinhardt, "Macroprudential FX Regulations: Shifting the Snowbanks of FX Vulnerability?" NBER Working Paper No. 25083, September 2018.

- **Category III:** Firms that have total assets of $250 billion or more, or those with total assets of $100 billion or more that also have $75 billion or more of a risk-based indicator (weighted short-term wholesale funding, nonbank assets, or off-balance-sheet exposure), would be subject to enhanced standards that are tailored to the risk profile of these firms.
- **Category IV:** Most firms with $100 billion to $250 billion in total assets would be subject to significantly reduced requirements. In particular, these firms would no longer be subject to standardized liquidity requirements or a requirement to conduct and publicly disclose the results of company-run capital stress test.

III. Empirical Results

This section assesses the proposal to tailor prudential standards for large banks using linear and nonlinear regression methods. A challenge in evaluating the Agencies' proposed tailoring framework is that there is no readily available empirical systemic risk measure for a bank. In this note, we use an independent market-based measure of the amount of capital a firm would need to survive a systemic crisis to gauge the degree to which firms pose risk to the financial system as a proxy for true systemic risk. Specifically, we used the systemic risk measure (SRISK) proposed by Acharya, Engle and Richardson (2012).[4] This measure is defined as the capital that a bank is expected to need if another financial crisis were to occur and is often called a "mark-to-market" stress, as it relies on banks' stock returns during a stress scenario. The stress scenario in SRISK is defined by a 40 percent fall in the stock market over a six-month period. The capital shortfall is evaluated using the market leverage ratio relative to a capital requirement of 8 percent under stress. A negative SRISK indicates the bank maintains a market leverage ratio under stress that is above 8 percent, whereas a positive SRISK implies a bank has a capital shortfall after the occurrence of the stress event.[5]

Any individual measure's estimate of systemic risk, including SRISK is insufficient by itself and fundamentally flawed. First, SRISK does not capture the spillover effects on the real economy that may arise if a bank were to fail. Second, SRISK is based on a simple model used to estimate the expected equity loss conditional on a single shock to the equity market and also places undue reliance on bank size. Finally, for the avoidance of doubt, measures such as SRISK do not capture the effect of the regulations prescribed to mitigate systemic risk. Nevertheless, we use SRISK as a proxy for systemic risk here because it uses a consistent metric across banks and it is also readily available, making it straightforward to replicate the results of our analysis.

In all regressions reported in the remainder of the note, the dependent variable is the average SRISK for each bank over the course of one year. To avoid reverse causality problems, all explanatory variables are as of the end of the previous year. We use data from 26 publicly traded banks between 2012-2018 using regulatory data provided in the

[4] Acharya, Viral V., Robert Engle and Matthew Richardson (2012), "Capital Shortfall: A New Approach to Ranking and Regulating Systemic Risks," American Economic Review, 102(3), 59-64.

[5] Note that the capital requirement acts as a scaling factor in the SRISK calculation, and the 8 percent choice represents the standard Cooke Ratio in place since the first Basel Accord.

FR Y-15, FR Y-9C and FR Y-9LP reporting forms. The SRISK data is provided by V-Lab at NYU-Stern. The definitions of the variables, summary statistics, and sources can be found in the Appendix.

III.1 Linear Regression Analysis

We assess the correlation between SRISK and each risk-based indicator: size, cross-jurisdictional activity, weighted short-term wholesale funding, nonbank assets, and off-balance-sheet exposure. Table 1 presents the estimates of regressing each bank's SRISK on the various risk-based indicators. All regressions include year fixed-effects (dummy variables for each year) to account for systematic changes in SRISK and use robust standard errors to control for the presence of autocorrelation and heteroskedasticity in regression residuals.

Table 1: Linear regression models with domestic banks.

