April 27, 2012

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Comments/Legal ESS
RIN 3064–AD91

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2–3
Washington, DC 20219
Docket Number OCC–2011–0029

Re: Stress Testing Requirements under Dodd-Frank Section 165(i)(2)

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("**The Clearing House**"), the American Bankers Association (the "**ABA**"), the Financial Services Forum (the "**Forum**"), The Financial Services Roundtable ("**The Roundtable**") and the Securities Industry and Financial Markets Association ("**SIFMA**" and, together with The Clearing House, the ABA, the Forum and The Roundtable, the "**Associations**")[1] are

[1] The Associations collectively represent financial institutions accounting for a substantial majority of banking and financial assets in the United States. Descriptions of the Associations are provided immediately following the signature page of this letter.

writing in connection with the Federal Deposit Insurance Corporation's (the "**FDIC**") and the Office of the Comptroller of the Currency's (the "**OCC**") respective notices of proposed rule making[2] implementing the applicable stress testing requirements of Section 165(i)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**").[3]

The Proposed FDIC Stress Test Rules and the Proposed OCC Stress Test Rules form part of the broader stress testing framework mandated by Section 165(i) of Dodd-Frank for depository institutions and their holding companies. Under Section 165(i)(1) of Dodd-Frank and Subparts F and G of the Board of Governors of the Federal Reserve System's (the "**Federal Reserve**") proposed stress test rules,[4] bank holding companies ("**BHCs**") with over $50 billion in assets are subject to supervisory stress test requirements. Pursuant to Section 165(i)(2) and the Proposed OCC and FDIC Stress Test Rules, as well as the Proposed Federal Reserve Stress Test Rules, the company-run stress test requirement are separately applicable to depository institutions having over $10 billion in assets, whether state non-member banks, national banks, or state member banks.[5] When these various statutory and proposed regulatory requirements are aggregated, an institution consisting on a consolidated basis of, for example, an over $50 billion BHC, a wholly-owned subsidiary state non-member bank and a wholly-owned subsidiary national bank, each with over $10 billion in assets, would therefore appear to be subject to multiple and technically separate stress test requirements supervised by three different Federal banking agencies.

The Associations are deeply concerned that these multiple overlapping stress test requirements, if not properly implemented and coordinated among the relevant agencies, will lead to a great degree of burdensome duplication and will add little marginal utility from a policy and supervisory perspective, particularly regarding BHCs where the subsidiary depository institutions represent, either singly or in the aggregate, a large percentage of the consolidated assets of the BHC.

We appreciate the statements of the FDIC, the OCC and the Federal Reserve to the effect that they will work together to coordinate the various stress test processes among the relevant agencies.[6] The Associations applaud this intention and respectfully urge the alignment of the aggregate

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[2] FDIC's *Annual Stress Test Notice of Proposed Rulemaking*, 77 Fed. Reg. 3166 (Jan. 23, 2012) (the "**Proposed FDIC Stress Test Rules**"); OCC's *Annual Stress Test Notice of Proposed Rulemaking*, 77 Fed. Reg. 3408 (Jan. 24, 2012) (the "**Proposed OCC Stress Test Rules**")

[3] Pub. L. No. 111-203 (2010)

[4] 77 Fed. Reg. 594 (Jan. 5, 2012) (Subparts F and G, the "**Proposed Federal Reserve Stress Test Rules**").

[5] Proposed FDIC Stress Test Rules, Section 325.203; Proposed OCC Stress Test Rules, Section 46.3; Proposed Federal Reserve Stress Test Rules Sections 252.141, 142.

[6] *See* e.g., FDIC Stress Test NPR at 3168; OCC Stress Test NPR at 3409, 3412.77; Fed. Reg. at 632.

stress testing process by robust coordination of its various aspects, including information gathering, public disclosure requirements, reporting forms, etc., across agencies so as to promote efficient use of covered company and supervisory resources and therefore minimize burdensome and inappropriate duplication of efforts. We particularly support § 46.8 of the Proposed OCC Stress Test Rules, which provides that a parent BHC's disclosures will satisfy the summary disclosure requirement under the annual stress test under Section 165(i)(2) for any subsidiary national bank of the BHC with $10 billion or more in assets, unless the OCC informs the bank otherwise. Likewise, the Associations also support the recognition in the Proposed OCC Stress Test Rules that it in some cases it would be appropriate to allow a bank subsidiary and its parent BHC to submit a single set of consolidated stress testing information because the inputs and results for both the bank subsidiary and its parent BHC would be substantially similar. We believe that allowing consolidated submissions in appropriate circumstances, such as where a BHC is predominately composed of a single bank subsidiary, would both fulfill the goals of Section 165(i)(2) and avoid unnecessary duplication. Finally, we urge the Federal banking agencies to refrain from requiring stress testing under the Basel II advanced internal ratings risk-based capital requirements as adopted in the U.S. until the parallel run is complete and such risk-based capital requirements are fully in effect for applicable banking institutions.

The Associations have set forth detailed stress testing related comments in our comprehensive letter concerning the Federal Reserve's notice of proposed rulemaking with respect to Section 165 of Dodd-Frank. We have attached this broader letter as Annex 1 hereto. In particular, our more specific stress testing related comments can be found in Parts I.E and II and Annex E of the Associations' comprehensive Section 165 Letter.

In conclusion, we appreciate the substantive efforts of the FDIC and the OCC in developing their respective Proposed Stress Test Rules. In light of the effectively intertwined nature of the stress test requirements of Section 165(i) of Dodd-Frank, the Associations strongly believe that well-coordinated and holistic actions by the Federal banking agencies are required in order to avoid burdensome duplication with respect to the application of the Proposed FDIC Stress Test Rules, the Proposed OCC Stress Test Rules and the Proposed Federal Reserve Stress Test Rules.

* * *

If you have any questions or need further information, please contact (i) at The Clearing House, Paul Saltzman, its President and General Counsel (e-mail – paul.saltzman@theclearinghouse.org, telephone number – (212) 613-0318); (ii) at the ABA, Wayne A. Abernathy, its Executive Vice President, Financial Institutions and Regulatory Affairs (e-mail – wabernat@aba.com, telephone number – (202) 663-5222); (iii) at the Forum, Robert S. Nichols, its President and CEO (e-mail – rob.nichols@financialservicesforum.org), telephone number – (202) 457-8765); (iv) at The Roundtable, Richard M. Whiting, its Executive Director and General Counsel (e-mail – Rich@fsround.org, telephone number – (202) 589-2413); and (v) at SIFMA, Kenneth E. Bentsen, Jr., its Executive Vice President, Public Policy and Advocacy (e-mail – kbentsen@sifma.org, telephone number – (202) 962-7400).

Respectfully submitted,

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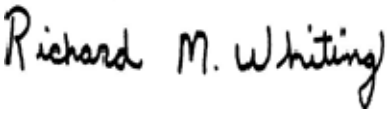

Richard M. Whiting
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cc: Hon. Thomas J. Curry
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The Associations

The Clearing House Association

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

American Bankers Association

The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its two million employees. Learn more at www.aba.com.

Financial Services Forum

The Financial Services Forum is a non-partisan financial and economic policy organization comprising the CEOs of 20 of the largest and most diversified financial services institutions doing business in the United States. The purpose of the Forum is to pursue policies that encourage savings and investment, promote an open and competitive global marketplace, and ensure the opportunity of people everywhere to participate fully and productively in the 21st-century global economy.

The Financial Services Roundtable

The Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine and account directly for $92.7 trillion in managed assets, $1.1 trillion in revenue, and 2.3 million jobs.

Securities Industry and Financial Markets Association

SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

Annex 1

April 27, 2012

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Jennifer J. Johnson, Secretary
Docket No. 1438; RIN 7100-AD-86

Re: Enhanced Prudential Standards and Early Remediation Regulations under Dodd-Frank 165/166

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("**The Clearing House**"), the American Bankers Association (the "**ABA**"), the Financial Services Forum (the "**Forum**"), The Financial Services Roundtable ("**The Roundtable**") and the Securities Industry and Financial Markets Association ("**SIFMA**" and, together with The Clearing House, the ABA, the Forum and The Roundtable, the "**Associations**")[1] are writing to comment on the Board of Governors of the Federal Reserve System's (the "**Federal Reserve**") notice of proposed rulemaking (the "**NPR**")[2] implementing the enhanced prudential standards and early remediation provisions of Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**").[3]

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[1] The Associations collectively represent financial institutions accounting for a substantial majority of banking and financial assets in the United States. Descriptions of the Associations are provided immediately following the signature page of this letter.

[2] 77 Fed. Reg. 594 (Jan. 5, 2012). The introduction and commentary included in the NPR are referred to herein as the "**Preamble**", and the proposed rules set forth in the NPR are referred to herein as the "**Proposed Rules**".

[3] Pub. L. No. 111-203 (2010)

The Associations and their members support a robust and effective regulatory system, which includes not only appropriately designed rules implementing Sections 165 and 166, but such other fundamental reforms as the Basel Committee on Banking Supervision's ("**BCBS**") capital and liquidity frameworks announced in December 2010 ("**Basel III**") and the Federal Reserve's Capital Plan Rule set forth in 12 C.F.R. § 225.8 (the "**Capital Plan Rule**"). If, however, implementing regulations (including the Proposed Rules) are not properly designed and calibrated to the risks they are designed to address, they raise the potential for damage to the financial system and the broader economy.[4] Our greatest concern in this regard as to the Proposed Rules relates to the extraordinary overstatement of exposures in the single-counterparty credit limits (the "**SCCL**") addressed in Subpart D of the Proposed Rules and in *Annex C* to this Comment Letter.[5]

We have set forth in separate annexes to this letter (including its annexes, this "**Comment Letter**") specific comments and recommendations regarding six of the seven topical areas addressed in the separate subparts of the Proposed Rules, as follows:[6]

- in *Annex A*, comments on Subpart B – Risk-Based Capital Requirements and Leverage Limits (the "**Proposed Capital and Leverage Rules**");
- in *Annex B*, comments on Subpart C – Liquidity Requirements (the "**Proposed Liquidity Rules**");
- in *Annex C*, comments on Subpart D – Single-Counterparty Credit Limits (the "**Proposed SCCL Rules**");
- in *Annex D*, comments on Subpart E – Risk Management (the "**Proposed Risk Management Rules**");

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[4] A number of other provisions of Dodd-Frank, including the Lincoln Amendment (Section 716), and, most importantly, the Volcker Rule (Section 619), also create concerns about damage to the financial system and economy.

[5] In *Annex C*, we also address the Proposed SCCL Rules' failure to satisfy basic administrative law standards requiring an agency to provide an appropriate explanation of the reasons for a proposed rule.

[6] This Comment Letter is focused on the concerns of bank holding companies ("**BHCs**"), and we do not address the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies. The Associations also are not addressing Subpart H – Debt-to-Equity Limits for Certain Covered Companies. Contemporaneously with our submission of this Comment Letter, we are delivering to the Federal Reserve and other recipients of this Comment Letter copies of previously submitted comment letters, studies and other submissions of the Associations referred to in the Annexes to this Comment Letter and bearing on our recommendations and concerns (collectively, the "**Prior Submissions**").

- in *Annex E*, comments on Subparts F and G – Supervisory Stress Test Requirements and Company-Run Stress Test Requirements (the "**Proposed Stress Test Rules**"); and

- in *Annex F*, comments on Subpart I – Early Remediation Framework (the "**Proposed Early Remediation Rules**").

Each Annex includes an executive summary of the Associations' comments on the subpart addressed in that Annex.[7]

Part I of this Comment Letter addresses seven key areas of concern, including our fundamental concerns with the Proposed SCCL Rules, and Part II summarizes certain of our key recommendations and concerns with respect to each subpart other than the Proposed SCCL Rules.

I. Key Concerns

A. The Associations support a robust regulatory regime and acknowledge the need to correct for past regulatory deficiencies and gaps. Some parts of the Proposed Rules, however, do more harm than good, potentially contributing to systemic risk rather than mitigating it and having an adverse impact on banking institutions' customers and the broader economy.

Legislators, regulators and banks have been largely aligned in their views of the core supervisory and management problems that contributed to the onset and escalation of the financial crisis:

- insufficient capital (in terms of both quantity and quality) at some institutions;

- insufficient liquidity at some institutions;

- Boards of Directors and management teams at some institutions that were late to recognize the scope of the crisis and failed to react and adjust with the speed required; and

- the absence of credible resolution regimes for large financial institutions.

The Associations have consistently supported significant and fundamental changes to the regulatory regime in order to establish a regulatory framework that both *protects* the financial system against potential systemic meltdowns of the type faced in the recent crisis and *enables* the financial system to play its necessary role in fostering economic and job growth.

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[7] Capitalized terms used in this letter and not otherwise defined are used with the meanings assigned to them in the attached Annexes. References in the Annexes to "**the Comment Letter**" mean this letter.

In the context of these dual objectives, the prudential regulatory framework should recognize that regulation has costs and limits. We understand that the legislative and regulatory responses to the severity of the financial crisis must be sufficiently comprehensive and robust to protect against a reoccurrence. At the same time, however, we are concerned that, in some crucial respects, regulatory reforms (including the Proposed Rules) are so imbalanced as to do more harm than good. The Proposed Rules cannot eliminate economic cycles or all risk, nor should they attempt to do so. It is critically important that decision makers (including the Federal Reserve and other agencies) promulgate rules required or permitted under Dodd-Frank that achieve a reasonable degree of regulatory balance by, among other things, informing their rulemakings with quantitative analysis where relevant and a holistic understanding of the consequences of their implementation.

The Associations submit that banks can perform their role in the economy only by taking controlled risks. The principal functions of banks include performing credit intermediation through the assumption of credit risk, properly controlled and limited and accurately measured, in relation to their borrowers and counterparties and providing maturity transformation for customers (that is, providing longer term loans to customers and accepting shorter-term deposits from customers), and managing the related risk. If the prudential regulatory framework inhibits these risk-taking functions of banks, the still nascent economic recovery may likely be stalled and future economic growth will be curtailed by a reduced availability of credit. We are also concerned that excessive limitations on the ability of U.S. banks to take controlled risks will reduce the role of the United States as a leader in the global financial system.

We also submit that the final rule should take into account the substantial progress that has already been made in terms of regulatory enhancement. A recent and graphic example is the performance of the largest U.S. banks under the Federal Reserve's comprehensive capital adequacy review ("**CCAR 2012**").[8] These banks demonstrated strong capital even under a scenario involving extremely adverse macro-economic assumptions and the Federal Reserve's conservative application of those assumptions (in terms of both depth of losses and front-end loading of those losses).

Our concerns with respect to regulatory imbalance focus on three principal aspects of the Proposed Rules:

First, as discussed in Part I.C and of most importance, the Proposed SCCL Rules would needlessly reduce liquidity in the financial system and thereby dampen economic activity. The Proposed SCCL Rules' imposition of:

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[8] Stress testing is important. But so too is learning lessons from that testing – for example, whether proposals to increase capital requirements sharply above the levels just validated under CCAR 2012 risk having higher costs than benefits. Moreover, as discussed in detail throughout this Comment Letter, certain aspects of the rules implementing Sections 165 and 166, if adopted as proposed, are likely to have a destabilizing impact and increase systemic risks.

- unrealistic and one-dimensional measures of exposure, such as the current exposure method ("**CEM**") for derivatives and the "add-on" approach used in securities lending and repurchase transactions ("**repo and securities lending transactions**"), drastically exaggerating actual exposures,

- the notional shifting requirement when utilizing credit protection or acting as a market maker in credit protection contexts, and

- the reduction of the credit limit to 10% for major covered companies (defined as those having consolidated total assets of $500 billion or more),

taken together with other aspects of the Proposed SCCL Rules, would result in the need for extraordinary adjustments of relationships among market participants that are unnecessary, unwise, potentially destabilizing and, in certain instances, unsupported by the statute or by Congressional intent. Moreover, the reduction of the credit limit to 10% cannot be implemented absent a determination that the statutory test mandated by Dodd-Frank for a variation from the 25% statutory standard has been met – i.e., "would be necessary to mitigate risks to the financial stability of the United States."[9]

Second, the capital surcharge contemplated by the Preamble's discussion of the Proposed Capital and Leverage Rules (i) is not required by Dodd-Frank Section 165's "more stringent" requirement, (ii) is premature, (iii) if based on the BCBS's G-SIB Surcharge (as is apparently intended), is fundamentally flawed in its methodology, and (iv) could result in such excessive capital levels that it harms the position of regulated banking organizations with investors and has an adverse impact on their customers and the broader economy.

Third, the Proposed Early Remediation Rules (i) include automatic triggers for falling into Level 2 and Level 3 remediation that are overly sensitive and rigid and, thus, threaten to impose significant regulatory constraints on firms that are not warranted by the firm's actual condition, and (ii) subject a firm to the entire panoply of early remediation restrictions and requirements as a result of reaching a single "triggering event", irrespective of whether such restrictions and requirements are related to the triggering event that caused the firm to be placed into the regime or, in the particular situation, would actually aid the company's recovery.

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[9] Section 165(e)(2) of Dodd-Frank (emphasis added).

B. It is exceedingly important that the Proposed Rules be analyzed holistically, not only with respect to the interplay among their subparts but also with other reforms, both in the United States and abroad. We urge the Federal Reserve and the other U.S. banking agencies to consider and address the interplay among reforms in the context of considering individual reforms.

The full potential combined impact of financial services regulatory reforms, including the Proposed Rules, Basel III (both capital and liquidity), Title II of Dodd-Frank, proposed margin requirements for swaps (Section 731 of Dodd-Frank) and the Volcker Rule (and related regulations currently under consideration by the Federal Reserve, Office of the Comptroller of the Currency ("**OCC**"), Federal Deposit Insurance Corporation ("**FDIC**"), Securities and Exchange Commission ("**SEC**") and Commodity Futures Trading Commission ("**CFTC**")), has not yet been comprehensively analyzed and, to our knowledge, no one in the regulatory or academic communities has asserted that it has. Public sector officials, including Federal Reserve Chairman Bernanke, have acknowledged that the aggregate impact of the current financial services regulatory reforms in the United States has not yet been fully analyzed (at least as of last summer).[10] Others in the regulatory community, including SEC Commissioner Troy Paredes and then Acting Comptroller of the Currency John Walsh, have expressed concern on this issue.[11] The reality is that the cumulative effects of the Proposed Rules and other

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[10] *See*, e.g., Chairman Bernanke, Remarks at a Question and Answer Session Following Chairman Bernanke's Speech on the U.S. Economic Outlook (June 7, 2011) (*transcript available at* http://video.cnbc.com/gallery/?video=3000026289).

[11] Commissioner Paredes commented in a September 2010 speech: "This builds to a straightforward but important point – that is, we need to use the regulatory authority Dodd-Frank has conferred upon us cautiously, carefully evaluating the intended benefits of our actions while giving due regard to the potential undesirable consequences of our regulatory steps. This should include assessing the cumulative impact of the entire package of new regulatory demands to anticipate the overall effect of the regulatory regime when viewed as a combined whole." (Remarks before the Security Traders Association 77th Annual Conference and Business Meeting (Sept. 24, 2010), *available at* http://www.sec.gov/news/speech/2010/spch092410tap.htm)

Then Acting Comptroller Walsh commented in a January 2012 speech: "Dodd-Frank…mak[es] very significant changes in the way business is done by financial institutions. There are so many moving parts that it is very hard to judge how these many approaches will interact, or what their cumulative effect will be." (Remarks before the Centre for the Study of Financial Innovation (June 21, 2011), *available at* http://www.occ.treas.gov/news-issuances/speeches/2011/pub-speech-2011-78.pdf) Then Acting Comptroller Walsh also commented in a June 2011 speech: "Nonetheless, it is also an undeniable quality of human nature that, in the frenzy of the moment, we can overreact in response to crisis. Describing this as a swinging pendulum may be a tired cliché, but it's worth asking ourselves: where is that pendulum right now? One of our OCC supervisors created the wonderful malapropism of 'trying to keep the pendulum in the middle of the road,' but that is surely not where we are today. To put it plainly, my view is that we are in danger of trying to squeeze too much risk and complexity out of banking as we institute reforms to address problems and abuses stemming from the last crisis." (Remarks at the American

rulemakings and reforms, which are often individually complex and when considered together amount to an incredibly complex mosaic, are almost certain to have unintended consequences and potential economic costs, and are likely in some cases to create the potential for actually increasing instead of decreasing systemic risks.

There are three specific aspects of this sweeping NPR that warrant reemphasizing the need for a holistic analysis of regulatory reforms, including the Proposed Rules:

First, a holistic analysis in the context of any particular regulatory reform has two foci – namely, (i) what other reforms are targeted to the same objective and, hence, should be taken into account by rulemakers in fashioning a particular set of rules (and in estimating the impact of those rules), and (ii) apart from the particular objective of a rule or set of rules, what are the impacts of combined rulemakings on customers for banking services and the economy more broadly. The Federal Reserve acknowledges the first component, noting in the Preamble that Dodd-Frank takes a "multi-prong approach" to "mitigating the threat to financial stability posed by systemically important financial companies," and then goes on to cite, among others, Title II's orderly liquidation authority, the Financial Stability Oversight Council ("**FSOC**"), and regulation of over-the-counter derivatives, other core financial markets and financial market utilities.[12] The Federal Reserve does not, however, acknowledge in the Preamble the other component – analyzing holistically the impacts of combined rulemakings on customers and the economy more broadly.

We believe the risk of severe consequences arising out of the Proposed Rules and other regulatory reforms, taken together, is more than negligible, which should argue persuasively for a thoughtful, holistic approach. At some point on the regulatory reform spectrum, macroprudential efforts to reduce systemic risk in the banking system will tip over into a reduction of credit availability and stall economic recovery. As we have consistently maintained in commenting on proposed reforms (including in this Comment Letter), the Associations' position is not that regulatory reform is unnecessary (indeed, we unequivocally recognize its need), but rather that it should be sufficiently balanced to avoid both the indirect risk of bank failure adversely impacting the economy and the direct risk of the rules themselves adversely impacting the economy.

Second, any analysis of the impact of a proposed rulemaking, even more so in the context of broad reforms, is incomplete without a cost/benefit analysis. The Associations note with disappointment that the NPR reflects little or no attempt by the Federal Reserve in many of the Proposed Rules, including in particular the Proposed SCCL Rules, to weigh the enormous costs to the covered companies and U.S. financial markets associated with the proposals against the likely benefits

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Securitization Forum Annual Conference (Jan. 24, 2012), *available at* http://www.occ.gov/news-issuances/speeches/2012/pub-speech-2012-11.pdf)

[12] 77 Fed. Reg. at 595.

of the proposals for the goal of U.S. financial stability.[13] Nor does the NPR indicate that the Federal Reserve made any effort to consider whether the benefits and goals of the proposals could be achieved and unnecessary costs avoided through other less burdensome regulatory alternatives. For example, before proposing the Proposed SCCL Rules, the Federal Reserve did not conduct a quantitative impact study ("**QIS**") to assess the actual impact on the covered companies or financial markets of the new requirements for measurement of credit exposure on derivatives and repo and securities lending transactions, the reduction of the statutory credit limit to 10%, or the coverage of individuals and high-quality sovereigns. The NPR also does not indicate that the Federal Reserve gave any consideration to whether the intended benefits of financial stability under the Proposed SCCL Rules could be achieved, and the significant costs associated with developing and maintaining completely new tracking, reporting and compliance mechanisms avoided, by aligning the SCCL requirements with existing risk management systems and utilizing long-established lending limit definitions and concepts.

The Proposed Rules thus contravene U.S. government policy requiring an analysis and "reasoned determination" regarding the costs and benefits of a proposed rule, including the "costs of cumulative regulations", and the consideration of less burdensome alternatives.[14] These are principles the Federal Reserve has stated it endeavors to abide by in developing and adopting regulatory protocols, including specifically those required under Dodd-Frank.[15] Indeed, contrary to the Federal Reserve's statement of policy, the Federal Reserve did not solicit comment in the NPR regarding the costs and benefits of the proposed approaches.

The Associations urge the Federal Reserve to conduct a QIS of the Proposed Rules, or, at the very least, the Proposed SCCL Rules, as promptly as practical and release the QIS results for public comment. If the QIS cannot be completed prior to publication of final rules, the Federal Reserve should subsequently request comment on whether the QIS results require modifications of the final rules. The QIS should be completed well in advance of the scheduled effective date of the Proposed SCCL Rules so that any necessary modifications can be made before banks must initiate their implementation programs.[16]

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[13] Costs associated with regulatory compliance are a significant issue for U.S. banks. *See,* e.g., Dan Fitzpatrick and Robin Sidel, *Costs Hobble Banks' Profits*, The Wall Street Journal (Apr. 12, 2012).

[14] Executive Order 13563, January 18, 2011. Executive Order 13579, July 11, 2011, states that independent regulatory agencies, such as the Federal Reserve, should comply with the cost benefit analysis and regulatory burden reduction requirements of Executive Order 13563.

[15] Letter from Federal Reserve Chairman Ben Bernanke to Mr. Cass R. Sunstein, Office of Information and Regulatory Affairs, dated Nov. 8, 2011.

[16] Alternatively, one or more of the Associations could conduct a QIS, in which case we would request a similar approach to timing.

Third, the United States has taken a more comprehensive approach than any other country to address regulatory reform. Although some countries have taken steps to address components of topics covered by Dodd-Frank, no country has adopted restrictions comparable to the Volcker Rule or adopted legislation or regulations having the scope of Dodd-Frank.[17] There can be no question but that substantive regulation has competitive consequences. It is essential that the Federal Reserve and other U.S. regulatory agencies, in proposing regulations, consider and analyze both the individual aspects and combined impact of proposed rules that may place U.S. banks at an unwarranted competitive disadvantage compared to those countries that have not implemented a comparable approach. Two principal respects in which the United States has moved more aggressively than other countries are:

- Covered companies' capital adequacy is measured under a very stringent stress test standard (namely, *5% Tier 1 common ratio*, calculated based on a severely stressed scenario, utilizing very conservative assumptions and projected over nine quarters) that may place covered companies at a competitive disadvantage to their international competitors, the capital adequacy of which is not analyzed under such severely adverse scenarios.

- The Proposed SCCL Rules would place covered companies under a very restrictive regime, which is not ultimately risk-based and is an approach not utilized by any other country. The result will be to drive a variety of key bank products to the non-U.S. competitors of U.S. banks which are not subject to comparable rules.

C. The Proposed SCCL Rules are so fundamentally flawed that they would have an adverse impact not only on regulated banking organizations but also on their customers and the broader economy, as noted above. The NPR also fails to satisfy basic administrative law standards.

The Proposed SCCL Rules would mandate methodologies that markedly depart from well-established and sensible risk management practices, drastically exaggerating actual exposures, and, if adopted as proposed, would require massive unwinding of existing transactions and reduce liquidity in key markets (perhaps severely). The arbitrary reduction of the credit limit for major covered companies (defined as having $500 billion or more of total consolidated assets) and the mandated use of one-dimensional, risk-insensitive measures of exposure will needlessly cause significant harm to U.S. financial institutions, their customers and the U.S. economy.

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[17] At a recent Senate hearing, a panel of witnesses consisting of senior representatives from several Federal agencies, including among others Martin Gruenberg, John Walsh, Dan Tarullo and Elisse Walter, was asked whether it could identify three countries that had passed a comprehensive set of regulations comparable to Dodd-Frank. No one on the panel identified a single country. *See Hearing on Orderly Liquidation, Derivatives and the Volcker Rule Before the Senate Banking, Housing and Urban Affairs*, 112th Congress (2012).

The Associations and their members support and have long embraced enterprise-wide measurement and regulation of risk exposures. Indeed, beyond statutorily-mandated bank lending limits, BHCs have established limits and monitored exposure in accordance with these enterprise-wide limits for many years. In implementing Section 165, however, the Federal Reserve has chosen to depart arbitrarily and radically from the approach taken by BHCs notwithstanding the Federal Reserve's review during the examination process of individual BHCs' approaches.

In order to assess the effects of the Proposed SCCL Rules on banking organizations and on the derivatives market more broadly, The Clearing House commissioned a QIS ("**The Clearing House SCCL Study**"), which has drawn on data provided by 13 banking organizations, including several banking organizations that are not members of The Clearing House. That study is currently being completed and will be delivered to the Federal Reserve and other U.S. banking agencies, as well as to the FSOC, upon its completion during the coming weeks. Preliminary results indicate that for the 13 organizations surveyed, if the Proposed SCCL Rules were adopted as proposed:[18]

- there would be in the aggregate 100 exposures to 29 unique counterparties in excess of the applicable credit limit;[19]
- the average counterparty exposure for those excesses would be 248% of the applicable credit limit;[20] and
- the counterparty exposures that would exceed the credit limit include exposures to seven highly-rated non-U.S. sovereigns and two CCPs.

The consequences of unwinding or terminating transactions to eliminate the extraordinary amount of excess exposures that would result if the Proposed SCCL Rules were adopted as

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[18] This data is based on our interpretation of how exposures would be calculated under the Proposed SCCL Rules. As a result, the numbers may be higher or lower if our interpretation is incorrect. In addition, some underlying data is based on approximations because certain data was not available at this time in the necessary form. Key assumptions and approximations include the following: (i) shifting to protection providers has not been capped at the amount of protection required to hedge net exposure to the reference name; (ii) exposure for protection providers has been netted within reference names for each netting set with the protection provider; (iii) collateral haircuts have not been fully applied; and (iv) the control definition has not been fully applied.

[19] If no allowance is made for short-term breaches of the credit limit (as discussed in Part III.C.2 of *Annex C*), covered companies inevitably will have to manage to a lower limit (e.g., 80% of the limit that would otherwise apply). Using 80% of the limit that would otherwise apply as the threshold, there would be 120 exposures in excess of that threshold.

[20] This average represents a "count-weighted" average (i.e., a straight average of the percentage for each of the 100 incidents of exposures in excess of the applicable credit limit).

proposed, as well as the consequences in future crises of constraining the ability of covered companies to provide liquidity to each other as well as to other market participants, cannot be fully known at this time, but the risks would obviously be substantial and potentially destabilizing.

As discussed in *Annex C*, the large number of exposures in excess of the credit limit are the result of a number of serious flaws in the Proposed SCCL Rules. The three principal flaws of the calculation methodology are: (i) use of CEM for derivatives and the add-on for repo and securities lending transactions; (ii) the requirement to shift the face amount of an exposure from a reference name to an eligible protection provider; and (iii) the 10% credit limit for major covered companies. Implementation of final rules with these provisions will likely create significant dislocations in financial markets and materially constrain liquidity in key markets.

The Federal Reserve's approach appears to be grounded in concerns that we believe are, in some important respects, unwarranted and, in all respects, can be addressed through alternative macroprudential rules without the severe and potentially adverse consequences resulting from the Proposed SCCL Rules.

Specifically, the usage of the one-dimensional CEM is apparently a reflection of the Federal Reserve's skepticism as to the accuracy of internal model methods ("**IMMs**") in times of market distress. Although we recognize that models are not infallible, the thorough review of these models during the examination process should significantly mitigate this risk. Likewise, the automatic risk-shifting appears to reflect a concern that banks' judgments as to when risk-shifting is appropriate are flawed, or even that banks will seek to evade single-counterparty credit limits absent this requirement. Although, once again, judgments are not infallible, arbitrary formulae such as mandated risk-shifting are inherently inaccurate and the examination process would deal with evasion. With respect to both calculation of exposure and risk-shifting, we recognize the need, from a supervisory and prudential perspective, to have a better understanding and appreciation of the scope of transactions between and among covered companies and other participants in financial markets. It should be possible, however, to address this concern through the reporting already required by Section 165(d)(2) of Dodd-Frank.

The arbitrarily determined 10% credit limit on "major covered companies" is not explained or otherwise articulated in the NPR, so it is impossible to provide informed comments. Nonetheless, we are concerned that this limit, and the potential consequences of the Proposed SCCL Rules more generally, reflect a view of the negative impact of interconnectivity that we believe is conceptually flawed. As discussed in *Annex C*, the financial contagion that occurred in the financial crisis was not principally a function of interconnectivity risk *per se* but of similarity risk.[21] Notwithstanding our views regarding interconnectivity risk, we recognize that the absence of a definitive analysis of the

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[21] By "similarity risk" we mean risk arising out of the similarity in the risk exposures among institutions (e.g., concentrations of exposures by multiple institutions to subprime lending), with the consequence that institutions with these exposures incurred periods of financial stress at the same time, not because of their exposures to each other, but because of their exposure to the same type or source of risk.

systemic nature of the recent financial crisis requires a meaningful response. Accordingly, the Associations have undertaken a thorough effort to develop alternatives that address the Federal Reserve's concerns, particularly model fallibility in stressed conditions, but that would not place financial markets at risk or constrain liquidity in key markets.

Specifically, our key recommendations are as follows:

- Alternatives to CEM. Requiring all covered companies to use CEM to calculate derivative exposure will result in an inaccurate and substantial overstatement of such exposure in relation to the risk posed by the exposure with potentially severe consequences for liquidity of the derivative markets. The Associations propose two approaches for measuring exposure that would be available to covered companies as an alternative to CEM. The alternatives are designed to address concerns with IMMs and capture the effect of future market volatility, but still provide meaningful and realistic measures of exposure by addressing the most significant flaw of CEM, which is its failure to take into account collateral and legally enforceable netting in the calculation of potential future exposure.

    - The first approach is a stressed IMM ("**Stressed IMM Approach**"), which could be effected in one of two ways: (1) the covered company would calculate the exposure under its IMM and then subject the result of that calculation to a multiplier specified by the Federal Reserve in order to provide an additional buffer against excessive credit exposure, or (2) the Federal Reserve could assign both (i) the confidence level that would be used by the covered company to calculate its estimate of potential future exposure under its IMM and (ii) the period of stress to be used in calibrating the IMM to either a historical lookback period or a set of market implied data, or specify criteria for selection of such period of stress.

    - The second approach would require a covered company to use a replacement cost, calculated in accordance with regulatory capital rules, for derivative transactions under specific stress scenarios specified by the Federal Reserve as the measure of exposure ("**Supervisory Stress Approach**"), similar to the approach recently used by the Federal Reserve for CCAR 2012.

- Optional exposure-shifting by protection buyer. The requirement that covered companies that buy eligible protection shift the face amount of an exposure from the reference name to the eligible protection provider results in a gross overstatement of the exposure covered companies have to eligible protection providers by ignoring the reduced likelihood that the covered company will experience a loss because both the counterparty and the protection provider would have to fail ("**double default**"). The likely consequences of this shifting requirement are a significant reduction in the availability of protection products, higher costs, and the perverse effect of transforming a risk mitigant into a risk exaggeration. This requirement should be eliminated, and the final rules should permit a covered company to make its own good faith

determination, subject to written policies and procedures (which would be subject to review during the examination process), regarding whether to shift an exposure from an underlying obligor to an eligible credit protection provider when the covered company purchases credit protection.

- Alternatives for repo and securities lending transactions. The proposed add-on that would be applied to a covered company's exposure in a repo or securities lending transaction and the haircut applied to the collateral securing such transactions result in a significant overstatement of exposure and the risk associated with it. This approach also fails to take into account the relationship between the securities transferred/lent and the type of collateral securing the transaction, as well as the risk-mitigating attributes of the portfolio as a whole. To address these concerns, the Associations propose that covered companies be permitted to use a simple Value at Risk ("**VaR**") method to calculate net credit exposure for repo and securities lending transactions. A covered company would not need separate and distinct approval by the Federal Reserve for this purpose if the covered company has already received approval to use a VaR method for regulatory capital compliance purposes. If the Federal Reserve determines that a more standardized approach is necessary, it could prescribe inputs and assumptions for the models. At a minimum, a different set of haircuts should be developed to be applied to repo and securities lending transactions that take into account the cash or securities on loan and the particular collateral securing the transactions.

- Do not reduce the 25% credit limit. The 25% statutory credit limit should not be reduced for any covered companies. The Federal Reserve has provided no basis to determine that imposing the dramatically lower and arbitrary 10% credit limit on certain major covered companies would even help mitigate risks to U.S. financial stability, much less be "necessary", as required by the statutory standard. [22]

- Exempt CCPs. Exposures to central counterparties ("**CCPs**") should be exempted from the credit limit, at least initially. Imposing a limit on a covered company's transactions with a CCP ignores the special regulatory scrutiny and regime to which CCPs are subject and will impede progress towards the goal of centralized clearing mandated by Dodd-Frank. Whether limits on a covered company's transactions with a CCP should be imposed, and the mechanics of any such limitation (including which exposures should be included in the aggregate exposure calculation and how

[22] As discussed in Part II.D of *Annex C,* courts have addressed on a number of occasions the meaning of the word "necessary" in statutory contexts. Courts have, in situations similar to those here, construed the term to mean "indispensable", and have always defined the term as something akin to "required", as opposed to merely "useful". If the Federal Reserve wishes to adopt for some group of covered companies a less than 25% credit limit relying on the "necessary to mitigate" language in Section 165(e)(2) of Dodd-Frank, it must undertake an analysis of the interplay between percentage credit limits and size and demonstrate their nexus to the statute's "necessary to mitigate" test.

those exposures are calculated), should be addressed as part of the larger exercise, both in the United States and abroad, of framing the regulatory regime applicable to CCPs.

- Do not apply the credit limit to high-quality non-U.S. sovereigns. Exposures to high-quality non-U.S. sovereign obligations should not be covered by the credit limit. Our recommendation is designed to ensure that covered companies will be able to continue to accept such high-quality obligations as collateral, and avoid distorting the market for, and reducing the liquidity of, these obligations. Importantly, Dodd-Frank does not require that non-U.S. sovereign obligations be subject to the credit limit because sovereigns are not companies under any accepted definition of that term.[23] Nor does the NPR indicate that the Federal Reserve conducted any analysis, as required by U.S. governmental policy, of the benefits of treating all non-U.S. sovereigns as companies against the potentially significant resulting costs and damage to covered companies and financial markets. Moreover, coverage of non-U.S. sovereigns, the obligations of which have similar levels of liquidity and creditworthiness as those of the United States, which the Federal Reserve did not subject to the credit limit (presumably because of its risk profile), is unsustainable under the Administrative Procedure Act ("**APA**"),[24] particularly given the absence of any explanation or basis for differentiation.

- Individuals should not be covered as counterparties. Exposures to individuals should not be covered by the Proposed SCCL Rules, as in no respect can the definition of "company" under the statute be read to cover individuals, nor would such coverage be consistent with Congressional intent and the purpose of Section 165(e) to address interconnectivity risk "among large financial companies."[25] Credit transactions by a covered company with individuals plainly do not present systemic interconnectivity concerns. Moreover, the Federal Reserve has not provided any basis or explanation for covering individuals as counterparties under the rule, and the NPR provides no indication that the Federal Reserve considered the very severe burdens that would be placed upon covered companies to monitor and calculate daily their exposures to millions of individual customers. Given the extreme unlikelihood that exposure to an individual would ever approach the credit limit or pose systemic interconnectivity issues, we submit that under no conceivable calculus can the burdens placed upon institutions by such a requirement be justified.

- Use financial reporting consolidation as "control" definition. The Proposed SCCL Rules adopt a broad definition of "control". This broad definition creates an aggregation of exposures that is inconsistent with financial reality and accurate risk-evaluation and goes beyond the

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[23] Under the Bank Holding Company Act, the Federal Reserve has explicitly excluded sovereigns from the definition of "company". 12 U.S.C. 1841(b). Banca Commerciale Italiano, 68 Fed. Res. Bull. 423 (1982); Letter dated August 19, 1988 from William W. Wiles to Patricia S. Skigen.

[24] 5 U.S.C. 551, *et seq.*

[25] 77 Fed. Reg. at 612.

requirements of the statute or its intent. The proposed definition of "control" would require that a covered company include all affiliates of a counterparty in calculating its aggregate exposure to that counterparty no matter how tenuous or remote the affiliation and regardless of the existence of any actual obligation or responsibility of the "individual company" for the affiliate or likelihood of support. As just one example, if a general partnership or managing member interest is treated as a voting security using a Bank Holding Company-type definition, exposure to all of the controlled portfolio companies of all the private equity funds with the same general partner (or similar fund advisor with an equity stake) and exposure to the funds themselves could potentially be aggregated.[26] The definition of "control" should be revised to include only those situations where a company is consolidated for financial reporting purposes. Using this definition of "control" will help avoid aggregation of exposures that do not reflect actual risk. It would also address compliance problems raised by the Proposed SCCL Rules, which would require access to information that is generally not available to a covered company.

- Limit compliance burden. The burden associated with requiring a covered company to calculate compliance for each and every counterparty on a daily basis cannot be justified by any supervisory or systemic benefit. As long as a covered company's policies and procedures are sufficient to prevent an exposure from approaching a specified percentage of the credit limit, there is no reason to require daily monitoring or any reporting of exposures that fall well below the credit limit.

- Provide a more reasonable effective date. The Proposed SCCL Rules have fundamental flaws and no delay in implementation of rules implementing Section 165(e) will address those flaws. At a minimum, however, given the complexity of calculating counterparty exposures under these rules, even if revised to address the flaws, we believe the Federal Reserve should exercise its authority to extend the transition period for the full two years. This extended effective date will provide needed time to shift credit relationships without causing market shocks. In addition, an extended transition period will provide covered companies with more time to develop enhanced systems to comply with the Proposed SCCL Rules.

[26] This represents one additional example of the presumably unintended consequence of a number of the proposed regulatory reforms of driving business from the regulated banking industry to the largely unregulated shadow banking sector.

D. Numerous aspects of the Proposed Rules, along with regulatory reform measures more broadly, appear premised on the "big is bad" belief that size inherently is a major indicator of and contributor to systemic risk, and assume that (i) "too big to fail" has not been addressed and cannot be solved and (ii) forcing institutions to reduce their size will reduce systemic risk without creating any loss of services or harm to customers or the domestic or international financial systems or economies. In our view, neither the belief nor the assumptions are correct.

Although some academics, legislators and even members of the Federal Reserve System have called for large banks to be broken up, this was not the decision that Congress made in Dodd-Frank.[27] Section 165 calls for enhanced prudential supervision of larger banks rather than their break-up. Nonetheless, the Federal Reserve appears to suggest that, contrary to Congress' determination, it has set a course to use Section 165 to achieve indirectly what it was not authorized to address directly – that is, precipitate a reduction in the size of large banks through size-based regulation.[28] The Preamble asserts that the Proposed Rules "would provide incentives for covered companies to reduce their systemic footprint . . ."[29] Two aspects of the Proposed Rules go directly to this point – (i) the Proposed SCCL Rules' 10% credit limit for major covered companies and (ii) the G-SIB Surcharge, as well as many of the indicators in the BCBS's G-SIB Surcharge (which the Preamble indicates may be the basis for a surcharge on covered companies or a subset of covered companies) that correlate with, and largely appear to be proxies for, size.[30] We submit that an approach grounded in a "too big" or "big is bad"

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[27] In April 2010, Senators Sherrod Brown and Ted Kaufman offered an amendment to the Senate's financial regulatory reform bill that, if enacted, would have had the effect of forcing some large U.S. banking organizations to downsize. That amendment was soundly rejected on the Senate floor by a bipartisan majority of senators. The vote was 33 to 61. (S. AMDT. 3733 to S. 3217, 111th Cong. (2010); 156 CONG. REC. S3352 (daily ed. May 6, 2010) (Roll Call Vote No. 136 Leg.)) Also, in May 2010, Senators Maria Cantwell, Russ Feingold, Tom Harkin, John McCain and Bernie Sanders offered an amendment to the same bill that would have reinstated the Glass-Steagall Act, which through its prohibition on the affiliation of commercial banks and investment banks, likely would have had the effect of forcing some large U.S. banking organizations to downsize. The Senate never debated or called the amendment for a vote. (156 Cong. Rec. S3793, 3808-09 (daily ed. May 17, 2010) (text of Senate Amendment No. 3884 to Amendment No. 3739 to S. 3217)

[28] This is an even more radical approach than suggested by two recent Federal Reserve application decisions that appear to interpret the new "financial stability factor" in Sections 3 and 4 of the Bank Holding Company Act as an inhibition to future growth by the largest banks. *See* Federal Reserve System, *Order Approving Acquisition of a State Member Bank* (Dec. 23, 2011) (approving an application by The PNC Financial Services Group, Inc. and PNC Bancorp, Inc. to acquire RBC Bank (USA)); Federal Reserve System, *Order Approving Acquisition of a Savings Association and Nonbanking Subsidiaries* (Feb. 14, 2012) (approving an application by Capital One Financial Corporation to acquire ING Bank, fsb).

[29] 77 Fed. Reg. at 596.

[30] We note, specifically, the provision in the BCBS proposal that threatens G-SIBs with a higher surcharge (including the 3.5% "empty bucket") if they grow by acquisition.

concept is not only contrary to Congress' intent but is misguided and detrimental to a sound, strong banking system and a strong economy for at least four reasons.

First, it is important for the American and global economies that there be banks of all sizes, including at least some banks of significant size. The variety allows the banking industry to serve customers from the very smallest firms to the largest, including multinational companies, with convenience that matches the needs of our customers, innovation that all types of banks can provide, and financings to bolster economic growth and job creation by meeting the demands of customers of all sizes.[31] Banks must mirror the economic system they are designed to serve. In the 21st century, companies served by international banks compete in a global economic system, exporting finished products, importing raw materials and components, and establishing substantial operations abroad. Therefore, they need banks that are competitive around the world and are able to meet quickly and efficiently a wide range of financial needs, from treasury services to overnight funding to trade finance to currency hedging. It is unrealistic to believe that these needs can be entirely met by small banks or by hedge funds or other members of the shadow banking system. There are many facets of an institution, not just size, that determine its effectiveness, productivity, risk and contribution to its customers and communities.

Second, the empirical record contradicts the argument that size alone correlates to risk. Between January 1, 2008 and March 31, 2012, the FDIC placed into receivership 430 banks having aggregate consolidated assets of approximately $682 billion. Of those receiverships, all but one of the banks had less than $50 billion of total consolidated assets. Likewise, two of the countries with the most concentrated banking systems, Canada and Australia, fared better during the crisis than almost any other country.

Third, although the Associations recognize that in many (but not necessarily all) cases, the failure of a large bank is more likely to result in national systemic risk than the failure of a smaller bank, we submit that this issue should be addressed by an effective and credible resolution regime for large institutions. We believe that such a regime has been created by the orderly liquidation authority of Title II of Dodd-Frank, which is supplemented by the living will requirements and other Dodd-Frank provisions.

As mentioned above, the Federal Reserve notes in the Preamble that Dodd-Frank takes a multi-prong approach to mitigating the threat to financial stability posed by systemically important financial companies, including the orderly liquidation authority in Title II of Dodd-Frank.[32] The Proposed

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[31] The Clearing House has addressed these considerations in a study previously provided to the Federal Reserve and the other U.S. banking agencies, titled "*Understanding the Economics of Large Banks,*" available on its website at http://www.theclearinghouse.org/index.html?f=073071.

[32] 77 Fed. Reg. at 595.

Rules' substantive provisions, however, with their focus on size and restrictions designed to encourage reduction in size, fail to give credibility to Title II.[33]

Fourth, the Associations agree that taxpayers should never again be required to bail out a financial institution and that "too big to fail" is an unacceptable policy. This issue is, however, addressed directly by Title II, which provides that stockholders are wiped out, management replaced and creditors held responsible for any losses suffered in the failure of a systemically important institution, and indirectly by several other provisions of Dodd-Frank and Basel III. In addition, unlike the Bankruptcy Code's Chapter XI reorganization arrangement, Title II provides no option to a government-controlled liquidation. In addition, Dodd-Frank amended Section 13(3) of the Federal Reserve Act to eliminate the potential for single-company special financing.

E. With respect to the Proposed Stress Test Rules, it is crucial that (i) the design of the models used as part of the stress test process be transparent and subject to an appropriate public consultative process prior to implementation, (ii) the CCAR 2012 disclosure template generally be used for disclosure of the results of both supervisory and company-run stress tests, at least for covered companies with consolidated assets of $50 billion or more, and (iii) disclosures are not provided, or required to be provided, in any circumstances under base case scenarios.

The macro-economic assumptions of the supervisory stress scenarios required by Section 165(i) of Dodd-Frank and Proposed Stress Test Rules are but one component of the stress test process. Equally important are the models, methodologies, techniques and underlying assumptions the Federal Reserve will use to calculate each covered company's stress test and capital plan results. In the wake of the CCAR 2012 experience, the Associations believe that the design of the models, techniques and underlying assumptions to be used as part of the stress test process should be transparent and subject to an appropriate public consultation and input well before adoption and implementation for purposes of the Proposed Stress Test Rules and, as a practical matter, the Capital Plan Rule. In particular, we strongly urge the Federal Reserve to provide detailed explanations of methodologies, models, techniques and underlying assumptions the Federal Reserve will use for purposes of the required supervisory stress test. This would help to ensure that covered companies have sufficient information to analyze meaningfully the supervisory stress test results, thereby reducing the potential "black box" aspects of the supervisory stress test and allowing firms to engage in the very type of forward-looking capital planning that the Federal Reserve seeks to promote. In addition, transparency in the models and methodologies will assist banks' ability to access the public capital markets in a timely

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[33] *The Economist* simulated the failure of a $1 trillion BHC at its Buttonwood Gathering on October 27, 2011. Notably, *not* among the options considered for dealing with the failure by the participants in the simulation (who included Larry Summers, John Dugan and Rodgin Cohen) was a government-sponsored bail out, because such bail outs are prohibited under Dodd-Frank. The Economist, *Fright Simulator: How to Deal with a Collapsing Bank under the Dodd-Frank Rules* (Nov. 12, 2011), *available at* http://www.economist.com/node/21538164.

and efficient manner by avoiding prolonged "blackout" periods for equity offerings. We do not believe it is appropriate for covered companies' capital planning and distribution decisions to be governed by models and methodologies that have never been subject to appropriate prior review and input. Aspects of CCAR 2012 stress testing methodology related information published heretofore by the Federal Reserve have been useful and instructive. The models themselves, however, continue to be described only in fairly general terms, with important methodological particulars being left open or vague. It is this continued lack of meaningful detail and specificity that furthers the problematic supervisory stress testing "black box".

In addition, given the mandated "summary" disclosure of company-run stress test results, without an understanding of the models and underlying assumptions used by the Federal Reserve, covered companies will find it challenging to explain differences in their own stress test results and those run by the Federal Reserve. The largely inexplicable disclosure of these differences would only serve to heighten the "black box" effect and lead to market confusion concerning annual stress test results.

We strongly disagree with suggestions that transparency into the supervisory models and their underlying assumptions would enable banks to "game" the system or otherwise lead to turning the capital planning and stress testing processes into mechanical compliance exercises. The Associations believe that the company-run stress test process is the proper supervisory forum for ensuring that the Capital Plan Rule and the Proposed Stress Test Rules encourage and result in enhanced risk management and capital planning processes by covered companies. It is simply unfair to ask a bank to pass a test – and manage towards the standards of that test – if the parameters are largely unknown or otherwise opaque. Doing so is functionally similar to establishing a minimum risk-based capital ratio, but then not publishing the rules explaining how banks are to calculate their risk-based assets for complying with the ratio.

We do commend the Federal Reserve for implementing the CCAR 2012 disclosure regime in a manner which was appropriately balanced by providing useful information to market participants while simultaneously ensuring that disclosure of stress test results does not result in effectively providing earnings guidance concerning base case scenarios or other information that would enable reverse-engineering of base case or quarter-by-quarter results. Thus, the Associations strongly urge that the Federal banking agencies generally adopt the template used in reporting the CCAR 2012 results for purposes of publication of both the results of supervisory stress tests conducted by the Federal Reserve and the annual and semi-annual stress tests conducted by covered companies with consolidated assets of $50 billion or more – e.g., publication of the results of only the "severely adverse" supervisory scenario for the annual supervisory and company-run stress tests and the company-generated "severely adverse" scenario for the mid-year company–run stress test, as applicable. This would be in accordance with the respective provisions of Sections 165(i)(1) and (2), which call for publication of only a "summary of the results" of the stress tests required thereunder. Under no circumstances should the Federal Reserve disclose, or should covered companies be required to disclose, base case stress test results.

Finally, in order to ameliorate the negative effects of what in reality is a variable or floating minimum capital requirement created by the interaction of the Proposed Stress Test Rules and the Capital Plan Rule, the Federal Reserve and the other banking agencies should adopt a uniform approach for identifying supervisory stress scenarios (which would apply absent exigent circumstances) so that changes from year to year do not unnecessarily make floating capital requirements more volatile than they otherwise need be.

F. The Proposed Risk Management Rules and the governance provisions of the Proposed Liquidity Rules (i) are so detailed and prescriptive as to risk impeding directors' proper discharge of their oversight duties and (ii) in several areas blur the distinction between the proper oversight role of the Board of Directors and management's responsibility for day-to-day operations.

The Associations unreservedly support more robust risk management and largely support the governance provisions in the Proposed Rules. We are concerned, however, that addressing such a complex subject with the granularity and rigidity brought to the topic by the Proposed Rules raises the risk that managing to compliance with rules will actually impede effective managing of the liquidity and other risks the Proposed Rules are designed to address. As discussed in detail in The Clearing House's recently published "*Guiding Principles for Enhancing Banking Organization Corporate Governance,*" it is essential that (i) the distinction between the roles of the Board of Directors and management be preserved and (ii) there be recognition that a one-size-fits-all approach will inherently fail to account for the wide variety of circumstances that exist among individual institutions.[34] The Proposed Risk Management Rules and the governance provisions of the Proposed Liquidity Rules would require the Board of Directors (or committee or subcommittee thereof) to become involved – to an unprecedented degree – in granular, management level matters that risk impeding directors' proper discharge of their oversight duties. We discuss our specific concerns in this regard in *Annex B* and *Annex D*.

G. For small, midsized and regional banks, implementation of regulations under Sections 165 and 166 should avoid creating a "cliff effect" by providing for a transition period after the institution has crossed the applicable asset threshold.

Dodd-Frank creates an unprecedented number of new regulations, and threatens regulatory expansion as targeted regulatory requirements intended for larger, more complex institutions are applied to smaller, and in many instances, low-risk traditional banking operations. Prudential supervision as envisioned in the Proposed Rules creates regulations and supervisory expectations applicable to the largest and most complex banks, but applies these same rules to all covered financial institutions, disregarding the significant differences in business model, complexity, risk, compliance resources, and potential systemic importance.

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[34] The Associations have long advocated this point. *See* Letter from the ABA to Governor Susan S. Bies, dated April 28, 2005.

Moreover, compliance expectations for institutions over $50 billion in assets should not be applied to institutions under $50 billion in assets as *de facto* best practices or in anticipation that at some point in time in the future the institution may cross the arbitrary $50 billion threshold. To address this concern in part the Associations recommend that the Federal Reserve develop transition rules that would permit an institution up to one additional year following the four-quarter period contemplated by the Proposed Rules after it crosses the $50 billion or, if applicable, $10 billion asset threshold, to phase in full compliance with the new requirements for that asset size. This is particularly true and necessary for the stress testing, liquidity and single counterparty concentration provisions, due to the significant investments in systems and resources needed.

II. Certain Key Recommendations and Concerns Addressed in Topical Annexes[35]

Proposed Capital and Leverage Rules (*Annex A*). The Associations and their members support a robust capital regime. Nonetheless, we strongly believe that it would be premature to impose a significant capital surcharge on covered companies, or a subset of covered companies, based on the framework established by the BCBS applicable to G-SIBs (or any other framework), and that such a surcharge is not required to satisfy Dodd-Frank's mandate for "more stringent" capital standards, for the following reasons:

- The Federal Reserve's application of its existing Capital Plan Rule, as the interface between that rule and the Proposed Stress Test Rules, in and of itself satisfies Dodd-Frank's "more stringent" capital standard. The most recent stress test for covered companies applied a capital standard that is far more stringent than the published capital requirements for U.S. banking organizations (or, for that matter, the capital requirements that exist, with very limited exceptions, anywhere else in the world) – a minimum 5% Tier 1 common ratio over nine quarters under severely stressed conditions and conservatively calculated. BHCs with $50 billion or more in total consolidated assets already are, and covered companies will be, required to maintain capital ratios substantially above those required of non-covered companies as a result of the interplay between this stress testing and the Capital Plan Rule. Indeed, the recent stress test results provide the ultimate refutation of the need for even more capital. To require U.S. banks to hold capital *beyond* what would be required for the bank to withstand – and continue to act as a financial intermediary through – a financial collapse in Europe and a depression in the United States (the model of the Federal Reserve's macro-economic assumptions) would be undeniably excessive.

- The 7% minimum Common Equity Tier 1 ("**CET1**") ratio under Basel III is equivalent to a 14% Tier 1 capital ratio under the pre-crisis Basel I rules for the United States. No large financial

[35] We addressed the Proposed SCCL Rules – both our key concerns and recommendations – in Part I because of both their serious flaws and systemic implications, and a more extensive discussion of the Proposed SCCL Rules is set forth in *Annex C*. Accordingly, we are not addressing the Proposed SCCL Rules in this Part II.

institution that met a 7% CET1 ratio (using the Basel III methodology) at the onset of the crisis suffered serious financial distress.[36]

- The negative impact of a capital surcharge on the investment attractiveness of covered companies' equity securities is readily demonstrated. A covered company with a return on equity of 12% would have its returns on equity ("**ROE**") slashed to about 9% by a 250 basis point surcharge. Even a 100 basis point surcharge would reduce a 12% ROE to about 10.5%, thereby reducing the firm's ability to attract capital.

- There are fundamental flaws in the design and indicator-based methodology of the G-SIB Surcharge, including the following:

    - Significant uncertainties regarding the measurement of systemic importance and the calibration of a significant surcharge on large banks, which undermine the credibility of the design and indicator-based methodology of the G-SIB Surcharge;

    - Lack of transparency surrounding the assessment and calculation of the proposed surcharge that frustrates bank management's ability to make fundamental business decisions on an informed basis and creates uncertainty regarding the amount of capital that must be held;

    - The failure to acknowledge the development, in certain countries, of credible recovery and resolution regimes, including Title II of Dodd-Frank and the living will requirements, although the G-SIB Surcharge is premised upon the consequence of a G-SIB failure; and

    - Numerous other flaws that, among other things, may create perverse incentives to increase instead of decrease risk and provide an inaccurate view of systemic importance. For example, the value of underwritten transactions or of assets under custody (at least in the United States) is not indicative of systemic importance in terms of substitutability.[37]

Proposed Liquidity Rules (*Annex B*). The Associations endorse the liquidity risk management tools addressed in the Proposed Liquidity Rules and believe the core principles embedded within the Proposed Liquidity Rules reflect actual risk and are consistent with current enhanced

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[36] *See* footnote 17 of *Annex A* for our definition of "serious financial distress".

[37] As in other areas (including The Clearing House SCCL Study noted above), the Associations have attempted to analyze proposals with hard analysis and data. In the case of possible surcharges, this has included The Clearing House Surcharge Study described in *Annex A* and included in the Prior Submissions, initially prepared in connection with the BCBS's proposal for its G-SIB Surcharge.

liquidity-risk management practices of many banks. The Associations, however, have significant concerns with certain aspects of the Proposed Liquidity Rules. These include:

- The Proposed Liquidity Rules' governance provisions address liquidity risk management with such granularity and rigidity as to raise the risk that Boards of Directors and managements will be forced to manage to compliance with rules to an extent that will impede managing the liquidity risk the rules are designed to address. We strongly urge the Federal Reserve to consider an approach more in line with the strategic and oversight responsibility of the Board of Directors.

- In several areas, the Proposed Liquidity Rules' risk governance provisions blur the distinction between the proper oversight rule of the Board of Directors and management's responsibility for day-to-day operations. We believe these provisions should be adjusted so that the focus of the Board of Directors or risk committee, insofar as liquidity risk is concerned, is on the oversight of liquidity risks, including approval of risk management policies developed and recommended by management.

- We appreciate that the Proposed Liquidity Rules address a number of the Associations' concerns with the Basel III methodology, including (i) permitting U.S. government-sponsored entity securities (most importantly, Fannie Mae and Freddie Mac debt and mortgage-backed securities) to be included in "highly liquid assets" without the artificial Level 1 ("**L1**")/Level 2 ("**L2**") distinction in Basel III's liquidity coverage ratio ("**LCR**"); and (ii) permitting covered companies to develop their own run-off factors and assumed drawn-down rates, provided that they rely on reasonably high-quality data and information to produce creditable outcomes. The Associations urge the Federal Reserve to work with the other U.S. banking agencies and their international counterparts to revise the Basel III liquidity framework's approach to the quantitative analysis of liquidity risk, implemented through its LCR (and, depending upon the review to which it will be subject during the observation period provided for in Basel III, potentially the net stable funding ratio ("**NSFR**")), to an approach more aligned with the Proposed Liquidity Rules.

Proposed Risk Management Rules (*Annex D*). The Associations' concerns and recommendations with respect to the Proposed Risk Management Rules include:

- As is the case with the risk governance provisions of the Proposed Liquidity Rules, the Proposed Risk Management Rules blur the distinction between the proper oversight role of the Board of Directors and management's responsibility for day-to-day operations in several areas. The Proposed Risk Management Rules should consistently preserve the distinction between a Board of Director's oversight role and management's operational role. Otherwise, boards and board committees will be overwhelmed with duties that impair their ability to provide independent and objective supervision to the company. The risk management committee should approve and oversee risk management policies developed and recommended by management.

- Effective risk management requires the oversight of the board and the involvement of various board committees. The final rules should explicitly acknowledge the Board of Directors' authority to allocate the oversight of certain, specific risk management responsibilities to appropriate board committees, such as an audit, credit or finance committee.

- The definition of "risk management expertise" should be replaced with a definition patterned after the SEC's definition of an "audit committee financial expert."[38] Moreover, the Associations believe that an effective risk committee can benefit from members with diverse backgrounds, including senior operational and managerial roles with nonbanking firms, who could provide useful insights into operational risks and reputation risks. We recommend that only one member of the risk committee be required to have "risk management expertise" as that term is appropriately defined.

- Dual reporting by the chief risk officer to the risk committee should not be mandated, nor should the chief risk officer be required to report directly to the chief executive officer. Although we believe the chief risk officer should have clear access to, and regular meetings or contact with, the risk committee and chief executive officer, no single corporate governance model is appropriate for all organizations, and dual reporting would impair effective risk management by complicating the relationship between management and the board.

Proposed Stress Test Rules (*Annex E*). The Associations believe that credible and robust stress tests can be invaluable tools for capital planning, provide important information to regulators and market participants and serve to enhance the stability of the financial system as a whole, but have several concerns (which have been intensified by the process for the 2012 stress tests) and recommendations with respect to the Proposed Stress Test Rules. These include:

- The design of the supervisory models, techniques and underlying assumptions to be used as part of the stress test process should be transparent and subject to appropriate public consultation and input *before* adoption and implementation for purposes of the Proposed Stress Test Rules. In particular, the Associations strongly urge the Federal Reserve to provide full and detailed explanations of methodologies, models, techniques and underlying assumptions the Federal Reserve will use for purposes of the required supervisory stress test well in advance of implementation. This would help to ensure that covered companies have sufficient information to analyze meaningfully and reconcile the supervisory stress test results, thereby reducing the potential "black box" aspects of the supervisory stress test. There is the potential for error in developing models, whether they are developed by the public or private sector, and a consultative process would help reduce those errors. Furthermore, we strongly disagree with any suggestion that transparency into the supervisory models and their underlying assumptions would somehow enable banks to "game" the system or otherwise lead to turning the capital

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[38] The SEC defines "audit committee financial expert" in Item 407(d)(5) of Regulation S-K. We discuss that definition in Part III.D of *Annex D*.

planning and stress testing processes into mechanical compliance exercises. The Associations believe that the company-run stress test process is the proper supervisory forum for ensuring that the Capital Plan Rule and the Proposed Stress Test Rules encourage and result in enhanced risk management and capital planning processes. It is simply unfair to ask banks to pass a test the parameters of which are largely unknown or otherwise opaque.

- The Federal banking agencies should work collectively to minimize effectively the duplicative burden of the multiple and overlapping stress test requirements of the Proposed Stress Test Rules and the OCC's and FDIC's respective stress test rules, including by consistently using the same supervisory stress test scenarios and models for purposes of the supervisory and the company-run stress tests and formulating common inter-agency information requirements.

- The CCAR 2012 disclosure template should generally be used for disclosure of both supervisory and company-run stress tests under Section 165(i) of Dodd-Frank and the Federal banking agencies' respective proposed stress test rules, at least for covered companies with consolidated assets of $50 billion or more.

- Under no circumstances should the Federal Reserve disclose, or should covered companies be required to disclose, base case stress test results or other information that could be used effectively to reverse-engineer earnings guidance or other quarter-by-quarter results under either the supervisory or company-run stress test requirements of the Proposed Stress Test Rules.

- Under the Capital Plan Rule, covered companies are required to demonstrate to the Federal Reserve their ability to maintain capital above existing minimum capital ratios and above a Tier 1 common ratio of 5% under both expected and stressed conditions or else face limitations on capital distributions such as dividends and share buy-backs. Because the amount of required capital will depend on the severity of the stress scenarios, the interplay of the Capital Plan Rule and the Proposed Stress Test Rules makes it challenging for covered companies to engage in prudent medium-to-long term capital planning as a practical matter. In order to ameliorate the negative effects of what in reality is a variable or floating minimum capital requirement, the Federal Reserve and the other banking agencies should adopt a uniform approach for identifying supervisory stress scenarios (which would apply absent exigent circumstances) so that changes from year to year do not unnecessarily make floating capital requirements more volatile than they otherwise need be. An example would be consistent severity and minimum probability of occurrence benchmarks.

Proposed Early Remediation Rules (*Annex F*). The Associations support the overall objective of Section 166 of Dodd-Frank of minimizing the probability that a covered company will become insolvent and the potential harm arising from such an insolvency. As we discuss in detail in *Annex F*, however, we are concerned that the sensitivity and rigidity of the automatic triggers and the failure of the mandated remediation measures to be calibrated to the nature of the applicable triggering event increase the risk that entry into the early remediation regime by a firm will precipitate its further

deterioration rather than address its deficiencies and enhance its financial condition. To address these concerns, our recommendations with respect to the Proposed Early Remediation Rules include:

- The use of automatic triggers as contemplated by the Proposed Early Remediation Rules creates the risk that certain triggers, if misapplied or misused, could have the procyclical effect of exacerbating funding or market pressures at the affected covered company. The Associations believe a more appropriate approach would be for the Federal Reserve to make early remediation decisions based on discretionary supervisory judgments, in light of all the facts and circumstances, taking into consideration non-determinative quantitative and qualitative factors. Related to this point, the Federal Reserve should not preclude flexibility to tailor remediation actions so that they appropriately address the issues requiring remediation. Once the determination is made that remediation is required, it is consistent with Section 166 for the Federal Reserve to choose one or more of several potential remediation actions.

- All notices, determinations and regulatory actions taken in the early remediation regime should be treated as non-public confidential supervisory information.

- The Associations believe that stress tests, the results of which are a function of the severity of hypothetical scenarios, should not be a trigger for early remediation; if they are to be used as a trigger, they should not trigger remediation requirements higher than Level 1. The supervisory stress tests as contemplated by the Proposed Stress Test Rules are based on hypothetical scenarios over a nine-quarter period, and therefore the outcome of the stress tests depends upon the severity of the scenarios as well as the Federal Reserve's calculation models. This creates a meaningful risk that remediation could be triggered by outlier results that have little basis in reality. Level 1 early remediation would allow the Federal Reserve to monitor a firm on the basis of failing to meet the requirements of the stress test, rather than mandating actions based on hypothetical assumptions. Moreover, covered companies that did not meet the required capital ratio under the severely adverse scenario under the supervisory stress tests would continue to be subject to meaningful and binding restrictions under the Capital Plan Rule, including the prohibition on making any capital distributions until a revised capital plan was submitted and received a no-objection from the Federal Reserve. Our concerns are exacerbated by the fact that market participants may be able to predict or discover early remediation actions against specific firms by scrutinizing stress test disclosures. The publicly observable nature of many of the automatic triggers may actually impair the ability of a firm to take appropriate restorative capital actions because market participants may assume the firm will inevitably fall into the early remediation regime prior to reaching an actual trigger.

- To the extent mandatory triggers are retained, the Associations have specific concerns with the triggers, including:

    - The prices of market indicators, such as credit default swaps and equity securities, are susceptible to manipulation, and movements in their prices may be otherwise unrelated to underlying financial or management weakness. In

particular, triggering a credit default swap-based indicator could quickly exacerbate liquidity stresses.

- Companies subject to the early remediation regime should be promptly released from applicable restrictions and requirements when restored to appropriate managerial or financial health.

- Immaterial non-compliance with the risk management, risk committee and liquidity requirements should not result in early remediation.[39] Materiality thresholds should be built into the triggers.

* * *

In conclusion, the Associations appreciate the substantial efforts of the Federal Reserve in developing the Proposed Rules. We are deeply concerned, however, that, in a number of key areas, implementation of the Proposed Rules could have serious adverse consequences that would increase risks to financial institutions, the markets, customers and the economy, notwithstanding that the objectives sought to be achieved are worthwhile. In this Comment Letter, we have attempted to identify those areas and propose recommendations that accomplish the objectives without incurring those consequences.

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[39] Non-compliance should also not trigger unrelated remediation actions. For example, a deficiency in meeting the risk committee requirements under the Proposed Risk Management Rules could by itself result in restrictions on distributions, even though that may do nothing to address the underlying risk management issue.

If you have any questions or need further information, please contact (i) at The Clearing House, Paul Saltzman, its President and General Counsel (e-mail – paul.saltzman@theclearinghouse.org, telephone number – (212) 613-0318); (ii) at the ABA, Wayne A. Abernathy, its Executive Vice President, Financial Institutions and Regulatory Affairs (e-mail – wabernat@aba.com, telephone number – (202) 663-5222); (iii) at the Forum, Robert S. Nichols, its President and CEO (e-mail – rob.nichols@financialservicesforum.org), telephone number – (202) 457-8765); (iv) at The Roundtable, Richard M. Whiting, its Executive Director and General Counsel (e-mail – Rich@fsround.org, telephone number – (202) 589-2413); and (v) at SIFMA, Kenneth E. Bentsen, Jr., its Executive Vice President, Public Policy and Advocacy (e-mail – kbentsen@sifma.org, telephone number – (202) 962-7400).

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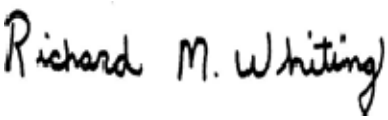

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The Clearing House Association

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

American Bankers Association

The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its two million employees. Learn more at www.aba.com.

Financial Services Forum

The Financial Services Forum is a non-partisan financial and economic policy organization comprising the CEOs of 20 of the largest and most diversified financial services institutions doing business in the United States. The purpose of the Forum is to pursue policies that encourage savings and investment, promote an open and competitive global marketplace, and ensure the opportunity of people everywhere to participate fully and productively in the 21st-century global economy.

The Financial Services Roundtable

The Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine and account directly for $92.7 trillion in managed assets, $1.1 trillion in revenue, and 2.3 million jobs.

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SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

Proposed Capital and Leverage Rules (Subpart B) – Risk-Based Capital Requirements and Leverage Limits[1]

The Federal Reserve indicated in the Preamble that it will address Dodd-Frank's requirement[2] that it establish risk-based capital and leverage standards for covered companies that are more stringent than the standards applicable to nonbank financial companies and BHCs that do not present similar risks "with a two-part effort."[3] The Proposed Capital and Leverage Rules take only a limited first step by applying the Federal Reserve's Capital Plan Rule, added to Regulation Y effective December 30, 2011,[4] to all covered companies (including nonbank covered companies) as well as to the BHCs with $50 billion or more in consolidated assets to which it currently applies. The Federal Reserve indicated that the second step in the two-part effort would be to implement a quantitative risk-based capital surcharge for covered companies or a subset of covered companies, based on the framework established by the BCBS applicable to global systemically important banks ("**G-SIBs**", and the BCBS's proposed surcharge, the "**G-SIB Surcharge**").[5]

The Associations commented at length on the BCBS's G-SIB Surcharge proposal, addressing concerns with the basic concept, fundamental reservations with its underlying assumptions and significant concerns with flaws in its indicator-based methodology. Those comment letters, copies of which were provided to the Federal Reserve, included:

- a letter, dated August 26, 2011, from The Clearing House and the Institute of International Bankers (the "**Prior TCH/IIB Surcharge Letter**");
- a letter, dated August 26, 2011, from the ABA; and
- a letter, dated August 26, 2011, from the Global Financial Markets Association, of which SIFMA is a member.

For ease of reference, copies of those letters (the "**Prior Surcharge Letters**") are included in the Prior Submissions.

The BCBS adopted final G-SIB Surcharge provisions (the "**G-SIB Final Rules Text**") substantially as initially proposed. When the BCBS released its G-SIB Final Rules Text, it also released a cover note (the "**Cover Note**") that discussed some of the comments submitted to the BCBS on the G-SIB Surcharge proposal and generally dismissed the comments, often in a conclusory fashion with little

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1 Capitalized terms used in this Annex and not otherwise defined are used with the meanings assigned to them in the Comment Letter to which this Annex is attached.

2 Section 165(b)(1)(A)(i) of Dodd-Frank.

3 77 Fed. Reg. at 598.

4 12 C.F.R. § 225.8.

5 *See* BCBS, *Global Systemically Banks: Assessment Methodology and the Additional Loss Absorbency Requirement – Rules Text* (November 2011).

explanation.[6] We urge the Federal Reserve, as it considers possible implementation of a surcharge applicable to covered companies or a subset of covered companies, to consider the concerns raised in the Prior Surcharge Letters. The Associations' comments in the Prior Surcharge Letters on the BCBS's G-SIB proposal, with limited exceptions, apply to the G-SIB Final Rules Text as well. Further, beyond our fundamental concern regarding any surcharge effectively based on size, our specific reservations regarding the BCBS's G-SIB Surcharge apply with equal force to any similar capital surcharge that the Federal Reserve may consider for covered companies or a subset of covered companies if based on the BCBS's G-SIB Surcharge.

As discussed in Part I.D of the Comment Letter in the context of the Proposed Rules as a whole (and in the Prior Surcharge Letters in the specific context of the BCBS's G-SIB Surcharge proposal), we do not agree with the simplistic view that size alone creates prudential concerns or, more broadly, that large banks are inherently problematic and do not provide important economic and other benefits or that it is not feasible to end "too big to fail." The Federal Reserve's proposal eventually to impose a surcharge on certain covered companies that builds on the G-SIB Final Rules Text, and the Proposed Rules more generally, has an apparent bias toward acceptance of those assumptions. Because these assumptions are untested, and may very well be profoundly inaccurate, we urge the Federal Reserve to proceed cautiously, particularly in the context of the Proposed Capital and Leverage Rules and the Federal Reserve's evaluation of how Dodd-Frank's "more stringent" requirement should be interpreted. As applied to risk-based capital requirements and leverage limits, we believe this requirement is sufficiently flexible to permit the Federal Reserve to consider a range of approaches, discussed further below, and does not require implementation of a surcharge.

Part I of this Annex summarizes our comments; Part II addresses our view as to the application of Dodd-Frank's "more stringent" requirement in the context of risk-based capital and leverage requirements; Part III addresses our fundamental reservations regarding the assumptions underlying a capital surcharge for entities deemed to be systemically important (whether these entities are G-SIBs or non-G-SIB covered companies); Part IV addresses our fundamental reservations regarding the design and indicator-based methodology of the G-SIB Surcharge; and Part V addresses certain specific questions raised by the Federal Reserve.

I. Executive Summary

<u>The "more stringent" test in Section 165 of Dodd-Frank does not require a capital surcharge on covered companies (Part II)</u>. The Associations strongly believe that the Proposed Capital

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[6] The U.S. banking agencies have suggested that, while (as required by law) they will publish for comment "a concrete proposal for implementation of a quantitative risk-based capital surcharge for covered companies, or a subset thereof, based on the BCBS approach" (using the Federal Reserve's words in the Preamble (77 Fed. Reg. at 604)), they feel bound to the agreement reached through the BCBS process. We continue to believe that the G-SIB Surcharge is deeply flawed and should be re-addressed by the regulatory community, both the U.S. banking agencies and their international counterparts. Moreover, consistent with the suggestion of prejudgment in the above-quoted language from the Preamble, U.S. banks are already being required to demonstrate a path to compliance with Basel III in their submissions under the Capital Plan Rule even before the U.S. banking agencies have published proposed rules for comment. We urge the Federal Reserve and the other agencies not to prejudge the application of the G-SIB Surcharge or other aspects of Basel III to covered companies (or banks more generally) and to give full consideration to comments submitted by the Associations and other commenters.

and Leverage Rules' application of the Capital Plan Rule to covered companies, combined with the stress testing regime applied as part of CCAR 2012 as it will be further developed by the Proposed Stress Test Rules (whether adopted as proposed or after giving effect to our comments in *Annex E* concerning those rules), satisfies Dodd-Frank's "more stringent" capital standard. Because of these rules, BHCs with $50 billion or more in total consolidated assets already are, and covered companies will be, required to maintain capital ratios considerably above those required of non-covered companies. Non-covered companies are not subject to a regulatory requirement that they project forward capital ratios for any period, let alone under stressed, as opposed to baseline, conditions for at least nine quarters.

The assumptions underlying any significant capital surcharge on covered companies are flawed (Part III). The Associations have fundamental reservations regarding the assumptions underlying the imposition of a significant capital surcharge on large banks, such as the G-SIB Surcharge. These assumptions appear to include: (i) capital-focused regulatory reforms that have already occurred or will occur as part of Basel III's implementation are not, in the absence of a surcharge like the G-SIB Surcharge, sufficient to address the role of inadequate capital as a contributor to systemic risk; and (ii) more capital is always better. Further, two critical assumptions underlying recent regulatory reform efforts more broadly, including the G-SIB Surcharge, appear to be that (i) these regulatory reforms, both nationally and internationally, have failed to address the systemic risks posed by large banks and meaningfully reduce the probability of their failure and (ii) large banks are inherently problematic and do not provide important economic and other benefits. For the reasons discussed in Part III, the Associations believe that these underlying assumptions are deeply flawed.

The BCBS's G-SIB Surcharge methodology is flawed (Part IV). The Associations strongly believe that the G-SIB Surcharge has fundamental flaws in design and with respect to its indicator-based methodology in particular. These include the following:

- There are significant uncertainties regarding the measurement of systemic importance and the calibration of a significant surcharge on large banks, undermining the credibility of the design and indicator-based methodology of the G-SIB Final Rules Text.

- There is a lack of transparency surrounding the assessment and calculation of the proposed surcharge that undermines the ability of a bank to determine its surcharge or determine what steps to take to reduce its surcharge. This lack of transparency frustrates bank managements' ability to make fundamental business decisions on an informed basis and creates uncertainty regarding the amount of capital that must be held.

- The G-SIB Final Rules Text discourages banks from diversifying their assets across jurisdictions and business lines.

- The G-SIB Final Rules Text inherently encourages banks to concentrate their activities in business lines that are not penalized under the indicator-based methodology, thereby amplifying the potential for systemic disruptions if those business lines turn out to be a primary source of problems in a subsequent financial crisis.

- Numerous specific aspects of the G -SIB Final Rules Text's indicator-based methodology are flawed, as discussed in Part IV.C.

As such, the Associations strongly believe that it would be premature to impose a significant capital surcharge on covered companies, or a subset of covered companies (or, for that matter, any group of banking organizations in the United States or internationally). At a minimum, any potentially viable capital surcharge regime should enable covered companies subject to the surcharge to evaluate their structure and operations and proactively determine the potential magnitude of the applicable surcharge on an on-going basis in order to manage and/or mitigate its potential impact; provide for the reduction of the surcharge as institutions reduce their systemic importance in the aggregate; take into account the regulatory environment in which covered companies operate, including the presence of effective and credible recovery and resolution regimes and other legislation and regulation designed to reduce systemic risk and moral hazard costs; reflect a more balanced and accurate view of systemic importance; not encourage increased risk-taking; and eliminate the other flaws of the proposed methodology set forth in the G-SIB Final Rules Text.

II. The Federal Reserve's application of its existing Capital Plan Rule, as the interplay between that rule and stress testing will be enhanced by the Proposed Stress Test Rules, in and of itself imposes a "more stringent" capital standard on covered companies.

Section 165 of Dodd-Frank requires that the prudential standards established under that section for covered companies, including risk-based capital requirements and leverage limits, be "more stringent than the standards and requirements" applicable to other financial institutions.[7] The statutory language does not mandate that the "more stringent" requirement be met with a capital surcharge or across-the-board higher capital ratios, as representatives of the U.S. banking agencies have acknowledged, albeit in the context of smaller covered companies.[8] We respectfully submit that the Proposed Capital and Leverage Rules' application of the Capital Plan Rule to covered companies, combined with the stress testing regime applied as part of CCAR 2012 as it will be further developed by the Proposed Stress Test Rules (whether adopted as proposed or after giving effect to our comments in *Annex E*), meets the more stringent requirement in and of themselves.

The Capital Plan Rule, which applies to all BHCs with consolidated assets of $50 billion or more, specifies that a BHC's capital plan must include a discussion of how the BHC will, "under expected and stressful conditions," maintain capital above minimum regulatory requirements and above a Tier 1 common ratio of 5%,[9] provides that the Federal Reserve will consider the BHC's ability to meet that standard in reviewing its capital plan[10] and specifies that the Federal Reserve will object to the capital plan if the BHC "has not demonstrated an ability" to maintain capital above those standards "on a pro

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[7] Section 165(a)(1)(A) of Dodd-Frank.

[8] *See*, e.g., the testimony of Governor Tarullo before the Senate Banking Committee in December 2011, where he commented that "[n]o decision has yet been made as to whether the more stringent capital to be applied to large U.S. banking firms that are not on the eventual list of global systemic banks will be in the form of a quantitative surcharge." *Continued Oversight of the Implementation of the Wall Street Reform Act: Hearing Before the S. Banking Comm*., 111th Cong. (Dec. 6, 2011) (statement of Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System).

[9] 12 C.F.R. § 225.8(d)(2)(ii)(A).

[10] 12 C.F.R. § 225.8(e)(1)(i)(C).

forma basis under expected and stressful conditions throughout the planning horizon."[11] The relevant time horizon, specified both in the Capital Plan Rule and the Proposed Stress Test Rules (both for supervisory and company-run stress scenarios), is at least nine quarters. It has been our members' experience that these stress tests serve as a governor on not only capital actions but on approvals for a variety of initiatives.

The Proposed Stress Test Rules do not indicate whether the stress scenario to be applied by the Federal Reserve in evaluating covered companies' capital plans will be the "adverse" or "severely adverse" scenario contemplated by the rules; the Federal Reserve applied a scenario that is described as "severely adverse" to the CCAR 2012 process. Irrespective of which scenario applies, the unavoidable arithmetic consequence is that BHCs with $50 billion or more in total consolidated assets already are, and covered companies will be, required by regulation to maintain capital ratios above those required of non-covered companies. Non-covered companies are not subject to a regulatory requirement that they project forward capital ratios for any period, let alone under stressed or severely stressed, as opposed to baseline, conditions for at least nine quarters. We are not suggesting that non-covered companies will in fact maintain capital ratios targeted only to regulatory *minima*. Prudent management and supervision in any event will result in even non-covered companies establishing targeted capital levels that are above regulatory *minima*, and even the existing regulatory standards for "well capitalized" status and consequences for falling below "well capitalized" status[12] effectively require all BHCs and banks (whether or not, in the case of BHCs, they are covered companies) to maintain capital above well-capitalized requirements. Additionally (and depending on how the U.S. banking agencies ultimately choose to apply the Basel III capital framework in the United States), Basel III's capital conservation buffer as a practical matter becomes part of the minimum capital requirements. Our point is simply this: apart from the requirements that otherwise apply (taking into account not only prudent management and supervision but also the possible application of the Basel III capital framework differently to different BHCs and banks based on size and other criteria), the interplay of the Capital Plan Rule and the Proposed Stress Test Rules will require covered companies to comply with a more stringent capital regime than is required of non-covered companies.

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[11] 12 C.F.R. § 225.8(e)(2)(ii)(C).

[12] For example, if the financial holding company or its depository institution subsidiary ceases to be "well-capitalized", a financial holding company must execute an agreement with the Federal Reserve explaining the actions the company will take to correct areas of noncompliance and providing a schedule within which each action will be taken. 12 C.F.R. § 225.83(c); Section 606 of Dodd-Frank. Until the Federal Reserve determines that a company has remedied the deficiencies that led to the loss of "well-capitalized" status, the Federal Reserve, among other potential supervisory actions, may impose limitations on the conduct and activities of the company. *Id.* § 225.83(d). If the company does not remedy the deficiencies within 180 days, the Federal Reserve may order the company to divest ownership or control of any depository institution owned or controlled by the company. *Id.* § 225.83(e). Further, under the prompt corrective action regime, a depository institution that is merely "adequately capitalized" (as opposed to "well capitalized") can on safety and soundness grounds be subjected to activity limitations and restrictions (including limitations on distributions) as though it were "undercapitalized". 12 U.S.C. § 1831o(g)(1)(B).

III. The assumptions underlying a punitive capital surcharge, such as the G-SIB Surcharge, are flawed.

The assumptions that underlie proposals to impose significant capital surcharges on large banks, such as the G-SIB Surcharge, generally appear to be:

- capital-focused regulatory reforms that have already occurred or will occur as part of Basel III's implementation are not, without a surcharge like the G-SIB Surcharge, sufficient to address the role of inadequate capital as a contributor to systemic risk; and

- more capital is always better.

Further, as discussed in the Comment Letter, two critical assumptions underlying the Proposed Rules (including the Proposed Capital and Leverage Rules as well as regulatory reform more generally) include:

- regulatory reforms, both nationally and internationally, have failed to address the systemic risks posed by large banks and meaningfully reduce the probability of their failure; and

- large banks are inherently problematic and do not provide important economic benefits.

We discuss these assumptions and their implications in the Comment Letter because they apply broadly to the Proposed Rules, not only the Proposed Capital and Leverage Rules.

The Associations and our members are joined with the Federal Reserve and other national and international regulators in a common endeavor – to address the weaknesses (both supervisory and management) that became apparent during the financial crisis. We seek to assist the Federal Reserve and other regulators in addressing the supervisory aspects of this endeavor, not to resist proper enhancements to regulation and supervision. We also believe, however, it is critically important that the multitude of on-going reforms achieve a regulatory balance that does not unnecessarily harm the financial system and the economy, customers that are the consumers and users of banking services, or banking organizations themselves. The regulatory community's focus on size as a prudential concern, whether in the context of regulating capital requirements or the other aims covered by Section 165 of Dodd-Frank and the Proposed Rules, must be tempered by (i) progress that has been made to end "too big to fail" in the United States as well as (ii) an understanding of the benefits attributable to larger institutions (and the consequences of losing those benefits).

The Associations continue to believe that the assumptions underlying the G-SIB Surcharge (or a similar surcharge that may be proposed under Section 165(b) of Dodd-Frank) are deeply flawed, as discussed in the Prior Surcharge Letters. Accordingly, we urge the Federal Reserve to proceed cautiously in considering application of a capital surcharge to covered companies or some subset of covered companies, particularly in view of the fact that Section 165's "more stringent" standard is sufficiently flexible to permit the Federal Reserve to satisfy its requirements without a surcharge and, as indicated above, we believe has already been met. Even apart from Section 165 of Dodd-Frank and the Proposed Capital and Leverage Rules, measures already taken by large banking organizations to improve the robustness of their capital, partly in response to the anticipated implementation of Basel III, have substantially addressed the role of inadequate capital as a contributor to large bank failures posing systemic risks by reducing their probability of failure.

Proposed Capital and Leverage Rules

Over the past two years, significant regulatory reforms have been introduced both by the BCBS and by regulators in the United States to address a wide variety of regulatory concerns, including capital adequacy, liquidity risk, market risk, stress testing, capital planning, derivatives reforms (including with respect to the role of central counterparties), and limitations on trading and investment activities that are perceived to be high risk. The final Basel III capital and liquidity frameworks have been the foundation for international efforts to address capital adequacy and liquidity risk; the U.S. banking agencies are moving ahead with the amendments to their market risk capital rules (known as Basel II.5);[13] the U.S. banking agencies issued in June 2011 proposed joint guidance on stress testing and requested public comments,[14] have adopted the Capital Plan Rule effective December 30, 2011 (and, pursuant to the Capital Plan Rule, recently completed its CCAR 2012 review; and the U.S. banking agencies are in the process of moving forward with regulations to implement the Volcker Rule. Many of these measures will require, or have in practice already required, BHCs that are covered companies to make major changes to their capital structures, balance sheet composition and liquidity and operational risk management functions, calling into question the need to impose an additional capital surcharge at this time.

The heightened capital requirements under Basel III alone will require U.S. banks to increase the amount of CET1 U.S. banks hold by *over 100%* from the amount held at December 31, 2007.[15] In addition, as a result of the imposition of Basel III's quantitative, qualitative and risk-weighting requirements, the 7% minimum CET1 ratio under Basel III is equivalent to a 14% Tier 1-capital ratio under the pre-crisis Basel I rules for U.S. banks. If the G-SIB Surcharge is also imposed, it would result in the U.S. banking system holding the equivalent of 16% Tier 1 capital in Basel I terms, or 400% the Tier 1 capital required before the crisis in order to be "adequately capitalized"(namely, 4%).[16] Moreover, Basel III and related enhancements to the capital framework made under Basel II.5 not only address aggregate capital requirements, but also the specific areas in which excessive risk was thought to be incurred. For example, Basel II.5 dramatically increases – often by 400% or more – the capital charge on trading positions held by large banks.

These increased capital requirements, in and of themselves, significantly reduce the potential for large banks to pose systemic risks and reducing their probability of failure in light of empirical evidence that shows that banks on a worldwide basis that had capital levels greater than the new Basel III effective CET1 minimum did not suffer serious financial distress in the recent crisis.[17] Banks

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[13] These proposed amendments are set forth in joint notices of proposed rulemaking regarding (i) revisions to their market risk capital rules to generally align them with Basel II.5 (76 Fed. Reg. 1890 (Jan. 11, 2011)) and (ii) the incorporation of alternative methodologies for calculating specific risk capital requirements for debt and securitization positions that do not rely on credit ratings (76 Fed. Reg. 79380 (Dec. 21, 2011)).

[14] *Proposed Guidance on Stress Testing for Banking Organizations with More Than $10 billion in Total Consolidated Assets*, 76 Fed. Reg. 35072 (June 15, 2011).

[15] For further information regarding how much additional common equity banks will need to hold relative to pre-crisis levels, as well as the data on which this estimate is based, see slides 9 and 13 of the study conducted on behalf of The Clearing House study entitled "*How Much Capital Is Enough? Capital Levels and G-SIB Capital Surcharges"* (the "**G-SIB Surcharge Study**") included in the Prior Submissions.

[16] *See* page 6 of the G-SIB Surcharge Study for further information.

[17] Data concerning 123 banks worldwide with more than $68 trillion in assets in the aggregate were examined in order to analyze the performance of banks during the recent financial crisis. This study

satisfying this minimum CET1 ratio, therefore, proved not to be the source of systemic risks in 2007-2009.

Given that banks currently satisfying the new Basel III capital standard (on a fully phased-in basis) did not suffer serious financial distress in the recent crisis and the other regulatory reform efforts that have been implemented (e.g., the Capital Plan Rule) or will be implemented (e.g., the Basel III liquidity ratios), there would appear to be little marginal utility in imposing additional significant capital surcharges on covered companies (or a subset of covered companies) that is in addition to the minimum 7% CET1 ratio under Basel III that will in any event apply.

A. More capital is not always better. Capital surcharges on large banks risk reducing economic and job growth and pushing financial transactions to the shadow banking sector.

1. Surcharges may lead to decreased availability of credit and increased costs for bank customers.

Imposing higher capital requirements on large banks is not necessarily a cost-free proposition. Materially higher capital requirements on banks may lead to decreased availability of credit as firms are encouraged to shrink their balance sheets in order to address the effects of the increases. A decrease in credit availability will be exacerbated by the new liquidity requirements (whether under the Proposed Liquidity Rules or the Basel III liquidity framework), which will largely foreclose banks' ability to shrink their balance sheets by reducing the amount of high-quality liquid assets they hold, leaving them with little choice but to reduce lending. In addition, as higher capital requirements cause banks' ROE to decrease, such firms acting rationally may well attempt to improve ROE by increasing the price of credit to generate greater returns, thereby imposing greater costs on their customers. These bank actions could reduce job growth and, more generally, harm the broader economy at a particularly difficult economic juncture while the U.S. economy is still recovering.

Some proponents of a surcharge have argued that higher capital requirements will lead investors to accept lower rates of return from banks subject to the requirements, which in turn will help

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determined that no institution that entered the 2007—2009 crisis with a CET1 ratio (calculated in accordance with Basel III rules) greater than 7% (that is, 100 basis points lower than the level at which banks are likely to operate after considering the voluntary cushion firms will likely hold to reduce the likelihood that capital levels will fall below the regulatory minimum) experienced serious financial distress – that is, failed, was placed into governmental receivership, was acquired under duress by another financial institution or received a substantial direct government capital investment or bail out. Thus, the Basel III CET1 ratio requirement, by itself, would appear to have been sufficient to prevent serious financial distress at banks throughout the world even through the severe disruptions of the financial crisis. See pages page 3 and 6 and slides 16 through 18 of the G-SIB Surcharge Study for further information regarding, and a description of the methodologies employed in, this study. For purposes of this study, a "substantial direct government capital investment or bail out" is defined as a total government capital investment greater than 30% of the bank's Tier 1 capital as of December 31, 2007. The 30% threshold generally filters out institutions that accepted TARP funds as mandated during the U.S. government's response to the financial crisis, but banks that received additional capital injections outside the standard TARP Capital Purchase Program process were treated as having received a "substantial direct government capital investment or bail out" for purposes of this study.

to offset any decrease in ROE and reduce any negative effects from such a decrease.[18] However, we do not believe that lower leverage will in practice lead investors to accept significantly lower ROE from banking institutions. To the contrary, any decreases in ROE on a percentage basis are likely to far exceed any offsetting benefits in the form of lower cost of equity ("**COE**") that might result from investor perception, reflected in the yields they demand on investments, that lower leverage implies investments in bank equity carry less risk.[19]

Because the very logic behind the imposition of a significant capital surcharge on large banks rests on the existence of substantial negative externalities and moral hazard, reforms which reduce such problems and otherwise decrease systemic risk – such as Title II of Dodd-Frank and Dodd-Frank's living will requirements – must be taken into account in order for any proposal to impose such surcharges to be consistent with its foundational premises.[20] We strongly believe that this doubling up of approaches – both (i) reforms to end too big to fail and decrease risk taking and systemic risk, which inherently involve substantial additional costs, and (ii) a significant capital surcharge – is not only inappropriate but deeply taints the logic of applying a significant capital surcharge on all or a subset of covered companies.

2. A capital surcharge on covered companies, or a subset of covered companies, will encourage the growth of the significantly less regulated and less transparent shadow banking system and therefore increase systemic risk.

Demand in the economy for the products and services that covered companies subject to a surcharge are no longer willing and able to provide because of the higher costs imposed by a capital

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18 *See,* e.g., David Miles, Jing Yang and Gilberto Marcheggiano, *Optimal Bank Capital*, Discussion Paper No. 31: Revised and Expanded Version, at 9, 10 (Apr. 2011), *available at* http://www.bankofengland.co.uk/publications/Documents/externalmpcpapers/extmpcpaper0031.pdf; Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig and Paul Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is* Not *Expensive*, at 1, 2 (Mar. 2011), *available at* https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf.