	Dependent variable (in $b)				
	SRISK	SRISK	SRISK	SRISK	SRISK
Explanatory variables (in $b):	(1)	(2)	(3)	(4)	(5)
Cross-Jurisdictional Activity	0.04***			0.02**	
	(0.004)			(0.01)	
Cross-Jurisdictional Claims		0.20***			0.16***
		(0.04)			(0.03)
Cross-Jurisdictional Liabilities		-0.13***			-0.12***
		(0.04)			(0.03)
Total Assets Consolidated			0.02***	-0.01	
			(0.003)	(0.01)	
Short-Term Wholesale Funding				0.09**	0.05***
				(0.04)	(0.01)
Nonbank Assets				-0.026*	
				(0.014)	
Off Balance Sheet Exposures				0.02	
				(0.02)	
Constant	9.86	3.65	12.71	-1.76	-2.42
	(8.77)	(4.60)	(9.96)	(7.07)	(5.26)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes
Adjusted R^2	0.6213	0.7088	0.4955	0.6802	0.7388
Number of Observations	135	135	135	123	123

Note: Each model is estimated using ordinary least squares and robust standard errors are reported in parenthesis. * p-value < 0.10; ** p-value < 0.05; and *** p-value < 0.01.

As shown in Table 1 column (1), cross-jurisdictional activity is positively correlated with SRISK. However, the results reported in the remaining columns of the Table indicate that cross-jurisdictional activity is a noisy measure of the degree of global activity of a bank. Specifically, when cross-jurisdictional activity is decomposed into its two main components – cross-jurisdictional claims and cross-jurisdictional liabilities – only the asset side of cross-border operations is positively correlated with SRISK (shown in column (2)). This variable includes all foreign assets held by banks and appears to be a valid proxy for the degree of complexity and resolvability of a bank if it were to fail. In

contrast, cross-jurisdictional liabilities are negatively correlated with SRISK and statistically different from zero at the 1 percent level. Moreover, as shown in columns (1) and (2), the model fit is considerably lower using cross-jurisdictional activity.

As shown in columns (3) and (4) of Table 1, bank size only helps predict SRISK when all other risk-based indicators are excluded from the linear model. For example, when we include cross-jurisdictional activity, short-term wholesale funding, nonbank assets and off-balance-sheet exposure to the model – shown in column (4) – bank size is no longer statistically different from zero (and has the opposite sign). Thus, bank size is only useful if it is the only variable included in the regression.[6] Lastly, as depicted in column (5), only cross-jurisdictional claims, cross-jurisdictional liabilities and short-term wholesale funding remain statistically different from zero at a 1 percent confidence level in the linear model.[7] In particular, nonbank assets and off-balance-sheet exposures are not statistically different from zero in the linear model (nonbank assets is not statistically different from zero when cross-jurisdictional activity is divided into two components).

To assess the robustness of the finding that the proxy for a bank's global activity should exclude cross-jurisdictional liabilities, we conducted a similar analysis to the one shown in Table 1 using the GSIB assessment sample created by the BCBS.[8] The sample includes all internationally active banks, of which we are able to match 77 banks to the SRISK measure.[9] We use as explanatory variables the various indicators included in the BCBS sample. The results depicted in Table 2 show that the positive correlation between SRISK and cross-jurisdictional claims and the negative correlation between SRISK and cross-jurisdictional liabilities observed for U.S. banks also holds in the BCBS sample.

As shown in column (1) of Table 2, the coefficient associated with cross-jurisdictional activity has a positive sign and it is statistically different from zero at the 1 percent confidence level. Column (2) shows that cross-jurisdictional claims is positively related with SRISK and statistically different from zero at the 1 percent level while the coefficient for cross-jurisdictional liabilities has a negative sign and is statistically different from zero at 10 percent level.

In addition, as shown in columns (3) and (4) of Table 2, bank size only helps predict SRISK when the other indicators are excluded from the linear model. In addition, we also find that SRISK is positively correlated with the notional value of OTC derivatives and securities outstanding (negatively) in addition to cross-jurisdictional claims. All model specifications control for country-year fixed effects.

[6] The adjusted R-squared of the regression that only includes year-fixed effects is approximately 15 percent.