19 Analyses conducted on behalf of The Clearing House estimate that the cumulative impact of the Basel III minimum capital requirement and G-SIB Surcharge would decrease bank ROE by up to 4.9 percentage points. *See* slide 20 of the G-SIB Surcharge Study for further information. Under the increased capital requirements of Basel III (even before the imposition of a significant capital surcharge), ROE is estimated to fall by approximately 290 basis points without changes to banks' business models to mitigate the impact. *See Id.* A G-SIB Surcharge of 2.5% is estimated to reduce bank ROE by an additional 200 basis points, absent business changes to mitigate the impact. *See Id.* Even assuming that lower leverage does in fact lead to decreased COE, it is estimated that ROE will decrease by substantially more than COE, based on the empirical relationship between ROE-COE over time, as well as the significant tax benefits of debt in certain jurisdictions. Regardless of whether the premise regarding some relationship between lower leverage and COE proves correct, the imposition of a G-SIB Surcharge can be expected to further decrease ROE substantially.

20 Nevertheless, and quite paradoxically, the BCBS has indicated that such considerations should not play a role in the G-SIB Surcharge equation. *See* G-SIB Final Rules Text, ¶ 56 ("Views on the quality of the policy/resolution framework within a jurisdiction should not play a role in this G-SIB identification process . . . ."). The very failure to recognize, or otherwise take into account the existence of, such reforms when determining the amount of, and whether to impose, the G-SIB Surcharge is indicative of a fundamental analytical flaw and internal logical inconsistency in the assumptions underlying the G-SIB Surcharge.

surcharge will not, of course, simply evaporate. The provision of some of these products and services is likely to shift to the less regulated and less transparent "shadow banking" sector.[21] The G-SIB Final Rules Text amplifies this problem by excluding shadow "banks" from the data used to determine indicator scores and thus banks are assessed without regard to the actual market for the activities, assets, liabilities, derivatives and exposures measured by the indicators. As banks subject to a surcharge gradually reduce the size of or abandon targeted business lines that are in effect taxed by the surcharge, "surviving" banks in the sector that are subject to the surcharge will take on ever larger shares of what business remains in the banking system and, thus, be still more heavily penalized by ever-larger surcharges, which will even further drive business, including traditional credit intermediation, to the shadow banking sector.[22] In view of the shadow banking system's role in lowering credit standards during the last decade,[23] and the absence of regulation and transparency, a migration to that system would have negative implications for the health of the financial system as a whole.[24] In addition, the shadow banking system can exhibit volatile and intermittent flows compared with the traditional banking system's credit intermediation function. This lack of reliability as a source of funding would subject borrowers to marketplace vagaries. Both of these outcomes would actually increase systemic risk – quite the opposite of the ultimate goal of the G-SIB Final Rules Text.

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In view of the empirical evidence suggesting that recent regulatory reform efforts may have significantly reduced the systemic risk and probability of failure of large banks and the potential negative economic and other consequences of applying a surcharge like the G-SIB Surcharge on some or all covered companies, the Associations have strong reservations regarding the assumptions underlying the very concept of the capital surcharge on all or a subset of covered companies, and strongly believe the imposition of such a surcharge at this time would be premature, especially given the currently fragile and volatile world market and economic environment.

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21 *See,* e.g., Kate Berry and Jeff Horwitz, *Regs Push MetLife Out of Banking, into Shadow System*, American Banker (July 2011) (discussing MetLife's decision to sell its bank but to continue writing mortgages). *See also* Thomas F. Cosimano and Dalia S. Hakura, *Bank Behavior in Response to Basel III: A Cross-Country Analysis*, IMF Working Paper (May 2011), at 6 (noting that even modest increases in lending costs as a result of increased capital requirements on banks "could create significant incentives for regulatory arbitrage and a shift away from traditional banking activity to the 'shadow-banking sector'").

22 The G-SIB Final Rules Text posits that smaller banks will take over this business, but this is at best uncertain, especially in view of the scale and investment required in several of the targeted business lines (e.g., clearing and settling payments for customers through payment systems).

23 *See* Financial Stability Board, *Shadow Banking: Scoping the Issues*: *A Background Note of the Financial Stability Board* (April 12, 2011), at 3, *available at* http://www.financialstabilityboard.org/publications/r_110412a.pdf.

24 *Cf.* Zoltan Pozsar, Tobias Adrian, Adam Ashcraft and Hayley Boesky, *Federal Reserve Bank of New York Staff Reports: Shadow Banking*, Staff Report No. 458, at 24 (July 2010, Revised February 2012) (questioning whether the economically viable parts of the shadow banking system "will ever be stable through credit cycles in the absence of official credit and liquidity puts").

IV. The Associations have fundamental reservations concerning the design of the G-SIB Surcharge and its indicator-based methodology in particular.

The Associations are deeply concerned that both the design and, in particular, the indicator-based methodology of the G-SIB Surcharge is deeply flawed. If the Federal Reserve ultimately determines to proceed with such a surcharge, it should do so only after addressing the flaws in the BCBS's G-SIB Surcharge's methodology.

A. There are significant uncertainties regarding the measurement of systemic importance and the calibration of a significant surcharge on large banks.

Even accepting, for argument's sake, the appropriateness of the G-SIB Surcharge, there are significant uncertainties and open questions concerning the theoretical and policy foundations of a G-SIB Surcharge.[25] Depending on the assumptions selected and measurement method chosen, the "systemic importance" of a bank can vary widely. The empirical measurement of systemic importance is in an early stage, and academic commentators pursuing this research regularly caution against directly adopting their work as part of a regulatory framework.[26] Further, the full potential combined impact of the current financial services regulatory reforms, including Basel III (both capital and liquidity), the reforms in the NPR and the G-SIB Surcharge, has not yet been comprehensively analyzed.[27] As a result, these complex rules could have economic costs and other unintended consequences and risks that are not readily apparent. These uncertainties regarding the appropriate calibration and method for measuring systemic importance undermine, in the view of the Associations, the credibility of the design and indicator-based methodology of the G-SIB Final Rules Text.

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[25] As the BCBS itself readily acknowledges, these questions also regard the appropriate method to calibrate such a surcharge. *See* G-SIB Final Rules Text, Annex 2 at 23 (noting that with regard to its empirical analysis undertaken in support of the assessment of the magnitude of additional loss absorbency that "[i]t is important to note that there is no single correct approach that is reliable enough to inform the assessment of the magnitude of additional loss absorbency . . . . All the approaches suffer from data gaps and the results are sensitive to assumptions made . . . . The estimates of the magnitude of additional loss absorbency based on the expected impact approach, assessment of the long-term economic impact and too-big to-fall [*sic*]. . . subsidies are based on imperfect models and involve numerous assumptions and judgements.").

[26] *Cf*. John B. Taylor, *Systemic Risk in Theory and in Practice*, at 51 (stating that systemic risk is still not well defined and that reform proposals relying on systemic risk to determine in advance whether a firm should be deemed systemically significant "are not ready for prime time") (2010), *available at* http://www.stanford.edu/~johntayl/Onlinepaperscombinedbyyear/2010/Defining_Systemic_Risk_Operationally.pdf.

[27] Public sector officials have acknowledged that the aggregate impact of the current financial services regulatory reforms in the United States, including Dodd-Frank and Basel III, has not yet been fully analyzed. *See,* e.g., Chairman Bernanke, Remarks at a Question and Answer Session Following Chairman Bernanke's Speech on the U.S. Economic Outlook (June 7, 2011) (*transcript available at* http://video.cnbc.com/gallery/?video=3000026289).

B. The G-SIB Final Rules Text has fundamental flaws in its design.

1. The G-SIB Final Rules Text creates a "black box" for calculating surcharges, rendering banks unable to determine their capital surcharge or what actions to take to reduce their global footprint.

It is essential that the determination of the surcharge – including, in particular, the calculation of the "indicator-based scores" and the allocation of affected banks to "buckets" – be conducted in a transparent manner for at least two reasons. First, banks should have the information necessary to adjust their risk profiles and business models in order to adapt to the new regulatory capital regime. Second, without transparency, a cloud of uncertainty is created over each potential G-SIB, which adversely affects the market price for its securities and thereby potentially affects the availability of capital. This uncertainty comes at a particularly inopportune time given the already acute uncertainty under which banks and their holding companies currently operate as a result of a multitude of new, complex rules following the financial crisis, many of which have not yet been finalized and therefore carry their own uncertainty.

Because the G-SIB Surcharge described in the G-SIB Final Rules Text effectively punishes size, global footprint and certain activities, banks should have the ability to evaluate their structure and operations and proactively determine the potential magnitude of the applicable surcharge in order to manage and/or mitigate its potential impact. However, a bank cannot determine its systemic importance score – and thus its surcharge – with any degree of accuracy over time because of two features of the G-SIB Surcharge's methodology for determining the surcharge. First, systemic importance scores are determined on a relative basis and the thresholds of the buckets may change. As a result, in order for a bank to calculate its individual systemic importance score and determine its surcharge, it will need the ability to calculate and forecast not just the amount of each of the individual indicators for it, but also the denominators of each of the respective indicators and the thresholds of the buckets. The metrics chosen for the indicators are difficult to model even internally for an individual bank; modeling how the denominators will change every three years for a subjective sample of 73 banks is not feasible. Moreover, the thresholds of the buckets may change every three years, further undermining a bank's ability to determine its surcharge in advance.[28]

Second, data for many of the indicators do not at present exist as acknowledged by the BCBS.[29] Creating a cross-jurisdictional uniform aggregated database that earns the confidence of the

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[28] In response to concerns regarding the G-SIB Surcharge's lack of transparency, the BCBS noted that it will disclose the values of the buckets' thresholds and the denominators of the indicators, the cut-off score for a bank to be a G-SIB and the threshold scores for the buckets by November 2014 based on year-end 2013 data. *See* BCBS, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement – Rules Text* (November 2011) (the "**Cover Note**"), ¶ 25-28. The disclosure of this information, however, does not address the issue of the feasibility of modeling how the denominators of the various indicators will change over time, nor does it address the feasibility of predicting how the cut-off score threshold scores for the buckets will change over time.

[29] G-SIB Final Rules Text, ¶ 71 ("The [BCBS] acknowledges that the data used to construct the indicator-based measurement approach currently may not be sufficiently reliable or complete. . . [T]he [BCBS] will address any outstanding data issues and re-run the indicator-based measurement approach using updated data well in advance of the implementation. This includes issues such as providing further guidance on the definition of the indicators, how to standardise further the reporting across the sample banks and how to address data that are currently difficult to collect or not publicly available."). Although

markets will involve substantial challenges that require addressing different business and reporting practices, different accounting regimes and currency conversion. If this database is not successfully created, the surcharges will almost certainly be unreliable and inequitable.[30] The present lack of such a database obviously creates a great deal of uncertainty in the capital and business planning of banks potentially subject to the proposed surcharge.

The inability of a bank to estimate its surcharge with any accuracy frustrates management's ability to make fundamental business decisions on an informed basis and creates uncertainty regarding the amount of capital that must be held. In general, given the potentially severe supervisory consequences of holding too little capital, uncertainty regarding the magnitude of the regulatory surcharge will require banks to hold a much higher amount of capital in the form of an "uncertainty surcharge". Although this result may seem to some like an acceptable, or even desirable, regulatory outcome, capital is not free, and the incidence of the costs of holding more capital than is necessary or appropriate will not fall solely on banks, but also on customers of the banks and the general economy.[31] The lack of transparency surrounding the calculation of a bank's systemic importance score also makes the banking industry more difficult to understand for investors by introducing volatility and uncertainty in capital and associated profitability projections.

2. The G-SIB Final Rules Text discourages banks from diversifying their assets across jurisdictions and business lines.

It is well established that an undiversified portfolio of securities or other assets is subject not only to systemic (i.e., market) risks but also to security specific risks, and that security specific risks can be reduced by investing in a variety of assets, the returns of which are not necessarily correlated. The G-SIB Final Rules Text not only fails to provide any offsetting benefits for banks with diversified assets, but actually penalizes them for diversifying their assets geographically and across business lines, which is inconsistent with best risk management practices. This failure constitutes another serious flaw in the G-SIB Final Rules Text's methodology that may increase rather than reduce the chances of G-SIB failure.

3. The G-SIB Final Rules Text inherently creates the incentive for G-SIBs to concentrate their activities in business lines that are not penalized under the indicator-based methodology, thereby amplifying the potential for systemic disruptions if those business lines are a primary source of problems in a subsequent financial crisis.

There are risks inherent in any rigid indicator-based methodology that effectively taxes business lines regulators deem to be "risky". Over time, banks subject to the G-SIB Final Rules Text will tend to allocate assets and deploy capital in business lines not subject to this tax, thereby concentrating

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rerunning the data and approach at a later date may prove helpful, it will be too late to mitigate the impact of the current uncertainty.

30 We strongly believe that the G-SIB Surcharge should not be implemented – whether formally or informally – prior to the completion of this database, regardless of whether this database is completed before the beginning of the proposed phase in period (i.e., January 1, 2016).

31 See Part III.A for a discussion of these costs.

risk in these non-penalized businesses. If another crisis occurs, and the business lines not penalized by the indicator-based methodology turn out to be a primary source of systemic risk, then the externalities of failures of G-SIBs could in fact increase in spite of, or even because of, the additional capital surcharge. As demonstrated by the recent financial crisis, it is difficult to identify in advance what asset classes will prove problematic, and the BCBS has not provided any substantive empirical evidence in support of the selection of categories and indicators used to determine the G-SIB Surcharge or the weighting of those categories and indicators. The Associations are thus deeply skeptical that the proposed indicators – or indeed any set of rigidly defined indicators – will be helpful in reducing systemic risk and believe such indicators may, to the contrary, actually increase it.

C. Numerous aspects of the G-SIB Final Rules Text's indicator-based methodology are seriously flawed.

The Associations generally agree that no measurement approach will perfectly measure systemic importance across all global banks, and perfection should not be demanded of any methodology. Nevertheless, we have serious concerns with various aspects of the G-SIB Final Rules Text's indicator-based methodology, including the following:

1. Under the G-SIB Final Rules Text's methodology, banks could collectively reduce their systemic importance but not reduce the capital surcharge applicable to them.

The deeply flawed nature of the G-SIB Surcharge is demonstrated by the fact that a significant and proportional downward adjustment in systemic risk among the 73 banks used to determine the denominators of the indicators might not produce any change in their individual capital surcharges. The G-SIB Final Rules Text provides that, after its implementation, the cut-off score, the threshold scores for buckets and the denominators used to normalize the indicators will be fixed for three years.[32] At the end of the three-year period, the entire process, as well as the cut-off scores and threshold scores for buckets, will be revisited and recalibrated. During each three-year period, each bank will have an incentive to reduce the aggregate value of its systemic importance score, in order to decrease its G-SIB buffer. However, if all 73 banks in the sample reduced the magnitude of each of their indicators over the three-year window by the same percentage (e.g., by 20%), all scores would decrease (assuming the denominator was unchanged) and, during the next calibration period, the total denominator would be reduced by the same amount that each bank reduced its numerator (i.e., 20%). As a consequence, every bank's score would return to its initial level (unless the threshold scores for buckets were also adjusted). This result is not sensible given that banks would have lowered their systemic importance scores and thus their systemic importance, as measured by the G-SIB Final Rules Text. We believe this result is indicative of serious flaws in the G-SIB Final Rules Text's methodology and alone would be sufficient to require reconsideration of the G-SIB Final Rules Text as a whole.

[32] *See* G-SIB Final Rules Text, ¶¶ 69, 70.

2. The G-SIB Final Rules Text's indicator-based methodology creates perverse incentives to increase instead of decrease risk.

a. The cross-jurisdictional indicators encourage banks to fund foreign claims with home country liabilities, an objectively riskier practice than funding these claims with local currency liabilities.

The G-SIB Final Rules Text's indicator-based methodology creates an incentive to fund local assets with home country liabilities, rather than with local liabilities – an objectively riskier practice in view of various factors, including exchange rate and exchange control risks and interest rate risks. To illustrate this issue, consider the following hypothetical structures:

- Structure 1: A U.S. BHC with subsidiaries or branches in 25 countries. Each subsidiary or branch has local currency assets funded entirely by local currency liabilities.

- Structure 2: A U.S. BHC with subsidiaries or branches in 25 countries. Each subsidiary or branch has local currency assets funded by U.S. liabilities.

Assume the size of the local currency assets in each of the 25 branches or subsidiaries are identical in Structures 1 and 2. All else held constant, Structure 2 would be the riskier structure of the two. However, according to the methodology for determining a G-SIB's score for the cross-jurisdictional activity indicator, Structure 2 would have the smaller indicator score, because in Structure 2 the BHC does not have any "cross-jurisdictional liabilities" for purposes of this indicator.[33] In other words, the proposed methodology would penalize a G-SIB for holding local assets in foreign jurisdictions that are funded by local liabilities, and instead encourage it to fund those assets with liabilities in its home country, even though match funding with local liabilities is far less risky. Thus, the methodology would incentivize cross-border funding of foreign operations, a practice that is objectively riskier as described above. We do not believe this is sensible.

b. The indicators' failure to account for the risk of assets, derivatives or exposures held by a bank is inconsistent with the stated aim of the G-SIB Final Rules Text to reduce the probability of failure of G-SIBs.

Each of the cross-jurisdictional activity, size, interconnectedness and complexity categories contains an indicator or indicators that attempt to quantify the amount of assets, derivatives or other exposures held by a bank. None of these indicators, however, takes into account the risk profile of those assets, derivatives or exposures for purposes of determining a bank's indicator-score. For example, the complexity category does not differentiate between (i) a $100 billion available for sale portfolio of local currency and investment grade sovereign debt, whether held for liquidity or as a safe investment of excess liquidity, and (ii) a $100 billion local currency trading portfolio of illiquid non-investment grade securitization tranches, even though the bank with the former portfolio has sharply less liquidity and credit risk and, therefore, a lesser risk of failure. This failure to account for the riskiness of the assets, derivatives and other exposures of G-SIBs is not consistent with the goal of reducing the probability of default of G-SIBs and highlights another serious flaw in the G-SIB Final Rules Text's methodology.

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[33] Structure 1 and Structure 2 are equivalent with respect to the other individual indicator for this category – cross-jurisdictional claims.

3. The G-SIB Final Rules Text lacks a mechanism to lower the capital surcharge as the global systemic importance of G-SIBs in the aggregate is reduced.

The G-SIB Final Rules Text provides that individual G-SIB systemic importance scores will be updated annually based on changes in the bank indicator amounts, and that the cut-off score and the threshold scores for the surcharge buckets will be initially fixed for three years and then reviewed, but does not appear to provide for a reassessment of the overall calibration of the surcharge itself and an adjustment downward if warranted. Given that the calibrations of the surcharge appear to have been based on current estimates and judgments regarding the probability of default of G-SIBs and the costs of such default, a meaningful reduction in the magnitude of either of these key variables would provide a compelling justification for reducing the size of the capital surcharge as a whole and therefore reducing the size of the buckets. The introduction of a mechanism to lower the surcharge (if warranted) would also encourage G-SIBs collectively to "reduce their systemic importance", one of the objectives of the G-SIB Final Rules Text.[34] The failure to provide for such a mechanism underscores a structural flaw in the design of the G-SIB Final Rules Text.

4. Several of the indicators are inaccurate measures of systemic importance.

Several of the indicators of the G-SIB Surcharge's indicator-based methodology do not, in our view, accurately reflect systemic importance:[35]

- We do not believe that assets under custody is inherently indicative of systemic importance. The G-SIB Final Rules Text states that the failure of a large custodian bank holding assets on behalf of customers could disrupt the operation of financial markets.[36] It therefore appears to assume that assets held under custody at a failed bank would become inaccessible to the customers as a result of the failure. We do not believe that assumption is warranted. Under U.S. law, it is quite clear that assets held by a bank as custodian are not part of the bank's receivership estate in a failure.

- The market for underwriting services is deep and competitive. Accordingly, we believe that the value of underwritten transactions is not indicative of systemic importance.

- Most over-the-counter ("**OTC**") derivatives activity is conducted pursuant to legally enforceable netting arrangements, and the exposure of such derivatives is limited to a net obligation. As a

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[34] *See* G-SIB Final Rules Text, ¶ 55.

[35] Regulators informally have acknowledged the absence of any apparent logical connection between certain indicators (e.g., securities underwritten or assets under custody as an indicator for substitutability) and systemic risk but have asserted that the indicators are nevertheless appropriate because they are "proxies" for systemic risk. The Federal Reserve and OCC, in their April 4, 2011 "*Supervisory Guidance on Model Risk Management,*" state that "[i]f data proxies are used, they should be carefully identified, justified, and documented." We are not aware of any attempt by the BCBS to meet that standard as to the G-SIB Surcharge. We urge the Federal Reserve to address the standard as it considers a surcharge for covered companies that builds on the BCBS's G-SIB Surcharge.

[36] *See* G-SIB Final Rules Text, ¶ 37.

result, a gross notional measure of OTC derivatives overstates the risks associated with holding such derivatives.

- If exposure as defined for purposes of the Basel III leverage ratio is the individual indictor for size, the Associations believe it is very important that concerns with respect to the breadth of that measure be addressed, including, among other concerns, (i) the inclusion of gross "sold" credit derivative positions without recognition of off-setting hedges and (ii) the failure to use reasonable conversion factors for off-balance sheet commitments (e.g., an assumed 100% draw-down on liquidity facilities, which is not justified by the available empirical data). Until these issues are resolved, the Basel III definition of exposure is not a meaningful indicator of size.

- There is significant overlap between the size category, on the one hand, and the interconnectedness, substitutability, cross-jurisdictional activity and complexity categories, on the other. As a consequence, size is significantly over-counted in the determination of a bank's systemic importance score. This over-counting is especially problematic given that size, by itself, is a poor indicator of systemic importance.

5. The G-SIB Final Rules Text may penalize well-managed banks with rising scores if they maintain or grow their share of businesses measured by the indicators while the industry as a whole contracts or even remains the same.

In determining a bank's systemic importance score, the G-SIB Final Rules Text compares big banks to big banks – that is, an individual bank's indicator score is determined by dividing the bank's amount for a particular indicator by the aggregate amount for that indicator for all banks in the sample. Because the G-SIB Final Rules Text determines systemic importance in this way, the G-SIB Final Rules Text's methodology could disadvantage well-managed banks if, by virtue of their safety and soundness, they maintain or grow their share of businesses – either organically or through acquisition of institutions (including institutions in financial distress) – measured by the indicators during periods when the industry shrinks as a whole or even remains the same. We do not believe it is sensible to penalize these banks under such circumstances.

V. Responses to Certain Specific Questions.[37]

Question 8. *What is the appropriate scope of application of a quantitative capital surcharge in the United States in light of section 165 of the Dodd-Frank Act? What adaptations to the BCBS framework, or alternative surcharge assessment methodologies, would be appropriate for determining a quantitative capital surcharge for covered companies that are not identified as global systemically important banks in the BCBS framework?*

The Associations strongly believe that the Proposed Capital and Leverage Rules' application of the Capital Plan Rule to covered companies, combined with the stress testing regime applied as part of CCAR 2012 as it will be further developed by the Proposed Stress Test Rules (whether adopted as proposed or after giving effect to our comments in *Annex E* concerning those rules), satisfy Dodd-Frank's "more stringent" capital standard. We do not believe a capital surcharge is appropriate

[37] As noted in footnote 6 to the Comment Letter, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies.

for any banks or is required in any event by Dodd-Frank for covered companies (or a subset of covered companies) and, in light of other regulatory reforms, consideration of a quantitative capital surcharge is premature. *See* the further discussion in Part II.

Proposed Liquidity Rules (Subpart C) – Liquidity Requirements[1]

The Associations are committed to effective liquidity-risk management and strongly support efforts by the Federal Reserve and other U.S. and international regulators to improve both regulatory standards and banking-industry practices in this area. Deficiencies in liquidity risk management were among the most glaring lessons learned from the financial crisis.

Since the onset of the financial crisis, banks have substantially enhanced their liquidity risk management practices – currently rooted in dynamic forward-looking stress testing, disciplined corporate governance, contingency funding plans, and comprehensive liquidity risk gradation of how a bank's various balance-sheet instruments will behave under stress.[2] We urge the Federal Reserve to consider our comments in the context of the substantially more solid foundation on which bank liquidity risk management currently rests, particularly in the case of the larger banking organizations that are covered companies under the Proposed Liquidity Rules.

The core principles embedded within the Proposed Liquidity Rules reflect and are consistent with current enhanced practices of many banks. However, the Associations have significant concerns with certain aspects of the Proposed Liquidity Rules, particularly with respect to two conceptual considerations. The first is the detailed and prescriptive approach of their governance-related provisions. Addressing such a complex subject (the risk-management approaches to which are rapidly evolving) with such granularity and rigidity raises the risk that managing to compliance with rules will impede managing the liquidity risk the rules are designed to address. That approach to the governance aspects of the Proposed Liquidity Rules stands in contrast to the Proposed Liquidity Rules' approach to quantitative analyses and metrics, where they take a more flexible principles-based approach. The second is the blurring of the proper oversight role of the Board of Directors and the management role of senior management.

The Federal Reserve notes in the Preamble that "too much liquidity can entail substantial opportunity costs and have a negative impact on the covered company's profitability." We agree with that observation but suggest that it understates the potential negative effects of too much liquidity. More important are the consequences for the financial system and economy more broadly of too much liquidity, not only as maintained by individual banks but also as maintained across the banking system. The consequences are little understood but almost certainly include, among others, (i) reduced lending as banks replace loans with investments in highly liquid assets and (ii) distortions in the markets for longer-term securities (including U.S. Treasury securities and mortgage-backed securities), as banks

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[1] Capitalized terms used in this Annex and not otherwise defined are used with the meanings assigned to them in the Comment Letter to which this Annex is attached.

[2] U.S. regulators played an important role in improving industry practices by establishing new policies on liquidity risk and by stepping up scrutiny of practices firm-by-firm, including most importantly the U.S. banking agencies' March 2010 *Interagency Policy Statement on Funding and Liquidity Risk Management*, 75 Fed. Reg. 13656 (March 22, 2010) (the "**Interagency Policy Statement**"). U.S. banks' enhancements to their liquidity risk management practices since the onset of the financial crisis are discussed in Chapter V (Enhanced Practices for Liquidity-Risk Management) of The Clearing House's white paper concerning liquidity risk management entitled, *The Basel III Liquidity Framework: Impacts and Recommendations*, dated November 2, 2011, *available at* http://www.theclearinghouse.org/index.html?f=073043 and included in the Prior Submissions ("**The Clearing House Liquidity White Paper**").

invest more heavily in shorter-term securities to satisfy regulatory requirements.[3] The Federal Reserve's approach to liquidity-related quantitative analyses and metrics for the most part permits covered companies to achieve a proper balance between appropriate levels of liquidity over a range of time horizons, on the one hand, and the dangers of too much liquidity, on the other hand. The exception is the 30-day time horizon, discussed in Parts III.G and III.H, below.

Part I of this Annex summarizes our comments on the Proposed Liquidity Rules; Part II addresses several key recommendations and concerns; Part III sets forth our more specific comments on the Proposed Liquidity Rules; and Part IV sets forth our responses to certain of the specific questions posed in the NPR.

I. Executive Summary

Key recommendations and concerns with respect to the Proposed Liquidity Rules (Part II):

- The Proposed Liquidity Rules address a number of the Associations' concerns with the Basel III methodology, including (i) permitting U.S. government-sponsored entity securities (most importantly, Fannie Mae and Freddie Mac debt and mortgage-backed securities) to be included in "highly liquid assets" without the artificial L1/L2 distinction in Basel III's LCR and (ii) permitting covered companies to develop their own run-off factors and assumed drawn-down rates, provided that they rely on reasonably high-quality data and information to produce creditable outcomes. The Associations urge the Federal Reserve to work with the other U.S. banking agencies and their international counterparts to move aspects of the Basel III liquidity framework's approach to the quantitative analysis of liquidity risk, implemented through its LCR and potentially its NSFR, to an approach more aligned with the Proposed Liquidity Rules.

- The Proposed Liquidity Rules' governance provisions are so detailed and prescriptive as to risk impeding directors' proper discharge of their oversight duties. We strongly urge the Federal Reserve to consider an approach more in line with the strategic and oversight responsibility of the Board of Directors, as addressed in Part II.A.

- In several areas, the Proposed Liquidity Rules' risk governance provisions blur the distinction between the proper oversight rule of the Board of Directors and management's responsibility for day-to-day operations. We believe these provisions should be adjusted so that the focus of the Board of Directors or risk committee, insofar as liquidity risk is concerned, is on the oversight of liquidity risks, including approval of risk management policies developed and recommended by management, as discussed in Part II.C.

Other specific comments with respect to the Proposed Liquidity Rules include (Part III):

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[3] Since the onset of the financial crisis, there has been a relative dearth of research focused on the macroprudential and macroeconomic effects of enhanced liquidity risk standards of the type contemplated by the Basel III liquidity framework or the Proposed Liquidity Rules as compared to the attention accorded capital requirements. *See* Part VI, Subchapter C (Other Qualitative Considerations – Research Assessment), of The Clearing House Liquidity White Paper for a discussion of liquidity-related research as of the fall of 2011.

Proposed Liquidity Rules

- Although the Associations appreciate the less prescriptive approach of the definition of "highly liquid assets" in the Proposed Liquidity Rules as compared to Basel III's LCR, we believe the definition should be further expanded to encompass foreign sovereign securities and securities or other obligations issued by multi-lateral development banks and central banks of sovereign countries whose debt is included, and should provide a broader-based flexibility for inclusion of high-quality securities and instruments at future dates.

- Assets that hedge trading positions should not be treated as encumbered, as covered companies can monetize the asset while still retaining the economic exposure and therefore the desired trading view of hedge relationship.

- Covered company assets that are technically subject to a lien but are excess collateral that the covered company may withdraw or otherwise free from the lien at any time should not be treated as encumbered for purposes of the Proposed Liquidity Rules.

- The risk committee's (or designated subcommittee's) quarterly reviews of stress testing practices, methodologies and assumptions should focus on material aspects of those practices, methodologies and assumptions.

- The cashflow provisions in Section 252.55 should permit a covered company discretion to use a methodology for projecting liquidity that it determines is most appropriate for its business model. Also, covered companies should be permitted reasonable discretion in determining the time horizon for "long-term cashflow projections" under Section 252.55.

- Covered companies should be permitted to take into account "other appropriate funding sources", including Federal Home Loan Bank ("**FHLB**") advances, for purposes of Section 252.57's liquidity buffer and 30-day or shorter time horizons for liquidity stress testing under Section 252.56.

- The final liquidity rule should acknowledge that, during a period of stress, covered companies may use their liquidity buffer, temporarily falling below the minimum requirement without adverse regulatory consequences.

- Securities issued or guaranteed by the U.S. government, a U.S. government agency or a U.S. government-sponsored agency should not be subject to the "sufficiently diversified" standard in Section 252.57 or to concentration limits under Section 252.59(a)(1).

- Section 252.59's requirement that covered companies establish "specific limits" as to designated items should incorporate the flexibility standard at the heart of Section 165 of Dodd-Frank and acknowledged elsewhere in the Proposed Rules – namely, "taking into consideration [the covered company's] capital structure, riskiness, complexity, financial activities (including the financial activities of [its] subsidiaries), size and any other risk-related factors that the [Federal Reserve] deems appropriate."

II. Key Recommendations and Concerns

A. The Associations urge the Federal Reserve to work with the other U.S. banking agencies and their international counterparts to move aspects of the Basel III liquidity framework's approach to the quantitative analysis of liquidity risk, implemented through its LCR and potentially its NSFR, to an approach more aligned with the Proposed Liquidity Rules.

The Federal Reserve recites in the Preamble that the Proposed Liquidity Rules are part of a multi-stage process that ultimately will include requirements "based on the Basel III liquidity ratios."[4] The area where the Proposed Liquidity Rules and the Basel III liquidity framework most overlap is (i) the Proposed Liquidity Rules' dynamic principles-based approach to stress testing as opposed to (ii) the formulaic approach to liquidity risk embodied in Basel III's LCR and NSFR. The Associations urge the Federal Reserve to work with the other U.S. banking agencies and their international counterparts, as they continue to evaluate the LCR and potentially the NSFR (depending upon changes made in the NSFR as a result of insights gained during the observation period) in their current proposed forms, to more closely align aspects of the approaches taken in those ratios to the approach of the Proposed Liquidity Rules, which would allow the Proposed Liquidity Rules and the pending Basel III rules to be integrated in a seamless and non-contradictory manner.[5]

The Basel III liquidity framework in its current form has serious flaws in its calculation methodology, addressed at length in prior comment letters of the Associations.[6] The Proposed Liquidity Rules address a number of our concerns with the Basel III methodology. Specifically:

- The Proposed Liquidity Rules' definition of "highly liquid assets" (i.e., the assets that a covered company maintains for the 30-day buffer) eliminates the Basel III L1/L2 distinction and, accordingly, does not limit the amount of U.S. government-sponsored entity securities (most

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[4] 77 Fed. Reg. at 604.

[5] The Group of Governors and Heads of Supervision ("**GHOS**"), the oversight body of the BCBS, in a January 2012 press release noted the BCBS members' commitment to introducing the LCR as a minimum standard in 2015, acknowledging the BCBS's "timeline to finalize key aspects of the LCR by addressing specific concerns regarding the pool of high-quality liquid assets as well as some adjustments to the calibration of net cash outflows." Press Release, GHOS, *Basel III Liquidity Standard and Strategy for Assessing Implementation of Standards Endorsed by a Group of Governors and Heads of Supervision* (Jan. 8, 2012). A number of the Associations' comments in this Annex concerning the interplay between the Proposed Liquidity Rules and the LCR relate to those key aspects.

[6] *See* Letter from the ABA to the BCBS, dated April 16, 2010, regarding the Basel III liquidity framework; Letter from The Clearing House to the BCBS, dated April 16, 2010, regarding the Basel III liquidity framework; Letter from The Clearing House to Timothy F. Geithner, *et al.*, dated November 5, 2010, regarding various capital and liquidity reforms including the Basel III liquidity framework; Letter from The Clearing House to Timothy F. Geithner, dated November 2, 2011, regarding the LCR; Letter from the Global Financial Markets Association (of which SIFMA is a member), British Bankers' Association and the International Swaps and Derivatives Association, dated April 16, 2010, regarding the Basel III liquidity framework; The Clearing House, *Assessing the Liquidity Coverage Ratio* (Nov. 2, 2011); The Clearing House, *The Basel III Liquidity Framework: Impacts and Recommendations* (Nov. 2, 2011). These materials are included in the Prior Submissions.

importantly, Fannie Mae and Freddie Mac debt and mortgage-backed securities) that may be included.

- Although the Proposed Liquidity Rules impose rigorous cash flow projections and stress testing requirements and a 30-day liquidity buffer, they do not follow the Basel III approach of specified uniform run-off factors and assumed draw-down rates for purposes of calculating net cash outflows. Instead, they require covered companies (i) in producing cash flow projections, to use reasonable assumptions taking into account the company's capital structure, risk profile, complexity, activities, size and other related factors[7] and (ii) although the Proposed Liquidity Rules themselves do not specify a severity standard for run-off factors and assumed draw-down rates for stress testing purposes, the Preamble states that covered companies must "rely on reasonably high-quality data and information to produce creditable outcomes."[8][9] We understand that the LCR is not likely to provide for that degree of company-by-company flexibility, even after giving effect to insights developed during Basel III's observation period for the LCR. However, we believe the LCR should be revised at the least to provide that national supervisors for the banks under their jurisdiction (the U.S. banking agencies in the case of the United States) may adopt calibrations for their jurisdictions that differ from calibrations specified in the Basel III LCR where they determine that a different calibration is warranted and supported by reasonably high-quality data.

- The Proposed Liquidity Rules permit each covered company to establish its own liquidity risk tolerance for each time horizon other than the liquidity buffer's 30-day horizon, taking into account the covered company's capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors. In the context of the Basel III framework, that approach would mean permitting a covered company to target a less than 100% NSFR.

- The Proposed Liquidity Rules address short-term liquidity risk by requiring covered companies to maintain a liquidity buffer of unencumbered highly liquid assets sufficient to meet projected net cash flows for 30 days over a range of liquidity stress scenarios, taking an approach that is conceptually similar to Basel III's LCR but less prescriptive. They address overnight, 90-day and one-year time horizons through stress testing, replacing Basel III's NSFR with the one-year stressed time horizon.

- The Proposed Liquidity Rules treat liquidity regulation as a supervisory, prudential and management function, and do not provide for disclosure of specific ratios. This is consistent with the industry's strongly-held view that liquidity risk management (unlike capital adequacy) does not lend itself to a standardized approach. We continue to believe the risk of market participants not understanding the implications of disclosure (and reacting in a way that is not

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[7] Section 252.55(b).

[8] 77 Fed. Reg. at 608-609.

[9] This is consistent with the U.S. banking agencies' acknowledgment, in response to FAQ 11 in their January 12, 2012 "*Interagency Advisory on Interest Rate Risk Management – Frequently Asked Questions,*" that for purposes of interest rate risk management "decay rates" (i.e., run-off rates) on non-maturity deposits should reflect the institution's profile and activities as opposed to standardized industry estimates, given inconsistencies across geographic areas and other considerations.

warranted by the disclosure or that unnecessarily exacerbates any liquidity weakness) substantially outweighs the benefits of any hoped-for market discipline resulting from disclosure.

Subject to our specific comments set forth below, the Associations strongly believe that these improvements to the quantitative analysis of liquidity risk should be incorporated into the Basel III liquidity framework.

B. The Proposed Liquidity Rules' governance provisions are so detailed and prescriptive as to risk impeding directors' proper discharge of their oversight duties.

The Associations agree with and endorse the liquidity risk management tools addressed in the Proposed Liquidity Rules, with their emphasis on stress testing, contingency funding plans and more rigorous oversight. As noted above, use of these tools as core principles reflects and is consistent with current enhanced practices in many banks.

However, we are concerned that the governance aspects of the Proposed Liquidity Rules are so detailed and specific that they would in fact impede directors' proper discharge of their duties and oversight. Boards of Directors have duties of care and loyalty that are well established under applicable corporate law. The role of directors is one of oversight and review, not operational or day-to-day management. Given the demands on directors in today's environment (particularly directors of financial institutions), it is critically important, in our view, that directors preserve the flexibility to determine how to discharge their duties and allocate their time among various tasks. The time allocation issue becomes more important the more complex the institution, raising a concern that too much time and energy will be devoted to liquidity risk at the expense of other issues, including potentially other risk disciplines.[10] Section 252.52 of the Proposed Liquidity Rules, specifying actions that must be taken by the Board of Directors in connection with liquidity risk management, is unusually detailed and prescriptive – really to an unprecedented degree, specifying, among other things, (i) which tasks must be undertaken by the Board of Directors as a whole and which may be delegated by the Board of Directors to the risk committee or by the risk committee to a subcommittee, (ii) the frequency with which the Board of Directors (or risk committee or a designated subcommittee) must conduct reviews, (iii) the precise items that must be reviewed and established and, in some cases, reviewed and approved, and (iv) that the risk committee or designated subcommittee must establish "procedures governing the content" of senior management reports. For some covered companies, the Proposed Liquidity Rules' requirements may largely align with current practices; for others they may not; and for all covered companies, as liquidity risk management tools progress and approaches to liquidity risk management are refined, they almost certainly will not align with best practices at some future date.[11]

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[10] In response to President Obama's initiatives to identify and reduce unnecessary governmental burdens on the private sector, the American Association of Bank Directors ("**AABD**") undertook a review of laws, regulations and federal banking agency regulatory guidance that direct bank Boards of Directors to take certain actions. The AABD report, released on March 14, 2012, states in the first paragraph of the executive summary that "[a]fter months of review, AABD found in excess of eight hundred such provisions. They were not easy to find, spread over numerous issuances and pronouncements, with no instructions to bank directors on how to find them." AABD, *Bank Director Regulatory Burden Report 2012*.

[11] We address in Part III, below, certain provisions in Section 252.52 that raise particular concerns.

We strongly urge the Federal Reserve to consider an approach more in line with the strategic and oversight responsibility of the Board of Directors. Such an approach would require each covered company to develop and implement a liquidity risk management program that (i) addresses the areas covered by the substantive provisions in Sections 252.55 through 252.59 of the Proposed Liquidity Rules (i.e., the covered company's liquidity risk tolerance, cash flow projections, liquidity stress testing, liquidity buffers, contingency funding plans, specific limits and on-going monitoring requirements, subject to our further comments below) but with a more flexible approach as to specific action items, (ii) addresses the company's approach for considering the liquidity costs, benefits and risks associated with significant new products and lines of businesses and the entry into new markets, and establishes the company's policies with respect to these matters, and (iii) provides that the Board of Directors (or, at its discretion, the risk committee) must approve and review the liquidity risk management program on at least an annual basis and identify the overall purpose of such reviews and approvals, but (iv) otherwise leaves the details for governing review and oversight, including frequency, to the discretion of the board.

C. In several areas, the Proposed Liquidity Rules' risk governance provisions blur the distinction between the proper oversight role of the Board of Directors and management's responsibility for day-to-day operations.

The Associations agree with the Federal Reserve's premise in the Proposed Liquidity Rules that an appropriate and robust internal governance approach to liquidity risk management is critically important. However, a number of provisions in the Proposed Liquidity Rules and the Proposed Risk Management Rules blur (and in our view cross) the line between the proper oversight role of the Board of Directors and the management role of senior management. In *Annex E*, we discuss this concern more broadly in the context of the Proposed Risk Management Rules. Blurring the traditional distinction between the Board of Directors' oversight responsibility and management's management responsibility raises its own risks. The focus of the Board of Directors or risk committee, insofar as liquidity risk is concerned, should be on the oversight of liquidity risks, including approval of risk management policies developed and recommended by management. We note four key provisions of the Proposed Liquidity Rules in this regard, as follows:

- Section 252.52(b)(1)(i) provides that the Board of Directors "must establish the covered company's liquidity risk tolerance at least annually." We strongly believe that the board's role should be to review and approve the covered company's risk tolerance, and that senior management should be responsible for proposing to the covered company's Board of Directors from time-to-time the appropriate liquidity risk tolerance for the covered company, including the quantitative and qualitative ways in which the covered company's liquidity risk tolerance is expressed and measured.[12]

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[12] The BCBS, in its *Principles for Sound Liquidity Risk Management and Supervision* (Sept. 2008), notes in the text accompanying Principle 2 that a Board of Directors "should establish the bank's liquidity risk tolerance," and then goes on to say that "[t]here are a variety of qualitative and quantitative ways in which a bank can express its risk tolerance." The U.S. banking agencies, in paragraphs 11 and 12 of the Interagency Policy Statement, deal generally with policies articulating a liquidity risk tolerance but do not specify that a Board of Directors must establish the company's liquidity risk tolerance. Instead, paragraph 7 states that "the board should ensure that the institution's liquidity risk tolerance is established and communicated in such a manner that all levels of management clearly understand . . .". We agree with that standard. While standard measures of risk are useful, banking organizations' managements should

- Section 252.52(b)(2)(i) requires the risk committee or a designated subcommittee to review and approve the liquidity costs, benefits and risks of each significant new business line and each significant new product before the covered company implements the business line or offers the product. In addition, Section 252.52(b)(2)(ii) requires the risk committee (or designated subcommittee) to annually review all *previously approved* significant business lines and products – the number of which likely would grow over time substantially. We urge the Federal Reserve to delete these requirements from the final rules. Liquidity risk is only one of the risks and relevant considerations that require consideration in connection with new business lines and product. In our view, proper risk management (liquidity and otherwise) will not be best served by isolating the liquidity component of the relevant considerations and, instead, should be left to the broader evaluation and approval process that would customarily apply (beginning with business level commitment committees, complex structured product committees and reviews, etc.). Moreover, requiring annual review of each previously approved product or business line could impose, over time, substantial burdens on the risk committee (or the designated subcommittee) and detract from its ability to have and maintain a holistic view of the firm's liquidity risk profile. If reduced to a regulatory compliance exercise, it will be exceedingly important to establish with clarity what is a "significant new business line" or "significant new product".

- Section 252.52(b)(4)(i)(F) requires the risk committee (or a designated subcommittee) to "[r]eview liquidity risk management information necessary to <u>identify</u>, <u>measure</u>, <u>monitor</u>, and <u>control</u> liquidity risk" (emphasis added). Identifying, measuring, monitoring and controlling liquidity risk in the first instance is a management responsibility, subject to oversight by the Board of Directors. Accordingly, we believe this section should be revised to require the risk committee (or a designated subcommittee) to "oversee and review liquidity risk management information developed and used by management for the purposes of identifying, measuring, monitoring and controlling liquidity risk."

- Section 252.52(b)(4)(iii) provides that the risk committee or a designated subcommittee "must establish procedures governing the content of senior management reports on the liquidity risk profile of the covered company." Although we are uncertain as to the precise intent of this clause, it seems to require that the risk committee or designated subcommittee determine the content of senior management reports on liquidity risk. We strongly believe that the proper role of the Board of Directors, whether exercised directly or through a committee, is to oversee the liquidity risk management process on an informed basis but that, in the first instance, the structure of the liquidity risk management program, including in the first instance the content of reports provided to directors, should be the role of senior management.

III. Specific Comments

A. Although the Associations appreciate the less prescriptive approach to the definition of "highly liquid assets" in the Proposed Liquidity Rules, we believe the definition

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be encouraged to continue to develop liquidity risk management approaches (and analytics for measuring liquidity risks) that take into account the liquidity position, vulnerabilities and capabilities of the specific firm. For example, stress test and scenario analysis taking into account these firm-specific items are essential to effective liquidity risk management. The Board of Directors should be briefed on these measures in sufficient detail to understand them and provide oversight.

should be further expanded to encompass foreign sovereign securities and securities or other obligations issued by multi-lateral development banks and central banks of sovereign countries whose debt is included. It should also provide flexibility for inclusion of high-quality securities and instruments at future dates.

The liquidity buffer and stress testing requirements must be met by "highly liquid assets", as defined in Section 252.51(g) of the Proposed Liquidity Rules. As indicated in the introductory paragraphs, we commend the Federal Reserve for including within the definition of highly liquid assets U.S. government, government agency and government-sponsored entity securities. However, we believe the definition should be expanded in five respects.

First, high-quality securities of foreign sovereigns should be included as highly liquid assets.[13] We appreciate that the U.S. banking agencies are currently evaluating comments received on their December 2011 notice of proposed rulemaking implementing Section 939A of Dodd-Frank to replace use of ratings in their revisions to their market risk capital rules, known as "**Basel II.5**", with other metrics.[14] Given the premise that highly liquid assets have low credit risk, the Federal Reserve and the other U.S. banking agencies will need to consider the interplay between the treatment of sovereign debt exposures under the market-risk rules and their qualification as highly liquid assets for purposes of the Proposed Liquidity Rules. The methodologies for evaluating sovereign debt exposures (and, for that matter, other exposures) under the market-risk rules are likely to evolve over the next several years. We urge the Federal Reserve to address the inclusion of high-quality sovereign debt (in each case with limitations on maturity that are appropriate for the particular time horizon involved) within highly liquid assets either by permitting the inclusion of:

- sovereign debt securities that are assigned a specific risk-weighting factor of 1.6 or less (equivalent to a risk-weighting of 20% or less under the U.S. banking agencies' Basel I-based capital rules) under the market-risk rules as they are amended, or

- securities issued or guaranteed by the government of a country that is a full member of the Organization for Economic Cooperation and Development or that has concluded special lending arrangements with the International Monetary Fund (which is the current standard under the U.S. banking agencies' Basel I-based capital rules for 20% risk-weighted sovereign securities).

Second, covered companies with international operations should be permitted to include securities issued or guaranteed by the sovereign government of any country (whether or not covered by the preceding paragraph) and recorded on the books and records of a branch, agency or subsidiary located within the relevant sovereign country (and subject to appropriate maturity constraints), at least to the extent of the liabilities of the covered company recorded on the books and records of a branch, agency or subsidiary located within such country. There have, of course, been numerous sovereign debt crises over the years. With limited exceptions, the debt of the affected sovereigns restructured in those crises has been debt issued cross-border to financial institutions and

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[13] Similar considerations with respect to the treatment of non-U.S. sovereign securities arise under the Proposed SCCL Rules and are discussed in Part II.F of *Annex C*.

[14] 76 Fed. Reg. 79380 (Dec. 21, 2011). The Associations, along with the American Securitization Forum and the International Swaps and Derivatives Association, Inc., commented on the proposed market risk rules by letter dated February 7, 2012.

others outside the sovereign country; customarily debt issued or guaranteed by the sovereign domestically, including to branches, agencies or subsidiaries of banking organizations organized or headquartered elsewhere but located within the sovereign, have been paid in accordance with their terms.[15] The eligibility of domestic debt for liquidity purposes hinges, of course, on the liquidity characteristics of the instruments. However, it is important to recognize that covered companies (including their bank subsidiaries) with international reach generally are required to maintain on the books and records of branches, agencies or subsidiaries within foreign countries securities issued by the relevant sovereign country.[16] It is important to the proper functioning of the international financial system that international banking organizations (which include many of the covered companies) continue to provide financial services within international reach in a broad array of areas, including trade finance, lending more generally, custody, and cross-border payments. The final version of the Proposed Liquidity Rules, as well as the Basel III liquidity framework, should not unnecessarily impede those important functions.

Third, securities or other obligations issued by multi-lateral development banks (including The International Bank For Reconstruction and Development, The International Finance Corporation, The Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the European Financial Stability Fund, the Nordic Investment Bank, and other multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member), in each case if maturing or withdrawable within the relevant time horizon (e.g., 30 days for the liquidity buffer), should be recognized as highly liquid assets. Under the Federal Reserve's and other U.S. bank agencies' risk-based capital guidelines, claims on these entities are recognized as high quality (assigned a 20% risk weighting) and, insofar as their liquidity characteristics are concerned, their performance during the financial crisis raised no issues.

Fourth, Section 252.51(g)(3) provides flexibility for the inclusion at future dates of additional assets as highly liquid assets, but it does so in a manner that would require each covered company to make an independent demonstration to the satisfaction of the Federal Reserve as to the relevant criteria and, apparently, would allow only the petitioning covered company to include the particular security or asset as a highly liquid asset if the Federal Reserve is satisfied with the demonstration. We urge the Federal Reserve to provide in the final rules that other securities specified from time-to-time by Federal Reserve order as highly liquid assets may be included. We believe it is important that the final rules include a mechanic for expanding the scope of highly liquid assets that is

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15 *See*, e.g., Congressional Research Service Report for Congress, *Argentina's Sovereign Debt Restructuring* (Oct. 19, 2004) (addressing the categories of Argentinian peso-denominated debt that was proposed to be restructured in its crisis that became acute in 2001, noting that restructuring of certain instruments placed domestically "with depositors and financial institutions, under some government pressure, . . . could jeopardize the banking system. Restructuring BODENs held by public sector pensions would be politically unfeasible for similar reasons.").

16 Some countries require banking institutions operating in that country to hold a percentage of their demand and time liabilities in the form of government securities. For example, the Reserve Bank of India mandates this in the form of a "Statutory Liquidity Ratio", which is currently at about 25% of the demand and time liabilities. To the extent that these government securities are not counted as eligible, banks with significant operations in these countries would be subject to a burdensome and duplicate reserve requirement.

more streamlined than a formal rulemaking proceeding under the Administrative Procedures Act. U.S. and international banks are making substantial efforts to identify and analyze metrics that demonstrate the liquidity of securities and other instruments and facilities in time of stress. If these endeavors result in agreement upon metrics that the Federal Reserve and other bank regulators as well as the industry believe are appropriate indicators of liquidity for stress testing and buffer purposes, it will be important to create a mechanic for expanding the definition of highly liquid assets to accommodate them for all covered companies in an expeditious manner (and not simply on a company-by-company basis).

Fifth, we urge the Federal Reserve to revise the definition of highly liquid assets to clarify that securities issued by or claims against central banks of sovereign countries whose debt securities are risk-weighted 0% (including the Federal Reserve Banks for the United States) fall within its scope, provided that they may be withdrawn or transferred within the relevant time horizon (e.g., 30 days for the liquidity buffer). The U.S. banking agencies' Basel I-based capital rules apply a 0% risk weighting to central governments of OECD countries and specify that central banks (including the Federal Reserve Banks for the United States) are encompassed within central governments. For example, deposits that banks maintain with the Federal Reserve Banks, including amounts in excess of the amount needed to satisfy reserve requirements under the Federal Reserve's Regulation D, should be included within highly liquid assets. Similarly, any deposits that a covered company may maintain with a Federal Reserve Bank under the term deposit facility proposed by the Federal Reserve as a monetary policy tool to manage the aggregate quantity of reserve balances held by depository institutions should be included.

B. Assets that hedge trading positions should not be treated as encumbered, because covered companies can monetize the asset while still retaining the economic exposure and therefore the desired trading view of the hedge relationship.

The definition of "unencumbered" in Section 252.51(n) excludes an asset designated as a hedge on a trading position, as defined in Section 252.51(l). The example given in the Preamble is corporate bonds held by a covered company to hedge a corporate bond index in its trading account.[17] This requirement appears to be focused on ensuring that liquid assets are segregated from assets that are traded. This segregation is unnecessary. Whether an asset is a trading position, or hedge to a trading position, does not prevent a covered company from being able to generate liquidity from it, including through repos in the secondary market, clearing houses or existing central bank facilities. In any of these instances, where the asset is used to generate funding, the covered company retains the economic exposure and therefore the desired trading view or hedge relationship.

C. Covered company assets that are technically subject to a lien but are excess collateral that can be withdrawn or freed of the lien at any time should not be treated as encumbered for purposes of the Proposed Liquidity Rules.

The Proposed Liquidity Rules define the term "unencumbered" very narrowly in a manner that would encompass many assets that are only technically encumbered and may be freed from the technical encumbrance at any time to serve as a liquidity source. Examples include (i) assets pledged to a central bank in excess of reserve requirements, (ii) assets pledged to a clearing counterparty in excess of the amounts required for clearing, and (iii) assets subject to ordinary course

[17] 77 Fed. Reg. at 609.

"bankers' liens" that apply to securities held in depository accounts or custody accounts (e.g., Euroclear ordinarily has a lien over securities held to cover its fees, and custodians, more generally, customarily have a lien over custodied assets to cover their fees, expenses and indemnities). Banks properly, in our view, treat those assets as unencumbered for liquidity risk management purposes. The Associations urge the Federal Reserve, when it finalizes the Proposed Liquidity Rules, to take the same approach and treat assets that are technically subject to a lien, but that the covered company may at any time withdraw or free from the lien, as unencumbered.

D. Senior management, not the Board of Directors, should "establish" a covered company's liquidity risk tolerances.

As discussed in Part II.C, senior management should be responsible for proposing to the Board of Directors from time-to-time the appropriate liquidity risk tolerance for the covered company, including the quantitative and qualitative ways in which the risk tolerance is expressed and measured. The Board of Directors' proper duty is to review and approve the covered company's liquidity risk tolerance as proposed and defined by senior management, not to establish it.

E. The Federal Reserve should not prescribe the approach taken by covered companies, or the role of the Board of Directors, in reviewing and evaluating significant new business lines and products.

As discussed in Part II.C, we urge the Federal Reserve to delete the requirement that the Board of Directors (or risk committee or a designated subcommittee) must review and approve significant new business lines and products. A covered company's approach to evaluating significant new business lines and products, and when and whether a covered company determines to involve its Board of Directors (or such committee or designated subcommittee), should be left to the purview of the Board of Directors, taking into account the broader array of considerations that relate to new business lines and products.

F. The risk committee's (or designated subcommittee's) quarterly reviews of stress testing practices, methodologies and assumptions should focus on material aspects of those practices, methodologies and assumptions.

Section 252.52(b)(4)(i)(B) requires that the risk committee (or a designated subcommittee) at least quarterly "[r]eview and approve . . . stress testing practices, methodologies, and assumptions." Because there is no materiality qualifier, this could potentially require that the risk committee (or subcommittee) review and approve practices, methodologies and assumptions at a very granular level. We urge the Federal Reserve to qualify the requirements of this provision so it requires the risk committee or designated subcommittee to review only material stress testing practices, methodologies and assumptions. Boards of Directors (whether acting through the whole board or through committees or subcommittees), should be acknowledged to have discretion as to the level of their review of particular matters and where, at any given time and taking into account the circumstances of a particular company, they choose to allocate their time and resources.

Also, once material practices, methodologies and assumptions are approved, we urge the Federal Reserve to consider replacing the requirement of a quarterly review with a requirement that the risk committee or a designated subcommittee (i) review and approve on an annual basis the material stress testing practices, methodologies and assumptions but (ii) review and approve material changes to those practices, methodologies and assumptions prior to their being implemented.

Quarterly review of unchanged practices, methodologies and assumptions is unnecessary and creates the potential for the reviews becoming perfunctory.

G. The cash flow provisions in Section 252.55 should be flexible enough to permit a covered company, in appropriate circumstances and with the Federal Reserve's approval, discretion to use an alternative methodology for projecting liquidity that it determines is more appropriate for its business model. Also, covered companies should be permitted reasonable discretion in determining the time horizon for "long-term cash flow projections" under Section 252.55.

The Associations urge the Federal Reserve to re-word Section 252.55 to require covered companies to produce comprehensive projections of their liquidity positions (which may be addressed by providing cash flow projections). Although "cash flow projections" of the type contemplated by Section 252.55 of the Proposed Liquidity Rules are a common management tool, for some firms they may not provide much insight into the firm's liquidity position. We believe that the Proposed Liquidity Rules should require covered companies to project liquidity needs but permit flexibility and discretion in choosing a methodology that is most appropriate for the covered company's business model. Mere cash flow projections are a somewhat blunt "one-size-fits-all" approach. For example, scenario analysis incorporating different assumptions with respect to asset balances and contractual/contingent liquidity outflows may be more relevant to some companies' business models (broker-dealers, for example) than individual security cash flows such as interest payments.

Section 252.55 requires that cash flow projections cover short-term and long-term periods but does not specify what time horizon satisfies the long-term requirement. We appreciate the Federal Reserve's approach in leaving determinations of the time horizons to covered companies. The Associations' members expect that their cash flow projections and liquidity stress testing will be integrated processes and, accordingly, that customarily a one-year time horizon would be the long-term time horizon for cash flow projection purposes. We would appreciate the Federal Reserve confirming, in the preamble or introductory statement to the final liquidity rules, that no time horizon longer than one year is required in order to achieve compliance with Section 252.55. Individual covered companies may, of course, choose to use longer-term time horizons depending on their circumstances.

H. Covered companies should be permitted to take into account "other appropriate funding sources" for purposes of Section 252.57's liquidity buffer and 30-day or shorter time horizons for liquidity stress testing under Section 252.56.

The Proposed Liquidity Rules provide that "only highly liquid assets that are unencumbered" may be used as cash flow sources for the first 30 days of a liquidity stress scenario, apparently encompassing the required overnight and 30-day time horizons, whereas, for other time horizons, "other appropriate funding sources" may also be taken into account. We believe that a covered company should also be permitted to include, for purposes of the overnight and 30-day time horizons, other funding sources that the covered company concludes are appropriately reliable and stable (i) within that time horizon and (ii) taking into account the parameters of the particular liquidity stress scenario involved. Two examples include:

- FHLB borrowing capacity. The Associations have commented at length on the Basel III liquidity framework's exclusion of FHLB borrowing capacity as a component of the stock of liquid assets

for purposes of the Basel III LCR.[18] The FHLB system and the role of the FHLBs as a liquidity source for banks are unique to the United States. The FHLB system has proven itself vital not only to mortgage finance over the decades, but also to providing emergency liquidity support during the most recent financial crisis, when FHLB advances grew to $1.01 trillion at the height of the crisis. This was essential to banks of all sizes in the United States, including not only large banks but also mid-size and smaller ones for which access to capital markets is principally effected through the FHLB system. Implementation of any liquidity risk-management standard – whether the Proposed Liquidity Rules or the Basel III framework – without regard to the value of this facility and the liquidity it provides will undermine, not advance, sound liquidity risk management. We continue to believe that some portion of FHLB borrowing capacity should be included in applicable short-term liquidity ratios as a source of liquidity, including (i) in the case of the Proposed Liquidity Rules for purposes of the liquidity buffer, whether as a component of highly liquid assets or as an "other appropriate funding source", and (ii) in the case of the Basel III LCR as finally implemented, as a component of the stock of highly liquid assets. We address this issue further in our response to Question 14 in Part IV.

- Inventory positions maintained by covered companies with significant broker-dealer businesses. In many cases those positions are highly liquid, although they include equity and other securities that do not fit within the definition of highly liquid assets. At least for covered entities with these types of operations, we believe that some portion of those inventory positions should be includible as "other appropriate funding sources", including for time horizons of 30 days or less, subject to appropriate haircuts and, in the case of time horizons of 30 days or less, perhaps a limitation on the proportion of the projected net cash outflows that can be addressed with those assets (20%, for example).

I. The final liquidity rules should acknowledge that, during a period of stress, covered companies may use their liquidity buffer, temporarily falling below the minimum requirement without adverse regulatory consequences.

Section 252.57(a) provides that the "liquidity buffer must be sufficient to meet projected net cash outflows and the projected loss or impairment of existing funding sources for 30 days over a range of liquidity stress scenarios." Notwithstanding Section 252.52(b)(1)'s language contemplating that a covered company shall establish its liquidity risk tolerance at least annually (and, impliedly, acknowledging that its liquidity risk tolerance for a particular horizon could be less than 100%), Section 252.57(a) as currently written effectively contemplates no liquidity risk tolerance (and, accordingly, a 100% buffer) over the 30-day time horizon. Provided that the final liquidity rules permit covered companies to take into account other appropriate funding sources for purposes of the liquidity buffer, the Associations agree that covered companies should maintain a 100% liquidity buffer during normal times. However, during periods of stress covered companies inevitably use their stock of highly liquid assets to meet liquidity needs and, as a consequence, temporarily may fall below the liquidity buffer's implicit 100% requirement. We urge the Federal Reserve to provide in the final rules that the

[18] *See* Letter from the ABA to the BCBS, dated April 16, 2010, regarding the Basel III liquidity framework; Letter from The Clearing House to the BCBS, dated April 16, 2010, regarding the Basel III liquidity framework; Letter from The Clearing House, dated November 5, 2010, regarding various capital and liquidity reforms; The Clearing House, *The Basel III Liquidity Framework: Impacts and Recommendations* (Nov. 2, 2011); The Clearing House, *Assessing the Liquidity Coverage Ratio* (Nov. 2, 2011). These materials are included in the Prior Submissions.

100% requirement applies during normal times but that, during periods of stress, covered companies may fall below the 100% requirement without being deemed to have violated the liquidity buffer requirement.[19]

J. Securities issued or guaranteed by the U.S. government, a U.S. government agency or a U.S. government-sponsored agency should not be subject to the "sufficiently diversified" standard in Section 252.57 or to concentration limits under Section 252.59(a)(1).

Section 252.57(d) requires that the unencumbered highly liquid assets included in the liquidity buffer be "sufficiently diversified". Similarly, Section 252.59(a)(1) reads broadly, providing that a covered company must establish and maintain, among others, limits on concentrations of funding by single-counterparty and counterparty type. Although limiting concentrations of liquidity sources is appropriate in some contexts, we believe it is not appropriate as applied to securities of the U.S. government, U.S. government agencies and U.S. government-sponsored entities. These securities are among the most liquid and safest liquidity sources and, inevitably, will be maintained (and need to be maintained) by covered companies at levels that will likely make concentration limits as applied to them not meaningful. The Federal Reserve's commentary in the Preamble appears to agree with this view. The Preamble states that "if a covered company holds high-quality assets other than cash and securities issued by the U.S. government, a U.S. government agency, or a U.S. government-sponsored entity, the assets should be diversified by collateral, counterparty, or borrowing capacity, and other liquidity risk identifiers."[20] Similarly, we note that Section 252.97 of the Proposed SCCL Rules exempts exposures to the United States and its agencies as well as Fannie Mae and Freddie Mac from the concentration limits addressed in those rules.

Apart from securities issued by the U.S. government, U.S. government agencies and U.S. government-sponsored agencies, specific limits on concentrations without question are appropriate for liquidity risk management purposes more generally. However, we urge the Federal Reserve, in considering comments concerning the scope of the definition of "highly liquid assets", to be mindful that the more narrow the definition, the more concentrated covered companies' exposures will be to particular types of obligors, particularly if U.S. government, U.S. government agencies and U.S. government-sponsored agencies securities are not exempted from the specific limits on concentration.

K. Section 252.59's requirement that covered companies establish "specific limits" as to designated items should incorporate the flexibility standard at the heart of Section

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[19] The GHOS acknowledged the same principle as applied to the LCR in its January 2012 press release referred to in footnote 5, stating:

"Once the LCR has been implemented, its threshold will be a minimum requirement in normal times. But during a period of stress, banks would be expected to use their pool of liquid assets, thereby temporarily falling below the minimum requirement."

Press Release, Group of Governors and Heads of Supervision, *Basel III Liquidity Standard and Strategy for Assessing Implementation of Standards Endorsed by Group of Governors and Heads of Supervision* (Jan. 8, 2012).

[20] 77 Fed. Reg. at 608.

165 of Dodd-Frank and acknowledged elsewhere in the Proposed Rules – namely, "taking into consideration [the covered company's] capital structure, riskiness, complexity, financial activities (including the financial activities of [its] subsidiaries), size and any other risk-related factors that the [Federal Reserve] deems appropriate."

Section 252.59, as written, is too prescriptive. We believe Section 252.59 should require covered companies to establish specific limits only as to those items that are relevant for the company's business, funding models, and the instruments that it holds and issues. For example, requiring limits on counterparties that do not have a future obligation to provide liquidity to the covered company (e.g., debt holders) is of limited utility in managing liquidity risk. As another example, setting limits on collateral could require the unwinding of risk-mitigating contracts and increase risk. For example, if a covered company were forced to unwind interest rate swaps, it could then have a mismatch between the interest basis of its assets and the interest basis liabilities (e.g., floating rate accounts receivable financed with fixed-rate debt).

IV. Responses to Specific Questions

We have set forth below responses to certain of the specific questions raised by the Federal Reserve in the NPR.[21]

Question 10. *Is the Federal Reserve's approach to enhanced liquidity standards for covered companies appropriate? Why or why not?*

The liquidity risk management tools addressed by the Proposed Liquidity Rules – particularly cash flow projections, liquidity stress testing, the maintenance of a short-term liquidity buffer, and contingency funding planning – are consistent with liquidity risk-management practices as they have evolved and improved since the onset of the liquidity crisis. Accordingly, the Associations are largely supportive of the Proposed Liquidity Rules; in broad scope we believe they focus on the right tools.

Our key recommendations and concerns are set forth in Part II. In particular:

- The Proposed Liquidity Rules address a number of our most serious concerns with the Basel III methodology. Accordingly, the Associations urge the Federal Reserve to work with the other U.S. banking agencies and their international counterparts to move the Basel III liquidity framework's approach to the quantitative analysis of liquidity risk to an approach more aligned with the Proposed Liquidity Rules.

- However, we urge the Federal Reserve to revisit aspects of the governance provisions of the Proposed Liquidity Rules. In our view, they are so detailed and prescriptive as to risk impeding directors' proper discharge of their oversight duties. Additionally, in several areas they blur the distinction between the proper oversight rule of the Board of Directors and management's responsibility for day-to-day operations.

See the more detailed discussion in Part II.

[21] As noted in footnote 6 to the Comment Letter, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies.

Question 11. *Are there other approaches that would effectively enhance liquidity standards for covered companies? If so, provide detailed examples and explanations.*

As indicated above, we believe the Proposed Liquidity Rules focus on the right tools for robust liquidity risk management. We also believe, however, that the Federal Reserve should revise the cash flow provisions in Section 252.55 to permit a covered company discretion to use a methodology for projecting liquidity that is most appropriate for its business model. *See* the discussion of this issue in Part III.G.

Question 12. *The Dodd-Frank Act contemplates additional enhanced prudential standards, including a limit on short-term debt. Should the Federal Reserve adopt a short-term debt limit in addition to or in place of the LCR and NSFR? Discuss why or why not?*

The level of short-term debt appropriately maintained by a covered company depends upon the entire mix of its assets and liabilities and the nature of its operations. A covered company's establishment of its liquidity risk tolerance under the Proposed Liquidity Rules requires the company to address the level of its short-term debt in any event as part of stress testing over the required time horizons, and the level of short-term debt inherently is a consideration that the company takes into account in establishing its required liquidity buffer. Further, specifically limiting short-term debt could work counter to the general principle of achieving the diversification in funding sources that could be vital in a crisis. Accordingly, the Associations strongly believe that a specific limit on short-term debt would not enhance prudent liquidity (or other) risk management and, accordingly, should not be adopted.

Question 13. *What challenges will covered companies face in formulating and implementing liquidity stress testing described in the proposed rule? What changes, if any, should be made to the proposed liquidity stress testing requirements (including the stress scenario requirements and required assumptions) to ensure that analyses of the stress testing will provide useful information for the management of a covered company's liquidity risk? What alternatives to the proposed liquidity stress testing requirements, including the stress scenario requirements and required assumptions, should the Federal Reserve consider? What additional parameters for the liquidity stress tests should the Federal Reserve consider defining?*

Subject to our comment in Part III.H (concerning the importance of permitting covered companies to take into account other appropriate funding sources in addition to highly liquid assets for purposes of the liquidity buffer) and our comment below concerning validation, we believe that Section 252.56's approach to liquidity stress testing is appropriate.

With respect to validation, Section 252.56(c)(2)(ii) requires that a covered company must have an effective system of control and oversight to ensure that the "stress process and assumptions are validated." We are uncertain as to what it means to "validate" the "stress process" or the "assumptions" used in that process and urge the Federal Reserve to provide clarification, either in the preamble or introductory statement accompanying the final liquidity rules or perhaps even in the final liquidity rules themselves. Validating the "stress process" may mean proving the arithmetic accuracy of the liquidity stress models once the data points are fed into the models, although we are not sure of the intent. With respect to validating the "assumptions", we urge the Federal Reserve to clarify that this does not mean back-testing. Back-testing of projected stress scenarios is a developing "art".

Moreover, it is not clear which assumptions must be validated. Does the reference encompass the parameters of the assumed stress scenarios, the run-off (i.e., "*decay*") and draw-down rates used for those scenarios, or both (and the interplay between the two)?

Question 14. *The Federal Reserve requests comment on all aspects of the proposed definitions of "highly liquid assets" and "unencumbered." What, if any, other assets should be specifically listed in the definition of highly liquid assets? Why should these other assets be included (that is, describe how the asset is easily and immediately convertible into cash with little or no loss in value during liquidity stress events)? Are the criteria for identifying additional assets for inclusion in the definition of highly liquid assets appropriate? If not, how and why should the Federal Reserve revise the criteria?*

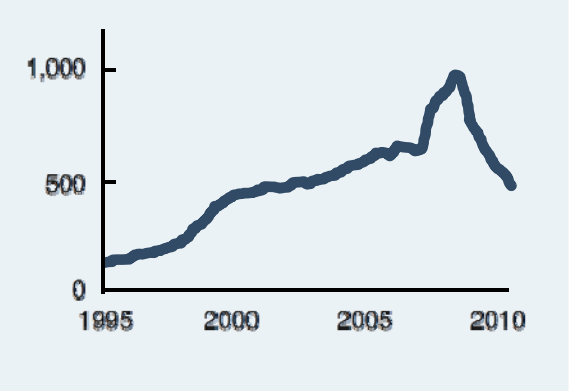
See our comments in Parts III.A and III.B.

Additionally, we wish to comment on two additional matters relating to the qualification of assets for the liquidity buffer and liquidity stress testing.

1. <u>FHLB Advances as a Source of Liquidity</u>.

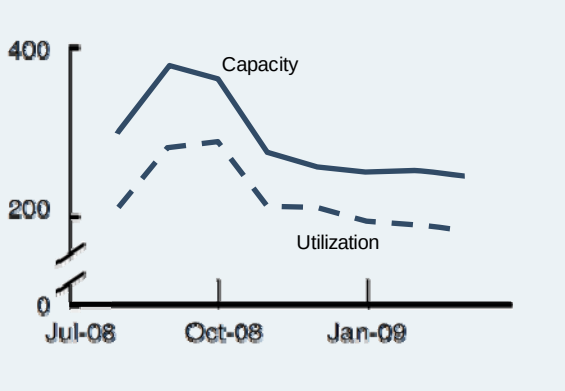
The first is the critical role of FHLB borrowing capacity as a source of liquidity, introduced in our comments in Part III.H. As demonstrated by the charts below, the FHLBs continued to provide liquidity that banks could draw upon during the crisis, in addition to other markets that maintained liquidity.

Quarterly FHLB advances 1995–2010 ($B)



- FHLB continued to provide liquidity even during the crisis

FHLB capacity and utilization ($B), TCH members



- Capacity and utilization increased during the crisis while excess capacity remained relatively constant

Source: Fed Flow of Funds; The Clearing House LLC member banks' supplemental data

Established by law in 1932,[22] FHLBs provide "advances" – that is, loans collateralized by eligible mortgages and other assets – to support residential-mortgage finance by member institutions.

[22] Federal Home Loan Bank Act of 1932, Pub. L. 72-304, 12 U.S.C. §§ 1421-1449.

Members – now more than 8,000 for the FHLB system as a whole[23] – are large and small banking organizations, as well as certain other eligible firms.

The FHLB System increased its lending to members in every part of the country by over 50% – or $300 billion – between the second quarter of 2007 and the third quarter of 2008.[24]

Some in the official sector have expressed concern that the FHLB role does not warrant recognition because the FHLBs pose taxpayer risk. However, several layers of protection exist to make it highly unlikely that any taxpayer subsidy would be required, because:

- the FHLBs are 100% privately capitalized with member stock and retained earnings;[25]
- joint and several liability within the FHLB System, through issuance of the FHLB system's "consolidated system-wide obligations", protects individual district FHLBs;[26]
- FHLB haircuts on the collateral that must back all advances are conservative, generally ranging from 25% to 50%;
- no FHLB has experienced a credit loss on advances;[27] and
- none of the FHLBs required government assistance during the financial crisis.

FHLB advances may be provided on an overnight or a term basis. The Federal Reserve and the other U.S. banking agencies have expressed concern, in the context of Basel III's LCR, as to whether a bank's ability to borrow on an overnight basis from an FHLB should be recognized for LCR purposes in either the numerator or denominator, given that overnight borrowings would be negated by the obligation to repay within 30 days were the funds actually drawn down. The same concerns would apply to FHLB advances as a liquidity source for the Proposed Liquidity Rules' liquidity buffer. The treatment of overnight FHLB facilities for any short-term liquidity metric requires further consideration.

The Proposed Liquidity Rules correctly address one of the Basel III LCR's important flaws – caps on the proportion of the LCR's stock of liquid assets that may consist of securities of government-sponsored entities (including debentures and mortgage-backed securities issued or guaranteed by Fannie Mae and Freddie Mac and consolidated system-wide obligations of the FHLB system). Presumably the reason for the Federal Reserve's approach is that there is a long and well-documented history that shows these securities remain liquid during times of stress, and in fact benefit from a flight to quality. In other words, there is a high degree of confidence that all banks can find a buyer for these

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[23] The Federal Home Loan Banks, *FHLBanks White Paper*, *available at* http://www.fhlbanks.com/assets/pdfs/sidebar/FHLBanksWhitePaper.pdf.

[24] *Id.* at 3.

[25] *Id*.

[26] Moody's Investors Service, *Credit Opinion: Federal Home Loan Banks* (Aug. 5, 2011), *available at* http://www.fhlb-of.com/ofweb_userWeb/resources/MoodysCreditAnalysis080511.pdf.

[27] *Id.* at 3.

securities, without incurring a loss, even in the midst of a crisis. When an FHLB member bank takes an advance from the FHLB system, it relies on the very same mechanism that allows FHLB consolidated system-wide securities to be included in the liquidity buffer. The FHLB's funding office sells consolidated system-wide obligations to raise cash for the borrowing member bank. These obligations are the very same securities that are included in a bank's liquidity buffer when they are held directly by a bank. There is no reason to believe that the market would be less willing to purchase securities directly from the issuer (as a new issue) than from a bank (as a secondary sale). Inasmuch as there is no reason to doubt the liquidity for FHLB consolidated system-wide obligations and there is no reason to differentiate between sellers, the exclusion of FHLB borrowing capacity from the liquidity buffer can only reasonably be attributed to the FHLBs' relationships with member banks. The FHLBs have a long history of lending to trouble institutions in times of crisis, provided the institution has sufficient collateral to support the advance. Washington Mutual, for example, obtained a sizable advance on the very day it was seized by the FDIC. The FHLBs are able to safely make these advances because they have extensive expertise supplying reasonable haircuts to pledged collateral. It is our understanding that no FHLB has ever lost any principal on a secured advance to a member bank. Given this long track record, there is no reason to doubt that the FHLBs will change this practice in the future. And because the FHLBs can be counted upon to continue this rational behavior, there is no reason to exclude a bank's existing borrowing capacity (with appropriate haircuts) from the liquidity buffer.

FHLB advances are a critically important liquidity source for U.S. banks, demonstrably available to U.S. banks throughout the financial crisis. The liquidity buffer, by limiting sources of liquidity to highly liquid assets, does not recognize the liquidity value of banks on drawn FHLB commitments. Subject to the open questions with respect to overnight FHLB advances discussed above, we strongly believe it should.

2. <u>Clarification as to the Availability of Liquidity</u>.

Second, in discussing the characteristics of highly liquid assets in the Preamble, the Federal Reserve comments that "highly liquid assets in the liquidity buffer should be readily available <u>at all times</u> to meet a covered company's liquidity needs."[28] We assume that the "at all times" reference in the quoted language, as applied to a particular asset, means that the asset will be available to the covered company by the end of the 30-day time horizon provided for in the liquidity buffer and not that the asset may not be included if it is subject to a repurchase agreement (as long as the maturity date of the repurchase agreement is at or before the end of the 30-day period as opposed to after the end of that period) or must mature on an overnight basis and continually be reinvested during the 30-day period in order to qualify. We would appreciate the Federal Reserve clarifying that understanding in the preamble or introductory text to the final rules.

Paragraph 26 of the Basel III liquidity framework uses slightly different terminology when it specifies that assets a bank includes in its stock of liquid assets for LCR purposes "must be available for the bank to convert into cash <u>at any time</u> to fill funding gaps between cash inflows and outflows during the stressed period."[29] The BCBS, in response to frequently asked questions, confirmed that paragraph 26 of the Basel III liquidity framework should be read together with paragraph 27; paragraph 27 provides that assets received in reverse repo and securities financing transactions that are

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[28] 77 Fed. Reg. at 609.

[29] Basel III liquidity framework, ¶ 26 (emphasis added).

held by a bank and have not been re-hypothecated, and are legally and contractually available for the bank's use, can be considered as part of the stock liquid assets. We believe the Federal Reserve should take the same approach for purposes of addressing the scope of unencumbered high-quality liquid assets in the Proposed Liquidity Rules. The repo markets continued to function during the financial crisis. A robust repo market is important both as a liquidity source for covered companies and other banking organizations and to a functioning financial system.

Question 15. *What changes, if any, should the Federal Reserve make to the proposed definition of unencumbered to make sure that assets in the buffer will be readily available at all times to meet a covered company's liquidity needs? The rule would require a covered company to discount the fair market value of assets that are included in the liquidity buffer. Please describe the process that covered company will use to determine the amount of the discount.*

See our comments in Parts III.A and III.B and our additional comments in response to Question 14**.**

Question 16. *Are the proposed CFP requirements appropriate for all covered companies? What alternative approaches to the CFP requirements outlined above should the Federal Reserve consider? If not, how should the Federal Reserve amend the requirements to make them appropriate for any covered company? Are there additional modifications the Federal Reserve should make to the proposed rule to enhance the ability of a covered company to comply with the CFP and establish a viable and effective plan for the management of liquidity stress events?*

Section 252.58's approach to contingency funding plans ("**CFPs**") is a principles'-based approach that we believe is sufficiently flexible to accommodate BHCs that are covered companies irrespective of size or the nature of their businesses. (As indicated in footnote 19, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve relating to, nonbank covered companies.)

There is one aspect of the CFP provisions, however, on which we request clarification – namely, the testing provisions in Section 252.58(b)(4). That section requires, among other things, that a covered company "must periodically test the methods it will use to access alternative funding sources to determine whether these funding sources will be readily available when needed." Our concern is that that language could be read to require covered companies to actually draw-down on liquidity lines or other funding sources (including, for example, the Federal Reserve discount window) or sell assets that they would not otherwise sell, albeit on a temporary basis, in order to assure that the funding mechanics actually work – essentially, take steps to "monetize" their liquidity sources, actually raising funds (even if only on an intraday basis). We strongly believe that covered companies should not be <u>required</u> to actually monetize liquidity sources as part of the testing process. Whether a particular covered company chooses as part of its testing process to actually monetize a liquidity source should be left to the discretion of the covered company, taking into account market conditions and the possibility that market participants may recognize but misinterpret the action. Financial markets that become aware of monetization activities likely will not understand that the particular step taken was merely part of the testing component of the covered company's CFP and may assume that the monetization action is an indication of liquidity stress, possibly resulting in responsive actions by market participants that are unnecessary, inappropriate and contribute to financial instability. Equally importantly, we believe that

covered companies can test the components of their CFP's reliability on a "war room" basis by simulating communication, coordination, and decision-making (as contemplated by Section 252.58(b)(4)(i)), but not only within the covered company but also involving outside providers of liquidity) in a way that provides adequate assurance of the continued availability of liquidity sources. We urge the Federal Reserve either to confirm in the preamble or introductory statement to the final liquidity rules that the testing requirements under Section 252.58 may be satisfied on a simulation basis without actual monetization of liquidity sources or, alternatively, to clarify in Section 252.58(b)(4) that the testing may be on a simulation basis.

Question 19. *The Federal Reserve requests comment on all aspects of the proposed rule. Specifically, what aspects of the proposed rule present implementation challenges and why? What alternative approaches to liquidity risk management should the Federal Reserve consider? Are the liquidity management requirements of this proposal too specific or too narrowly defined? If, so explain how. Responses should be detailed as to the nature and impact of these challenges and should address whether the Federal Reserve should consider implementing transitional arrangements in the rule to address these challenges.*

Liquidity risk management is a discipline that has undergone significant improvement and advancement during the last several years but continues to evolve and progress. As a consequence, our key concern at this juncture is not that the Proposed Liquidity Rules have not encompassed the appropriate tools, based on current "best" or "enhanced" practices, but that they are cast so specifically that they may impede the development of new and better tools – for example, recognition by regulators and the industry, including as a result of the ongoing substantial efforts of U.S. and international banks to identify and analyze metrics that demonstrate liquidity (referred to in Part III.A), that instruments not recognized by the final version of the Proposed Liquidity Rules as highly liquid should be, or, conversely, that instruments that are recognized as highly liquid should no longer be so recognized. *See* our comments in Part II.B.

Proposed SCCL Rules (Subpart D) – Single-Counterparty Credit Limits[1]

The principal objective of the single-counterparty credit limit is to reduce risk in the U.S. financial system posed by the interconnectivity among large financial companies.[2] The Proposed SCCL Rules, however, take no account of the actual risk posed, or the degree of interconnectivity created, by the exposures the rule is designed to limit and instead impose an arbitrary, one-dimensional and one-size-fits-all methodology for calculating credit exposures that has no economic or analytical basis. This methodology would result in a gross overstatement of the exposure of any covered company to any counterparty.

The 10% credit limit imposed on major covered companies—and even the 25% credit limit imposed on all covered companies—may severely restrict legitimate and economically desirable credit-related business, even where the actual risk of that credit has been mitigated in sound ways. To comply with the proposed requirements, the provision of some credit products and services may have to be reduced significantly with consequences for the liquidity of many asset classes. Constrained liquidity would lead to higher costs for all market participants. In a crisis, the Proposed SCCL Rules would have the pro-cyclical impact of further preventing access to liquidity. Consequently, if implemented, the Proposed SCCL Rules will have impacts that are felt well beyond the covered companies themselves and will actually increase risk to U.S. financial stability—the very antithesis of the purpose of Dodd-Frank and the prudential measures in Section 165 of Dodd-Frank in particular.

Strikingly, there is no mention in the NPR of the enormous magnitude of the effect of the Proposed SCCL Rules. As discussed in Part I.C. of the Comment Letter to which this Annex is attached, the preliminary results of The Clearing House SCCL Study demonstrate that the effect of the Proposed SCCL Rules would be significant. As noted, preliminary results indicate:

- there would be in the aggregate 100 exposures to 29 unique counterparties in excess of the applicable credit limit;[3]
- the average counterparty exposure for those excesses would be 248% of the applicable credit limit;[4] and
- the counterparty exposures that would exceed the credit limit include exposures to seven highly-rated non-U.S. sovereigns and two CCPs.

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1 Capitalized terms used in this Annex and not otherwise defined are used with the meanings assigned to them in the Comment Letter to which this Annex is attached.

2 77 Fed. Reg. at 612.

3 If no allowance is made for short-term breaches of the credit limit (as discussed in Part III.C.2 of this Annex), covered companies inevitably will have to manage to a lower limit (e.g., 80% of the limit that would otherwise apply). Using 80% of the limit that would otherwise apply as the threshold, there would be 120 exposures in excess of that threshold.

4 This average represents a "count-weighted" average (i.e., a straight average of the percentage for each of the 100 incidents of exposures in excess of the applicable credit limit).

These "excesses" are the result of several factors. The calculation methodologies are flawed in a number of ways that result in an overstatement of actual economic exposure. The proposed use of CEM for all covered companies, rather than the IMMs used by the larger covered companies for capital and risk management purposes, creates an overstatement of the realistic economic exposure. The "add on" approach for calculating exposure under repo and securities lending transactions similarly overstates exposure. The automatic exposure-shifting (or substitution) that is required when a covered company purchases credit protection sharply exaggerates risk by requiring a shift of the face amount of the credit protection, which disregards the creditworthiness of the reference name and ignores the fact that any loss would require a double default.

Another cause of the limit excesses relates to the proposed reduction of the statutory credit limit. Maintaining the statutory credit limit of 25% rather than dramatically lowering the credit limit to an arbitrary 10% for certain major covered companies would mitigate the impact of the Proposed SCCL Rules on the financial markets, and still leave the Federal Reserve with the ability to lower the limit if, as required by Section 165, it is in fact determined at a later time to be "necessary to mitigate risks to the financial stability of the United States." Maintaining the 25% credit limit for all covered companies also would avoid the forced shifting of activity from larger financial institutions to their smaller and potentially less well-capitalized and less regulated counterparts that are not covered companies or to the largely unregulated shadow banking system. Finally, the Proposed SCCL Rules' approach of subjecting CCPs and non-U.S. sovereigns to the credit limit also drives the limit excesses.

We also believe that the focus on the risks of "interconnectivity" or "interconnectedness", which the Federal Reserve has identified as the driving force of the Proposed SCCL Rules,[5] may reflect a view of the risk of financial contagion that we believe is conceptually flawed. The Associations recognize that the failure of one large institution can place substantial pressure on other large institutions. This is, however, because investors and funders are concerned that the other institutions have invested in similar classes of assets as the first institution, or have other similar risk issues, and will experience similar losses. As demonstrated in the financial crisis, it is not principally because the other institutions have substantial exposure to the first. Indeed, the absence of interconnectivity losses during the crisis creates a very high barrier for the Federal Reserve to justify a departure from the BHCs' risk-based approach.

The Associations strongly urge the Federal Reserve to reconsider the approach taken in the Proposed SCCL Rules. Rushing into a rule that would upset existing legitimate credit-related business and constrain market liquidity would needlessly cause significant harm to U.S. financial institutions, their customers and the U.S. economy that will not be easily undone. Furthermore, the single-counterparty credit limit is not the lone guardian of U.S. financial stability, nor is it the sole means of addressing concerns of interconnectivity among large financial institutions and the related systemic risk. These concerns are being addressed through many other means—increased regulatory capital requirements, liquidity requirements, the new liquidation authority, and a host of other requirements (many of which are contained in the Proposed Rules). Taking into account these other supervisory and regulatory initiatives that seek to address similar concerns as the single-counterparty credit limit, as well as the concerns set forth herein, will result in a rule that is workable and achieves the purpose of the concentration limit without threatening the proper functioning of the credit markets or the availability

[5] *See* 77 Fed. Reg. at 612, 616.

of liquidity or increasing risk in the financial system. In addition, because the Federal Reserve retains the authority to adjust any rule it adopts, based on its experience and actual data it will gather in administering the rule, it should not act precipitously on the basis of speculation and assumptions regarding the effects of the Proposed SCCL Rules.

To be clear, the Associations support an organization-wide single-counterparty credit limit. In fact, monitoring counterparty exposure is a central component of the risk management functions of our members today. The Proposed SCCL Rules, however, largely ignore the existing systems and methods that BHCs use to measure and monitor credit exposures for regulatory capital purposes, and are completely divorced from the credit risk management and other systems that BHCs have developed over many years in close collaboration with their supervisors. In addition, the Proposed SCCL Rules diverge from other regimes applicable to banking organizations, such as state or federal bank lending limits. As a result, the Proposed SCCL Rules would require covered companies to develop a duplicative and less effective risk management system, the operational and system costs of which would far outweigh any supervisory benefits. This would divert resources and management attention from the systems actually used and relied upon by covered companies and their regulators to monitor and control risk to developing and maintaining an arbitrary system that has no basis or use in the economic functioning of the company. In addition, because the Proposed SCCL Rules differ in significant ways from similar regimes in other jurisdictions, covered companies with global operations will have to administer multiple, inconsistent risk management systems. For example, the EU Commission's large exposure regime, which is implemented by member countries, excludes from the applicable credit limit exposures to sovereigns with a 0% risk-weight and certain CCPs.[6] In addition, that regime would permit the use of models to measure certain exposures and would not impose a lower 10% credit limit.

There is no indication that, in proposing the Proposed SCCL Rules, the Federal Reserve weighed the significant costs and burdens associated with developing, tracking, reporting, and other compliance mechanisms against the likely benefit to covered companies or the U.S. financial system stability that would be derived from this approach. Similarly, the NPR does not consider whether the benefits could be achieved, and the unnecessary costs avoided, by aligning the requirements of the single-counterparty credit limit with existing systems. The Proposed SCCL Rules thus contravene U.S. government policy requiring an analysis and "reasoned determination" regarding the costs and benefits of a proposed rule and consideration of less burdensome alternatives.[7] These are principles the Federal Reserve has stated it endeavors to abide by in developing regulatory proposals, including specifically those required under Dodd-Frank.[8]

In addition, the Proposed SCCL Rules disregard the fundamental requirements of the APA by denying to those affected by the rule a meaningful opportunity to comment on the basis and

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[6] *See* Capital Requirements Directive II (2009/111/EC)("**CRD II**"). CRD IV, which modifies CRD II in certain respects, is intended to come into force on January 1, 2013.

[7] Exec. Order 13563 (Jan. 18, 2011). Exec. Order 13579 (July 11, 2011) states that independent regulatory agencies, such as the Federal Reserve, should comply with the cost-benefit analysis and regulatory balance burden reduction requirements of Exec. Order 13563.

[8] Letter from Federal Reserve Chairman Bernanke to Mr. Cass R. Sunstein, Office of Information and Regulatory Affairs, dated Nov. 8, 2011.

rationale for a number of these draconian changes to risk management. There is not, for example, any explanation as to why CEM was selected as an appropriate measure for all covered companies or BHCs' IMMs disregarded. Nor is any explanation provided for the proposed reduction from the 25% statutory limit to 10% or how such a reduction meets the statutory requirement that the reduction be "necessary" to mitigate risk to U.S. financial stability. Similarly, the NPR does not describe the basis for the $500 billion asset threshold for "major covered companies" and "major counterparties". In the interest of fundamental administrative fairness, the Federal Reserve should republish for comment revised Proposed SCCL Rules in order to provide a meaningful opportunity to comment as required under the APA given the lack of any rationale in the NPR on these issues.

Part I of this Annex summarizes our comments concerning the Proposed SCCL Rules; Part II addresses our key concerns and recommendations; Part III addresses certain other concerns; and Part IV sets forth our responses to certain of the specific questions posed in the NPR.

I. Executive Summary

The Associations strongly urge the Federal Reserve to incorporate the recommendations below into a final rule. These recommendations are designed to address the gross overstatement of exposure, and the inclusion of exposures that do not pose significant risk, to covered companies, while in no way undermining the overall purpose of the single-counterparty credit limit.

- <u>Allow covered companies the option to measure derivative exposures using Federal Reserve-assigned stress measures as an alternative to CEM</u>. Requiring all covered companies to use CEM to calculate derivative exposure will result in a substantial overstatement of the exposure in relation to the risk posed by the exposure with potentially severe consequences for liquidity of the derivative markets. The Associations propose two alternative approaches to CEM for measuring exposure. These alternatives are designed to address the Federal Reserve's concerns with IMMs and capture the effect of future market volatility but still provide meaningful and realistic measures of exposure. Both approaches address the most significant flaw of CEM, which is its failure to appropriately take into account collateral and legally enforceable netting in the calculation of potential future exposure.

    - The first approach is a stressed IMM ("**Stressed IMM Approach**"), which could be effected in one of two ways. Under one method, the covered company would calculate the exposure under its IMM and then subject the result of that calculation to a multiplier specified by the Federal Reserve in order to provide an additional buffer against excessive credit exposure. Alternatively, the Federal Reserve could assign both (i) the confidence level that would be used by the covered company to calculate its estimate of potential future exposure under its IMM and (ii) the period of stress to be used in calibrating the IMM to either a historical lookback period or a set of market implied data, or specify criteria for selection of such period of stress. A multiplier or higher confidence level and lookback period provided by the Federal Reserve would alleviate concerns with the potential fallibility of IMMs in times of market distress.

    - The second approach, the "**Supervisory Stress Approach**", would require a covered company to use a replacement cost, calculated consistently with regulatory capital rules, of derivative transactions under specific stress scenarios specified by the Federal

Reserve as the measure of exposure, similar to the approach recently used by the Federal Reserve for the CCAR 2012 stress tests. The Supervisory Stress Approach would be uniform across the covered companies using that approach.

- Allow covered companies to determine whether to shift exposure in accordance with the covered company's policies and procedures. The Proposed SCCL Rules include a substitution approach under which the covered company automatically and universally substitutes the credit of the eligible protection provider for the credit of the underlying obligor. This substitution requirement overstates actual exposure because, among other things, it does not take into account the reduced likelihood of a double default. The overstatement is exacerbated because, when the covered company substitutes the protection provider, the exposure must be measured at the face or notional amount of the credit protection purchased (up to the gross credit exposure to the underlying obligor), treating all exposures the same and disregarding differences in creditworthiness entirely. With respect to credit and equity derivative markets, the use of notional amounts would severely limit the ability of covered companies to continue to provide such products. The final rules should permit a covered company to make its own good faith determination, subject to written policies and procedures reviewed by the company's principal regulator and the Federal Reserve, whether to shift an exposure from an underlying obligor to an eligible credit protection provider when the covered company purchases eligible credit protection. Furthermore, the exposure that would be shifted to the eligible protection provider would be the covered company's net default value exposure. The exposure shifted to the reference name when the covered company is the protection provider would be calculated in the same way.