[7] Later we show in Table 3 that the remaining risk-based indicators are statistically significant using nonlinear specifications.

[8] We used the dataset provided in the paper by Benoit, Sylvain, Christophe Hurlin, and Christophe Perignon (2018) "Pitfalls in Systemic-Risk Scoring," *Journal of Financial Intermediation* (Forthcoming).

[9] The Chinese banks that are part of the BCBS sample were excluded. China has a very specific macroeconomic and regulatory environment which impacts some of the largest banks in our sample (including the largest bank). As a result, none of the indicators considered are statistically different from zero when Chinese banks are included.

Table 2: Linear regression models with the GSIB BCBS assessment sample.

Explanatory variables (in $b):	Dependent Variable (in $b)				
	SRISK	SRISK	SRISK	SRISK	SRISK
	(1)	(2)	(3)	(4)	(5)
Cross-Jurisdictional Activity	0.03***				
	(0.003)				
Cross-Jurisdictional Claims		0.09***		0.08***	0.07***
		(0.02)		(0.02)	(0.02)
Cross-Jurisdictional Liabilities		-0.04*		-0.03	-0.03
		(0.02)		(0.03)	(0.02)
Total Exposures			0.02***	-0.01	
			(0.002)	(0.01)	
Intra-Financial System Assets				0.04	
				(0.05)	
Intra-Financial System Liabilities				-0.03	
				(0.03)	
Securities Outstanding				-0.05	-0.05***
				(0.03)	(0.02)
Payments Activity				0.0001	
				(0.0001)	
Assets Under Custody				-0.0003	
				(0.0003)	
Underwritten Transactions in Debt and Equity Markets				0.01	
				(0.03)	
Notional Amount of Over-the-Counter Derivative Contracts				0.001**	0.001***
				(0.0002)	(0.0001)
Trading and AFS Securities				0.0005	
				(0.03)	
Level 3 Assets				0.42	
				(0.26)	
Constant	9.84***	9.94***	9.79***	11.68***	10.28***
	(3.11)	(3.12)	(3.33)	(3.19)	(2.65)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes
Country Fixed Effects	Yes	Yes	Yes	Yes	Yes
Adjusted R^2	0.7374	0.7480	0.6977	0.8023	0.8013
Number of Observations	343	343	343	343	343

Note: Chinese internationally active banks are excluded from the analysis. Each model is estimated using ordinary least squares and robust standard errors are reported in parenthesis. * p-value < 0.10; ** p-value < 0.05; and *** p-value < 0.01.

In economic terms, the BCBS recommended the inclusion of cross-jurisdictional activity to measure systemic loss given default because of its belief that a larger global footprint would make a bank's resolution more difficult to coordinate, with attendant systemic instability.[10] Although our empirical analysis suggests that resolvability challenges and spillovers are the reason cross-jurisdictional claims are positively correlated with our proxy for systemic risk (i.e., SRISK), other economic factors appear to explain the negative correlation between cross-jurisdictional liabilities and SRISK. For example, a recent paper by Ahnert, Forbes, Friedrich and Reinhardt (2018)

[10] Basel Committee on Banking Supervision, "Global systemically important banks: revised assessment methodology and the higher loss absorbency requirement," July 2018.