- Allow covered companies the option to measure their exposure in repo and securities lending transactions using a simple VaR method as an alternative to the proposed "add-on" approach. The proposed add-on that would be applied to a covered company's exposure as a seller or lender in a repo and securities lending transaction and the haircut applied to the collateral result in a significant overstatement of exposure and the risk associated with it. The overstatement results from the use of arbitrary haircuts that are not empirically supported. This approach also fails to take into account the relationship between the securities transferred/lent and the type of collateral securing the transaction, as well as the risk-mitigating attributes of the portfolio as a whole. To address these concerns, the Associations propose that covered companies be permitted to use a simple VaR method to calculate net credit exposure when acting as the seller or lender in repo and securities lending transactions. A covered company would not need separate and distinct approval by the Federal Reserve for this purpose if the covered company has already received approval to use a VaR method for regulatory capital compliance purposes. If the Federal Reserve determines that a more standardized approach is necessary, it could prescribe inputs and assumptions for the models. At a minimum, a new set of more reasoned haircuts should be developed to be applied to repo and securities lending transactions that reflect static correlations between different types of loaned securities and collateral in the transaction.

- Do not reduce the statutory 25% credit limit for any covered companies. The extraordinary reduction in the credit limit for "major covered companies", when combined with the calculation flaws described in the previous three bullets points, will force these companies to engage in a massive reduction of their current credit exposures. There does not appear to be

any basis to determine that the dramatic reduction from the 25% credit limit to 10% is necessary to mitigate risks to U.S. financial stability, and the Federal Reserve has provided no explanation of the basis or reasoning for the reduction. As a result, covered companies are denied their statutory right to provide meaningful comment, a right that is especially critical given the enormous impact of the proposal. In light of the many other initiatives that will have an impact on covered companies, we recommend proceeding cautiously, and only with a full understanding of the impact and effect of the Proposed SCCL Rules. This understanding can only be achieved through the assessment of data of the type that would be submitted to the Federal Reserve under Section 252.96 of the Proposed Rules and Section 165(d)(2) of Dodd-Frank. The argument for caution is especially compelling in the face of the potentially severe negative consequences for the markets.

- Exempt exposures to CCPs from the credit limit. The Proposed SCCL Rules are in tension with the mandate in Dodd-Frank to clear transactions through CCPs because they subject exposures to CCPs to the credit limit. Imposing a limit on a covered company's transactions with a CCP ignores the special regulatory scrutiny and regime to which CCPs are subject, and application of the limit to them will impede progress towards the goal of centralized clearing. Instead, any limitation of exposures to CCPs should be addressed in tandem with the development of the regulatory regime for CCPs, both in the United States and internationally.

- Do not apply the credit limit to exposures to high-quality non-U.S. sovereigns. Section 165(e) does not require that exposures to sovereigns be subject to the credit limit because sovereigns are not companies under any accepted definition of that term. Given the Federal Reserve's decision not to cover exposure to the U.S. Government under the credit limit, coverage of exposure to non-U.S. sovereigns with similar levels of liquidity and creditworthiness is not justified as a matter of policy or logic and cannot be supported under the applicable legal standards for agency action specified in the APA. Applying a 25% credit limit to all non U.S. sovereigns and their various agencies and authorities may prevent covered companies from investing in, or accepting as collateral, non-U.S. sovereign obligations, and, as a consequence, will distort the market for non-U.S. sovereign obligations and reduce liquidity for these obligations. To preserve liquidity in these markets, exposures to high-quality non-U.S. sovereigns should not be covered by the credit limit. The Associations believe that the same approach to non-U.S. sovereign obligations recommended by the Associations for inclusion as "highly liquid assets"[9] under the Proposed Liquidity Rules should be used here as well.

- Individuals should not be covered as counterparties. Section 165(e) covers credit exposure to companies, not to individuals, and the Federal Reserve has not articulated any rationale for covering individuals as counterparties under the Proposed SCCL Rules. In light of the fact that credit exposures to individuals are highly unlikely to approach the credit limit or pose systemic interconnectivity risk, coverage of individuals as counterparties under the Proposed SCCL Rules is not justified. Moreover, coverage of individuals as counterparties fails any reasonable cost/benefit analysis for the same reasons.

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[9] *See* Part III.A of *Annex B*.

- Define "control" to include only companies that are consolidated for financial reporting purposes to ensure the definition is readily administrable and appropriately reflects credit risk. The Proposed SCCL Rules adopt a broad definition of "control". This broad definition creates an aggregation of exposures that is inconsistent with financial reality and accurate risk-evaluation and goes beyond the requirements of the statute or its intent. The proposed definition of "control" would require that a covered company include all affiliates of a counterparty in calculating its aggregate exposure to that counterparty no matter how tenuous or remote the affiliation and regardless of the existence of any actual obligation or responsibility of the "individual company" for the affiliate or likelihood of support. For example, because a private equity firm is typically the general partner of each of its funds and, therefore, under a Bank Holding Company Act control analysis may be deemed to control 100% of a class of the fund's voting securities, all exposures to all companies "controlled" by all the firm's funds would be aggregated with the firm's exposures. To avoid this gross overstatement of credit exposure, "control" should be defined to include only companies that are consolidated for a company's financial reporting purposes, such as under U.S. GAAP. In addition, the proposed definition of "control" is unworkable because it assumes ongoing access to information regarding all of a counterparty's investments that in reality is generally unavailable.

- Do not require daily compliance and monthly reporting for counterparty exposures that are not reasonably likely to approach a specified percentage of the credit limit. If a covered company's policies and procedures are sufficient to prevent an exposure from approaching a specified percentage of the credit limit (which specified percentage would be set below that limit), there is no reason to require daily monitoring or any reporting of exposures that fall well below the credit limit. Because a covered company's exposure to most counterparties will never come close to the credit limit, a daily determination of compliance for all counterparties that is based on calculating aggregate exposure to each counterparty would impose a burden that cannot be justified under a cost/benefit analysis or for financial stability purposes.

- Provide a more reasonable effective date. The Proposed SCCL Rules would require significant adjustments to existing credit relationships even if the rules are modified to address the flaws identified in this Comment Letter. To allow markets to absorb these shifts, the Federal Reserve should delay the effective date for the full two-year transition period (July 2015). Moreover, all covered companies will require additional time to develop or enhance systems to comply with the requirements of the final rules.

II. Key Concerns and Recommendations

A. The Associations strongly urge the Federal Reserve to provide a covered company the option, as an alternative to CEM, to measure derivative exposures under either the Stressed IMM Approach or Supervisory Stress Approach.

The proposed calculation methodology for derivative transactions results in a gross overstatement of the exposure in relation to the risk posed by such transactions. Section 252.94 requires that the exposure to a counterparty under a derivatives contract entered into pursuant to a qualifying master netting agreement be measured using the method provided in 12 C.F.R. Part 225,

Appx. G, Sec. 32(c)(6), which is generally referred to as the "current exposure method", or CEM.[10] CEM is a misnomer because it includes an artificial future exposure as well as actual current exposure.

The limitations of CEM are readily apparent. Overall, CEM's flaws lie in its risk-insensitivity, which results in an overstatement of the realistic economic exposure of derivative transactions. In particular, counterparty credit exposure under CEM is calculated as net current exposure plus potential future exposure, and the overstatement is driven mostly by the calculation of potential future exposure. Under CEM, the potential future exposure calculation significantly limits the degree to which netting may be taken into account, even though the transactions are subject to a qualifying master netting agreement. In addition, the potential future exposure does not include collateral that will be posted against future exposures. Any methodology for calculating derivative exposure must address these fundamental limitations of CEM to avoid an outsized measure of exposure that will limit the ability of covered companies that are active in these markets to continue these activities.

In fact, the CEM approach produces exposures that are, in many cases, not merely significantly higher than those calculated under IMMs (which seek to measure actual risk), but are substantial *multiples* of the IMM calculations. In the case of credit and equity derivatives, this is compounded by the "substitution" requirement discussed in Part II.B below. The only conceivable reason for using CEM is if there were no viable alternative for dealing with the potential fallibility of models, but there are viable alternatives.

BHCs that regularly engage in a significant volume of derivative transactions generally have developed IMMs for purposes of measuring counterparty credit risk for compliance with regulatory capital requirements and internal risk management. These IMMs are reviewed by the appropriate federal bank supervisor and subject to rigorous back testing. Notwithstanding these protections, the Federal Reserve appears to be reluctant to permit the use of IMMs to measure derivative exposure, presumably because of models' potential fallibility in times of market distress and a possible "doubling down" of risk due to their use for regulatory capital purposes ("**model risk**"). We believe, however, that when the testing and reliability of the models are taken into account, they are far more accurate than the CEM approach in measuring risk. In addition, models could be subject to continuous review by the Federal Reserve on a horizontal basis.

We understand the potential limitations of model-based approaches. The Associations acknowledge that the financial crisis exposed deficiencies in models used to measure and evaluate risk. Likewise, we recognize that, in the case of internal models that are or will be used by banks for capital purposes (principally for purposes of the A-IRB approach under the U.S. banking agencies' Basel II-based capital guidelines and, for a broader group of banks, the agencies' market risk capital rules), the magnitude of the understatement of risk was significant. Nonetheless, the areas where significant deficiencies existed were quite limited, mostly dealing with the treatment of mortgage securitizations and correlation trading positions. It is also important to recognize that the deficiencies in models were not with respect to the models themselves but, instead, were principally with respect to one flawed assumption used in the models. This mis-assumption in many bank and rating agency models was the

[10] Derivative transactions not subject to such a netting agreement are calculated pursuant to a similar methodology but with no allowance for netting. The Associations' proposal for calculating derivative exposure would cover both types of derivatives.

failure to recognize that the assumed default rates and potential losses on mortgage and mortgage-backed securities were premised on historical data during periods (albeit relatively long periods) of only stable or rising housing prices, that housing prices could fall (potentially sharply), and that the consequences could be sharply increased defaults and losses. These deficiencies can be addressed in the context of single-counterparty credit limits without abandoning models altogether.

Our proposed approaches—the Stressed IMM Approach or the Supervisory Stress Approach—are meant to solve for these deficiencies while at the same time providing a measure of exposure that is both realistic and consistent with the purposes of the single-counterparty credit limit. The Associations propose that either one of these two approaches be provided in the final SCCL rules as an alternative to CEM for measuring derivative transactions, including for credit and equity derivatives.

The Associations' proposed Stressed IMM Approach would use the basic mechanics of a covered company's IMM, but then solve for the potential fallibility of even well-conceived and examined models. It could be implemented in one of two ways. Under one method, the covered company would calculate the exposure under its IMM and then subject the result of that calculation to a multiplier specified by the Federal Reserve. This would provide a meaningful buffer to try to address unexpected market volatility. Alternatively, the Stressed IMM Approach, rather than using a multiplier, could instead change certain inputs to the IMMs. First, the estimation of potential future exposure would be based on a confidence level to be provided by the Federal Reserve. In particular, to calculate potential future exposure, the company would not use the Effective Expected Positive Exposure ("**EEPE**") that is used for regulatory capital purposes, but instead would measure counterparty exposure at a confidence level provided by the Federal Reserve that would represent a stressed market environment. Second, the Federal Reserve would determine a period of stress to be used in calibrating the IMM to either a historical lookback period or market implied data, or specify the criteria for selection of such a period of stress. This approach also would ensure that the calibration of a covered company's model is sufficiently stressed and uniform across covered companies using the Stressed IMM Approach. This approach also would be consistent with Basel III, which retains risk-sensitive counterparty exposure models but requires calibration to a period of market stress.

Our other proposed alternative—the Supervisory Stress Approach—would not rely on IMMs at all. Instead, the Supervisory Stress Approach would provide a simple, uniform method to measure exposure based on a stress scenario. In order to address the concern that the measure of exposure account for potential future distressed market conditions, the Supervisory Stress Approach would estimate a covered company's counterparty exposure based on the replacement value of derivative transactions assuming a severe, instantaneous shock to market risk factors, less applicable collateral. The specific stressed market conditions would be established by the Federal Reserve, similar to the approach recently used for CCAR 2012. For this purpose, replacement value would be defined consistently with regulatory capital rules. In particular, under current Basel II rules, replacement cost or current exposure is defined as "with respect to a netting set, the larger of zero or the market value of a transaction or portfolio of transactions within the netting set that would be lost upon default of the counterparty, assuming no recovery on the value of the transactions."[11]

[11] 12 C.F.R. Part 225 Appx. G, §2.

The Associations and their members are committed to working with the Federal Reserve to develop these or other alternatives for measuring exposure for derivative transactions. We firmly believe, however, that any approach to calculating potential future exposure must take into account legally enforceable netting and collateral in order to provide a realistic measure of exposure that more accurately reflects risk.

B. The "substitution" requirement in the Proposed SCCL Rules should be modified to require a shift only in accordance with a covered company's established policies and procedures. Without such a change, the ability of covered companies to provide credit protection to, and obtain credit protection from, market participants may be significantly limited.

The Proposed SCCL Rules create an entirely new methodology for calculating exposures involving credit and equity derivatives that is unrelated to the way these exposures currently are measured and managed for credit risk purposes or for regulatory capital compliance. In particular, the requirement in Section 252.95(e) to shift automatically the amount of the underlying exposure to the protection provider (up to the notional amount of the protection purchased) may have significant market impacts, as discussed below.

The substitution requirement represents a transmogrification of the role of credit protection. When a lender obtains credit protection, it is for the purpose of reducing its risk. The lender is then exposed to risk of loss only if <u>both</u> the borrower and credit protection provider default (double default). The Proposed SCCL Rules, however, ignore this basic financial architecture and provide absolutely no credit for this risk mitigation approach. Even worse, this substitution concentrates the risk in the protection provider. Because the protection is typically provided by another financial institution and the lender will often have unrelated transactions with that financial institution, the mandatory substitution requirement reduces lenders' ability to obtain protection and exaggerates the exposure created by these independent transactions. If a covered company has purchased eligible credit protection on multiple reference names from an eligible protection provider, the effect is multiplied because the covered company must shift the exposure associated with each reference name.

Because credit and equity derivatives are "derivative transactions" under Section 252.92(p), but also may be "eligible credit derivatives" or "eligible equity derivatives", the rule read literally would appear to have the consequence (which may be unintentional) of requiring a covered company to include both of those exposures when calculating its exposure to that counterparty even though it would in a sense be counting the same exposure twice. The first exposure arises when the covered company enters into a credit or equity derivative transaction with a counterparty that would be calculated under Section 252.94(a)(10) or (11). The second exposures arises when that credit or equity derivative transaction is an eligible credit or equity derivative and is entered into with an eligible protection provider with respect to a reference name held by the covered company, and the covered company is required to shift the exposure in accordance with Section 252.95(e).

The Proposed SCCL Rules' substitution requirement would have a significant impact on the ability of covered companies, in particular major covered companies, to continue to provide credit protection. Because of the capital and expertise required to manage a credit default swap trading book, there are relatively few entities that are in a position to offer these services. A consequence of the constraints imposed by the Proposed SCCL Rules is that the availability of these products would

decrease and the costs would increase. This in turn will limit the ability of major covered companies to manage their risk, as well as limit the risk management options of other market participants. It could also drive this business into the shadow banking market, where it would be both unregulated and opaque.

The Associations recommend that a covered company be permitted to choose whether to shift the exposure to the eligible credit protection provider in accordance with written policies and procedures that are subject to review during the examination process. Such an approach would result in more realistic measures of exposure. For example, a shift generally could be required under a covered company's policies and procedures when the risk posed by the protection provider is highly correlated with the underlying exposure (so-called "wrong way risk"). These policies and procedures would be subject to continuous supervisory review (including, potentially, horizontal review) during the examination process for both substance and implementation. If a shift is not required under a covered company's policies and procedures, the covered company would treat its counterparty exposure to the eligible protection provider as a derivative (with the exposure measured under one of the stress approaches we have proposed or CEM) and would continue to include any net protection sold as an exposure to the reference name (in accordance with Section 252.94(a)(12)). The exposure to the reference name should be measured as suggested in Question 56, taking into account netting pursuant to legally enforceable netting agreements of protection bought and sold within that reference name.

In line with the above, the final rules should clarify that a covered company may net credit protection that the covered company has sold on a reference name with eligible credit protection purchased from an eligible protection provider on the same reference name pursuant to legally enforceable netting agreements. This will have an impact on the amount of the exposure that a covered company would shift to a protection provider when such shift is required under its policies and procedures. The Associations propose that the amount the covered company would shift to the protection provider would be the amount of the covered company's net default exposure value (as described in Question 56) rather than the face amount of the underlying exposure. In this way, reference name exposure and any shift of that exposure to a protection provider would be measured on the same basis – net default with zero recovery.

Finally, irrespective of whether the exposure is shifted, a covered company could still be required under Section 165(d)(2) of Dodd-Frank to modify its reporting to identify the exposure to the eligible protection provider to provide the Federal Reserve with a fuller understanding of the scope of transactions in this market.

C. A VaR-based methodology should be available as an alternative way to measure exposure under repo and securities lending transactions to avoid potentially significant negative consequences for the securities markets.

Under Section 252.94(a)(4), repurchase agreements would be valued at the market value of securities transferred by the covered company to the counterparty plus an add-on representing the collateral haircut applicable to the securities transferred. The haircut is determined by applying a static conversion factor in Table 2 of the Proposed SCCL Rules. Similarly, under Section 252.94(a)(7), securities lending transactions would be valued at the market value of the securities loaned by the covered company to the counterparty plus an add-on representing the collateral haircut applicable to the securities transferred (under Table 2). This add-on approach in both types of transactions provides

an inaccurate and overstated measure of exposure because the haircuts are excessive in relation to the risk posed by such transactions.

These exposures may also be adjusted, or netted, under Section 252.95. In addition to permitting netting under a bilateral netting agreement for repo and securities lending transactions, Section 252.95 permits a covered company to reduce its gross credit exposure to a counterparty for any transaction, including a repo or securities lending transaction, by the adjusted market value of any eligible collateral. In accordance with the "substitution" rule, however, the covered company must include the "adjusted market value" of the eligible collateral when calculating its gross credit exposure to the issuer of the eligible collateral, among other requirements. Moreover, the "adjusted market value" is defined as the fair market value of the eligible collateral *after* application of the haircut in Table 2. These transactions, therefore, are penalized on both sides—in the "add on" when calculating gross exposure and in the haircut applied to the collateral when reducing gross exposure—which both individually and together result in a gross overstatement of the risk associated with the transaction.

The proposed methodology does not adequately take into account the built-in protections of repo and securities lending transactions—the daily marking-to-market and the posting of additional collateral to make up any shortfall. Nor does it take into account the relationship between the securities lent and non-cash collateral securing the transaction or potential portfolio diversification benefits.

Securities financing markets would be disproportionately affected by the proposal for a number of reasons. First, the add-on included in calculating gross exposure represents a significant increase to the actual exposure. Because securities lending frequently involves equity and other securities that are subject to higher haircuts under Section 252.94 and Table 2, the impact on securities lending is significant. In many cases, the overstatement of the exposure is not sufficiently mitigated by the ability of the covered company to reduce the amount of the exposure to the counterparty in a securities lending transaction through collateral. In addition, the collateral is subject to a haircut, as noted above.

The effects of this calculation methodology will differ depending on the particular circumstances, but the difference will not necessarily have any relationship to risk. In some cases, the covered company may, as part of its regular practice, or because of the size of its aggregate exposure to the counterparty, choose to shift the exposure to the collateral issuer as opposed to the counterparty. This is a workable solution if the covered company does not have significant exposure to the collateral issuer or the collateral is cash or U.S. government or other exempt obligations. In that case, the exposure to the counterparty is reduced by the collateral and there is no exposure to the collateral issuer that needs to be taken into account.[12]

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[12] We note, however, that even in the case of collateral that is exempt U.S. government obligations it appears that the collateral still would be subject to the haircut. In other words, when calculating the amount of the exposure to the securities lending counterparty, the covered company would be permitted to deduct the fair market value of those obligations but in addition would have to adjust the value by the collateral haircut in Table 2. In Table 2, the United States would be a sovereign entity with a OECD risk classification of 0-1, and the haircut would be determined accordingly. In light of the fact that the direct obligation would be exempt, we believe the final rule should clarify that no collateral haircut would need to be applied to an obligation, such as a U.S. government obligation, that itself would not be subject to

The calculation methodology may impose real limits on the ability of a covered company to engage in securities lending transactions, however, if the covered company lends securities to a counterparty to which it is credit-constrained or if the covered company is credit-constrained with respect to the collateral issuer. Based on our preliminary analysis, covered companies are most likely to be credit constrained in the following circumstances:

- High-quality non-U.S. sovereign obligations are frequently posted as collateral to secure securities lending transactions. As a result, a securities lender could become credit constrained with respect to these non-U.S. sovereigns when these transactions are aggregated with all other transactions with such sovereign.

- Because major covered companies are frequent participants in the securities financing markets, the 10% credit limit imposed on exposures between major covered companies and major counterparties may result in severe constraints on credit.

Even with an exemption for high-quality non-U.S. sovereign obligations and a uniform 25% credit limit, covered companies that are active in these markets will experience credit constraints that may limit their ability to provide these services.

A more accurate measure of exposure would alleviate the negative market effects while in no way undermining the intent of Section 165(e). The Associations propose that covered companies be provided the option to calculate net credit exposure for repo and securities lending transactions under a VaR methodology. A covered company would not need separate and distinct approval by the Federal Reserve for this purpose if the covered company has already received approval to use a VaR method for regulatory capital compliance purposes. Because VaR models take in account the type of collateral securing a loan, as well as the relationship between loaned securities and non-cash collateral, they provide a more risk-sensitive measure of actual economic exposure. In addition, covered companies that are active participants in these markets already use a VaR model to calculate regulatory capital requirements and those models have been and will continue to be subject to supervisory review and evaluated by auditors.

Although the Associations believe that the ongoing review to which the VaR models are subject help address concerns about their reliability in times of market distress, if the Federal Reserve determines that allowing firms to utilize their internal VaR-based models would not be appropriate, we propose as an alternative that the final rule permit a covered company to calculate net credit exposure using a simple VaR model with Federal Reserve mandated inputs, in particular, the assumptions and confidence levels.

If the Federal Reserve determines that a VaR-based model is not appropriate, the Associations request that, at a minimum, the Federal Reserve, with input from the industry, develop a new haircut matrix that would be used for calculating exposures to repo and securities lending transactions. The new haircut matrix would assign haircuts taking into account both the securities loaned and the particular collateral posted to capture at least some of the risk-mitigating benefits of that relationship.

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the credit limit. A similar clarification should be made with respect to any high-quality non-U.S. governmental obligations if certain qualifications are met as discussed in Part II.F.

Addressing these issues is critical. Securities financing activities are essential to the liquidity of the securities markets because they enable broker-dealers and their customers to meet security delivery obligations and enable short sales. A constrained securities financing market will have a negative impact on liquidity and efficiency in the broader capital markets, which could lead to constrained trading and settlement failures.

D. The statutory 25% credit limit should not be reduced unless or until there is a basis for determining that a lower limit is "necessary to mitigate risks to the financial stability of the United States," the required statutory predicate for such a reduction.

In the case of the single-counterparty credit limit, Section 165(e)(2) of Dodd-Frank requires the Federal Reserve to issue regulations prohibiting certain nonbank financial companies and bank holding companies "from having credit exposure to any unaffiliated company that exceeds 25 percent of the capital stock and surplus" of the covered company. The Federal Reserve has *discretion* to—i.e., it "may"—impose a "lower amount" for the single-counterparty credit limit, but only if it first "determine[s] by regulation" that a lower single-counterparty credit limit is "*necessary* to mitigate risks to the financial stability of the United States." [13] We believe that there are compelling reasons of both law and policy why that discretion should not and cannot be exercised here.

As a legal matter, the Federal Reserve's determination to lower the single-counterparty credit limit to 10% for major covered companies is invalid on each of three separate grounds. First, there is no basis for the statement in the NPR that Dodd-Frank "indeed requires" the two-tier approach in the single-counterparty credit limit provisions or that this approach is a "directive" of Section 165,[14] and the NPR cites none. There is no requirement or directive anywhere in Section 165 that the Federal Reserve distinguish between covered BHCs with assets of more or less than $500 billion with respect to the single-counterparty credit limit, as opposed to distinguishing between all covered BHCs and smaller BHCs. The single-counterparty credit limit, therefore, was adopted under a mistaken interpretation of the statute, which *per se* invalidates the reduction of the credit limit.[15]

Second, Section 165(e)(2) deals specifically with the Federal Reserve's authority to lower the single-counterparty credit limit below the statutorily mandated 25% level and, as mentioned, that authority is narrowly circumscribed. The requisite Federal Reserve determination that such a lower level be "necessary" creates a very high legal bar. As stated in a leading decision, *GTE Service*: "Something is *necessary* if it is *required* or *indispensable* to achieve a certain result."[16] "Necessary" does not mean "useful."[17] Rather, "a statutory reference to 'necessary' must be construed in a fashion that is

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[14] 77 Fed. Reg. at 616.

[14] 77 Fed. Reg. at 616.

[15] *MCI Telecommunications Corp.* v. *AT&T Co.*, 512 U.S. 218, 229 (1994) ("[A]n agency's interpretation of a statute is not entitled to deference when it goes beyond the meaning that the statute can bear…").

[16] *GTE Service Corp.* v. *F.C.C.*, 205 F.3d 416, 422 (D.C. Cir. 2000).

[17] *Id.* at 422.

consistent with the ordinary and fair meaning of the word, i.e., so as to limit 'necessary' to that which is *required* to achieve a desired goal."[18]

The D.C. Circuit's decision in *GTE Services* is particularly relevant here because it was issued in the context of a review of an agency regulation rather than a *de novo* analysis of statutory language. The Court explicitly recognized the *Chevron* analysis of judicial deference,[19] but held that the FCC's interpretation of "necessary" as "useful" "appear[s] to diverge from any realistic meaning of the statute."[20]

If Congress had wanted to adopt a more flexible standard, it certainly knew how to do so. For example, to grant an exemption to the requirements of Section 619 of Dodd-Frank, the Federal Reserve need only show that the exemption "promote[s]" financial stability. The exemption need not be "*necessary* to promote" financial stability.[21] This distinction is apparent in other contexts as well. For example, in a leading case involving the Truth in Lending Act, *Mourning* v. *Family Publication Service, Inc.*,[22] the relevant statute authorized rules that were either "necessary or proper" —a more lenient standard than the "necessary" standard that Congress imposed here. Therefore, Section 165(e)(2) requires the Federal Reserve "to apply *some* limiting standard" to its determination to impose a lower single-counterparty credit limit on specified covered companies, one that is "rationally related to the goals of the [Dodd-Frank] Act": preserving the financial stability of the United States.[23] The Federal

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18 *Id.* at 423 (citing *AT&T Corp.* v. *Iowa Util. Bd.*, 525 U.S. 366 (1999)) (emphasis added).

19 *Chevron, U.S.A., Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

20 *GTE Service*, 205 F.3d at 421. We recognize that, in another case, *Cellular Telecommunications*, the word "necessary" has been given a somewhat broader meaning in a particular context. *Cellular Telecommunications & Internet Association v. Federal Communications Commission*, 330 F. 3d 502 (D.C. Cir. 2003). The Court there stressed, however, that its broader reading was appropriate because the context was a "forbearance" statute. *Id.* at 506, 509-513. The statute instructed the FCC to take a certain action and to forebear from that action only upon a petition demonstrating that the action was *not* necessary to protect the consumer. In other words, Congress' decision could be overridden only if the petitioner could demonstrate that the action was not necessary.

In the case of the SCCL, the statutory context is virtually the opposite. Congress has established a statutory regime and authorized the Federal Reserve to vary from that regime only if the action is necessary. It is understandable that the courts would impose a higher standard when the regulator would be acting contrary to Congress' general mandate. Moreover, unlike the situation in *Cellular Telecommunications*, a narrow reading of "necessary" for purposes of Section 165 does not produce an "absurd result". *Id.* at 511.

20 Furthermore, the Court in *Cellular Telecommunications* acknowledged that the "indispensable" standard could be appropriate in a case such as *GTE Service*. *Id.* at 510-11.

21 Section 619(d)(1)(J) of Dodd-Frank (emphasis added).

22 411 U.S. 356, 361–62 (1977).

23 *AT&T Corp.*, 525 U.S. at 388.

Reserve's failure to use a definition of "necessary" that is at least similar to the definition in *GTE Service* would also invalidate the reduction of the credit limit.[24]

Third, the Federal Reserve's Proposed Rule, contains no determination that a lower single-counterparty credit limit is in fact "necessary" to mitigate a threat to the financial stability of the United States—and certainly provides no reasoned explanation for any such finding. For example, the Proposed Rule does not address any of the following questions: What is the nature and extent of the threat to financial stability? Why does the Federal Reserve believe that the 10% limit is the right limit—the one "necessary" to mitigate risks to financial stability? Why institutions with $500 billion in assets? The Federal Reserve has offered no evidence, explanation, theory, or rationale to support any "necess[ity]" for its proposed 10% single-counterparty credit limit.[25]

We respectfully submit that, in the absence of an articulated rationale for its determination, the Federal Reserve would not be entitled to deference in a judicial proceeding. An agency's self-professed expertise in performing certain calculations is no substitute for demonstrating how it is actually performing those calculations.[26] Because this failure to provide a rationale denies the public of the opportunity to provide any meaningful comment, adoption of a reduction in the credit limit below 25% would be arbitrary and capricious.[27]

We also submit that, under clear legal precedent, this deficiency cannot be cured by a rationale developed for the first time in a final rule. That approach negates the obligation of notice and opportunity for comment.[28] At this point, the Federal Reserve has articulated no basis for concluding that a lower limit is necessary. Without even an initial analysis of the application of the Proposed SCCL Rules to real-life circumstances, it is not possible to support the conclusion that a more restrictive limit for larger companies is "necessary." By failing to articulate a basis for these determinations, the proposal does not abide by a fundamental principle of the APA, which requires that the public have a meaningful opportunity to comment on the basis and rationale for a rule. The APA requires the Federal Reserve to "provide sufficient notice and opportunity to comment for its [proposed rule]."[29] The

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[24] *Motor Vehicle Manufacturers Association of the United States* v. *State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983); *Business Roundtable and Chamber of Commerce* v. *SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

[25] *See Appalachian Power Co.* v. *EPA*, 249 F.3d 1032, 1053-54, 1063 (D.C. Cir. 2001) (per curiam) ("There must be an actual reason articulated by the agency at some point in the rulemaking process.").

[26] *See,* e.g., *id.*; *Bluewater Network* v. *EPA*, 370 F.3d 1, 21 (D.C. Cir. 2004) ("[I]n order to determine whether that decision reflects a 'rational connection between the facts found and the choice made,' a reasonable explanation of the specific analysis and evidence upon which the Agency relied is necessary. . . . It will not do for a court to be compelled to guess at the theory underlying the agency's action." (internal citations omitted)).

[27] *NetCoalition* v. *SEC*, 615 F.3d 525, 539 (D.C. Cir. 2010) ("[Courts] do not defer to the agency's conclusory or unsupported suppositions."); *U.S. Air Tour Ass'n* v. *FAA*, 298 F.3d 997, 1008 (D.C. Cir. 2002).

[28] *Rep. Airline Inc.* v. *Dep't of Transp.*, 669 F.3d 296, 299-300 (D.C. Cir. 2012).

[29] *Appalachian Power*, 251 F.3d at 1039.

purpose for this requirement is to ensure that the "'most critical factual material" used by the agency" and the terms of its proposal have "been tested through exposure to public comment."[30]

But the Federal Reserve has precluded any such testing by not only failing to make the required determination that the 10% single-counterparty credit limit even is necessary to mitigate a threat to the financial stability of the United States, but also failing to provide any such rationale to the public. As a result, market participants are essentially commenting in a vacuum with no insight or guidance from the Federal Reserve regarding the necessity of such lower limit. The Proposed Rule simply fails to afford commenters any *meaningful* opportunity to comment on the statutorily-required basis for the proposed 10% single-counterparty credit limit. Before promulgating the 10% single-counterparty credit limit as a final rule, the Federal Reserve accordingly must afford commenters that meaningful opportunity to confront the Board's evidence and rationale for why the proposed 10% single-counterparty credit limit is necessary to mitigate risks to the financial stability of the United States.[31] If the Federal Reserve determines that a lower limit is necessary for a class of covered companies, it should repropose the requirement and clearly explain the basis for any such limit and the corresponding classification of certain covered companies

Moreover, in the absence of an articulated rationale to support the necessity of the 10% single-counterparty credit limit, and with all due respect to its expertise, the Federal Reserve's apparent *ipse dixit* that 10% is the right amount for the single-counterparty credit limit is wholly insufficient.[32] It is well established law that an agency must provide "a rational connection between the facts found and the choice made," and that the failure to do so is a basis for vacatur of the agency's action.[33]

In any event, the Associations respectfully submit that there is no rational basis for the Federal Reserve to conclude *at this time* that the 10% limit is "necessary" to mitigate risks to the financial stability of the United States. As a policy matter, a 10% single-counterparty credit limit, combined with the calculation methodology flaws described above, could be highly disruptive, reduce market liquidity and loan capacity, drive financial services into the opaque and largely unregulated shadow banking sector, and adversely affect the safety and soundness of banking institutions. Moreover, until the full ramifications of the multiple regulatory, supervisory and other changes are understood, the necessity, and indeed even the desirability, of the proposed 10% single-counterparty credit limit cannot be evaluated.

Dodd-Frank and other legislative, regulatory, and supervisory changes will continue to have a substantial impact on the financial industry in the United States. Because so many significant

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30 *Chamber of Commerce of the United States* v. *SEC*, 443 F.3d 890, 900 (D.C. Cir. 2006) (quoting *Association of Data Processing Serv. Orgs., Inc.* v. *Board of Governors of the Fed. Reserve Sys.*, 745 F.2d 677, 684 (D.C. Cir. 1984)).

31 *Owner-Operator Independent Drivers Ass'n, Inc.* v. *Federal Motor Carrier Safety Admin.*, 494 F.3d 188, 203 (D.C. Cir. 2007).

32 *NetCoalition* v. *SEC*, 615 F.3d 525, 539 (D.C. Cir. 2010) ("[Courts] do not defer to the agency's conclusory or unsupported suppositions.") (internal citation omitted); *Bluewater*, 370 F.3d at 21.

33 *State Farm*, 463 U.S. at 43; *Business Roundtable* v. *SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

changes must happen largely at the same time, it is difficult to anticipate what the effect of any one change will be. As a result, where possible, substantial changes in market practice should be approached cautiously and on a sound evidentiary basis, especially where those changes may pose real danger of negative consequences for market liquidity and U.S. financial stability. Accordingly, we believe the more prudent approach is to monitor the impact of the required 25% credit limit in the context of the many other changes affecting the availability of liquidity and the proper functioning of the credit markets before determining whether or at what level a lower limit should be imposed. The Federal Reserve would have the opportunity to review the information regarding credit exposure that would be submitted to the Federal Reserve under the Proposed SCCL Rules and Section 165(d)(2) of Dodd-Frank and use that data to make a more informed decision regarding whether a lower limit is necessary.[34]

The same principles apply to determining which covered companies should be considered "major covered companies" and which counterparties should be considered "major counterparties." The NPR does not explain the basis for using a $500 billion asset threshold to determine which covered companies are major and, therefore, should be subject to a lower credit limit when engaging in covered transactions with similarly sized counterparties. Again we urge caution in establishing a threshold before sufficient information has been gathered and analyzed to assist with this determination.

E. Exposures to certain CCPs should be exempt from the credit limit, at least initially, to support the policy objective of moving most over-the-counter ("OTC") derivative transactions to central clearing.

A key component of Dodd-Frank is the enhanced regulation of OTC derivatives. Chief among the changes to the OTC derivative markets is the requirement that most OTC derivative transactions be cleared through a regulated CCP. This represents a fundamental shift in the OTC derivatives market and will force the migration of transactions to CCPs. CCPs will be subject to substantial regulation and, in appropriate cases, the FSOC has the authority to determine that a CCP is "systemic" and therefore subject to heightened supervision as a financial market utility.[35] All CCPs will be required to develop systems and procedures intended to address member failures, market crises, operational failures and manage exposures.

Despite the heightened scrutiny to which CCPs are or will be subject, and the special role to be played by CCPs in the post-Dodd-Frank market system, the Proposed SCCL Rules would subject exposures to a CCP, including the guaranty and initial and excess variation margin posted to the CCP, to the single-counterparty credit limit on exactly the same basis as it would apply to a credit exposure to a completely unregulated entity. Subjecting exposures to CCPs to the credit limit may discourage covered company market participants from facilitating the clearing of transactions as they become eligible for clearing and affect liquidity in the markets.

Given the mandate to use a CCP for OTC derivative transactions where possible, the regulatory scrutiny to which CCPs are or will be subject, the risk management systems that CCPs must

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[34] The Federal Reserve will be receiving reports under Section 252.96.

[35] *See* Section 804 of Dodd-Frank.

implement, and the heightened supervision to which "systemic" CCPs may become subject, it is unnecessary to subject exposure to these entities to the single-counterparty credit limit. Moreover, because there are likely to be so few CCPs, at least initially, subjecting these exposures to the credit limit could have the effect of preventing covered companies from engaging in certain types of transactions altogether and limiting their ability to provide their customers with a full range of products.

To ensure that the exemption applies only to CCPs that meet rigorous standards, the Federal Reserve could limit the exemption to CCPs that meet the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions principles for financial market infrastructures. Over time, the appropriate treatment of CCPs under the single-counterparty credit limit could be determined in the context of framing the regulatory regime that will be applicable to CCPs, both in the United States and globally.

F. Exposures to high-quality non-U.S. sovereign obligations and those sovereigns' central banks should not be covered by the single-counterparty credit limit.

Section 165 of Dodd-Frank does not cover non-U.S. sovereigns under the credit limit because they are not "companies" under any normal definition.[36] Moreover, the NPR provides little discussion or support for subjecting exposure to all non-U.S. sovereigns to the credit limit, nor is there any indication that the consequences of doing so, including the costs and potential damage to U.S. financial institutions and markets, have been weighed against potential supervisory and systemic benefits. The Proposed SCCL Rules would exempt exposures to the U.S. government, but no basis is provided for not also exempting exposure to non-U.S. sovereigns that have liquidity and creditworthiness similar to that of the United States. Such differential treatment in the absence of a reasoned basis on which meaningful comment may be provided is, therefore, unsustainable under the APA. Under the final rule, exposure to high-quality non-U.S. sovereigns should also be exempt.

The coverage of such high-quality non-U.S. sovereigns under the Proposed SCCL Rules could have unintended negative effects on covered companies, our economic and strategic national partners, and market liquidity for non-U.S. sovereign obligations because the 25% credit limit does not accommodate current activity that is important to proper market functioning. The Proposed SCCL Rules may have the effect of forcing covered companies to restrict the acceptance of high-quality obligations issued by non-U.S. governments as collateral and preventing covered companies from placing excess, temporary liquidity with non-U.S. central banks, as is the current practice.

As has been extensively discussed in the comments to Section 619 of Dodd-Frank by covered companies and non-U.S. sovereigns, the liquidity of non-U.S. sovereign obligations relies on the ability of covered companies to invest in them.[37] In addition, subjecting high-quality obligations of non-

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[36] Under the Bank Holding Company Act, the Federal Reserve has explicitly excluded sovereigns from the definition of "company". 12 U.S.C. 1841(b). Banca Commerciale Italiano, 68 Fed. Res. Bull. 423 (1982); Letter dated August 19, 1988 from William W. Wiles, to Patricia S. Skigen.

[37] *See* letters from: Office of the Superintendent of Financial Institutions Canada, *available at* http://www.federalreserve.gov/SECRS/2012/January/20120111/R-1432/R-1432_122811_88639_481623396475_l.pdf; Canadian Minister of Finance, *available at* http://www.federalreserve.gov/SECRS/20l2/February/20120228/R-1432/R-1432_021312_104923_519924448346_l.pdf; Deutsche Bundesbank and BaFin, *available at*

U.S. sovereigns to the single-counterparty credit limit is in tension with other regulatory reform initiatives, such as the Basel III liquidity framework, which encourage organizations to hold a stock of highly liquid assets. Under the Basel III liquidity framework, marketable securities representing claims on or claims guaranteed by sovereigns, central banks, non-central government public sector entities, the Bank for International Settlements, the International Monetary Fund, the European Commission, or multilateral development banks that meet certain conditions[38] are considered highly liquid assets.

We believe that the inclusion of creditworthy non-U.S. sovereigns and their central banks as "counterparties" will have a significant impact on the balance sheet and liquidity management function at individual covered companies as well as adverse systemic implications. Furthermore, we believe that the resulting limitation on holdings of such instruments may complicate efforts to limit contagion risk. Holdings of instruments and exposures to such entities may be both necessary and beneficial from a risk-management perspective for any covered company with operations in, and exposures to, the relevant jurisdictions.

As noted, the capacity of many covered companies to deal with a number of creditworthy countries with stable economies will be limited by the Proposed SCCL Rules. This will immediately affect covered companies with significant non-U.S. operations for a number of reasons. As one example, an increasing number of jurisdictions are requiring subsidiaries and affiliates of the Associations' members regulated by those jurisdictions to hold sovereign obligations issued by the relevant jurisdictions in order to meet those jurisdictions' liquidity rules. Restricting covered companies' holdings of these instruments will constrain these non-U.S. subsidiaries and the ability of covered companies to operate and compete in those jurisdictions.

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http://www.federalreserve.gov/SECRS/2012/February/20120221/R-1432/R-1432_021312_104929_536151947408_l.pdf; U.K. Financial Services Authority, *available at* http://www.federalreserve.gov/SECRS/2012/February/20120228/R-1432/R-1432_022212_105560_462867299076_l.pdf; EU Council of Ministers (ECOFlN), *available at* http://www.federalreserve.gov/SECRS/2012/February/20120228/R-1432/R-1432_022212_105564_326398330626_l.pdf; Mexico CNBV, *available at* http://www.federalreserve.gov/SECRS/2012/March/20120305/R-1432/R-1432_021312_105416_439625820801_l.pdf; Banco de Mexico, *available at* http://www.federalreserve.gov/SECRS/2012/March/20120309/R-1432/R-1432_030512_105861_508765807767_1.pdf; The Reserve Bank of Australia, *available at* http://www.federalreserve.gov/SECRS/20l2/March/20120309/R-1432/R-1432_022112_105565_411082456530_l.pdf; Chairmen of the *Autorite de controle prudentiel* and the *Autorite des marches financiers* of France and the Head of the French Treasury, *available at* http://www.federalreserve.gov/SECRS/2012/March/20120305/R-1432/R-1432_021412_104999_542080131636_l.pdf.

[38] The conditions are that "the securities are assigned a 0% risk-weight under the Basel II Standardised Approach; traded in large, deep and active repo or cash markets characterised by a low level of concentration; proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions; and not an obligation of a financial institution or any of its affiliated entities." We also understand that the BIS is considering broadening the types of instruments that qualify as highly liquid assets under Basel III.

Even where such holdings are not specifically required, central bank and sovereign obligations are key elements in banks' response to stress conditions, serving as relatively safe and liquid assets that are important in maintaining liquidity and managing exposures to banks in those jurisdictions. Imposing severe limits on covered companies' holdings of these assets will amplify systemic risk. The recent experience of major banks in responding to the Eurozone crisis is an example of how the use of central bank facilities is important in allowing major financial institutions to maintain sufficient liquidity while at the same time reducing counterparty exposure to financial institutions.

These constraints on holdings of non-U.S. sovereign and central bank obligations will force some covered companies to hold more liquidity at the Federal Reserve or in other instruments where there are no limitations on counterparty concentrations or where the covered company is not constrained. This also could have adverse systemic implications, because some of these institutions would likely then be forced to swap out of "excess" non-U.S. currencies in order to place their excess funds at the Federal Reserve, which could both result in artificial elevation in measures of contagion risk, such as swap spreads relating to the affected currencies, as well as withholding liquidity from other market participants.

For these reasons, we believe that exposures to high-quality non-U.S. sovereigns should be exempt. In determining which non-U.S. sovereigns should be exempt, the criteria used in other related regulatory contexts are instructive. The Associations believe that the same approach to non-U.S. sovereigns recommended by the Associations for inclusion as "highly liquid assets"[39] for use under the Proposed Liquidity Rules should be used here as well. Accordingly, the following securities should be exempt from the single-counterparty credit limit:

- sovereign debt securities that are assigned a specific risk-weighting factor of 1.6 or less (equivalent to a risk-weighting of 20% or less under the U.S. banking agencies' Basel I-based capital rules) under the market-risk rules as they are amended; and

- securities issued or guaranteed by the government of a country that is a full member of the Organization for Economic Cooperation and Development or that has concluded special lending arrangements with the International Monetary Fund (which is the current standard under the U.S. banking agencies' Basel I-based capital rules for 20% risk-weighted sovereign securities).

In addition, the Associations propose that the central banks in countries that are identified through these criteria should also be exempt.

G. Individuals should not be covered as "counterparties".

Although Section 165(e) subjects credit exposures to "companies" rather than "persons" to the credit limit, the Proposed SCCL Rules improperly subject credit exposures to individuals and their families as well. The Associations believe that the Federal Reserve should respect the decision and clear intent of Congress not to subject credit exposures to individuals to the credit limit. As noted, the Federal Reserve has provided no explanation or basis for the decision to cover individuals. Nor do the Associations believe any such decision can be justified on the basis of safety and soundness or financial stability, given the extreme unlikelihood that exposure to an individual by a covered company would

[39] *See* Part III.A of *Annex B*.

ever reach the statutory 25% limit or pose any risk of systemic interconnectivity among "large financial companies" that Section 165(e) was designed to address. On this basis, it would also be unwarranted under any reasonable cost/benefit analysis to require covered companies to develop and maintain the mechanisms for tracking exposure to an individual and the individual's immediate family for purposes of this limit. Exposures to individuals are already amply covered by existing lending limits and by internal risk management systems of covered companies. Any concern regarding exposures to individuals that may arise out of an attempt to evade the requirements of the single-counterparty credit limit would be covered by the attribution rule in Section 165(e)(4), which applies to a transaction with "any person" where the benefits of the transaction "are used for the benefit of, or transferred to," a company.

H. A company should "control" another entity only if it consolidates that entity for financial reporting purposes.

Under Section 252.94(a), a covered company is required to include in its calculation of exposure to a counterparty both its own exposure and that of all its "subsidiaries". Similarly, in aggregating exposures to a counterparty, the covered company (or its subsidiaries) must include all exposure to the counterparty and its subsidiaries. For this purpose, "subsidiary" is defined as a company that is "directly or indirectly controlled by" the covered company, and a company "controls" another company if it (i) owns, controls, or has power to vote 25% or more of a class of voting securities of the company; (ii) owns or controls 25% or more of the total equity of the company; or (iii) consolidates the company for financial reporting purposes.[40] This definition would be difficult, if not impossible in certain instances, to administer in practice and would subject to the credit limit exposures that do not appreciably increase the risks the rule was designed to address.

Section 165(e) limits the risk that "failure of an individual company" could pose to a covered company by restricting the covered company's credit exposure to "any unaffiliated company". The Proposed SCCL Rules, however, calculate credit exposure not only to the "individual company", or "unaffiliated company", but to all companies that are in any way affiliated with the company, even where the affiliation may be remote or tenuous and presumes that, because of this affiliation, the individual company is responsible for the obligations of the affiliate or that repayment by the affiliate depends upon the resources of the individual company. We submit that this approach goes far beyond the provisions or intent of the statute to capture the risk of failure of an individual company to a covered company and greatly exaggerates the credit exposure of a covered company to its counterparties.

The main purpose of including subsidiaries of a company in the definition of "counterparty" should be to identify those entities where the covered company is looking to the same source of funds for repayment of the exposure. The approach should be aimed at capturing only those subsidiaries. Minority investments that would be deemed "controlling" under the Proposed SCCL Rules' expansive definition are common in many industries, and, in most cases, the investing company has no obligation in respect of the "subsidiary's" obligations beyond its investment in the subsidiary, and would not be required to contribute capital or assume liabilities if the subsidiary were unable to meet its obligations. Nor could the parent counterparty seek to utilize the assets of the minority subsidiary to satisfy its own obligations. As another example of the expansive reach of the Proposed SCCL Rules, if a

[40] Sections 252.92(j)(j), 252.92(i).

general partnership or managing member interest is treated as a voting security using a Bank Holding Company Act-type definition, exposure to all of the controlled portfolio companies of all the private equity funds and exposure to the funds themselves could potentially be aggregated. Furthermore, under the Proposed SCCL Rules, a covered company would be required to aggregate each company that has a 25% investment in the counterparty. This could result in the same exposures being aggregated with multiple different counterparties.

There would be practical issues as well with administering the "control" definition in the Proposed SCCL Rules. With respect to the counterparty, covered companies do not have access to information to determine, either initially and certainly not on an ongoing basis, whether the credit exposures of two counterparties should be aggregated where one counterparty has, for example, only a minority investment in another company. For example, it is unlikely that a covered company would have the ability to determine whether a counterparty's voting equity interest constitutes a separate class of securities if that interest votes together with other classes on some issues, but votes separately on other issues. This type of information is often not publicly available. When indirect subsidiaries are considered, implementation becomes even more problematic. The issue is further complicated when voting and equity ownership are not coterminous; this differentiation is commonplace in a number of widely-used business vehicles such as investment funds and other limited partnerships. If the proposed "control" definition is applied to such entities, the result would be a massively overstated exposure to the companies directly or indirectly comprising fund investments for private equity firms and similar fund management firms.

Similar complications arise with the "control" definition in the context of the covered company itself. Of course, the covered company is in a position to know and track which companies it has an investment in that would meet the "control" definition in the Proposed SCCL Rules. Even in this context, however, the definition remains overly broad. For example, a covered company may make a minority investment in a company that exceeds 25% of a class of voting stock or total equity but still not have the ability to monitor all the transactions in which the company engages or to prevent that company from engaging in credit transactions. Moreover, this approach is again over-inclusive—the covered company must include the entity as a subsidiary for purposes of calculating aggregate exposure while at the same time the covered company does not have the benefit of the "subsidiary's" capital (in fact, under certain circumstances, the covered company's investment in the subsidiary may even be deducted from the covered company's regulatory capital). This is particularly true for collective investment vehicles where the equity and control ownership is not coterminous, but is also generally the case for all minority investments. In effect, this reduces the limit for all covered companies to the extent they must aggregate the exposures of entities that are not consolidated.

To address these concerns, and to ensure a more transparent and accessible test that is much easier to use, we recommend that "control" should be defined for this purpose to include only companies that are consolidated for the company's financial reporting purposes (e.g., U.S. GAAP or IFRS, as applicable).[41] We believe that this standard is a reasonable proxy for situations where a company will

[41] The Associations also believe that a limited exemption would be appropriate for investment vehicles that are seeded by a covered company, similar to the exemption provided for seeding funds under the Volcker Rule. As part of the process of developing and marketing new investment vehicles, a covered company generally needs to invest its own capital on an initial basis to demonstrate its own commitment to the investment and to provide potential investors with the ability to evaluate the performance record of the investment vehicle. To provide covered companies with the flexibility needed to conduct this key part of

have responsibility for another company in which it invests. In addition, a covered company's own internal credit risk management policies may require aggregation in other situations, which would address safety and soundness concerns. Revising the definition in accordance with a company's financial accounting consolidation requirements would lessen the burden associated with identifying subsidiaries while still capturing the credit exposures that are likely to concentrate risk.

I. The rule should clarify that the daily compliance and monthly report requirements do not require tracking and aggregating exposures to counterparties where the exposures do not approach the credit limit.

Section 252.96 would require covered companies to be in compliance on a daily basis and to submit on a monthly basis a report demonstrating its daily compliance. In some cases, monitoring compliance on a daily basis is prudent because a covered company may approach the applicable credit limit on a regular basis. In most cases, however, exposures to a counterparty will always be far below the applicable credit limit—whether 25% or 10% (if retained in the final rule). In order to meet the daily compliance requirement, a covered company should not have to aggregate exposures across the organization with respect to each and every counterparty and document what that exposure is every day. The burden of running the calculation for each counterparty on a daily basis when only a relatively small number of counterparties at most will approach the limit would not be justified by any possible supervisory benefit.

Instead, a covered company should be required to monitor on a daily basis only those counterparty exposures that exceed a buffer of a significant percentage of the credit limit (for example, 25%). In this regard, a covered company could be required to have and maintain policies and procedures that are reasonably designed to identify aggregate credit exposures to a counterparty that exceed such buffer. For example, it would be expected that, as part of its regular credit risk monitoring, the covered company would evaluate whether as the result of any change in circumstance exposure to a particular counterparty could exceed the threshold.

In addition, the monthly report required under Section 252.96 should include a report of only the exposures that are within a stated percentage of the limit in order to demonstrate daily compliance rather than requiring a report that lists the aggregate exposure to each counterparty.

J. To ensure markets can accommodate the shifts in credit relationships and covered companies have sufficient time to develop the new systems to comply with the rules, the Federal Reserve should exercise its discretion to extend the compliance date to the end of the two-year transition period.

As noted, the Proposed SCCL Rules could require significant shifting of credit relationships. To achieve this result without disrupting the market unduly, covered companies will need sufficient time to unwind these relationships in an orderly manner.

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their asset management businesses, we request that a seeded fund not be considered part of the covered company for a 12-month period from the date of the creation of the fund regardless of whether they are consolidated for U.S. GAAP financial reporting purposes.

Moreover, as discussed in many contexts above, implementation of the single-counterparty credit limit as proposed would necessitate the development of new systems for monitoring and tracking exposures to all the counterparties of the covered company on a consolidated basis. The extent of the system development that will be required will depend on the approach taken in the final rule. Based on the Proposed SCCL Rules, however, we anticipate that new systems, or enhancements to existing systems, will be required at a minimum for the following purposes:

- Development of monthly reports to demonstrate compliance with the single-counterparty credit limits;
- Daily aggregation of some amount of exposures across the organization and across all business lines;
- Tracking of exposure shifts associated with collateral, guarantees, and credit and equity derivatives;
- Tracking of exposure to issuers of securities on a dual basis—market value and purchase price;
- Measurement of exposures for repo and securities lending transactions and derivative transactions if different from the systems used to comply with IMM or other existing credit risk management models; and
- Modifications to, or a development of, systems to account for the new definitions that would be introduced under the Proposed SCCL Rules, including the "control" definition, and the aggregation requirements for non-U.S. sovereigns and U.S. states.

Based on the sheer number of systems changes required and the amount of additional time required to integrate and test such systems changes so that covered companies can make their required certifications, an October 2013 compliance date is unrealistic.

We urge the Federal Reserve to use the authority granted under the statute to delay the effective date for two years.

III. Other Concerns

A. Counterparty and Covered Company Definitions

1. Non-U.S. sovereigns and U.S. states, including agencies, instrumentalities, and political subdivisions, should be treated in accordance with their treatment under the lending limit applicable to the covered company's lead depository institution.

a. <u>Non-U.S. sovereigns</u>

Section 252.92(k)(5) would include in the definition of "counterparty" a non-U.S. sovereign entity and all of its agencies, instrumentalities, and political subdivisions, collectively. The Associations do not believe this aggregation is reasonable or justified absent some showing that one entity is responsible for the obligations of the other, particularly where the repayment of the credit is

supported by a defined source of revenue. In addition, this aggregation requirement may lead a covered company to become credit-constrained with respect to a non-U.S. sovereign with all the negative effects on covered companies, non-U.S. governments, and market liquidity discussed above for any sovereign that is not exempted from the credit limit. Such aggregation also would cover situations where the government has taken control of an institution for systemic reasons. In a crisis, aggregating such companies with the government likely would have a procyclical effect of triggering and magnifying a retraction of interbank credit, the very phenomenon at issue in the financial crisis in 2007-2008.

Moreover, because this method of aggregation is inconsistent with covered companies' existing credit risk management practices, covered companies would need to alter existing systems for purposes of complying with this rule, even though it would provide little if any benefit for credit risk management purposes. Rather than impose a new, separate tracking regime on exposures to non-U.S. sovereign entities, the standards under which a covered company's lead subsidiary depository institution would aggregate exposures (i.e., the national bank lending limit or applicable state law lending limit) should be used under the Proposed SCCL Rules as well. The depository institution subsidiaries of covered companies subject to the Proposed SCCL Rules already have systems to measure and monitor these exposures, which could be used to capture exposures organization-wide. In addition, this approach would more accurately capture and aggregate only those exposures that present a true concentration risk.

b. U.S. States

Section 252.92(k)(4) similarly would aggregate a U.S. state and its agencies, instrumentalities, and political subdivisions (including municipalities). As with non-U.S. sovereigns, the Associations do not believe that the proposed aggregation is reasonable or justified absent a showing of financial responsibility between the entities, particularly where there is a dedicated source of repayment for the obligation. For example, there does not appear to be any reasonable basis to aggregate exposures to all municipalities in the same state simply because they are in the same state and irrespective of their local economy, revenues or creditworthiness. In addition, the consolidation of the agencies, instrumentalities, and political subdivisions of a U.S. state with the state also is inappropriate principally because the aggregation method does not accurately capture actual concentration of credit risk.

As with non-U.S. sovereigns, a covered company should be permitted to treat exposures to U.S. states and their agencies, instrumentalities, and political subdivisions in the same manner as its lead insured depository institution is required to under applicable law (i.e., the national bank lending limit or applicable state law lending limit). In some cases this may mean that those exposures are exempt. However, each covered company's existing credit risk management framework, which is subject to supervisory oversight, would still provide ample protection.

At a minimum, exposures to the agencies, instrumentalities, and political subdivisions of a U.S. state should not be aggregated to the extent the obligation is supported only by a defined source of revenue. For example, municipal revenue bonds, which are generally issued to finance public works, are supported directly by the revenues that are derived from the project, and the bondholders do not have any claim on the issuer's other resources. Because of the clear delineation of the obligations, aggregation would not be appropriate in these circumstances.

2. Special purpose vehicles should not be deemed to be controlled by or otherwise consolidated with the issuer of the underlying assets or vehicle sponsor and such exposures should be managed under a covered company's credit risk management policies and procedures rather than potentially be subject to a retroactive determination under a proposed reservation of authority.

The Preamble identifies certain entities that would not be considered subsidiaries, as defined in the Proposed SCCL Rules, but that, in the Federal Reserve's view, may raise the same issues.[42] In particular, the Federal Reserve notes that under a proposed reservation of authority, the Federal Reserve may look through certain SPVs either to the issuer of the underlying assets in the vehicle or to the sponsor. In some circumstances, under this authority, the Federal Reserve may require covered companies to look through to the underlying assets of an SPV but "only if the SPV failed certain discrete concentration tests, such as having more than 20 underlying exposures."[43] If the Federal Reserve determines to exercise this authority, the Associations believe the Federal Reserve should first publish for comment a notice of proposed rulemaking.

As an initial matter, the Associations believe that such entities should be aggregated only where a legal obligation exists to support the entity financially rather than based on subjective, hypothetical possibilities. Moreover, the determination of whether to look through SPVs to an issuer of the underlying assets or the sponsor should align with a covered company's existing internal risk management policies. No look-through should be required if the covered company is not relying on the issuer or sponsor for repayment or if the income stream from the assets in the SPV is sufficient to repay principal and accrued interest. From a business and compliance perspective, a covered company needs certainty regarding the treatment of SPVs. Lack of clarity would require a covered company to develop additional monitoring capabilities for SPVs in case a retroactive determination is made that a particular SPV should be treated on a look-through basis.

3. Money market mutual funds and other collective investment vehicles should not be included as part of the covered company in the absence of any legal financial support obligation.

The Federal Reserve specifically asks whether money market mutual funds ("**MMMF**") and other funds that the covered company sponsors or advises should be included as part of the covered company for purposes of the Proposed SCCL Rules because a covered company may have strong incentives to provide support in times of distress.[44] We do not believe that it is necessary or appropriate to include sponsored or advised funds such as MMMFs within the definition of "covered company" in the absence of any legal financial support obligation. With respect to MMMFs, these funds

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[42] 77 Fed. Reg. at 615.

[43] *Id.*

[44] 77 Fed. Reg. at 614.

are subject to a regulatory framework that has increased their ability to sustain themselves in the face of economic stresses and reduce the risks of large, sudden redemptions of the funds' shares.[45]

With respect to other mutual funds, the market expectation for support is even weaker since they are generally viewed as investment vehicles rather than alternatives to cash. With respect to private equity and similar fund investments that have the ability to limit withdrawals and postpone redemptions during periods of economic stress, there is certainly no expectation of support. As pointed out under the discussion of "control" above, there are practical difficulties of looking through various funds managed by the covered company to determine exposure. Furthermore, such a look-through would result in a massively overstated exposure for the covered company.

Consequently, to address these concerns we recommend that MMMFs and other collective investment vehicles be excluded from the definition of "subsidiary" both for purposes of the covered company (as well as for purposes of the counterparty) absent express support obligations.

B. Other Calculation Methodology Issues

1. The proposed methodology for measuring exposure related to equity and debt securities would provide little, if any, risk management benefit.

With respect to debt securities, gross exposure for trading and available for sale debt securities as proposed would be equal to the greater of amortized purchase price and market value. Equity securities would be held at the greater of the purchase price and market value.

The Preamble states that a floor of purchase price was introduced to protect against the possibility that credit transactions could increase if the security loses value and thereby allows for more credit transactions. This requirement assumes that there are no other risk management mechanisms in place that take account of the creditworthiness of the counterparty and, therefore, the credit limit is necessary to protect against a covered company increasing its exposures to counterparties with impaired credit. As a matter of prudent risk management, the creditworthiness of the counterparty is taken into consideration before entering into any type of credit transaction. The proposed requirement layers purchase price as a floor on top of existing credit risk management practices. The added requirement is not necessary to protect against credit quality risk but at the same time imposes an additional tracking requirement that is not consistent with the existing risk-management systems of covered companies.

The Associations recommend that the exposure to debt and equity securities be measured in accordance with the accounting treatment of the asset utilized by the company under its applicable accounting standards. This would eliminate the need to develop costly new systems to track the market value of the securities relative to purchase price, and would provide a straightforward mechanism for covered companies to distinguish among distinct types of investments in equity securities—for example, equity securities held as part of trading activity as opposed to strategic minority investments.

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[45] *See*, e.g., Money Market Fund Reform, SEC Release No. IC-29132 (Feb. 23, 2010), 75 Fed. Reg. 10060 (adopting release), *available at*: http://www.sec.gov/rules/final/2010/ic-29132fr.pdf.

2. Substitution should not be required for guarantees.

As with eligible credit and equity derivatives, Section 252.95(d) would require a covered company to shift the underlying exposure to a guarantor that is an eligible protection provider (up to the amount of the eligible guarantee). As discussed in Part II.B, the substitution requirement overstates risk because it fails to take into account the lower likelihood of double default. Because of this shortcoming, an automatic substitution requirement is not part of covered companies' credit risk management processes. As a result, covered companies would need to develop new systems or undertake significant modifications to existing systems to incorporate this substitution approach. Because requiring substitution for all guarantees would not materially reduce risk to covered companies, the Associations believe that the cost and burden associated with the requirement outweigh any possible supervisory benefit. Accordingly, the Associations recommend that substitution in connection with a guarantee be required only in accordance with a covered company's written credit risk management policies and procedures (as discussed above in Part II.B).

3. If the treatment of credit and equity derivatives is not fundamentally changed in the final rule, clarification of the calculation methodology is needed in several respects.

The calculation methodologies for credit and equity derivatives under Sections 252.94 and 252.95 raise a number of issues that would benefit from clarification in the final rule.

- The Proposed SCCL Rules do not address the situation where a covered company, as part of its credit or equity derivative trading or otherwise, purchases an eligible credit or equity derivative for which it has no underlying reference asset/issuer. We believe that in this circumstance the covered company's gross exposure would be calculated under the methodologies used for other derivative transactions in Sections 252.94(a)(10) or (11).

- As discussed above in Section II.B, because credit and equity derivatives are "derivative transactions" under Section 252.92(p) but also may be "eligible credit derivatives" or "eligible equity derivatives", the rule would appear technically to require a covered company to include both of those exposures when calculating its exposure to that counterparty even though it would in a sense be counting the same exposure twice. This perhaps unintended double-counting is inappropriate, and the final rule should be clear that it is not required.

- The Proposed SCCL Rules do not specifically address exposures to indices, but indices raise some of the same issues discussed in the context of SPVs above. Similar to our position that it is not appropriate generally to look through SPVs, a covered company should not have to look through an index except as otherwise required by a company's internal risk management policy. Requiring a look-through in all cases would be impractical and unnecessary from a risk management perspective.

4. The limitation of the application of the attribution rule to prevent evasions as proposed in the Preamble should be reflected in the rule text itself.

Section 252.94(b) includes the statutory attribution rule, which requires a covered company to treat a transaction with any person as a credit exposure to a counterparty to the extent the proceeds of the transaction are used for the benefit of or transferred to that counterparty. We

appreciate the acknowledgment in the Preamble that "an overly broad interpretation of the attribution rule would lead to inappropriate results and create a daunting tracking exercise for covered companies" and agree that the scope of application of the rule should be limited to preventing evasions.[46] In other words, the attribution rule should apply only where the covered company effectively has sought to evade a true exposure to one party by structuring the transaction with another party. The Preamble includes a useful example of how broadly the language of the attribution rule itself could be read but where its application would not be appropriate—a situation where a covered company makes a loan to a counterparty that uses the loan proceeds to purchase goods from another person (i.e., are transferred to or benefit the other person). Section 252.94(b) itself, however, does not include this clarification. In light of the broad language of the attribution rule, it is important that the intention to limit the application of the rule to preventing evasions be reflected in the final rule itself.

The term "evasion" would be difficult to define in this context. Even without a definition, however, we believe the language limiting the application of the attribution rule to situations where evasion is present would play an important role in defining the scope of the attribution rule's application. The final rule also should include, as an example, the example provided in the Preamble that the attribution rule does not apply when a covered company makes a loan to a person that uses the proceeds to purchase goods from another person.

C. Compliance Requirements

1. A transition period should be provided for covered companies that become major covered companies and entities that become counterparties or major counterparties to allow all parties to adjust to a potentially more stringent credit limit.

The Proposed SCCL Rules do not contain a transition period for circumstances where a covered company crosses the "major" threshold. If the "major" determination is retained in the final rules, the Associations recommend that there be a transition period of six months from the date the covered company crosses the asset threshold to allow a company to adjust to the new limits without unduly upsetting existing credit relationships.

In addition, transition periods would be appropriate based on the status of the counterparty in the following circumstances:

- Under Section 252.97(a)(2), credit transactions that are direct claims on, and the portion of claims that are directly and fully guaranteed as to principal and interest by, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are exempt from the limits but only while they are operation under the conservatorship or receivership of the Federal Housing Finance Agency. Significant adjustments will be necessary if and when those entities are no longer under conservatorship. To avoid reduced liquidity and market losses, covered companies would need a period of at least one year to bring those entities within the credit limit.

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[46] The Preamble states that "The Board thus proposes to minimize the scope of application of this attribution rule consistent with preventing evasion of the single-counterparty credit limit." 77 Fed. Reg. at 618.

- If a counterparty becomes a major counterparty (other than through merger of two counterparties as provided in Section 252.96(b)(3)), there is no grace period for a major covered company to bring its credit transactions with that counterparty within the proposed lower 10% credit limit. If the 10% credit limit is maintained in the final SCCL rules, a major covered company would need a transition period of six months to bring its exposure to a counterparty that becomes a major counterparty for any reason into compliance with the 10% credit limit.

2. The final rule should provide a short grace period for a breach of the credit limit with respect to a counterparty provided that the exposure does not exceed the credit limit by more than 25% where the covered company reasonably believes that the breach can be rectified in that time period.

Without a limited, short-term exception, the credit limits will effectively be set even lower because covered companies will need to establish buffers below the actual limit to protect against inadvertent breaches. This could have the effect of further constraining market liquidity and the availability of credit. A limited exception to the credit limit that includes a short grace period will provide needed flexibility without introducing significant risk.

3. A limited exemption should be provided for temporary breaches that result from short-term exposures related to payment and settlement services.

An exemption for operational payments and deposits is necessary to allow covered companies to continue to provide the same level of low-risk services for transaction settlement that they provide today. Requiring a covered company to include in the credit limit exposures that result from temporary overdrafts or delivery failures will result in increased operational and systemic risk and would limit the ability of covered companies to manage operational exposures in a manner consistent with how those exposures are managed by institutions in other jurisdictions.

Although the vast majority of transactional payments settle as expected and, therefore, would be exempt intraday exposures under the Proposed SCCL Rules, on occasion settlement is delayed for a variety of technical, operational reasons beyond the control of the parties. Such delays are explicitly recognized and provided for in a number of other regulatory contexts:

- Under regulations implementing the national bank lending limits, "amounts paid against uncollected funds in the normal process of collection" are excepted from the limit.[47]

- The Federal Reserve's Regulation F relating to interbank liabilities excludes "exposures related to the settlement of transactions, intraday exposure, and transactions in an agency or similar capacity where losses will be passed back to the principal or other party…"

Regulation F also contains a requirement that a bank should structure its transactions so that the exposure "ordinarily does not" exceed the internal limit, but permits "occasional excesses resulting from unusual market disturbances, market movements favorable to the bank, increases in activity, operational problems, or other unusual circumstances." In addition, other jurisdictions have

[47] 12 C.F.R. Part 32.

recognized the need for an exception to cover operational payments in similar contexts, for example the EC "large exposure" regime.[48]

The Associations recommend that an exemption for such exposures, subject to the following conditions, be included in the final rules:

- The exposure arises in the ordinary course of providing payment and settlement services for transactions, including foreign exchange, securities, derivatives, commodities and similar transactions;

- The covered company has policies and procedures that appropriately govern the credit and liquidity risks of the counterparty and exposures related to payments and settlements, and provide for the daily monitoring of exposures;

- To the extent that the aggregate exposure to the counterparty exceeds the credit limit, the covered company takes appropriate action, consistent with safety and soundness considerations, to reduce the excess exposure as quickly as reasonably practicable and in any event within a reasonable period of time from the day the excess first occurred; and

- The covered company reports the excess exposure to its Federal Reserve Bank not later than the first business day after the excess occurs, and advises as to actions it has taken or will take to eliminate the excess exposure consistent within an appropriate timeframe specified by the Federal Reserve.

This proposal and further description of settlement issues is addressed in a comment letter concerning the Proposed SCCL Rules being submitted by certain custody banks.[49]

4. The grace period in the rule should be automatic rather than subject to Federal Reserve approval and additional credit transactions should be permitted during the grace period under certain circumstances.

As proposed in Section 252.96(b), a 90-day grace period to return to compliance with the credit limit would be permitted in the following cases: for a decrease in capital stock and surplus; merger with another covered company;[50] merger of two unaffiliated counterparties;[51] or other appropriate circumstances as determined by the Federal Reserve if the covered company uses reasonable efforts to return to compliance during the grace period. The Proposed Rules suggest that none of the grace periods would be granted automatically. Instead, the Federal Reserve would have to

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48 See e.g., Committee of European Bank Supervisors, Implementation Guidelines on Article 106(2)(c) and (d) of Directive 2006/48/EC, providing exemptions related to clearing, settlement and custody services provided to clients.

49 Letter from Northern Trust, State Street, and BNY Mellon to the Federal Reserve dated April 2012.

50 We note that other transactions that are similar to mergers, such as stock or asset purchases, should similarly be afforded a grace period.

51 *See* footnote 50.

grant approval.[52] Because a grace period is permitted in such limited circumstances and those circumstances may be beyond the control of the covered company, the grace period should be automatic for the specified circumstances as well as other circumstances that the Federal Reserve may determine in the future, such as in cases where additional liquidity is needed in the markets during a financial crisis. The requirement that the covered company use reasonable efforts to return to compliance protects against a covered company relying too heavily on the grace period. A covered company could still be required to provide the Federal Reserve with prompt notice of any such breach.

Furthermore, we believe it would be appropriate to permit covered companies to continue to engage in credit transactions during the grace period provided that the covered company can demonstrate that the exposure can be brought into compliance within a reasonable period of time.

D. Other Issues

1. The final rule should clarify that any portion of a syndicated loan, letter of credit, or other extension of credit, that has been sold or otherwise transferred, under appropriate conditions, to another third party, is not included in the gross credit exposure to the counterparty.

The final SCCL rules should reflect the actual credit exposure of each covered company to any given counterparty. When a covered company in any syndicated extension of credit or under a derivative transaction has transferred a participation in that extension of credit or credit exposure to a third party on terms and conditions that extinguish the legal obligation to extend the transferred portion of the credit, the covered company is no longer exposed to the transferred portion of the credit extension or credit exposure.

This approach to loan participations is reflected in the national bank lending limit, which disregards, for the purpose of calculating an originating bank's exposure to a counterparty, any portion of an extension of credit to that counterparty that has been sold as a participation on a nonrecourse basis, provided the participation results in a *pro rata* sharing of credit risk proportionate to retained interests of the originating and participating lenders.[53] The final rule should apply the same approach to both loan participations and risk participations in connection with derivatives.[54]

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[52] Section 252.96 states that "In granting approval for such a special temporary credit exposure limit, the [Federal Reserve] will consider the following: (1) A decrease in capital stock and surplus. (2) The merger of the covered company with another covered company. (3) A merger of two unaffiliated counterparties. (4) Any other circumstances the [Federal Reserve] determines is appropriate."

[53] *See* 12 C.F.R. § 32.2(k)(2)(vi).

[54] Derivative transactions currently are not subject to the national bank lending limit, but will become so as a result of Section 610 of Dodd-Frank.

2. The definition of "eligible collateral" is too limited and should be expanded to include other types of collateral commonly accepted in the market, subject to appropriate haircuts.

The definition of "eligible collateral" in Section 252.92(q) includes cash on deposit with the covered company (including cash held for the covered company by a third-party custodian or trustee); debt securities (other than mortgage- or asset-backed securities)[55] that are bank eligible investments; equity securities that are public traded; or convertible bonds that are publicly traded.

The definition of "eligible collateral" is too narrow and could put significant limits on the ability of covered companies to lend on a secured basis. As long as collateral is given appropriate haircuts, there is a broader range of collateral that should be included for these purposes. Permitting a wider range of collateral would be appropriate in light of the fact that the covered company would have to include the exposure to the collateral issuer when calculating compliance with the limits to the extent it relies on that collateral to reduce other exposures. For example, private label asset-backed and mortgage-backed securities are frequently used as collateral today in a variety of credit transactions. As a result, covered companies have had to develop internal methodologies to estimate appropriate haircuts for such collateral, and those methodologies should be applied in this context as well. With appropriate haircuts, expanding the definition of eligible collateral would not materially increase the risk to the covered company nor would it undermine the goal of decreasing interconnectedness.

Furthermore, collateral that meets the "eligible collateral" definition would likely be favored, which could cause a significant decline in the demand for and liquidity of other types of collateral. This may artificially affect the price for eligible versus ineligible collateral. Expanding the definition would help avoid these unintended consequences.

3. If the "substitution" requirement is retained, the definition of "eligible protection provider" should be expanded to include other providers that are able to post sufficient high-quality collateral to avoid providing a disincentive to covered companies to purchase protection products.

The Proposed SCCL Rules permit a covered company to reduce its gross exposure to a counterparty in certain circumstances if the covered company acquires an eligible guarantee or eligible credit or equity derivative if the protection is acquired from an "eligible protection provider".[56] In light of the treatment of exposures to an eligible protection provider under the Proposed SCCL Rules, this definition is too narrow.

Under the Proposed SCCL Rules, a covered company may only "net" exposures to a counterparty with protection provided by an eligible protection provider. As a result, protection

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[55] We assume that the exclusion for "mortgage-backed securities" was not intended to include mortgage-backed securities the principal and interest on which are fully guaranteed by the United States, one of its agencies, or Fannie Mae or Freddie Mac (while operating in conservatorship), as these exposures are completely exempted from the credit limit and, thus, should clearly qualify as "eligible collateral". We request that this clarification be included in the final rule.

[56] Section 252.92(u).

provided by a non-eligible protection provider does not replace an existing exposure but simply adds to it. Therefore, despite having purchased protection, a covered company continues to have to recognize the exposure to the initial counterparty for the full amount and must recognize a separate exposure to the non-eligible protection provider (each calculated in accordance with the rule).

With respect to credit and equity derivatives, there are a limited number of market participants among those that would qualify as eligible protection providers that have the infrastructure and capability to provide these products. Consequently, in order to obtain the benefit of the protection under the rule, covered companies will have to turn to a limited number of market participants that generally will be covered companies, which may have the effect of restricting the availability of these products. Among covered companies that would be considered major covered companies under the proposal, the effect is only magnified as most providers of credit and equity derivatives would be major covered companies and, therefore, subject to the 10% credit limit.

If the treatment of exposures to eligible protection providers is not substantially changed in the final rule, the definition of "eligible protection provider" should be expanded to accommodate providers that are capable of posting sufficient, high-quality collateral. This would provide covered companies with alternatives for purchasing protection.

IV. Responses to Questions Posed in the NPR

We have set forth below responses to, or cross-references to discussions in this *Annex C* of, certain specific questions raised by the Federal Reserve with respect to the Proposed SCCL Rules.[57]

As an introductory comment, we note that the multiple questions that refer to a "more conservative" approach may reflect a misunderstanding of how extraordinarily conservative the Proposed SCCL Rules actually are.

Question 20. *How would the limits of section 165(e) and the proposed rule interact with the other existing limits such as the investment and lending limits applicable to banks and what other conflicts might arise in complying with these different regimes?*

The approach taken in the Proposed SCCL Rules imposes an entirely new framework on top of existing lending and investment limits. In many cases the exposure calculation and other requirements of the Proposed SCCL Rules are inconsistent with these existing requirements. Moreover, the imposition of a 10% credit limit on major covered companies would effectively lower the applicable national or state lending limit. We also note that the regime established by the Proposed SCCL Rules conflicts in some respects with similar regimes in other jurisdictions, such as the EC large exposure regime, as discussed in the Introduction.

Question 21. *Should the Federal Reserve consider a longer phase-in for all or a subset of covered companies?*

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[57] As noted in footnote 6 to the Comment Letter, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies.

See our comments in Part II.J.

Question 22. *Is the approach of including all subsidiaries of a covered company in the definition of covered company for purposes of the proposed rule appropriate? If not, explain why not.*

See our comments in Part II.H.

Question 23. *Should the Bank Holding Company Act/Regulation Y definition of "control" be adopted for purposes of the proposed rule? Are there alternative approaches to defining when a company is a subsidiary of another the Board should consider?*

The Bank Holding Company Act/Regulation Y definition of "control" should not be adopted for purposes of the Proposed SCCL Rules. The administrative difficulties described in Part II.H would be infinitely compounded if that definition of control with its subjective "controlling influence" prong were relied on. Indeed, administration could become a true impossibility.[58] Moreover, the rationale for a broad definition of control under the Bank Holding Company Act is not relevant to the Proposed SCCL Rules. *See* our comments in Part II.F for a discussion of our proposed alternative approach to define "control" in accordance with consolidation requirements under a covered company's applicable accounting standard.

Question 24. *Since a covered company may have strong incentives to provide support in times of distress to MMMFs and certain other funds or vehicles that it sponsors or advises, the Board seeks comment on whether such funds or vehicles should be included as part of the covered company for purposes of this rule. Is the proposed rule's definition of "control" effective, and should the proposal's definition of "subsidiary" be expanded to include any investment fund or vehicle advised or sponsored by a covered company or any other entity?*

See our comments in Parts II.F and III.A.3.

Question 25. *Should the definition of "counterparty" differentiate between types of exposures to a foreign sovereign entity including exposures to local governments? Should exposures to a company controlled by a foreign sovereign entity be included in the exposure to that foreign sovereign entity?*

See our comments in Part III.A.1 on types of exposures and aggregation of entities with a non-U.S. sovereign entity.

Question 26. *Should certain credit exposures to foreign sovereign entities be exempted from the limitations of the proposed rule—for example, exposures to foreign central banks necessary to facilitate the operation of a foreign banking business by a covered company?*

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[58] This is even more so the case because of the facts and circumstances nature of the Bank Holding Company Act control analysis.

See our comments in Part II.F.

Question 27. *How should exposures to SPVs and their underlying assets and sponsors be treated? What other alternatives should the Federal Reserve consider?*

See our comments in Part III.A.2.

Question 28. *Are the measures of "capital stock and surplus" in the proposed rule effective in light of the intent and purpose of section 165(e) or would a measure of "capital stock and surplus" that focuses on tier 1 common equity be more effective? What other alternatives to the proposed definition of "capital stock and surplus" should the Federal Reserve consider?*

The Associations support the measure of "capital stock and surplus" in the Proposed SCCL Rules. Similar definitions are used in other comparable regulatory contexts, such as the national bank lending limit, which will help align regimes with similar purposes.

Question 29. *What other limits or modifications to the proposed limits on aggregate net credit exposure should the Federal Reserve consider?*

See our comments in Parts II.A – C and Part III.B. In addition, aggregate net credit exposure should include a mechanism for reducing exposure to take account of legally enforceable set-off netting.

Question 30. *Should the Federal Reserve adopt a more nuanced approach, like the BCBS approach, in determining which covered companies should be treated as major covered companies or which counterparties should be considered major counterparties?*

The Associations do not believe that any reduction in the credit limit is appropriate until there has been a thorough and reasoned quantitative impact analysis and an opportunity for meaningful comment on the rationale for any such reduction. *See* our comments in Part II.D.

Question 31. *Should the Federal Reserve introduce more granular categories of covered companies to determine to appropriate net credit exposure limit? If so, how could such granularity best be accomplished?*

See our comments in Part II.D and our response to Question 30.

Question 32. *Should the Federal Reserve supplement the net credit exposure limit with limits on gross credit exposure for all covered companies or a subset of covered company, i.e., major covered companies? Explain why or why not?*

The concentration limit is aimed at mitigating undue risk. Measuring exposure on a gross basis only and thereby not taking into account risk mitigants, such as netting, collateral and credit protection, would grossly overstate risk and actual exposure and would not be justified.

Question 34. *What transactions, if any, should be exempt from the definition of credit transaction?*

See our comments in Part II.F, footnote 41 and Part III.C.

Question 35. *What alternative or additional valuation rules should the Federal Reserve consider for calculating gross credit exposure?*

See our comments in Part II.A and III.B.

Question 36. *What impediments to calculating gross credit exposure in the manner described above would covered companies face?*

See our comments in Part II.A and III.B.

Question 37. *Does the requirement to use the greater of purchase price or market value introduce significant burden for covered companies? Would the use of the market value alone be consistent with the purposes of section 165(e)?*

See our comments in Part III.B.1.

Question 38. *The Federal Reserve seeks comment on all aspects of the proposed approach to calculating gross credit exposures for securities financing and derivative transactions, including the add-on in the proposed gross valuation rule for repurchase agreements and securities lending transactions.*

See our comments in Parts II.A and C.

Question 39. *Should margin posted and contributions to a CCP guaranty fund be considered a credit exposure for purposes of the proposed rule? The Federal Reserve recognizes that there are competing policy concerns in considering whether to limit a covered company's exposure to central counterparties. The Federal Reserve seeks comment on the benefits and drawbacks of such limits.*

See our comments in Part II.E.

Question 40. *The Federal Reserve requests comment on whether the proposed scope of the attribution rule is appropriate or whether additional regulatory clarity around the attribution rule would be appropriate. What alternative approaches to applying the attribution rule should the Federal Reserve consider? What is the potential cost or burden of applying the attribution rule as described above?*

See our comments in Part III.B.4.

Question 41. *Should the list of eligible collateral be broadened or narrowed?*

See our comments in Part III.E.2.

Question 42. *Should a covered company be able to use its own internal estimates for collateral haircuts as permitted under Appendix G to Regulation Y?*

See our comments in Part III.D.2.

Question 44. *What is the burden on a covered company associated with the proposed rule's approach to changes in the eligibility of collateral? Should the Federal Reserve instead consider introducing stricter collateral haircuts for collateral that ceases to be eligible collateral?*

As discussed in Part III.D.2, the Associations believe that the definition of "eligible collateral" should be expanded as long as appropriate haircuts are assigned to the collateral.

Question 46. *Alternatively, should eligible collateral be treated the same way eligible guarantees and eligible credit and equity derivative hedges are treated (as described below), thus requiring a mandatory look-through to eligible collateral?*

For the same reasons we support optional shifting to the protection provider, we would not support a mandatory look-through for collateral.

Question 48. *In what ways should the definition of eligible protection provider be expanded or narrowed?*

See our comments in Part III.E.3.

Question 50. *Should covered companies have the choice of whether or not to fully shift exposures to eligible protection providers in the case of eligible guarantees or to divide an exposure between the original counterparty and the eligible protection provider in some manner?*

See our comments in Part III.B.2.

Question 51. *Would a more conservative approach to eligible guarantees be more appropriate to penalize financial sector interconnectedness–for example, one in which the covered company would be required to recognize gross credit exposure both to the original counterparty and the eligible protection provider in the full amount of the original credit exposure? What other alternative approaches to the treatment of eligible guarantees should the Federal Reserve consider?*

We believe that the term "penalize" in this question illustrates an erroneous view of the role of interconnectivity among financial institutions in the financial crisis. *See* our comments in the introduction of this *Annex C*.

Question 53. *What alternative approaches, if any, should the Federal Reserve consider to capture the risk mitigation benefits of proxy or portfolio hedges or to permit covered companies to use internal models to measure potential exposures to sellers of credit protection?*

See our comments in Parts II.A and B.

Question 54. *Should covered companies have the choice to recognize and shift exposures to protection providers in the case of eligible credit or equity derivative hedges or to apportion the exposure between the original counterparty and the eligible protection provider?*

See our comments in Part II.B.

Question 55. *Would a more conservative approach to eligible credit or equity derivative hedges be more appropriate, such as one in which the covered company would be required to recognize gross notional credit exposure both to the original counterparty and the eligible protection provider?*

See our comments in Part II.B.

Question 56. *Rather than requiring firms to calculate gross trading exposures and offset that exposure with eligible credit and equity derivatives or short positions, should the Federal Reserve allow covered companies to use internal pricing models to calculate the net mark-to-market loss impact of an issuer default, applying a zero percent recovery rate assumption, to all instruments and positions in the trading book? Under this approach, gains and losses would be estimated using full revaluation to the greatest extent possible, and simply summed. For derivatives products, all pricing inputs other than those directly related to the default of the issuer would remain constant. Similar to the proposed approach, only single-name and index credit default swaps, total return swaps, or equity derivatives would be included in this valuation. Would such a models-based approach better reflect traded credit exposures? If so, why?*

See our comments in Part II.B.

Question 57. *Are there additional non-compliance circumstances for which some cure period should be provided?*

See our comments in Part III.C.

Question 58. *Is the 90-day cure period appropriate and is it appropriate to generally prohibit additional credit transactions with the affected counterparty during the cure period? If not, why not?*

See our comments in Part III.C.

Question 59. *Is the scope of the exemption for direct claims on, and the portions of claims that are directly and fully guaranteed as to principal and interest by, the United States and it agencies appropriate? If not, explain the reasons why in detail and indicate whether there are alternatives the Federal Reserve should consider. Are there other governmental entities that should receive an exemption from the limits of the proposed rule?*

The scope of the exemption for claims that are directly and fully guaranteed as to principal and interest by the United States and its agencies should be clarified to apply to Federal Family Education Loan Program securities where the underlying loans are U.S. government-guaranteed but the security itself is not.

See our comments in Part II.C, footnote 12, and Part D.II, footnote 55.

Question 60. *Should other credit exposures be exempted from the limitations of the proposed rule. If so, explain why?*

The Associations believe that the Proposed SCCL Rules represent an overly broad and inappropriate expansion of Section 165(e), for example, the coverage of high-quality non-U.S. sovereigns and individuals. In addition, we believe an exemption is appropriate for CCPs as discussed in Part II.F.

Proposed Risk Management Rules (Subpart E) – Risk Management[1]

The importance of effective risk management has long been recognized by financial regulators and the industry. In 2006, then Federal Reserve Governor Susan Bies noted that "[a]t the Federal Reserve, we believe that all banking organizations need good risk management."[2] An even earlier report by the industry-sponsored Committee on Sponsoring Organizations of the Treadway Commission (COSO) proposed an integrated framework for enterprise-wide risk management, which has been a model for many companies.[3]

Recent market events have caused financial regulators and the industry to focus even greater attention on risk management. For example, the Senior Supervisors Group, which includes financial supervisors from each of the major industrialized countries, has issued two reports that assess risk management practices during and after the global banking crisis.[4] These reports are referenced in the Preamble.[5]

Dodd-Frank imposes additional risk management requirements on certain BHCs and nonbank financial companies supervised by the Federal Reserve. Section 165(b) of Dodd-Frank directs the Federal Reserve to establish enhanced risk management standards for covered institutions. Further, Section 165(h) of Dodd-Frank requires all BHCs with more than $10 billion in assets and all nonbank financial companies supervised by the Federal Reserve to establish a risk management committee of the Board of Directors, and it directs the Federal Reserve to issue rules implementing that requirement. The Proposed Risk Management Rules and the governance provisions in the Proposed Liquidity Rules have been published in response to these statutory directives.

The Associations acknowledge the importance of effective enterprise-wide risk management, and support the intent of the Proposed Risk Management Rules and governance provisions of the Proposed Liquidity Rules. Indeed, the companies covered by these rules already have expended significant resources to enhance sound risk management and control functions. Nonetheless, the Associations are concerned that some of the provisions in these rules are overly prescriptive and potentially counterproductive.

Our chief concern is that the Proposed Risk Management Rules and the governance provisions in the Proposed Liquidity Rules would place operational responsibilities on a company's board and risk committee that would interfere with the ability of the board and risk committee to exercise effective supervision of the company. As such, these rules would produce results contrary to their

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1 Capitalized terms used but not defined in this Annex have the meanings assigned to them in the Comment Letter to which this Annex is attached.

2 Governor Susan Schmidt Bies, "*A Bank Supervisor's Perspective on Enterprise Risk Management,*" Enterprise Risk Management Roundtable, North Carolina State University, Raleigh, North Carolina (Apr. 28, 2006).

3 COSO Enterprise Risk Management – Integrated Framework (2004).

4 *Observations on Risk Management Practices during the Recent Market Turbulence* (Mar. 6, 2008), and *Risk Management Lessons from the Global Banking Crisis of 2008* (Oct. 21, 2009).

5 77 Fed. Reg. at 622.

purpose. We also have concerns related to the structure of the risk committee and the role of the chief risk officer.

We make several recommendations below to address our concerns with the Proposed Risk Management Rules. Our recommendations would establish a clearer distinction between the role of a board and its committees and the role of management. They also would replace some of the overly prescriptive features of the Proposed Risk Management Rules with some general directives that we believe would be equally or even more effective in promoting sound risk management. Our recommendations addressing our concerns with the governance provisions in the Proposed Liquidity Rules are discussed in Parts II.B and II.C of *Annex B*.

We believe that with our proposed changes, the Proposed Risk Management Rules would establish risk management standards that are more stringent than the regulatory requirements applicable to companies not covered by the rules. For the first time, all covered companies would be required, by regulation, to have a board committee chartered to address risk management and that committee would be responsible for approving a comprehensive risk management framework for the company. Additionally, for the first time, larger BHCs and nonbank financial companies subject to supervision by the Federal Reserve would be required, by regulation, to have a chief risk officer who is charged with general risk management responsibilities.

This Annex is divided into seven parts. Part I is an executive summary; Part II addresses the functions of the risk management committee; Part III addresses the structure of the risk management committee; Part IV addresses the role of the chief risk officer; Part V addresses the relationship between these rules and other supervisory standards; Part VI addresses the use of risk management as a trigger in the early remediation framework; and Part VII addresses certain specific questions posed by the Federal Reserve in the Preamble.

I. Executive Summary

The Associations' key recommendations and concerns with respect to the Proposed Risk Management Rules are as follows:

- The Proposed Risk Management Rules blur the distinction between the proper oversight role of the board and management's responsibility for day-to-day operations in several areas. The Proposed Risk Management Rules should consistently preserve the distinction between a board's oversight role and management's operational role. Otherwise, boards and board committees will be overwhelmed with duties that impair their ability to provide independent, effective and objective supervision to the company. The risk management committee should approve and oversee risk management policies developed and recommended by management. Similar issues are raised by the corporate governance provisions of the Proposed Liquidity Rules.

- Effective risk management requires the oversight of the board and the involvement of various board committees. The final rules should explicitly acknowledge the Board of Directors' authority to allocate the oversight of certain, specific risk management responsibilities to appropriate board committees, such as an audit, credit or finance committee. Absent such a clarification, the Proposed Risk Management Rules could result in the duplication of risk management oversight functions and lead to less effective risk management.

- The definition of "risk management expertise", as applied to the risk committee, should be replaced with a definition patterned after the SEC's definition of an "audit committee financial expert". Moreover, an effective risk committee can benefit from members with diverse backgrounds, including senior operational and managerial roles with nonbanking firms, who could provide useful and effective input into operational, strategic and reputation risks. We recommend that only one member of the risk committee be required to have "risk management expertise" as that term is appropriately defined. We also recommend that only the chair of the risk management committee be required to be independent. Although an independent chair can help ensure that the committee is sufficiently independent of management and committed to compliance with its charter, the deliberations of the committee may be enhanced by management and other non-independent directors with a sound understanding of the risks facing the company.

- The chief risk officer should not be required to have "risk management expertise" as defined under the Proposed Risk Management Rules. Instead, management and the board should be able to determine what combination of skill, experience and education is appropriate for the chief risk officer given the company's culture, business, strategy and risk profile.

- The Proposed Risk Management Rules should not mandate dual reporting by the chief risk officer to the risk committee, or require the chief risk officer to report directly to the chief executive officer. Although we believe the chief risk officer should have clear access to, and regular meetings or contact with, the risk committee and chief executive officer, no single corporate governance model is appropriate for all organizations, and dual reporting would impair effective risk management by complicating the relationship between management and the board.

- The Proposed Risk Management Rules provide for the chief risk officer to provide direct oversight of a granular list of responsibilities and fail to acknowledge that the chief risk officer works with, and through, the individual business and staff functions in the company. These rules should instead be less granular in design and acknowledge the primary role of business units and corporate staff in risk management.

II. Functions of Risk Management Committee

A. The risk management committee should not be charged with operational responsibilities. It should be directed to approve risk management policies that are material to the enterprise-wide risk profile of the company and that are recommended by management and to hold management accountable for implementing the policies. Collectively, these policies would constitute the company's risk management framework.