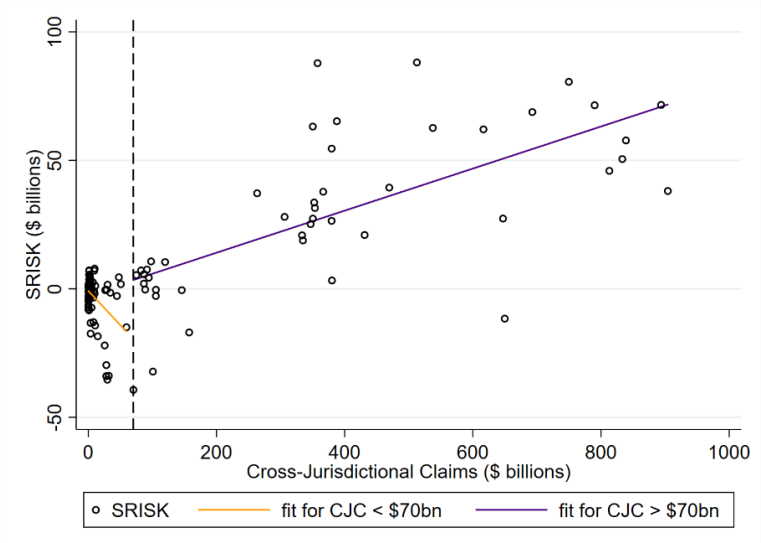
finds that cross-border foreign exchange borrowing has some benefits because it is often cheaper than borrowing in the local currency.[11] Also, banks have ample experience in hedging foreign exchange risk, and there is a risk management motive to diversify the funding base.

In summary, our results indicate that cross-jurisdictional liabilities are not positively correlated with SRISK as a proxy for systemic risk and the results hold both for the domestic and the GSIB BCBS assessment sample. In addition, the linear models indicate that bank size, nonbank assets and off-balance-sheet exposures are not strongly correlated with SRISK. although as shown in the next section, some of the correlations are statistically significant using nonlinear models which analyze the suitability of the nominal thresholds proposed.

III.2 Nonlinear Regression Analysis

To determine the validity of the nominal thresholds contained in the proposal, this section analyzes the correlation between SRISK and each of the risk-based indicators conditional on the level of each risk-based indicator. The idea is that there is a threshold value for each indicator for which the correlation with our proxy for systemic risk is positive and statistically different from zero, therefore potentially warranting stricter prudential standards. The linear analysis conducted in the previous section is not enough because it just says whether a given risk-based indicator is important to explain our proxy for systemic risk and does not provide guidance regarding the level of the indicator above which it starts being an important driver of systemic risk. For this purpose, this section uses nonlinear (or threshold) models that relate SRISK to the various risk-based indicators. A threshold regression model is a regression model that has a discontinuity at the threshold point based on a given risk-based indicator. Moreover, the threshold point is assumed to be unknown and needs to be estimated (see appendix for additional details).

Figure 1: Scatterplot of SRISK and Cross-Jurisdictional Claims, with estimated threshold model



[11] Ahnert, Toni, Kristin Forbes, Christian Friedrich, and Dennis Reinhardt, "Macroprudential FX Regulations: Shifting the Snowbanks of FX Vulnerability?" NBER Working Paper No. 25083, September 2018.

Figure 1 illustrates the regression analysis using the relationship between SRISK (y-axis) and cross-jurisdictional claims (x-axis). For banks' assets outside the U.S. under $70 billion (i.e., those to the left of the dashed vertical line) the relationship between SRISK and cross-jurisdictional claims is negative – as shown by the negative slope of the orange line – and not statistically different from zero at the 5 percent level. In contrast, for values of cross-jurisdictional claims above $70 billion, we observe a positive relationship between this risk-based indicator and SRISK (shown by the purple line) and the coefficient is statistically different from zero at the 1 percent level.

Table 3: Non-linear regression models with domestic banks.

	Dependent variable (in $b except column 5)				
Explanatory variables (in $b except STWF / Assets):	SRISK (1)	SRISK (2)	SRISK (3)	SRISK (4)	SRISK/Assets (5)
Cross-Jurisdictional Claims	-0.33** (0.14)	0.07*** (0.01)	0.07*** (0.02)		
CJC X Dummy (=1 if CJC>$70B)	0.39*** (0.14)				
Nonbank Assets		-0.22*** (0.07)			
NBA x Dummy (=1 if NBA>$80B)		0.25*** (0.08)			
Off-Balance Sheet Exposures			-0.09 (0.06)		
OBS x Dummy (=1 if OBS>$50B)			0.11* (0.06)		
Short-Term Wholesale Funding	0.06*** (0.02)			0.02 (0.1)	195.26*** (56.25)
STWF x Dummy (=1 if $50b<STWF<$75b)				–	
STWF x Dummy (=1 if STWF>$75b)				0.11 (0.10)	
STWF / Assets x Dummy (=1 if 0.2<STWF/Assets<0.3)					-274.62 (173.19)
STWF / Assets x Dummy (=1 if STWF / Assets>0.3)					-182.57*** (57.48)
Constant	8.46 (6.57)	11.38 (6.98)	10.73 (7.72)	1.15 (8.20)	-16.00** (7.74)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes
Adjusted R^2	0.7231	0.6987	0.6600	0.6350	0.1200
Number of Observations	123	135	135	123	123