The Proposed Risk Management Rules provide that the risk management committee should document, review and approve the company's enterprise-wide risk management practices.[6] The Proposed Risk Management Rules further provide that the committee shall oversee the operation of a risk management framework that is commensurate with the company's capital structure, risk profile,

[6] Section 252.126(c).

complexity, activities and size, and that this framework include: (i) risk limitations for each business line; (ii) policies and procedures for risk management governance, risk management practices, and risk control infrastructure; (iii) processes and systems for identifying and reporting on risks and risk management deficiencies; (iv) monitoring compliance with the company's risk limit structure and policies and procedures related to risk management governance, practices and risk controls; (v) effective and timely implementation of corrective actions to address risk management deficiencies; (vi) specification of management and employees' authority and independence to carry out risk management responsibilities; and (vii) integration of risk management control objectives in management goals and the company's compensation structure.[7]

This detailed mandate blurs the distinction between the oversight role of the board and board committees and the operational role of management. One of the fundamental features of corporate governance is the distinction and balance between the role of a company's Board of Directors and the company's management. It is generally recognized that the board is responsible for oversight of a company, and management is responsible for the day-to-day operations of the company. This distinction and balance is embedded in state law,[8] federal corporate law,[9] and international standards,[10] as well as prior guidance issued by the Federal Reserve.[11] It permits a board to stand above and apart from the day-to-day operations of the company and thereby bring a broader strategic and policy perspective, as well as independent judgment, to the company.

To preserve the appropriate distinction between the board and board committees and management, we recommend that Section 252.126(c) of the Proposed Risk Management Rules not require the committee to approve risk management "practices", including the features of the risk management framework listed in Sections 252.126(c)(1) – (7). The term "practices" may be interpreted to reach each and every activity that a company undertakes to identify, measure, monitor and control risk. Such a requirement would overwhelm the committee, and impair its ability to focus on the most important existing or emerging risks facing the company and "look at the big picture" from a more

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[7] Sections 252.126(c)(1)-(7).

[8] Delaware courts, for example, have equated a director's duties with a responsibility to exercise oversight of the company, and have found that directors cannot be held liable for a failure to exercise their duties absent "a sustained or systematic failure of the board to exercise oversight." *See In re Caremark International Inc. Derivative Litigation*, 698 A. 2d 959, 971 (Del. Ch. 1996). Also, in *Schoonejongen* v. *Curtiss-Wright Corp*., 143 F. 3d 120 (3rd Cir. 1998) the court noted that "[T]he ability to delegate is the essence of corporate management, as the law does not expect the board to fully immerse itself in the daily complexities of corporate operation."

[9] SEC Regulation S-K, Item 407(h) requires proxy statements to "disclose the extent of the board's role in the risk *oversight* of the registrant…" (emphasis added).

[10] "The board has overall responsibility for the bank, including approving and *overseeing* the implementation of the bank's … risk strategy…", Principles for Enhancing Corporate Governance, Basel Committee on Banking Supervision, October 2010, page 7 (emphasis added).

[11] "Boards of directors are responsible …for establishing clear *policies* regarding the management of key risks…", Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles, SR 08-8 (October 16, 2008) (emphasis added).

balanced perspective. Even a more limited interpretation, however, would still perpetuate a confusion between the responsibilities of the board and those of management.

We further recommend that the risk management committee be directed to approve only those risk management "policies" that are material to the enterprise-wide risk profile of the company that are developed by management. Collectively, these policies would constitute the company's risk management framework.

We believe that such policies should include the following:

- Policies governing the identification and control of emerging risks;
- Policies governing key risk parameters, tolerances and limitations;
- Policies governing the company's risk management governance structure;
- Policies governing risk compliance monitoring and corrective actions to address risk management deficiencies;
- Policies governing the authority and independence of employees engaged in risk management; and
- Policies governing the integration of risk management in the company's goals and compensation structure.[12]

In addition to the approval of these policies, the risk management committee should be expected effectively to challenge the recommendations of management and to hold management accountable for the implementation of the policies.

B. The governance provisions of the Proposed Liquidity Rules should not impose operational responsibilities on the board or the risk committee.

In addition to the overall risk management framework discussed above, the Proposed Liquidity Rules impose detailed liquidity risk management responsibilities on the board and/or the risk committee of the board. Examples of the types of specific responsibilities that would be imposed upon the board or the risk committee include: the board must establish liquidity risk tolerance annually, and must conduct a semi-annual review of the company's compliance; the risk committee or a subcommittee of the risk committee must review and approve liquidity costs, benefits and risks of each new business line and each significant product line; the risk committee or a subcommittee of the risk committee annually must review each significant business line and product for unanticipated liquidity risk; and the risk committee or a subcommittee of the risk committee must review data related to

[12] As noted below in Part III.A., the *Interagency Guidance on Sound Incentive Compensation Policies* provides that the board, itself, or a compensation committee of the board, should have primary responsibility for overseeing the incentive compensation framework for a covered company. Consistent with that guidance, we expect that in most circumstances the risk committee would seek to oversee the integration of risk management principles into the company's compensation framework through appropriate interactions with the full board or its compensation committee.

liquidity risk compliance. Some of these obligations go well beyond the oversight function of the board and a board committee. *See* Parts II.B and II.C of *Annex B* for a more complete discussion of our concerns with the governance provisions in the Proposed Liquidity Rules and our recommendations for addressing those concerns.

III. Structure of the Risk Management Committee

A. The Proposed Risk Management Rules should acknowledge a board's responsibility to allocate risk management oversight responsibilities to various committees. Otherwise, the rules could result in the duplication of risk management oversight functions and lead to less effective risk management.

The Proposed Risk Management Rules require the maintenance of an enterprise-wide risk committee by each publicly-traded BHC with more than $10 billion in assets, each BHC with more than $50 billion in assets, and each nonbank financial company designated for supervision by the Federal Reserve under the terms of Section 113 of Dodd-Frank.[13]

The Associations support the maintenance of a board committee that oversees enterprise-wide risk management. One committee of the board, working in coordination with other committees and the board, as a whole, should have the responsibility for looking at risk across the entire company. Section 252.126(a), however, may be interpreted to place sole responsibility for risk management within this committee. Effective risk management is not an isolated function within a particular board committee.

Effective risk management requires the oversight of the board and the involvement of various board committees. For example, where applicable, the credit committee of a board typically has responsibility for overseeing credit risk and the finance committee typically has responsibility for overseeing interest rate risk and liquidity risk. Additionally, audit committees of public companies have certain responsibilities related to risk management. The rules of the New York Stock Exchange require audit committees to address the company's policies on risk assessment and risk management.[14] Audit committees also may have primary responsibility for monitoring and overseeing risk associated with a covered company's consolidated financial statements and related internal controls (including those applicable under the Sarbanes-Oxley Act and the Federal Deposit Insurance Corporation Improvement Act of 1991). Furthermore, consistent with Federal Reserve guidance, compensation committees may have primary responsibility for overseeing risks associated with a covered company's incentive compensation arrangements.[15]

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[13] Section 252.126(a). For purposes of this requirement, the term "enterprise-wide risk committee" would be defined in Section 252.125(g) to mean a board committee that "oversees the risk management practices of such company's worldwide operations."

[14] NYSE Listing Company Manual Section 303A.07(b)(iii)(D). The commentary to this requirement reads, in part, as follows: "While it is the job of the CEO and senior management to assess and manage the listed company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company's major financial risk exposures and the steps management has taken to monitor and control such exposures."

[15] See *Interagency Guidance on Sound Incentive Compensation Policies*, 75 Fed. Reg. 36396, 36402 (June 25, 2010).

Given the important role various board committees may perform in the oversight of risk management, the Associations recommend that Section 252.126(a) not only direct a board to establish a risk committee that oversees risk on an enterprise-wide basis, but also acknowledge the board's authority to allocate the oversight of certain, specific risk management responsibilities to appropriate board committees. If the primary purpose of the enterprise-wide risk committee is to oversee enterprise-wide risk management practices of a company, then Section 256.126(a) should specifically permit the committee to aggregate information received from other board level committees addressing specific risks (e.g., the audit committee or credit committee).

Absent such a clarification, the risk management committee could be expected to duplicate risk management oversight functions performed by other board committees. Such a result would complicate the governance of risk management and could lead to less, not more, effective risk management. The enterprise wide-risk committee should, however, maintain appropriate lines of communication with other board committees that have primary responsibility for overseeing other material risks to the company. Those lines of communication should assist the risk committee, as well as other board committees with risk responsibilities, to assess the potential impact of the combination of, or inter-linkages between, risks under the primary oversight of separate committees.

Finally, in the Preamble, the Federal Reserve asks how it can ensure that the risk committee has sufficient resources to carry out its proposed oversight role.[16] We agree that effective risk management requires a combination of trained personnel and systems. We also believe, as discussed above, that the risk committee should be required to approve a policy on the company's risk management governance structure, and that policy could require the allocation of sufficient resources for the risk management function.

B. Covered companies should be given the flexibility to determine how to structure the enterprise-wide risk management committee.

The Proposed Risk Management Rules require that the risk committee maintained by BHCs with more than $50 billion in assets and nonbank financial companies supervised by the Federal Reserve not be housed within another board committee or be part of a joint committee.[17] In other words, large BHCs and nonbank financial companies supervised by the Federal Reserve must maintain "stand alone" risk management committees. This requirement places form over function.

The Board of Directors of large BHCs and nonbank financial companies subject to supervision by the Federal Reserve should be given sufficient flexibility to determine how to structure the enterprise-wide risk management committee based upon the company's business strategy and risk profile. In order to give companies this flexibility, we recommend that Section 252.126(b)(5)(i) be deleted. We note, moreover, that it is common practice for a risk committee at the holding company level to also serve as the risk committee for subsidiaries, such as subsidiary banks, where such a risk committee is needed. This practice can be quite helpful in assisting the risk committee of both the parent holding company and the subsidiary bank in understanding, monitoring and evaluating the risks facing the relevant organization, including the risks arising from the activities of affiliated entities. Holding company risk committees and subsidiary risk committees will often have overlapping

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[16] Preamble, Question 67.

[17] Section 252.126(b)(5)(i).

membership with meetings that are held simultaneously. We do not believe that proposed Section 252.126(b)(5)(i) was intended to prohibit the use of joint *risk* committees by a covered company and its significant subsidiaries and respectfully request that this be made clear in any final rule.

C. The board committee responsible for enterprise-wide risk management should be chaired by an independent director, but other members of the committee need not be independent.

The Proposed Risk Management Rules require that the board committee responsible for enterprise-wide risk management be chaired by an independent director.[18] For purposes of this requirement an independent director would be defined to mean an individual who: (i) is not an officer or employee of the company; (ii) has not been an officer or employee of the company during the preceding three years; (iii) is not an immediate family member of such an individual; and (iv) is classified as independent under SEC Regulation S-K, Item 407(a)(17 C.F.R. 229.407(a)).[19]

We support the requirement for an independent chair of the risk committee. An independent chairperson who sets the agenda for the committee and guides its deliberation can help to ensure that the committee is sufficiently independent of management and committed to compliance with the charter of the risk committee.

We also support the proposed definition of independence. The definition is consistent with existing SEC standards and is similar to the standard applicable to public companies listed on the New York Stock Exchange.[20] Consistency with these existing standards will enhance compliance and avoid confusion and conflict.

In the Preamble, the Federal Reserve asks if the regulation should include additional qualifications for independence,[21] and if more than one member of the enterprise-wide risk committee should be independent.[22] Given the consistency with other standards for independence, we see no need for the regulation to include additional qualifications for independence. Nor do we see a need to require additional members of the risk committee to be independent. Although many companies may choose to include more than one independent member, participation on the risk committee by management and other non-independent directors can enhance the deliberations of the committee because these individuals will have a sound understanding of the risks facing the company.

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[18] Section 252.126(b)(3).

[19] Section 252.125(i).

[20] New York Stock Exchange Listed Company Manual, Section 303A.02.

[21] Preamble, Question 61.

[22] Preamble, Question 62.

D. As applied to the risk committee, the definition of "risk management expertise" should be patterned after the SEC's definition of "audit committee financial expert". Also, only one member of the risk management committee should be required to have such expertise.

The Proposed Risk Management Rules require that at least one member of the risk committee have "risk management expertise" commensurate with "the company's capital structure, risk profile, complexity, activities, size, and other appropriate risk related factors."[23] For purposes of this requirement, risk management expertise would be defined as (i) an understanding of risk management principles and practices, and (ii) experience in developing and applying risk management practices and procedures, measuring and identifying risks, and monitoring and testing risk controls.[24]

In addition to this requirement, the Federal Reserve states in the Preamble that "a risk committee's members generally will have an understanding of risk management principles and practices… [and] should also have experience developing and applying risk management practices and procedures, measuring and identifying risks, and monitoring and testing risk controls…"[25] Also, in the Preamble, the Federal Reserve asks if it should specify minimum qualifications, including educational attainment and professional experience, for risk management expertise on a risk committee.

The Associations support a requirement for one member of the risk committee to have risk management expertise. It is not realistic, however, to require a risk expert to have experience in the "monitoring and testing" of risk controls. This language suggests that an individual must have experience with the compliance or audit function of a banking organization to qualify as having "risk management expertise". Such a requirement would be unduly limiting and could well prevent well qualified individuals with substantial risk management experience from performing the functions contemplated by the Proposed Risk Management Rules. Moreover, the practices related to the monitoring and testing of risk controls are still evolving and relatively few individuals have direct experience with such practices.

We also are concerned that, as proposed, Section 225.125(l) places an emphasis on risk management experience within a banking organization, as opposed to other types of organizations. Insurance companies, securities broker-dealers and other financial institutions are exposed to many of the same types of risk as covered companies, and individuals with substantial risk management experience at nonbank financial companies should not automatically be prejudged as lacking "risk management expertise". Indeed, individuals with such backgrounds would provide an informed, but less insular, management perspective to the committee's deliberations. This is also important given that banking organizations already have difficulty locating qualified individuals who are willing and able to serve on the board, particularly given limitations on having interlocking directors under the Federal Reserve's Regulation L and corporate fiduciary issues that may arise when a director serves on boards of banking organizations that compete in the same market. We note, moreover, that the "risk management expertise" of any individual (including an individual with experience with a nonbank

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[23] Section 252.126(b)(2).

[24] Section 252.125(l).

[25] 77 Fed. Reg. at 624 (Jan. 5, 2012).

financial company) would have to be commensurate with the company's capital structure, risk profile, complexity, activities, size and other appropriate risk related factors.[26]

Given these concerns, the Associations recommend that, for purposes of the risk management committee, the Federal Reserve replace the proposed definition of risk management expertise with a definition patterned after the SEC's definition of an "audit committee financial expert".[27] This would require that the "risk management expert" have an understanding of risk management, an ability to apply the principles of risk management, and experience in applying those principles. This approach also would acknowledge that such attributes could have been acquired through experience as a risk officer for an organization or within a business unit, experience supervising a risk officer, or experience overseeing overall risk management at a banking organization, depository institution, or other financial company.

Finally, we are quite concerned about the commentary in the Preamble, which suggests that all members of the risk committee have risk management expertise. Such a bias would exclude individuals who could bring an informed perspective on key risk issues to the committee. For example, individuals who have had senior operational and managerial roles with nonbanking firms could provide useful and effective input into operational, strategic, and reputation risks. We urge the Federal Reserve to acknowledge that a risk committee composed of a variety of individuals, with different operational and managerial experiences, can help the committee identify and address the various types of risks facing a company.

IV. Chief Risk Officer

A. Management and the board should have the authority to determine the qualifications of the chief risk officer.

The Proposed Risk Management Rules require the chief risk officer to have risk management expertise commensurate with the company's capital structure, risk profile, complexity, activities and size.[28] Also, the Federal Reserve has asked if it also should specify minimum qualifications for the chief risk officer.[29]

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[26] Section 252.126(b)(2).

[27] 17 C.F.R. 407(d)(5). An audit committee financial expert is a person who has: (i) an understanding of generally accepted accounting principles and financial statements, (ii) the ability to assess the general application of such principles in connection with accounting for estimates, accruals and reserves, (iii) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the company's financial statements, or experience actively supervising one or more persons engaged in such activities, (iv) an understanding of internal control over financial reporting, and (v) and understanding of audit committee functions. SEC Regulation S-K, 407(d) further specifies appropriate education and experience through which such attributes shall have been gained, such as experience as a principal financial or accounting officer or auditor, or experience actively supervising such a person or other relevant experience.

[28] Section 252.126(d)(1).

[29] Preamble, Question 68.

As noted above, we believe that the "risk management expertise" required of a member of the risk committee should be aligned with the SEC's definition of an "audit committee financial expert". In the case of the chief risk officer, however, we believe that management and the board should be able to determine what combination of skill, experience, and education is appropriate for the chief risk officer given the company's culture, business strategy and risk profile. Management and the board are in the best position to understand the company and decide what skill set is most appropriate for the company. We also disagree with the Federal Reserve's expectation, as expressed in the Preamble, that risk management skills gained in particular business line may not be appropriate for another business line or an organization engaged in a diverse set of activities.[30] Although the risks associated with different financial businesses may vary, the basic principles of risk management can be transferrable between different types of financial businesses and organizations, and somewhat varied experience can often introduce additional helpful objectivity into an organization's risk management process. Accordingly, we recommend that Section 225.126(d)(1) be revised to delete the reference to "risk management expertise", and that no minimum qualifications be specified for the chief risk officer, other than that the individual's qualifications are commensurate with the company's capital structure, risk profile, complexity, activities, and other risk-related factors.

If the Federal Reserve does not adopt this recommendation, then, at a minimum, the definition of risk management expertise, as applied to the chief risk officer, should be modified to remove the requirement that such expertise include "monitoring and testing risk controls" and should acknowledge that individuals with risk management experience at nonbank financial companies may have "risk management expertise". As discussed above, those standards would place unnecessary and overly prescriptive limits on the pool of individuals who have "risk management expertise".

B. The chief risk officer should not be subject to a mandatory dual reporting requirement or required to report directly to the chief executive officer.

The Proposed Risk Management Rules require that the chief risk officer report directly to both the risk committee of the board and the chief executive officer of the company.[31] Close interaction and full and frank communication between the chief risk officer and the risk committee is important for effective risk management. We do not believe, however, that it is appropriate for the Proposed Risk Management Rules to mandate that the chief risk officer be subject to a dual reporting requirement to the risk committee. Dual reporting would have the effect of separating the chief risk officer from a company's senior management team and complicate the relationship between management and the board. As such, it would have the unintended consequence of impairing, rather than enhancing, risk management. We believe that the objectives of the Proposed Risk Management Rules would be better achieved by providing that the risk management governance policies of a covered company require the chief risk officer to have clear access to the risk committee and meet with the committee on a regular basis, including, as appropriate, in executive sessions with the committee.

We also acknowledge that the chief risk officer should be part of the senior management team for a company. However, we believe that the Proposed Risk Management Rules should not require that the chief risk officer report directly to the chief executive officer. The chief risk officer should have clear access and regular contact with the chief executive officer, but no single

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[30] 71 Fed. Reg. at 625.

[31] Section 252.126(d)(3).

corporate governance model is appropriate for all organizations. We recommend that individual companies be given sufficient flexibility to establish reporting arrangements based upon their business strategies and risk profiles.

C. The Proposed Risk Management Rules should acknowledge the role of business units and corporate staff in risk management.

The Proposed Risk Management Rules provide that the chief risk officer would oversee "directly" the following responsibilities on an enterprise-wide basis: (i) allocating delegated risk limits and monitoring compliance with such limits; (ii) implementation of, and ongoing compliance with, policies and procedures related to risk management governance, practices, and risk controls as well as monitoring compliance with such policies and procedures; (iii) developing appropriate processes and systems for identifying and reporting risks and risk management deficiencies, including emerging risks, on an enterprise-wide basis; (iv) managing risk exposures and risk controls within the parameter of the company's risk control framework; (v) monitoring and testing the company's risk controls; (vi) reporting risk management deficiencies and emerging risks to the enterprise-wide risk committee; and (vii) ensuring that risk management deficiencies are effectively resolved in a timely manner.[32]

This list of responsibilities includes matters not appropriately assigned to risk managers. Specifically, the development of processes and systems for identifying and reporting risks is often a function of information technology groups (with appropriate input from other areas), and the monitoring and testing of the company's risk controls is a function of the audit or finance group. These are important functions, but are more properly managed by other parts of an organization.

Additionally, the requirement that the chief risk officer "directly" oversee these functions fails to acknowledge that the chief risk officer works with, and through, the individual business units and staff functions in the company. Individual business units within a company have a primary role in managing risks in their businesses, including identifying risks, setting risk limitations, and monitoring risk exposures. It is the business units that are most closely involved in the day-to-day operations of the lines of business, and must translate risk management policies into operational practices and procedures. The chief risk officer should have a sufficient degree of autonomy from the business units, but have sufficient seniority within the company to oversee the decisions of the business units and be able effectively to challenge risk decisions that affect the business units.

Given the foregoing concerns, the Associations recommend that Section 252.126(d)(4) be revised to be more general in design, yet comprehensive in nature. Specifically, we recommend that the chief risk officer be required to perform the following duties:

- Oversee the development of the risk management policies that constitute the company's risk management framework;
- Guide senior management in their risk management responsibilities;
- Bring a risk-focused perspective to strategic planning, including the identification of emerging risks;

[32] Sections 252.126(d)(4)(i)-(vii).

- Provide central oversight of the company's risk management organization and risk management functions;
- Review and have input upon the risk management functions of the business units and staff functions; and
- Report, as appropriate, to the company's board and risk committee.

V. The Relationship Between the Proposed Risk Management Rules and Other Standards

A. The Proposed Risk Management Rules should be harmonized with risk management standards imposed by other financial regulators.

The Associations recognize that the risk management standards required under Section 165 of Dodd-Frank must be more stringent than the standards applicable to nonbank financial companies and BHCs that are not subject to Section 165. Subsidiaries and affiliates of a covered company, however, may be subject to standards imposed by other regulators. For example, the OCC imposes extensive risk management standards on a national bank that may be the largest subsidiary within a BHC structure.[33] Therefore, we urge the Federal Reserve to harmonize, and avoid conflict, with risk management standards imposed by other financial regulators.

B. The Federal Reserve and other financial regulators should avoid the imposition of the enhanced risk management standards to smaller institutions that are not subject to the Proposed Risk Management Rules.

As noted above, the prudential standards required under Section 165 of Dodd-Frank are intended to be more stringent than the standards applicable to institutions that pose little, if any, risk to the financial stability of the United States. We urge the Federal Reserve, and other financial regulators, to be mindful of this statutory distinction and not impose these more stringent standards on smaller institutions that are not covered by the Proposed Risk Management Rules. Smaller institutions, by their very nature, have more streamlined and simpler governance structures than large institutions, and should not be held to the same standards as large institutions.

VI. Early Remediation

One of the proposed triggers for early remediation is a company's "compliance" with the enhanced risk management and risk committee requirements outlined above.[34] In the earlier parts of this Annex and *Annex B* we have recommended some changes to the Proposed Risk Management Rules and the Proposed Liquidity Rules to clarify the role and responsibilities of the board, the risk

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[33] *See* Comptroller's Handbook for Large Bank Supervision, January 2010.

[34] A company may be subject to Level 1 early remediation if it exhibits "weakness" in meeting the enhanced risk management and risk committee requirements. Level 2 early remediation may be required if a company demonstrates "multiple deficiencies" in meeting the enhanced risk management and risk committee requirements. Finally, Level 3 early remediation may be triggered if a company is in "substantial noncompliance" with the enhanced risk management and risk committee requirements.

committee, and senior management (including the chief risk officer). Those changes not only would enhance compliance with the rules, but also should facilitate supervisory review of compliance.

Nonetheless, we are concerned that an assessment of a firm's compliance with risk management requirements could be quite subjective, and this could present significant problems for a company under the Proposed Early Remediation Rules.

To address that concern, we recommend, in *Annex F*, that the Federal Reserve establish a materiality threshold for the application of risk management compliance in connection with the Proposed Early Remediation Rules. Such a threshold would ensure that immaterial non-compliance with the risk management standards is not a basis for early remediation.

VII. Responses to Specific Questions.

We have set forth below responses to, or cross-references to discussions in this *Annex D* of, certain specific questions raised by the Federal Reserve with respect to the Proposed Risk Management Rules.[35]

Question 61 *Should the Federal Reserve consider specifying by regulation additional qualifications for director independence? If so, what factors should the Federal Reserve consider in establishing these qualifications?*

See our comments in Part III.C.

Question 62. *Would it be appropriate for the Federal Reserve to require the membership of a risk committee to include more than one independent director under certain circumstances? If so, what factors should the Federal Reserve consider in establishing these requirements?*

See our comments in Part III.C.

Question 63. *Should the Federal Reserve consider specifying by regulation the minimum qualifications, including educational attainment and professional experience, for risk management expertise on a risk committee?*

See our comments in Part III.D.

Question 64. *What alternatives to the requirements for the structure of the risk committee and related requirements should the Federal Reserve consider?*

See our comments in Part III.A – D.

Question 65. *What is the appropriate role of the members of the risk committee in overseeing enterprise-wide risk management practices at the company and is that role effectively addressed by this proposal?*

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[35] As noted in footnote 6 to the Comment Letter, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies.

See our comments in Parts II.A and III.A – B.

Question 66. *Is the scope of review of enterprise-wide risk management that this proposal would require appropriate for a committee of the board of directors? Why or why not?*

See our comments in Parts II.A and III.A – B.

Question 67. *How can the Federal Reserve ensure that risk committees at companies have sufficient resources to effectively carry out the oversight role described in this proposal?*

See our comments in Part III.A.

Question 68. *Should the Federal Reserve consider specifying by regulation the minimum qualifications, including educational attainment and professional experience, for a CRO? If so, what type of additional experience or education is generally expected in the industry for positions of this importance?*

See our comments in Part IV.A.

Proposed Stress Test Rules (Subparts F and G) – Supervisory and Company-Run Stress Test Requirements[1]

As evidenced by the Supervisory Capital Assessment Program ("**SCAP**") and the subsequent Comprehensive Capital Analysis and Review ("**CCAR**") process, the Associations agree that credible and robust stress tests can be invaluable tools for capital planning, provide important information to market participants and serve to enhance the stability of the financial system as a whole.

Nevertheless, we have a number of concerns and recommendations regarding certain aspects of the NPR's implementation of the stress test requirements of Section 165(i) of Dodd-Frank. Our comments are centered around four main areas: (i) aspects of the stress test process itself, including the need for greater transparency into the Federal Reserve's models for implementing the supervisory stress tests and more comprehensive guidance with respect to exactly what standards will be used to analyze the company-run stress tests; (ii) the content and scope of stress test results disclosure; (iii) the need for coordination among the multiple and overlapping stress test requirements applicable at multiple levels within the same consolidated banking organization pursuant to the Proposed Stress Test Rules and the concurrent OCC[2] and FDIC[3] proposed stress test regulations; and (iv) the importance of consistency in the probability and severity of the supervisory stress scenarios in light of the interplay between annual supervisory stress tests and the Federal Reserve's capital plan guidance creating an effective minimum capital requirement that can change from year to year as the stress test scenarios change.

Part I of this *Annex E* summarizes our comments on the Proposed Stress Test Rules in an Executive Summary; Part II focuses on the stress test process and our recommendations with respect thereto; Part III sets forth our thoughts and suggestions concerning the disclosure of stress test results; Part IV centers around the need for coordination among overlapping stress test requirements and the Federal banking agencies to avoid burdensome duplication; Part V addresses certain aspects of the interplay between annual supervisory stress test results and related capital requirements; Part VI sets forth our requests for clarification concerning certain aspects of the Proposed Stress Test Rules; and Part VII references our responses to certain of the specific questions posed in the Preamble to the NPR.

I. Executive Summary

As detailed further below, the Associations strongly believe that:

- The design of the supervisory models, techniques and underlying assumptions to be used as part of the stress test process should be transparent and subject to public consultation and input

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1 Capitalized terms used in this Annex and not otherwise defined are used with the meanings assigned to them in the Comment Letter to which this Annex is attached.

2 OCC's *Annual Stress Test Notice of Proposed Rulemaking*, 77 Fed. Reg. 3408 (Jan. 24, 2012) (the "**OCC Stress Test NPR**", and the proposed rules set forth in the OCC Stress Test NPR, the "**Proposed OCC Stress Test Rules**")

3 FDIC's *Annual Stress Test Notice of Proposed Rulemaking*, 77 Fed. Reg. 3166 (Jan. 23, 2012) (the "**FDIC Stress Test NPR**" and the proposed rules set forth in the FDIC Stress Test NPR, the "**Proposed FDIC Stress Test Rules**").

before adoption and implementation for purposes of the Proposed Stress Test Rules. This will avoid prolonged "blackout" periods for equity offerings.

- The Federal banking agencies should work collectively effectively to minimize the duplicative burden of the multiple and overlapping stress test requirements of the Proposed Stress Test Rules and the OCC's and FDIC's respective stress test rules, including by consistently using the same supervisory stress test scenarios and models for purposes of the supervisory and the company-run stress tests and formulating common inter-agency information reporting requirements.

- The CCAR 2012 disclosure template should generally be used for disclosure of both supervisory and company-run stress tests under Section 165(i) of Dodd-Frank and the Federal banking agencies' respective proposed stress test rules, at least for covered companies with consolidated assets of $50 billion or more.

- Under no circumstances should the Federal Reserve disclose, or should covered companies be required to disclose, base case stress test results or other information that could be used effectively to reverse-engineer earnings guidance or other quarter-by-quarter results under either the supervisory or company-run stress test requirements of the Proposed Stress Test Rules.

- Publication of summary results under the adverse scenario (as opposed to the severely adverse scenario) should not be required, except in situations where the covered company's results under the severely adverse scenario indicate it would fail to meet the 5% minimum common equity requirement, for purposes of either the annual supervisory and company-run and mid-year company-run stress tests.

- The company-run stress tests to be performed under the Proposed Stress Test Rules should be deemed to fully satisfy the separate stress test requirement of the Capital Plan Rule in order to minimize further potential inconsistencies and duplicative burdens on covered companies.

- In order to ameliorate the negative effects of what in reality is a variable or floating minimum capital requirement created by the interaction of the Proposed Stress Test Rules and the Capital Plan Rule, the Federal Reserve and the other banking agencies should adopt a uniform approach for identifying supervisory stress scenarios (which would apply absent exigent circumstances) so that changes from year to year do not unnecessarily make floating capital requirements more volatile than they otherwise need be. An example would be using consistent severity and minimum probability of occurrence benchmarks.

- The completion of stress testing and related supervisory evaluation process should not hinder or otherwise delay covered companies' ability to take necessary strategic capital actions not otherwise set forth in previously approved capital plans.

II. Concerns and Recommendations Regarding the Stress Test Process

A. The design of the models used as part of the stress test process should be transparent and subject to an appropriate public consultative process.

1. Well in advance of implementation by the Federal Reserve, there should be greater transparency into the details and mechanics of the models to be used in conducting the annual supervisory stress tests and evaluation of banks' proposed capital plans.

The macro-economic assumptions of the supervisory stress scenarios required by Section 165(i) of Dodd-Frank and the Proposed Stress Test Rules are but one component of the stress test process.[4] Equally important are the models, methodologies, techniques and underlying assumptions the Federal Reserve will use to calculate each covered company's "projected losses, revenues and other factors affecting capital"[5] when applying the stress scenarios to a particular covered company's portfolio and planned capital actions. The results of the supervisory stress test are important for several reasons, not in the least for purposes of the Capital Plan Rule and the effective 5% floating capital requirement discussed in Part V below. As such, we believe it is crucial that covered companies possess the requisite information to understand fully the models and their underlying assumptions and methodologies by which the Federal Reserve will conduct the supervisory stress tests and any weaknesses and limitations inherent in such models (particularly as applied to the idiosyncratic business and risks of an individual covered company) well in advance of the next round of supervisory stress tests and capital plan reviews. Banks' understanding of the Federal Reserve's modeling assumptions (e.g., how the hypothetical timing of credit losses and magnitude assumptions regarding operational risk factors such as mortgage securitization put-back liabilities) is quite important not only in the stress testing context, but, perhaps more fundamentally, in how banks consider and develop their capital plans pursuant to the Capital Plan Rule. The more transparent the Federal Reserve and other agencies are in describing and disclosing the methodologies and assumptions underlying the models they use for supervisory stress tests, the more effective they will be in their supervision of capital adequacy.

The absence of this information places substantial strain on publicly-traded BHCs seeking to sell common equity securities during the stress test process. BHCs may find it difficult to market common stock at a time when the company's capacity to pay dividends is subject to key unknown factors. In effect, this could create a multi-month blackout period, which could have a pro-cyclical impact in times of high market volatility.

A substantial number of the covered companies that were subject to the CCAR 2012 process felt that they lacked sufficient information concerning the supervisory models and methodologies to fully understand, analyze and reconcile the Federal Reserve's results, which, in certain instances were materially different from those generated by the banks' models under the same supervisory scenario. Such differences in results are by necessity a result of the Federal Reserve and covered companies applying different models and assumptions to the same macro-economic scenarios. We strongly believe that the lack of adequate transparency into the supervisory models will have

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[4] 77 Fed. Reg. at 629.

[5] *Id*.

negative on-going consequences for covered companies' capital planning and stress testing processes as banks will be unable to predict with any degree of accuracy how the Federal Reserve will model the banks' losses under the specific stress scenarios. Simply put, covered companies will not be able to engage in effective capital planning if the models and methods employed in supervisory stress testing remain an opaque "black box". We do not believe it is appropriate for covered companies' capital planning and distribution decisions to be governed by models and methodologies that have never been subject to any prior review and input by them.

Moreover, because Section 165(i) mandates "summary" disclosure of company-run stress test results (*see* Part III below), without an understanding of the models and underlying assumptions used by the Federal Reserve, covered companies will find it challenging to explain differences in their own stress test results and those run by the Federal Reserve. The largely inexplicable disclosure of these differences would only serve to heighten the "black box" effect and lead to market confusion concerning annual (and even semi-annual) stress test results.

We strongly disagree with any suggestion that transparency into the supervisory models and their underlying assumptions would somehow enable banks to "game" the system or otherwise lead to turning the capital planning and stress testing processes into mechanical compliance exercises as opposed to encouraging covered companies to develop and improve their own risk management and capital planning functions. The Proposed Stress Test Rules require company-run stress tests the results of which will be reviewed by the Federal banking regulators. We believe that the company-run stress test process is the proper supervisory forum for ensuring that the Capital Plan Rules and the Proposed Stress Test rules encourage and result in enhanced risk management and capital planning processes by covered companies. The Federal Reserve and the other Federal banking agencies already possess a wide array of tools as part of their examination and supervisory powers to ensure that this will indeed be the case. As a policy matter, the reason for banks to "fail" the stress tests and therefore face objections to their proposed capital distributions should be because they do not have sufficient capital, not because they do not understand the Federal Reserve's models and underlying assumptions. It is simply unfair to ask a bank to pass a test – and manage towards the standards of that test – if the parameters are largely unknown or otherwise opaque. Doing so is functionally similar to establishing a minimum risk-based capital ratio, but then not publishing the rules explaining how banks are to calculate their risk-based assets for complying with the ratio.

Although the Associations commend the Federal Reserve's publication of the CCAR 2012 supervisory methodologies "frequently asked questions" document[6] and the announcement of the formation of the Model Validation Council as well as the up-coming stress testing best practices symposium,[7] we continue to strongly urge that the Federal Reserve provide full and detailed explanations of methodologies, models, techniques and underlying assumptions the Federal Reserve will use well in advance of the next round of supervisory stress tests and capital plan reviews. In this regard, we respectfully submit that the Federal Reserve should provide much more detailed and specific guidance concerning its models and related methodologies than was previously published in connection

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[6] Federal Reserve, "*Frequently Asked Questions: Supervisory Methodologies in CCAR 2012"* (Apr. 20, 2012) ("**CCAR 2012 Supervisory Methodologies FAQs**").

[7] Press Release, Federal Reserve, *Fed announces stress test advisory council, publishes FAQs on CCAR 2012* (Apr. 20, 2012).

with the results of CCAR 2012.[8] Aspects of CCAR 2012 stress testing methodology related information published heretofore by the Federal Reserve have been useful and instructive, but the models themselves continue to be described only in fairly general terms, with important methodological particulars being left open or vague. It is this continued lack of meaningful detail and specificity that furthers the problematic supervisory stress testing "black box". To the extent that such disclosure would involve details and other information that the Federal Reserve believes would constitute confidential supervisory information that would not be appropriate for public disclosure, we believe such details could nevertheless be provided on a confidential basis by the Federal Reserve to covered companies as part of the normal supervisory process. Such information would be subject to the strong protections already provided by the Federal Reserve's rules on disclosure of confidential supervisory information.[9] Although such information may have some value after completion of the supervisory stress tests, we believe only detailed prior disclosure will be effective in eliminating the "black box" aspects of the supervisory stress tests.

2. The Federal Reserve should engage in an appropriate public consultative process and be open to input in the design of the models to be used for purposes of the supervisory stress tests and the Capital Plan Rule.

The design of models to predict losses and timing of losses on a wide variety of loan portfolios, including mortgages, home equity lines of credit, commercial and industrial loans. commercial real estate, and credit card and other consumer loans, provisions, revenue, losses and timing of losses on securities portfolios, and trading losses given particular macro-economic scenarios is an inherently difficult process, where there can be more than ample room for reasonable disagreement concerning assumptions, techniques, and methodologies. There is a similar range of views as to both the potential and timing of operational losses, such as litigation. The Associations respectfully request that, before implementing or materially modifying a particular set of models for purposes of the supervisory stress tests and the Capital Plan Rule, the Federal Reserve should provide a detailed description of the models in the form of consultative "white papers", and give covered companies and other appropriate parties an opportunity to provide their views concerning the mechanics of such models either directly or through normal supervisory channels. While the recently announced Model Validation Council and the stress testing best practices symposium are first steps, we believe that the foregoing recommended public consultative process would be most constructive if conducted with the benefit of banks having the opportunity to first preview and analyze the detailed information concerning the models set forth for such purposes in such "white paper" and thereby making the supervisory stress test and Capital Plan Rule processes more effective and enhancing their utility from a supervisory perspective. As appropriate, these consultative "white papers" could supplement more granular information provided covered companies through the supervisory process to facilitate their actual stress testing and capital planning activities.

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[8] *See* CCAR 2012 Supervisory Methodologies FAQs; *see also* Federal Reserve, *Comprehensive Capital Analysis and Review 2012: Methodology and Results for Stress Scenario Projections* (March 13, 2012). Aspects of this publication were useful and instructive, but the models used in CCAR 2012 themselves are not disclosed or described, except in the most general terms.

[9] *See* 12 C.F.R. § 261.20(g).

B. The Federal banking agencies should provide more comprehensive guidance with respect to the standards by which the company-run stress tests will be analyzed.

The Associations recognize that the Preamble and the Proposed Stress Test Rules do provide some specific information concerning timing and other concrete process mechanics, as well as some level of guidance with respect to the methods and standards by which the Federal Reserve and the other banking agencies will evaluate the company-run stress tests.[10] Such guidance is, however, general in nature and, in certain instances, is at a fairly high level of abstraction. The guidance that has been provided heretofore lacks specificity as to how exactly and under what specific standards the Federal Reserve and other banking agencies intend to review the results of company-run stress tests, including whether the Federal banking agencies plan to use the supervisory stress models to examine the mid-year company-run stress tests.[11] We believe that the Federal banking agencies should provide to covered companies, either formally through the relevant adopting releases or more informally through the supervisory and examination process, additional guidance concerning, among other things, the standard of review and analysis process with respect to the company-run stress tests prior to implementation of such rules pursuant to Section 165(i) of Dodd-Frank. The Associations believe such additional guidance will be crucial to enable covered companies to better implement the company-run stress test process by aligning their processes and procedures to regulatory expectations.

C. The completion of the stress testing and related supervisory evaluation process should not hinder or delay covered companies' ability to take necessary strategic capital actions not otherwise set forth in previously approved capital plans.

In connection with CCAR 2012 at least, the Federal Reserve appears to have taken the informal position that a covered company may not seek to change its outstanding capital plan, including with respect to dividends and stock buy-backs, throughout the stress test process. This could prove problematic since, pursuant to the Proposed Stress Test Rules, the annual supervisory stress test process potentially runs from mid-November to early April of the next year.[12] The annual company-run stress test process has a similar time line.[13] In addition, there is also the mid-year company-run stress test process which would run effectively from mid-May to mid-October of each year for over $50 billion covered companies.[14] The inability of covered companies to respond, with any degree of promptness and for prolonged periods of time, to changes in market conditions will unnecessarily restrict timely and otherwise proper strategic decisions. Thus, the Associations believe that covered companies should, subject to proper prudential regulatory consultation, be able to take capital actions not otherwise contemplated or approved in a previous capital plan and related stress test process in response to changing market conditions or other opportunities during periods in which stress testing is otherwise pending.

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[10] *See,* e.g., 77 Fed. Reg. at 627-629.

[11] *See,* e.g., 77 Fed. Reg. at 632.

[12] 77 Fed. Reg. at 627-628.

[13] *Id*. at 631.

[14] *Id.*

D. The Federal banking agencies should provide the supervisory stress test scenarios and model related information by October 15 of each year.

Covered companies will be required to submit the results of their company-run stress tests to the Federal banking agencies by January 5 of each year.[15] Similarly, covered companies subject to the Capital Plan Rule must submit their capital plans, taking into account stress test results under the supervisory scenarios as discussed above, by January 5 of each year.[16] Assuming publication of the stress scenarios by mid-November as set forth in the Preamble, covered companies will have only approximately six weeks to complete a great amount of work in respect of the stress testing and capital planning processes during the same period which also overlaps with normal year end and financial closing activities and the seasonal holidays. Moreover, as the CCAR 2012 process demonstrated, there may be an initial period when the relevant scenarios have been released, but where covered companies and the Federal banking agencies must work together to clarify ambiguities in the supervisory scenarios, thus effectively decreasing the time to actually perform the required stress testing and capital planning under the Proposed Stress Test Rules and the Capital Plan Rule, respectively. In light of the foregoing, we respectfully urge that the supervisory stress scenarios and the model and underlying assumption related information requested in Part II.A.1 above be provided not later than October 15 of each year in order to give covered companies the necessary time to complete the substantial amount of work involved without undue burden. This time frame for release of the supervisory stress scenarios is consistent with the time frame proposed by the OCC in its stress test rule.[17]

E. The Proposed Stress Test Rules should include a formalized "reconsideration"-type process through which covered companies can raise any concerns they may have regarding the results of the supervisory stress tests and the evaluation of the company-run stress tests prior to the publication of stress test results.

The supervisory and company-run stress tests are, by their very nature, highly complex undertakings, the results of which will be dependent on numerous assumptions and other factors. Thus, there will be the potential of legitimate and reasonable disagreement between a covered company and the Federal banking agencies concerning the results of the supervisory stress test. The Associations believe that the Proposed Stress Test Rules should include a more formalized "reconsideration"-type process through which covered companies can raise any concerns they may have in a timely manner prior to the publication of stress test results. The publication of potentially erroneous stress test results could quickly lead to situations where market perceptions trump reality and investors unfairly punish the applicable covered company. Such negative capital markets consequences may not be fully ameliorated by the publication of an after-the-fact correction. We respectfully submit that a "reconsideration" process would also serve to increase the reliability of stress test results and evaluation process by allowing for a safety-valve in the case of specific situations which may not otherwise fit within the normal parameters of the process, or more prosaically, to simply correct mathematical or other errors. A more formalized "reconsideration" system, as opposed to informal regulatory discussions, will provide more certainty and ensure that any disagreements between covered

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[15] Section 252.146(a).

[16] 12 C.F.R. 225.8(d)(1)(ii).

[17] *See* OCC Stress Test NPR, 77 Fed. Reg. at 3411.

companies, regardless of size, are resolved promptly and efficiently. Such reconsideration process should be based on the procedures set forth in Section 225.8(e)(3) of the Capital Plan Rule.[18]

F. The effectiveness of the company-run stress test rule for covered companies with assets over $10 billion but below $50 billion should be moved to 2014.

Under the Proposed Stress Test Rules, the company-run stress test requirements would be immediately applicable to all covered companies and over $10 billion covered companies.[19] While many over $50 billion covered companies previously participated in SCAP and CCAR, covered companies with over $10 billion but less than $50 billion in consolidated assets will need to develop internal processes and procedures, hire or repurpose staff and expertise, and develop appropriate systems, in each case, in order to be able to fully comply with the requirements of the Proposed Stress Test Rules. Assuming that a final rule will be promulgated in the second quarter of 2012, such entities will only have approximately four-and-a-half months to prepare for the arrival of the supervisory stress scenarios for the annual company-run stress tests for 2013. We believe this timing will be unduly burdensome and will not give such institutions adequate time to properly implement their preparations in order to run the required stress tests since these institutions are, by definition, smaller in size and lack prior experience with SCAP and CCAR and therefore have less readily available resources to dedicate to fulfilling the mandate of Section 165(i) of Dodd-Frank absent prior experience with SCAP and CCAR. The Associations respectfully urge the Federal banking agencies to move the effective date of the Proposed Stress Test Rules for covered companies between $10 and $50 billion in assets to January 5, 2014.

G. The effectiveness of the mid-year company-run stress test should be moved to 2013.

The comment period for the Proposed Rules ends on April 30, 2012. Even assuming, *arguendo*, a relatively brief period between the end of the comment period and the adoption and publication in the Federal Register of the final stress test rules, there will be very little time for covered companies subject to the mid-year company-run stress test to develop the required company-generated scenarios, conduct the stress test and submit results by July 5 of this year. The Associations believe that the supervisory goals of the mid-year company-run stress tests would be better served by moving the effectiveness of the implementation of this requirement until July 5, 2013 in order for subject covered companies to have sufficient time to be well prepared to run such stress tests and thereby deliver a better product for evaluation by the Federal banking agencies.

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[18] We do not believe the 12 C.F.R. §225.8(e)(3) process (which contemplates reconsideration within 10 days *after* Federal Reserve objection to a proposed capital plan) is an adequate remedy because, as discussed above, the mere publication of potentially erroneous stress test results could in and of itself be harmful to the covered company.

[19] Section 252.141(a)(2).

III. Disclosure of Stress Test Results

A. The CCAR 2012 disclosure template should be used for disclosure of the results of the severely adverse scenario for purposes of both supervisory and company-run stress tests under Section 165(i) of Dodd-Frank and the Proposed Stress Test Rules at least for covered companies with consolidated assets of $50 billion or more.

The Associations agree that the form and content of the CCAR 2012 disclosures "have struck about the right balance between providing useful information to investors, counterparties and the public, on the one hand, and protecting proprietary information the release of which might result in competitive harm to firms, on the other," [20] by ensuring that disclosure of stress test results does not result in effectively providing earnings guidance concerning base case scenarios or other information that would enable reverse-engineering of base case or quarter-by-quarter results. Furthermore, the CCAR 2012 disclosure template is consistent with the Sections 165(i)(1) and (2) respective requirements of publication of only a "summary of the results" of the stress tests required thereunder. As such, we strongly urge that the Federal banking agencies generally adopt the template used in reporting the CCAR 2012 results for purposes of publication of both the results of supervisory stress tests conducted by the Federal Reserve and the annual and semi-annual stress tests conducted by covered companies with consolidated assets of $50 billion or more – e.g., publication of the results of only the "severely adverse" supervisory scenario for the annual supervisory and company-run stress tests and the company-generated "severely adverse" scenario for the mid-year company–run stress test, as applicable.

More particularly, under no circumstances should the Federal Reserve disclose, or should covered companies be required to disclose, base case stress test results or other information that could be used to effectively reverse-engineer earnings guidance or other quarter-by-quarter results under either the supervisory or company-run stress test requirements of the Proposed Stress Test Rules. To do otherwise would be the equivalent of requiring covered companies to frequently provide earnings guidance and detailed profit and loss forecasts for the following nine quarters and would create significant and unnecessary risks for banks and the banking sector. Differences between actual results and the expectations set forth in any baseline disclosures could create significant and unnecessary risks to the safety and soundness of banks and potentially lead to exposure to other liabilities under the securities laws or otherwise. Such disclosures could become "checklists", and covered companies that failed to deliver short-term results consistent with the "checklists" could face significant volatility, spiraling negative perceptions and sentiment among investors and customers and the sudden loss of liquidity from a loss of confidence among depositors and counterparties. From a safety and soundness perspective, these required disclosures would likely incentivize covered companies to prioritize the achievement of short-term results to meet "checklist" expectations over more appropriate longer-term risk management and sustained long-term results. In light of the foregoing, we strongly urge the Federal Reserve and the other Federal banking agencies to avoid expanding the successful disclosure template of CCAR 2012 for purposes of the Proposed Stress Test Rules.