Note: Each model is estimated using ordinary least squares and robust standard errors are reported in parenthesis. * p-value < 0.10; ** p-value < 0.05; and *** p-value < 0.01.

The threshold for cross-jurisdictional claims is an important policy parameter, so we need to show how it is determined optimally in the nonlinear model. To determine the optimal threshold of $70 billion, we conducted a

search across various possible values and chose the threshold value that minimizes the residual sum of squares of the model. Note that the search for a threshold value cannot be too close to the top or bottom of the sample, otherwise there are not enough degrees of freedom to estimate the parameters of the model in one of the regions. For this reason, we also picked the optimal threshold that resulted in slope coefficients that are significant at least at the 10 percent level.

The results for the proposed $70 billion nominal threshold for cross-jurisdictional claims is reported in column (1) of Table 3. The coefficient for cross-jurisdictional claims above $70 billion is statistically different from zero at the 1 percent level. For banks with less than $70 billion in cross-jurisdictional claims, there is a negative correlation between our measure of global footprint and SRISK as our proxy for systemic risk. Thus, having a geographically diversified portfolio could reduce systemic risk up to a certain point since spillover effects as a result of a bank's failure are likely immaterial for a bank with a small global footprint. In addition, we tested whether the $70 billion nominal threshold for cross-jurisdictional claims is statistically different from $75 billion (the threshold for cross-jurisdictional activity contained in the proposal) using a Hausman test and find that they are not statistically different from each other at the 10 percent level. The model also includes the short-term wholesale funding variable because we showed in Table 1 that it is an important driver of SRISK.

We repeat the same procedure to assess the nominal thresholds for nonbank assets and for off-balance-sheet exposures; the results are shown in columns (2) and (3) of Table 3, respectively. The estimated optimal nominal threshold for nonbank assets is $80 billion and, like the results obtained for cross-jurisdictional claims, increased nonbank activities are only associated with more a high SRISK score above a nominal threshold of $80 billion. Similarly, we find that the optimal threshold for off-balance sheet exposures is $50 billion, although the coefficient associated with the threshold is only statistically different from zero at the 10 percent level. Because the correlation between off-balance-sheet exposures and SRISK is statistically very weak, we find that the estimated optimal threshold of $50 billion is not statistically different from the proposed $75 billion threshold at the 1 percent confidence level.

The results for short-term wholesale funding are reported in columns (4) and (5) of Table 3. Our econometric procedure indicates that there are two thresholds for short-term wholesale funding at $50 billion and $75 billion, but only the range above $75 billion is positively related to SRISK. Moreover, we are only able to obtain nonlinear relationships that are statistically different from zero using a specification that divides both the dependent and explanatory variables by total assets for each bank-year observation (column (5)). The threshold is chosen based on a ratio analysis and then multiplied by the lower bound of total consolidated assets for the relevant category ($250 billion), that is the reliance on short-term wholesale funding is only relevant for banks that have between $250 billion and $700 billion in assets. For example, a ratio of 0.3 of short-term wholesale funding divided by assets would be equivalent to a threshold of $75 billion (i.e., $250 x 0.3).

IV. Summary

Our findings indicate that of the four risk-based indicators used by the Agencies in their notice of proposed rulemaking to tailor prudential standards for large banks only cross jurisdictional activity and short-term wholesale funding are statistically significant factors for explaining the market-based measure (SRISK) that we have used as a proxy for systemic risk in the analysis. In addition, our results indicate that cross jurisdictional claims are a better predictor of SRISK than cross jurisdictional activity (the sum of cross-jurisdictional claims and liabilities). Results based on nonlinear models, yield thresholds for cross-jurisdictional claims, nonbank assets, short-term wholesale funding and off-balance-sheet exposures at $70B, $80B, $75B and $50B respectively. However, these estimated thresholds are not statistically different from the $75 billion thresholds advanced in the proposal at a 10 percent confidence level.

Appendix

AI. Regression Models

We estimate a linear regression of SRISK on a set of explanatory variables:

$$SRISK_{it} = \beta' X_{it-1} + \gamma' T_t + \epsilon_{it}$$

Where $SRISK_{it}$ denotes SRISK of bank i in year t. The vector X_{it-1} includes a set of pre-determined explanatory variables:

- Cross-jurisdictional activity;
- Cross-jurisdictional claims;
- Cross-jurisdictional liabilities;
- Short-term wholesale funding;
- Nonbank assets;
- Off-balance-sheet exposures;
- Total consolidated assets.

The vector T_t includes a set of year dummies. Next, we use threshold regression to assess the validity of the thresholds:

$$SRISK_{it} = \beta_1' X_{it-1} + \gamma' T_t + \epsilon_{it} \quad \text{if} \quad -\infty < w_t \leq \delta$$

$$SRISK_{it} = \beta_2' X_{it-1} + \gamma' T_t + \epsilon_{it} \quad \text{if} \quad \delta < w_t \leq \infty$$

where w_t is the threshold variable (e.g., cross-jurisdictional activity) and δ is the threshold (i.e., $75 billion).

AII. Data Sources

To implement the methodology described above, we used the Banking Organization Systemic Risk Report (the FR Y-15 form) and the Consolidated Financial Statements for Bank Holding Companies (the FR Y-9C form) covering the period between 2012:Q4 and 2017:Q4. To be included in the sample, an institution must have reported total consolidated assets of $50 billion or more, which is the size cut-off for an institution to file the FR Y-15.

The following table contains all data items included in the analysis and data sources. A few observations on the data sources:

- **Short-term wholesale funding proxy**: We use weighted short-term wholesale funding data from FR Y-15 when available (RISKY894). When the wSTWF metric is not available, we used an approximation based on the ratio of reported weighted short-term wholesale funding to BPI's short-term wholesale funding metric used in the bank conditions index. The latter is derived using data from FR Y-9C as described in the table below.

- **Off-balance-sheet exposures**: we substituted total exposure RISKY832 for RISKM350 when the former is unavailable.

- **Non-bank assets proxy**: We used total nonbank assets data from FR Y-9LP (BHCPHK02) when available. When the data is not available, we used the ratio of total nonbank assets to nonbank assets of nonbank subsidiaries (BHCP4778) of that bank in other periods to impute the missing observation.

Table A1: Description and Source of Variables Used in the Analysis for the Domestic Sample

Data item	Definition	Reg Filling	Item codes
SRISK	SRISK measures the capital shortfall of a bank conditional on a severe market decline. See https://vlab.stern.nyu.edu/en/welcome/risk/ for additional details.	N.A.	N.A.
Cross-Jurisdictional Activity	Cross-jurisdictional activity would be defined as the sum of cross-jurisdictional claims and liabilities, as each is reported on the FR Y-15 by holding companies	FRY-15	RISKM422 - Claims RISKM426 – Liabilities
Short-Term Wholesale Funding	Weighted short-term wholesale funding, calculated in accordance with the instructions of the FR Y-15.	FRY-15	RISKY894
BCI Weighted Short-Term Wholesale Funding	Proxy of Short-Term Wholesale Funding when data from the FR Y-15 is not available.	FRY9C	BHCK2309 + BHCT3190 + BHDMB987 + BHCKB989 + BHCK2332 + BHDMA242 + BHFNA245 + BHDMA243
Off-Balance-Sheet Exposure	Off-balance-sheet exposure would be defined as total exposure, calculated in accordance with the instructions to the FR Y-15 or equivalent reporting form, minus the total average consolidated assets as reported on the FR Y-9C.	FRY-15 and FRY-9C	RISKY832 - BHCK3368
Nonbank Assets	Total nonbank assets, calculated in accordance with the instructions to the FR Y-9LP.	FRY-9LP	BHCPHK02
Nonbank Assets from Nonbank Subsidiaries	Total combined nonbank assets of nonbanks subsidiaries	FRY-9LP	BHCP4778
Total Consolidated Assets	Total assets	FRY-9C	BHCK2170

A.III Summary statistics

The tables below contain selected summary statistics for the bank-specific variables used in the empirical specifications. The domestic sample includes 26 banks while the global sample includes 77 banks. For domestic banks, the list of variables includes all risk-based indicators included in the NPR while the global sample includes all 5 systemic indicators used in the Method 1 score methodology.

Table A2: Summary Statistics for the Domestic Sample

Data Series ($bn)	# of banks	# of obs.	Mean	SD	Minimum	P25	P50	P75	Maximum
SRISK	26	135	7.8	24.3	-39.2	-2.6	0.9	7.2	88.1
Total Assets	26	135	573.1	729.9	49.3	122.3	205.2	801.5	2573.0
Cross-Jurisdictional Activity	26	135	260.5	444.5	0.1	2.0	10.5	267.8	1761.1
Cross-Jurisdictional Claims	26	135	131.7	231.7	0.1	1.6	6.9	105.3	904.0
Cross-Jurisdictional Liabilities	26	135	128.7	215.0	0.0	0.6	2.7	164.1	857.2
Short-Term Wholesale Funding	26	123	128.9	189.9	1.1	8.1	18.1	198.5	743.7
Nonbank assets	26	135	153.7	258.8	0.0	0.5	5.5	161.9	843.1
Off-balance-sheet exposure	26	135	183.6	275.4	2.6	21.7	35.0	294.2	1239.6

Table A3: Summary Statistics for the BCBS Sample

Data Series ($bn)	# of banks	# of obs.	Mean	SD	Minimum	P25	P50	P75	Maximum
SRISK	77	373	21.9	36.0	-54.8	0.3	11.1	30.3	160.0
Total exposures	77	343	829.9	802.4	64.6	265.9	517.3	1071.8	3743.1
Cross-Jurisdictional Activity	77	343	486.7	598.9	0.1	40.3	263.5	673.6	3238.2
Cross-Jurisdictional Claims	77	343	256.5	320.4	0.1	19.2	131.9	367.2	1608.8
Cross-Jurisdictional Liabilities	77	343	230.2	282.3	0.0	20.4	138.9	319.8	1708.2
Intra-Financial System Assets	77	343	95.7	105.0	0.7	17.6	52.3	155.1	546.3
Intra-Financial System Liabilities	77	343	95.9	112.6	0.01	13.9	47.0	157.1	600.0
Securities Outstanding	77	343	166.8	138.7	9.2	61.1	129.2	233.5	675.7
Payments Activity	77	343	29110.6	54125.0	0.0	1479.9	10520.7	30211.0	323174.0
Assets Under Custody	77	343	1980.3	4867.4	0.0	63.0	210.6	1205.7	26578.4
Underwritten Transactions in Debt and Equity Markets	77	343	76.3	125.1	0.0	2.0	19.6	83.1	551.2
OTC Derivative Contracts	77	343	9115.6	15598.4	3.0	182.5	1694.2	7216.5	68374.4
Trading and AFS Securities	77	343	46.9	67.4	0.2	5.5	19.5	53.1	446.3
Level 3 Assets	77	343	6.9	10.9	0.0	0.5	2.5	7.6	69.3