Publication of summary results under the adverse scenario (as opposed to the severely adverse scenario) should not be made or required to be made, except in situations where the covered

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[20] *See* Governor Daniel K. Tarullo, Remarks to the Federal Reserve Bank of Chicago Annual Risk Conference: Developing Tools for Dynamic Capital Supervision, at 9 (Apr. 10, 2012) (*transcript available at* http://www.federalreserve.gov/newsevents/speech/tarullo20120410a.pdf).

company's results under the severely adverse scenario indicates it would fail to meet the 5% minimum common equity requirement, for purposes of either the annual supervisory and company-run and mid-year company-run stress tests. As a general matter, the publication of the adverse scenario would not provide any useful additional information for market participants since, by definition, the severely adverse scenario subsumes the merely adverse scenario. However, publication of the results under the adverse scenario where an institution fails the severely adverse scenario would be beneficial in revealing additional information concerning the ability of the subject institution to withstand negative economic circumstance that could be useful to market participants and enhance the stability of the financial system more broadly.

In addition to the data set forth in the CCAR 2012 template, we support the requirement for covered companies to disclose a high-level description of the scenarios used and their key variables (for the mid-year company-run stress tests), as well as a general description of the models and methodologies used to generate the stress test results for the company-run stress tests.[21] However, consistent with the CCAR 2012 template, we do not believe quarter-by-quarter data disclosure over the planning horizon pursuant to Section 252.148(b)(4) of the Proposed Stress Test Rules is justified or would serve any particular purpose since the aggregate losses, provisions and capital levels (and the lowest period results) are the relevant data points for market participants in order to determine an institution's relative strength in the face of the severely adverse stress scenario.

IV. Coordination Among Multiple Overlapping Stress Test Requirements and Regulatory Agencies

A. The Federal banking agencies should work collectively to effectively minimize the duplicative burden of these multiple and overlapping stress test requirements on BHCs and subsidiary depository institutions.

Under Section 165(i)(1) of Dodd-Frank and the Proposed Stress Test Rules, BHCs with over $50 billion in assets are subject to the supervisory stress test. Pursuant to Section 165(i)(2) and the Proposed Stress Test Rules,[22] BHCs with over $10 billion in assets are required to conduct company-run stress tests; the mid-year company-run stress tests are applicable only to the over $50 billion covered companies. The company-run stress test requirement is also separately applicable to depository institutions having over $10 billion in assets, whether national banks, state member banks or state non-member banks.[23] With respect to depository institutions, the Federal Reserve would supervise company-run stress tests for state member banks under the Proposed Stress Test Rules, the OCC would supervise stress test under its own proposed rule pursuant to Section 165(i)(2) of Dodd-Frank for national banks, and the FDIC would do so for state non-member banks.[24] Over $50 billion BHCs are also subject to the technically separate stress test requirements under the Capital Plan Rules.

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[21] Sections 252.148(b)(1)-(3).

[22] The stress requirements are also applicable to nonbank financial companies supervised by the Federal Reserve.

[23] Sections 252.141, 142.

[24] Proposed OCC Stress Test Rules, Section 46.3; Proposed FDIC Stress Test Rules, Section 325.203.

Proposed Stress Test Rules

When these various statutory and regulatory requirements are aggregated, an institution consisting on a consolidated basis of, for example, an over $50 billion BHC, a wholly-owned subsidiary national bank and a wholly-owned subsidiary state non-member bank, each with over $10 billion in assets, would therefore appear to be subject to at least five[25] technically separate stress test requirements supervised by three different Federal banking agencies. While we recognize that this result appears to be, at least in part, mandated by the statutory language of Section 165(i) of Dodd-Frank, the Associations are deeply concerned that these multiple overlapping stress test requirements, if not properly implemented and coordinated among the relevant agencies, will lead to a great degree of burdensome duplication and will add little marginal utility from a policy and supervisory perspective, particularly regarding BHCs where the subsidiary depository institutions represent, either singly or in the aggregate, a large percentage of the consolidated assets of the BHC. Moreover, we believe that this is true even where the subsidiary depository institutions represent a smaller percentage of the consolidated assets of a BHC parent given the codification of the Federal Reserve's "source of strength" doctrine as part of Dodd-Frank.[26] In either case, the stress test results for the parent BHC must, by logical and practical necessity, include data concerning its subsidiary depository institution(s).

We appreciate the statements of the various Federal banking regulatory agencies to the effect that they will work together to coordinate the various stress test processes among the Federal Reserve, the OCC and the FDIC.[27] The Associations applaud this intention and respectfully urge the alignment of the aggregate stress testing process by robust coordination of its various aspects, including information gathering, public disclosure requirements, reporting forms, etc., across agencies so as to promote efficient use of covered company and supervisory resources and therefore minimize burdensome and inappropriate duplication of efforts, including that:

- the Federal banking agencies coordinate their stress test related activities through the Federal Financial Institution Examination Council (the "**FFIEC**") (or another appropriate joint supervisory forum) and develop inter-agency forms, policies and procedures, assumptions, methodologies and criteria with respect to the stress tests mandated by Section 165(i) of Dodd-Frank;

- the final rules governing such Section 165 stress test be adopted through joint interagency rulemaking in order to provide covered companies clear and coordinated guidance from all three relevant agencies; and

- with respect to depository institution subsidiaries which represent a large percentage of the consolidated assets of a parent covered BHC, the Proposed Stress Test Rules' requirement be met by submission of the BHC's company-run stress results together with a brief addendum

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[25] For these purposes, we have not taken into account the stress testing requirements of the Proposed Liquidity Rule discussed in *Annex B*.

[26] *See* Section 616(d) of Dodd-Frank.

[27] *See* e.g., 77 Fed. Reg. at 632; FDIC Stress Test NPR at 3168; OCC Stress Test NPR at 3409, 3412. We particularly support § 46.8 of the Proposed OCC Stress Test Rules, which provides that a covered company's disclosures will satisfy the disclosure requirement under the annual stress test under Section 165(i)(2) for any subsidiary national bank of the covered company with $10 billion or more in assets, unless the OCC informs the bank otherwise.

describing any material idiosyncratic circumstances or issues that are applicable only to such depository institutions' subsidiaries from a stress test perspective.

B. The information reporting requirements for purposes of the Stress Test Rules should be designed to and implemented as to avoid duplication.

Covered companies will be required to submit a variety of data to the Federal Reserve for purposes of the supervisory stress tests. The format and contents of such data have yet to be determined.[28] In connection with the company-run stress tests, the Federal Reserve may "require companies to provide other information on a supplemental basis"[29] in addition to the submission of stress test results. In addition, covered companies may also be subject to information reporting requirements under the Capital Plan Rules. There will likely be a great degree of overlap between information reporting requirements for purposes of stress tests to be run at different levels of a consolidated organization and to be reported to different Federal banking agencies.

The Associations respectfully submit that information reporting requirements for purposes of the Proposed Stress Test Rules (and their OCC and FDIC counterparts) should be designed to avoid duplication and should be substantially similar to the data content, forms and templates required under the Capital Plan Rules to the greatest extent possible. Moreover, the Federal banking agencies should develop, possibly under the auspices of the FFIEC, an interagency data repository and related interagency forms to avoid needless duplication of data reporting and information gathering. Finally, covered companies should not be required to separately and duplicatively report data mandated by Forms FR Y-14A/Q/M, for example, for purposes of the Proposed Stress Test Rules.

C. The Federal banking agencies should be consistent in their use of the same supervisory stress test scenarios and models for purposes of each of the supervisory stress tests and the annual company-run stress tests.

The Associations are concerned that both the FDIC and the OCC NPRs appear to leave open the possibility that different supervisory stress scenarios may be provided by the OCC or FDIC for purposes of the depository institutions' stress tests than what is used for purposes of the Federal Reserve's supervisory stress test and annual company-run stress tests for over $50 billion BHCs.[30] Most covered companies consist on a consolidated basis of a BHC and at least one subsidiary depository institution. Using one set of supervisory stress scenarios at the BHC level and a different set of supervisory stress scenarios at the subsidiary depository institution and, if results under both scenarios were disclosed, would be needlessly burdensome and would likely result in the public disclosure of divergent results which would be both confusing and of little value to investors and other market participants. In addition, to the extent, as discussed below, the Federal banking agencies use their own models to evaluate the annual (for entities not otherwise subject to the supervisory stress test) and mid-year, as applicable, company-run stress test results, such models and their application should be consistent among the Federal banking agencies. We do not believe there is any analytical or policy

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[28] 77 Fed. Reg. at 628-629.

[29] *Id.* at 631.

[30] *See* OCC Stress Test NPR at 3411; FDIC Stress Test NPR at 3168.

justification for different results with respect to projecting income, loan losses or allowances, for example, when the Federal Reserve analyzes a BHC's consolidated company-run stress test versus when the OCC or the FDIC evaluates the company-run stress test conducted by the BHC's over $10 billion depositary institutions.

Thus, we strongly urge the Federal banking agencies to collectively and consistently use the same set of supervisory stress scenarios and models for all purposes under Section 165(i) of Dodd-Frank.

D. The company-run stress tests to be performed under Section 165(i) of Dodd-Frank should be deemed to fully satisfy the separate stress test requirement under the Capital Plan Rule.

The Capital Plan Rule requires that a covered company perform a stress test based on at least one scenario developed by the BHC, as well as under the Federal Reserve's supervisory stress scenarios.[31] This requirement appears duplicative with the annual separate company-run stress requirement of Section 252.143 of the Proposed Stress Test Rules. More importantly, covered companies subject to the Capital Plan Rule are also generally subject to the mid-year stress test requirements of Section 252.144 of the Proposed Stress Test Rules. As such, the separate company-derived stress test scenario requirement of Section 225.8(d)(2)(i)(A) of the Capital Plan Rule appears superfluous, at best, in light of the Proposed Stress Test Rules since the mid-year stress test requirement can serve to fulfill any perceived supervisory need for a stress test based on company-generated scenarios, and indeed, is more comprehensive in this regard as it contemplates not just one but three company scenarios. Therefore, we urge that the Federal Reserve deem the three company-run stress tests to be performed under Section 165(i)(2) of Dodd-Frank and the Proposed Stress Test Rules to fully satisfy the separate company-generated stress scenario and stress test requirement under the Capital Plan Rule.

V. Stress Test Results and Capital Requirements

A. The design and severity of the supervisory stress scenarios should be consistent and properly cabined in light of the interplay between annual supervisory stress tests and the Federal Reserve's Capital Plan Rule creating an effective minimum capital requirement that can change from year to year as the stress test scenarios change.

As discussed further below, the Associations urge the Federal banking regulators to adopt a uniform approach for identifying supervisory stress scenarios in order to, as much as possible, minimize volatility of capital requirements from year to year in light of the interplay between Proposed Stress Test Rules and the capital plans mandated by Capital Plan Rule, which, in effect, create difficult to plan for variable or floating minimum capital requirements.

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[31] 12 C.F.R. § 225.8(d)(2)(i)(A).

Proposed Stress Test Rules

1. The interplay between annual supervisory stress tests and the Federal Reserve's capital plan guidance creates effective minimum capital requirements that change from year to year as the stress scenarios change.

Under the Proposed Capital and Leverage Rules, all covered companies will become subject to the Federal Reserve's Capital Plan Rule, which requires, among other things, stress testing as part of each covered company's yearly capital plan to be submitted to the Federal Reserve. The Preamble states that the Federal Reserve "expects that a covered company will integrate into its capital plan, as one part of the underlying analysis, the results of the company-run stress tests conducted in accordance with section 165(i)(2) of [Dodd-Frank]."[32] Furthermore, "[t]he results of those stress tests, as well as the annual supervisory stress test conducted by the [Federal Reserve] under section 165(i)(1) of Dodd-Frank, will be considered in the evaluation of a covered company's capital plan."[33] Pursuant to Adopting Release for the Capital Plan Rule, "the stress scenarios that [the Federal Reserve] provides…will be consistent with the stress scenarios it will provide for firms for stress tests they conduct under Section 165 of [Dodd-Frank]."[34] Most significantly, the Federal Reserve has taken the position that, under the Capital Plan Rule, "covered companies would be required to demonstrate to the [Federal Reserve] their ability to maintain capital above existing minimum regulatory capital ratios and above a tier 1 common ratio of 5% under both expected and stressed conditions…" or else face limitations on capital distributions such as dividends and share buy-backs. [35] In light of significant negative consequences for banking institutions that are unable to make capital distributions due to regulatory concerns, we believe this position effectively creates a new *de facto* minimum regulatory capital requirement for covered companies. Moreover, in order to build in a margin of safety, many institutions will likely find it necessary to hold capital well in excess of the 5% stressed minimum in order to have a margin of safety. As discussed in greater detail in *Annex B*, this results in the "more stringent" capital requirements mandated by Section 165(a) of Dodd-Frank.

Unlike regulatory capital floors pursuant to the Federal Deposit Insurance Act (the "FDIA") and related regulations' "prompt corrective action" provisions and under the Basel III requirements, the amount of capital required by this effective 5% minimum will necessarily depend on the severity of the various assumptions underlying the applicable stress scenarios, which, under the Capital Plan Rule and the Proposed Stress Test Rules, will likely change each and every year. In essence, this will create a "floating" minimum capital requirement for covered companies that will be different each year depending on what macroeconomic and other variables the Federal Reserve deems appropriate to use for purposes of the stress scenarios.

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[32] 77 Fed. Reg. at 599.

[33] *Id.* at 599; *see also Id.* at 626.

[34] 76 Fed. Reg. at 74635.

[35] 77 Fed. Reg. at 599; *see also* Capital Plan Rule Adopting Release, 76 Fed. Reg. at 74636-74637.

2. This floating minimum capital requirement will make it challenging for covered companies to develop and implement appropriate medium and long-term capital planning as a practical matter.

The severity of the supervisory severely adverse scenario may fluctuate significantly from year to year as was the case when comparing the 2011 CCAR to the 2012 CCAR. While the severity of the stress severely adverse scenario may fluctuate, the 5% Basel I Tier 1 common threshold is consistent. A significant change in the severity of the severely adverse scenario from year to year could result in a bank passing the stress test with a sizeable margin over the 5% threshold in one year and then failing the stress test the following year even if its risk profile has not changed. Essentially, this creates a moving target for the amount of capital that banks need to hold each year as a result of the fluctuations in the severity of the supervisory defined stress scenarios. While the Associations agree that stress tests provide important information to the market participants, we respectfully submit that ever changing effective minimum capital requirements based on changing stress scenarios could serve to undermine the credibility of the stress tests as well as market confidence in banking institutions as investors and other market participants may have difficulty making meaningful evaluations of covered companies' prospects and future actions when minimum capital requirements effectively float from year to year.

3. The Federal Reserve and the other banking agencies should adopt a uniform approach for identifying supervisory stress scenarios (which would apply absent exigent circumstances) so that changes from year to year do not unnecessarily make floating capital requirements more volatile than they otherwise need be.

The Associations believe that the foregoing problems inherent in capital requirements that are effectively floating can be ameliorated by the Federal Reserve and the other banking agencies, absent exigent circumstances, adopting a uniform approach for identifying stress scenarios so that changes in these scenarios from year to year do not unnecessarily make floating capital requirements more volatile than they otherwise need be. For example, a consistent set of severity and minimum probability of occurrence benchmarks in the design of the supervisory stress scenarios could be used so that risk factor moves in the adverse and the severely adverse stress scenarios are generally anchored to statistical probabilities of occurrence ceilings of no more than once in five years (i.e., a 20% probability of occurrence case) and no more than once in 20 years (i.e., a 5% probability of occurrence case), respectively. Thus, while the specific macro-economic variables of the adverse and severely adverse scenarios could change from year to year, their severity (and therefore the impact on the floating capital requirements) could be calibrated to the probability of occurrence ceiling. We respectfully submit that such a uniform approach would serve to reduce volatility and provide greater predictability in the amount of capital that covered companies will be required to hold pursuant to the floating capital requirement resulting from the Capital Plan Rule and the Proposed Stress Test Rules and therefore serve to improve the ability of such institutions to engage in more meaningful medium-to-long term capital planning as a practical matter. Moreover, this greater degree of predictability (especially when coupled with greater transparency as per Part III.A above) should serve to enable investors and other market participants to make better and more consistent evaluations of the strength of financial institutions and thereby enhance systemic stability as the degree of potentially artificial volatility in capital requirements as a result of the design of regulatory stress scenarios is reduced.

B. At a minimum, the Federal banking agencies should subject the stress scenarios to appropriate public consultation and input prior to their use.

Since, as described above, the stress scenarios will, in effect, dictate how much capital covered companies will be required to hold in any given year, such stress scenarios should not be the product of pure regulatory fiat but rather be subject to an appropriate degree of public consultation and input in order to help ensure that the chosen stress scenarios for any given year are neither so outlandish as to create meaningless results far outside the realm of the possible nor ignore real risks present in the broader national and global economy at the relevant time. The Associations believe that such public consultation and input with respect to the scenario creation process will serve to provide to the Federal banking agencies important outside perspective regarding the relevant issues involved and, as with the models to be used for purposes of the supervisory stress test, therefore enhance the utility of stress testing from a supervisory perspective. We respectfully submit that an informal public consultative process would be more appropriate and efficient than a formal agency rulemaking procedure.

VI. Other Issues

A. Requests for clarification.

The Associations appreciate the efforts of the Federal banking agencies to address the various requirements of Section 165 of Dodd-Frank. Nevertheless, there are certain aspects of the NPR and the Proposed Stress Test Rules, including how they interrelate with other rules (e.g., the Proposed Liquidity Rule), that we urge the Federal banking agencies to clarify when the final Section 165 rules are adopted. More particularly:

- What are the Federal banking agencies' concrete supervisory expectations regarding covered companies' "broader stress testing activities"[36] other than as required by Section 165, the Proposed Stress Test Rules and the Liquidity Rule?

- Exactly how will the results of the annual and mid-year company-run stress tests be used from a supervisory and prudential perspective?

- What is the practical relationship between the use of models and supervisory judgment in determining the results of the supervisory stress tests for purpose of the Proposed Stress Test Rules and the Capital Plan Rules?

VII. Responses to Specific Questions

Below please find our responses or cross references to our responses above, as applicable, with respect to stress-test specific questions posed in the Preamble.[37]

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[36] 77 Fed. Reg. at 630.

[37] As noted in footnote 6 to the Comment Letter, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies.

Question 70. *Are the timing requirements of this proposal sufficient to allow a covered company or nonbank covered company to prepare, collect, and submit to the Federal Reserve the information necessary to support the supervisory stress test? If not, what alternative timing should the Federal Reserve consider?*

Please *see* Parts II.D, F and G above.

Question 71. *What is the potential burden on covered companies stemming from the requirements to submit internal data to support the supervisory stress tests?*

Please *see* Part II.B above.

Question 72. *What alternative models or methodologies for estimating a covered company's losses and revenues should the Federal Reserve consider?*

Please *see* Parts II.A and B above.

Question 73. *What are the benefits and drawbacks associated with company-specific disclosures? What, if any, company-specific items relating to the supervisory stress tests would present challenges or raise issues if disclosed, and what is the nature of those challenges or issues? What specific concerns about the possible release of a company's proprietary information exist? What alternatives to the company-specific disclosures being proposed should the Federal Reserve consider?*

Please *see* Part III above. In addition, we note that the considerations involved with respect to stress test related disclosure issues for non-U.S. BHCs and nonbank financial companies supervised by the Federal Reserve may very well be different. We respectfully reserve the right to comment further on these topics as the Section 165 regulatory process evolves regarding non-U.S. BHCs and nonbank SIFIs.

Question 74. *What alternative to the public disclosure requirements of the proposed rule should the Federal Reserve consider? What are the potential consequences of the proposed public disclosures of the company-run stress test results.*

Please *see* Part III above.

Question 75. *Is the proposed timing of stress testing appropriate, and why? If not, what alternatives would be more appropriate? What, if any, specific challenges exist with respect to the proposed steps and timeframes? What specific alternatives exist to address these challenges that still allow the Federal Reserve to meet its statutory requirements? Please comment on the use of the "as of" date of September 30 (and March 31 for additional stress tests), the January 5 reporting date (and July 5 for additional stress test) the publication date, and the sufficiency of time for completion of the stress tests.*

Please *see* Parts II.D, F and G above.

Question 76. *Does the immediate effectiveness of the proposed rule provide sufficient time for an institution that is covered at the effective date of the rule to conduct its first annual*

stress test? Would over $10 billion companies, in particular, have sufficient time to prepare for the first annual stress test, under either the proposed initial or proposed ongoing applicability rules?

Please *see* Parts II.G and F above. In addition, even for institutions that were subject to CCAR 2012 and are subject to the Capital Plan Rule on a consolidated basis, implementing company-run stress tests at the depository institution subsidiary level may proven challenging in the required timeframe in light of the fact that many such institutions manage their business on an business-line as opposed to legal entity by legal entity basis. Covered companies may need additional time to develop the systems and infrastructure that would allow them perform stress tests broken down with respect to a specific depository institutions subsidiary even though they are able to perform holding company consolidated stress tests. Thus, the Associations respectfully urge that Federal banking agencies delay the implementation of the depository institution specific stress tests where the BHC otherwise covered company under the Proposed Stress Test Rules until January 4, 2014.

Proposed Early Remediation Rules (Subpart I) – Early Remediation Framework[1]

The Associations support the overall objective of Section 166 of Dodd-Frank, which is to require the Federal Reserve to put into place an early remediation regime for large BHCs and nonbank SIFIs in financial distress in order to minimize the probability that the covered company will become insolvent and the potential harm of such insolvency on U.S. financial stability.

As described below, however, the Associations have certain concerns about the Proposed Early Remediation Rules. The Associations respectfully submit that a successful early remediation regime would, in general, apply only to firms subject to genuine financial or management weaknesses, impose individually-tailored conditions and restrictions on those firms, and facilitate a prompt exit from the regime when such firms return to health. The early remediation regime should be designed to help firms overcome weaknesses and protect the stability of the financial system as a whole. The early remediation regime should not subject firms to conditions or restrictions that are interminable or overly broad or impede firms' ability to return to health. A poorly designed early remediation system will exacerbate firms' financial or management weaknesses and destabilize the financial system.

The Associations also believe that any notices, determinations and regulatory actions taken under the early remediation regime should be treated as non-public confidential supervisory information, for the reasons discussed below.

In addition to the specific concerns that follow, the Associations recommend that the early remediation regime be viewed in context with the numerous regulatory reform efforts that are concurrently underway. We see the various strands of the Section 165 enhanced prudential standards coming together through the early remediation regime, and as such, we believe that the elements should all work together, not at cross-purposes. Dodd-Frank eliminated certain categories of regulatory capital, imposed new limitations on certain asset classes and required a general move to the clearing of derivatives; the U.S. banking agencies are preparing proposed rules to implement Basel III; and the Financial Stability Board has endorsed the imposition of a "G-SIB" surcharge on the world's largest banking entities, including most of the "Major Covered Companies" under the Proposed SCCL Rules. The early remediation regime is not an isolated response to the financial crisis. The Associations respectfully submit that the Federal Reserve should proceed cautiously when putting the early remediation regime into place, recognizing the many related measures that have been or will be adopted to otherwise reduce systemic risk in the financial system.

Part I of this Annex summarizes our comments on the Proposed Early Remediation Rules; Part II provides, for ease of reference, a brief summary of the early remediation triggers and resulting actions; Parts III–VII detail our specific recommendations and concerns; and Part VIII sets forth our responses to certain of the specific questions posed in the NPR.

I. Executive Summary

We are concerned that the sensitivity of the automatic triggers of the Proposed Early Remediation Rules and the lack of discretion left to the banking supervisors to determine appropriate

[1] Capitalized terms used in this Annex and not otherwise defined are used with the meanings assigned to them in the Comment Letter to which this Annex is attached.

remediation actions, including the inability to calibrate any such actions to the nature of the applicable triggering event, create the risk that entry into the early remediation regime by a firm will precipitate its further deterioration rather than address and strengthen its shortcomings. In particular, we believe that:

- The Proposed Early Remediation Rules should rely on discretionary supervisory judgments rather than mandatory triggering events;
- Regulatory flexibility is particularly important at Level 2, when initial remediation steps are being taken;
- Stress tests, the results of which are a function of the severity of hypothetical scenarios, should not be a trigger for early remediation; if they are to be used as a trigger, they should not trigger remediation requirements higher than Level 1;
- Automatic triggers may become self-fulfilling prophecies, and market indicators in particular are susceptible to manipulation and may be volatile for reasons unrelated to financial and management weaknesses; in particular, triggering a credit default swap-based indicator could quickly exacerbate liquidity stresses;
- Risk management, risk committee and liquidity requirements should be subject to a materiality threshold for triggering early remediation;
- Required remediation unrelated to the triggering event may harm healthy operations and impair the ability to remediate the problem; and
- Inflexible restrictions on executive compensation could work at cross-purposes with the broader goals of the early remediation regime by harming the company's ability to attract new management or retain skilled and experienced managers that did not contribute to the company's decline.

We also recommend that:

- Early remediation regimes, triggers and requirements employed by different regulatory agencies be harmonized to avoid incongruous outcomes, and in particular, the interplay of stress testing, capital planning and early remediation triggers should be carefully examined, as should the interplay of the early remediation regime with prompt corrective action ("**PCA**");
- Companies subject to the early remediation regime should be promptly released from applicable restrictions and requirements when restored to appropriate managerial or financial health; and
- All notices, determinations and regulatory actions taken in the early remediation regime should be treated as non-public confidential supervisory information.

II. Summary of Proposed Early Remediation Rules

The Federal Reserve's proposed rules to implement Section 166 of Dodd-Frank would establish an early remediation regime for BHCs with $50 billion or more of consolidated assets and any

U.S. nonbank financial company designated by the FSOC for oversight by the Federal Reserve (collectively, "**Early Remediation Covered Companies**"). Under the Proposed Early Remediation Rules, Early Remediation Covered Companies would potentially be subject to any of four levels of early remediation: Heightened Supervisory Review (Level 1), Initial Remediation (Level 2), Recovery (Level 3) and Resolution Assessment (Level 4). The restrictions on, and oversight over, Early Remediation Covered Companies rise significantly with each level of the early remediation regime.

A. Level 1: Heightened Supervisory Review.

Level 1 is triggered when there are signs of financial distress or material risk management weaknesses such that further decline of the company is probable. A largely discretionary standard, Level 1 review is triggered if:

- the covered company is well-capitalized, but the Federal Reserve determines that the company's capital structure, capital planning processes or amount of capital held is not commensurate with the level and nature of risks to which it is exposed;
- there is non-compliance with the Federal Reserve's capital plan and stress testing rules;
- there are signs of weakness in meeting the enhanced risk management, risk committee, or liquidity risk management requirements under the rules; or
- the median value of any market indicator exceeds the applicable threshold for the breach period (market indicators such as expected default frequency, marginal expected shortfall, market equity ratio, option-implied volatility, credit default swap and bond spreads are to be published separately).

In the event Level 1 is triggered, the Federal Reserve would be *required* to produce a report on the elements evidencing deterioration within 30 days and to determine whether the institution should be elevated to a higher level of remediation.

B. Level 2: Initial Remediation.

Level 2 is triggered if:

- risk-based capital and leverage ratios fall to adequately-capitalized levels;
- the results under the severely adverse scenario pursuant to supervisory stress tests reflect a Tier 1 common risk-based capital ratio of less than 5%; or
- there are multiple deficiencies in meeting the enhanced risk management, risk committee, or liquidity risk management requirements under the rules.

In the event Level 2 is triggered, certain mandatory remediation actions will result, including:

- restrictions on capital distributions, acquisitions and asset growth;

- a requirement for the covered company to enter into a non-public memorandum of understanding with the Federal Reserve to establish an action plan for improving its financial condition; and

- a requirement to obtain prior Federal Reserve approval to acquire a controlling interest in any company.

In addition, the Federal Reserve may impose limitations or conditions on conduct or activities.

C. Level 3: Recovery.

Level 3 is triggered if:

- risk-based capital and leverage ratios fall to under-capitalized levels;

- the results under the severely adverse scenario pursuant to supervisory stress tests reflect a Tier 1 common risk-based capital ratio of less than 3%; or

- there is substantial noncompliance in meeting the enhanced risk management, risk committee, or liquidity risk management requirements under the rules.

In the event Level 3 is triggered, certain mandatory remediation actions will result, including:

- a prohibition on asset growth and capital distributions;

- a prohibition on any acquisitions, establishment of offices or engaging in new business lines;

- limits on executive compensation; and

- a requirement that the covered company enter into a written agreement or other form of formal enforcement action with the Federal Reserve that would specify that it must raise capital and take other actions to improve capital adequacy, and may require divestiture.

In addition, the Federal Reserve may require management changes, restrict transactions with affiliates, impose limitations or conditions on conduct or activities, or impose additional requirements on a case-by-case basis.

D. Level 4: Resolution Assessment.

Level 4 is triggered if risk-based capital and leverage ratios fall to significantly under-capitalized levels. If the threshold is triggered, the Federal Reserve will consider whether to recommend that the covered company be placed into resolution under Title II of Dodd-Frank (the "**Orderly Liquidation Authority**"). Such recommendation would be one of the "three keys" required to invoke the Orderly Liquidation Authority, to which the FDIC and the Treasury Secretary would also have to agree.[2]

[2] Section 203 of Dodd-Frank.

III. Key Concerns Regarding Triggering Events and Regulatory Discretion

A. The Proposed Early Remediation Rules should rely on discretionary supervisory judgments rather than mandatory "triggering events".

The Proposed Early Remediation Rules include certain "triggering events" which, when reached, would automatically result in an Early Remediation Covered Company becoming subject to a new, or heightened, level of the early remediation regime. There are four sets of triggering events: (1) capital and leverage triggering events, calculated based on regulatory capital and leverage standards; (2) stress test triggering events, determined with respect to capital planning requirements imposed by the Federal Reserve and stress tests conducted pursuant to other sections of the NPR; (3) risk management standards, triggered by a determination by the Federal Reserve of "manifested signs of weakness", "multiple deficiencies", and "substantial noncompliance" in management areas; and (4) market indicators.[3]

The Associations have concerns about the use of mandatory "triggering events" at all levels in the Proposed Early Remediation Rules. The Associations respectfully submit that a more appropriate approach would be for the Federal Reserve to make early remediation determinations based on discretionary supervisory judgments, in light of all of the facts and circumstances, taking into consideration non-determinative quantitative and qualitative factors. The use of market indicators as mandatory triggers, rather than as merely informative factors, is particularly troublesome, for the reasons discussed below.

The Associations support an early remediation regime that allows the Federal Reserve to intervene early at an Early Remediation Covered Company that is showing signs of material financial or management distress. We believe that it is important that the early remediation process be used to create a virtuous cycle that quickly identifies a troubled covered company, and then allows regulators and management to work together to strengthen the institution, rather than creating a vicious cycle where the early remediation requirements of the regulators precipitate a death spiral at the covered company in distress, and the regulators find themselves with no discretion to take countervailing actions to prevent the precipitous decline.

While we agree with the goals of the early remediation proposed rule, it is important that the early remediation process also allow for regulatory tailoring and discretion to act as required by a specific situation, both in terms of triggers and in terms of regulatory action within each level of remediation review. As the early remediation proposed rule itself recognizes, there is a risk that certain triggers, if misapplied or misused, could exacerbate funding or market pressures at the affected covered company, rather than providing for early remediation of such issues. Therefore, we believe that providing regulators the authority to intervene early at Early Remediation Covered Companies is better than requiring regulatory action upon triggering events. Such regulatory discretion is especially important given the wide range of institutions potentially subject to the Proposed Early Remediation Rules.[4]

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[3] Section 252.163.

[4] For those institutions just within the $50 billion threshold, there is a significant risk that a heavy-handed application of the Proposed Early Remediation Rules could put such firms at a significant disadvantage to their slightly smaller competitors.

Further, in order to be truly effective, the triggers should avoid, where possible, the use of fixed numeric standards; as the Federal Reserve recognizes, the use of a single fixed standard gives rise to risks of both "false positives" (remediation for a firm without material weaknesses) and "false negatives" (lack of remediation for a firm whose financial condition has indeed deteriorated), therefore forcing a covered company into an inappropriate level of remediation, a problem that regulators familiar with the institution would be able to avoid with more discretion. The use of more flexible triggers would also facilitate the conformance of the early remediation framework with any revised capital and leverage standards (such as Basel III) as they are incorporated into U.S. regulation—conformance which the Federal Reserve indicates it expects to monitor,[5] and which the Associations endorse.

B. Flexibility is particularly important at Level 2.

This regime should give regulators flexibility to tailor remediation requirements to circumstances, particularly in Level 2 Initial Remediation, so that regulators could choose among one or more specified actions but would not be required to implement all of them. Such flexibility in choosing steps for Initial Remediation would let regulators avoid actions that are inappropriate given the cause or severity of distress or that could exacerbate funding or market pressures. A dynamic process should exist that allows institutions to exit remediation stages when conditions improve.

C. Stress test results should not trigger early remediation requirements, or at least should not trigger requirements higher than Level 1.

The Proposed Early Remediation Rules would place a firm into Level 2 early remediation if the results of the supervisory stress tests in any quarter of the planning horizon reflect a Tier 1 common risk-based capital ratio of less than 5%.[6] If the results of stress tests are even lower, a firm can be placed into Level 3 early remediation.[7] The planning horizon under the supervisory stress tests must be at least nine quarters.[8] Although they can be useful tools, the supervisory stress tests necessarily involve imperfect assumptions about market conditions, and the Associations believe that a single quarter of projected financial weakness under the Federal Reserve's most adverse stress scenarios should not be a trigger of early remediation action.

We do not believe it is appropriate for the results of the supervisory stress tests to trigger any level of early remediation requirements, given the statutory requirement that heightened remediation requirements be linked to the declining financial condition of a covered company. A covered company's stress test results are a function of the severity of the hypothetical scenarios, not the actual financial condition of the covered company.

If stress tests are nevertheless to be used as an early remediation trigger, the Associations respectfully submit that, in light of the serious consequences of Level 2 or Level 3 early remediation and the imperfect assumptions underlying forward-looking stress tests, that the failure to

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[5] 77 Fed. Reg. at 634.

[6] Section 252.163(b)(2).

[7] Section 252.163(b)(3).

[8] Section 252.132(g).

meet the required capital ratio under the severely adverse scenario pursuant to supervisory stress tests should trigger Level 1 early remediation requirements, rather than Level 2 or Level 3 early remediation requirements. We believe the remediation actions under Level 1 are more appropriate in the event the stress test requirements are not met, because they allow the Federal Reserve to monitor a firm on the basis of failing the meet the requirements of the stress test, rather than mandating actions based on hypothetical assumptions. We also note that it is unnecessary for stress test results to trigger the full range of Level 2 or Level 3 early remediation, as the Capital Plan Rule already imposes significant restrictions on covered companies that do not meet the 5% Tier 1 common requirement on a post-stress basis.[9]

Further, the Proposed Early Remediation Rules, particularly the stress test triggers, should be better coordinated with the Proposed Capital and Leverage Rules. Under those requirements, firms are already subject to Federal Reserve action if their Tier 1 capital falls below mandated thresholds, making a similar set of remediation actions under the Proposed Early Remediation Rules both superfluous and burdensome.

D. Automatic triggers may become self-fulfilling prophecies, and market indicators, in particular, are susceptible to manipulation.

In an early remediation system based on automatic, publicly-disclosed thresholds, firms may find that depositors and counterparties abandon or turn against them if regulatory capital or leverage levels temporarily fall close to, but still above, "triggering event" levels, or if market indicators near applicable thresholds. An automatic trigger system may inadvertently impair the ability of an Early Remediation Covered Company to take appropriate restorative capital actions because market participants assume the firm will inevitably become subject to the early remediation regime. An early remediation regime without automatic triggers, or with triggers that are not public, would reduce the risk of self-fulfilling death spirals.

If placement into the early remediation regime is based on automatic triggers, counterparties or market participants may deliberately take actions that have the effect of temporarily triggering an Early Remediation Level. Market indicators such as spreads on single-name credit default swaps or equity securities prices, for example, could be manipulated. To the extent triggers are not automatic or are not publicly-disclosed, the risk of manipulation would be mitigated.

The Associations also have serious concerns about the use of automatic early remediation triggers based on changes in indicators like credit default swap spreads and the prices of equity securities that can be quite volatile and may arise from circumstances unrelated to financial and management weaknesses, including investors' perceptions of sector- or region-wide strength, potential merger or acquisition activity and analysts' expectations of earnings. In addition, many smaller Early Remediation Covered Companies have a limited number of market indicators and the trading volume in their securities (or instruments based on such securities) may be smaller than for other covered companies, increasing the potential for manipulation or "false positives". While the Federal Reserve has not yet published the initial indicator list, market indicator thresholds, and breach period,[10] the

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[9] *See* 76 Fed. Reg. 74631, 74647 (Dec. 1, 2011).

[10] Section 252.163(e)(2).

Associations expect that the market indicators for these smaller Early Remediation Covered Companies will primarily be the equity securities of such firms.

E. Risk management, risk committee and liquidity requirements should be subject to a materiality threshold for triggering early remediation.

The Associations recommend that, to the extent weaknesses in meeting the risk management, risk committee and liquidity requirements form a basis for triggering early remediation, there should be a materiality threshold for triggering early remediation requirements. Immaterial non-compliance with the risk management, risk committee and liquidity requirements should not result in the early remediation regime being invoked. In addition, the evaluation of risk management for purposes of the early remediation regime should not be inconsistent with current supervisory examinations of risk management at BHCs, and in no event should the results of the evaluation under the early remediation regime be more severe than the results in the examination process.

IV. Appropriateness of the Required Remediation under the NPR

The Associations have concerns about the appropriateness of the required remediation under the Proposed Early Remediation Rules. As proposed, an Early Remediation Covered Company may become subject to early remediation restrictions or requirements as a result of reaching a single "triggering event". Once placed within the regime, however, the firm is subject to the entire panoply of restrictions and requirements, irrespective of whether they are related to the triggering event that caused the firm to be placed into the regime. For instance, a deficiency in meeting the risk committee requirements could by itself result in restrictions on a firm's asset size and future acquisitions, even if the deficiency were unrelated to financial or growth issues.

A. Required remediation unrelated to the triggering event may harm healthy operations and impair the ability to remediate the problem.

Subjecting Early Remediation Covered Companies to restrictions or requirements unrelated to an actual triggering event may unnecessarily impair the healthy operations or activities of the firm, which could, in turn, harm the ability of the firm to improve its overall financial or managerial health. If firms are required, or find it necessary under securities laws, to disclose their early remediation status, the application of the full panoply of early remediation requirements and restrictions based on a discrete triggering event may have substantial market effects or even, in severe cases, inaccurately signal to the market that a firm is in an irreversible decline. In addition, given the range in size, risk profile and activities of Early Remediation Covered Companies, a one-size-fits-all approach fails to recognize meaningful distinctions among firms that, if properly evaluated, would result in tailored early remediation restrictions and requirements.

Consistent with the Associations' view that placement within the early remediation regime should involve regulatory decision-making and discretion, the Associations respectfully submit that, in the case of each firm placed within the early remediation regime, the Federal Reserve should determine the appropriateness of the restriction or requirement under the applicable early remediation level before imposing such restriction or requirement. This tailored approach would ensure that any Early Remediation Covered Company experiencing financial or management weaknesses is placed within a carefully designed regulatory framework that will best manage the firm's particular problems and protect the financial system.

B. Absolute and inflexible compensation restrictions would work at cross-purposes with the broader goals of the early remediation regime.

In addition, we are concerned that the absolute prohibition on the payment of bonuses to, or any increase in the compensation of, senior executive officers or directors in the Level 3 early remediation would work at cross-purposes with the broader goals of the early remediation regime. In contrast to other similar regulatory measures, there is no exception in the Proposed Early Remediation Rules to this prohibition (even with regulatory approval) to allow a company to attract new management that may be brought in to help address the issues which have caused the firm to be in early remediation.[11]

In addition, there is no level of culpability required to be shown in order for the prohibition to apply. In other contexts, firms are having to show how they will keep key management in place at times of distress;[12] moreover, other rules would apply to clawback bonus compensation from culpable executives of a firm which did not remediate and failed.[13] Accordingly, we believe that this remedial requirement under the Proposed Rules does not support the goals of the early remediation regime, and could, in fact, contribute to a firm's decline rather than promoting the restoration of the firm's financial health.

V. Coordination With Other Prudential and Supervisory Regimes and Existing Regulatory Tools

Early remediation regimes, triggers and requirements employed by different regulatory agencies should be harmonized to avoid incongruous outcomes. The NPR notes that the early remediation regime is intended to "supplement rather than replace the Federal Reserve's other supervisory processes with respect to covered companies" and that the Federal Reserve may use other supervisory authority to cause a covered company to take remedial actions. It is currently unclear how the existing supervisory process is intended to interact with the early remediation regime, especially given the overlap in certain of the triggers (capital requirements, stress testing) with the current supervisory process.

A. The interplay of stress testing, capital planning and early remediation triggers needs to be carefully examined.

Other provisions of the NPR impose stress testing requirements on Early Remediation Covered Companies. The Proposed Stress Test Rules require both supervisory stress tests, firm-run stress tests and separate liquidity stress tests.[14] Each set of stress tests involves analyses of regulatory

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[11] *See* the FDIC's Orderly Liquidation Final Rule, which notes that directors and senior executives hired to turn the firm around are presumed not to be substantially responsible for the firm's eventual failure. 12 C.F.R. § 380.7(b)(3).

[12] E.g., the Federal Reserve and the FDIC's Resolution Plan Final Rule, which requires strategic planning for the rapid and orderly resolution of covered companies in the event of material financial distress or failure. 76 Fed. Reg. 67323 (Nov. 1, 2011).

[13] *See* the FDIC's Orderly Liquidation Final Rule regarding recoupment of compensation from senior executives or directors materially responsible for a firm's failure. 76 Fed. Reg. 41626 (July 15, 2011).

[14] *See* Proposed Rules, Subparts F and G.

capital, leverage or liquidity measures, as applicable, over a forward-looking planning period,[15] and firms must submit the results of firm-run stress tests to the Federal Reserve for evaluation.[16] As explained in the commentary to the Proposed Early Remediation Rules, the stress test requirements "are designed to work in tandem with the Board's capital plan rule. . . ."[17] In combination, stress tests and capital planning are intended to guide the future activities, capital actions and liquidity management of firms over defined planning periods.

Stress tests help regulators and firms anticipate firms' future capital, leverage or liquidity problems before they develop, but stress tests necessarily involve imperfect assumptions about the future conditions and actions of firms, counterparties and the broader economy. Such imperfect assumptions should not be used to subject firms to punitive regulatory measures before financial weaknesses actually appear. The early remediation regime, in contrast, prescribes a set of specific regulatory responses to verified financial or management weaknesses. The early remediation regime is necessarily reactive, because other regulatory tools address forward-looking stress scenarios and capital planning and because it would be inappropriate to subject firms to burdensome early remediation requirements and restrictions without clear evidence of actual weaknesses. The Associations have concerns, however, that the early remediation triggering events, by incorporating the Federal Reserve's assessments of Early Remediation Covered Companies' capital planning,[18] may result in the Federal Reserve finding that a firm has breached a triggering event based upon the firm's projected capital actions or economic conditions.

The Associations have two concerns about this interplay of stress tests and capital planning with the early remediation regime. First, as noted above, firms may be subject to early remediation actions based on imperfect assumptions about future developments or economic conditions. The Associations respectfully submit that firms' regulators have other suitable tools, including capital requirements, to respond to the possibility of weaknesses in the firms' prospective capital, liquidity or risk management processes. A firm should not become subject to a mandatory early remediation action unless and until a firm has demonstrated actual financial or management weaknesses.

Second, as discussed more fully below, the stress testing regime in the NPR involves public disclosures.[19] The Associations have concerns that if the early remediation regime incorporates stress testing or capital planning elements into early remediation triggering events, market participants may be able to predict or discover early remediation actions against specific firms by scrutinizing stress test disclosures. Perceptions that a firm may in the future, or has already, become subject to an early remediation action could precipitate the very financial weaknesses that capital planning, stress tests and the early remediation system are intended to prevent. Accordingly, the Associations respectfully submit

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[15] Section 252.133 (supervisory stress tests); Section 252.145 (firm-run stress tests); Section 252.52 (liquidity stress tests).

[16] Section 252.146.

[17] 77 Fed. Reg. at 626, *citing* 12 C.F.R. § 225.8.

[18] Section 252.163(a)(1).

[19] Section 252.148.

that early remediation triggers should not be dependent on, or otherwise linked to, forward-looking stress tests or capital planning.

B. The interplay of the prompt corrective action regime and the early remediation regime needs to be carefully examined.

Separate from Dodd-Frank and the NPR's provisions, insured depository institutions in the United States may become subject to PCA if their capital ratios decline below established benchmarks.[20] While the existing PCA framework has been criticized for inadequately protecting the financial health of banking entities and the financial system as a whole,[21] PCA remains an important tool available to regulators to address banks' financial distress and the risk of losses to the FDIC's Deposit Insurance Fund.

The Associations respectfully submit that the early remediation framework should generally serve to augment PCA standards and processes. In addition, early remediation should not be used to promote industry reorganization. While the PCA framework may require revisions, PCA appropriately focuses on institution-specific weaknesses. Early remediation should likewise be used to address specific financial or management issues at Early Remediation Covered Companies, and should not be used to effect industry-wide reorganizations.

VI. Exit from the Early Remediation Regime

Under the Proposed Early Remediation Rules, a firm placed under the early remediation regime remains subject to the regime until "the Board provides written notice to the covered company that its financial condition or risk management no longer warrants application of the requirement."[22] The Proposed Early Remediation Rules do not otherwise describe the process of exiting from the early remediation regime.

As discussed above, a successful early remediation regime would ensure that Early Remediation Covered Companies, when restored to appropriate managerial or financial health, are promptly released from the restrictions and requirements of the regime. Such a quick exit would ensure that firms are able to perform their normal range of market activities, thus fostering healthy credit markets and economic growth. In light of these objectives, the Associations are concerned that the Proposed Early Remediation Rules do not provide adequate clarity concerning the process for existing the regime.

We believe that once a firm has addressed the issue that triggered the application of the Early Remediation Rules for two consecutive quarters, the firm should be released from the application

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[20] 12 U.S.C. § 1831o(e).

[21] *See,* e.g., United States Government Accountability Office, "Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness," June 2011, http://www.gao.gov/assets/330/320102.pdf; Financial Stability Oversight Council, "Report to the Congress on Prompt Corrective Action," December 2011, http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%20PCA%20Report%20FINAL.PDF.

[22] Section 252.164(c).

of the sanctions. Such a clear exit rule would also encourage firms to act quickly to remediate rather than disputing the triggering event.

VII. Public Disclosure Issues

Neither the Proposed Early Remediation Rules nor the accompanying release discusses public disclosure issues related to the early remediation regime. The Associations respectfully submit that all notices, determinations and regulatory actions taken in the early remediation regime should be treated as non-public confidential supervisory information.

As discussed above, one danger of an improperly designed or administered early remediation regime is that signals of weakness can become self-fulfilling prophecies. A firm with moderate financial or management weaknesses may face sudden pressure if its counterparties interpret an early remediation action as signaling the decline of the firm. The goal of the early remediation regime should be to arrest and reverse weaknesses at firms, not propel firms toward collapse. Public disclosure of an early remediation action could further weaken any firm subject to the regime.

Finally, the Federal Reserve has already taken actions in other areas to increase large banking entities' disclosure obligations. Under the Proposed Stress Test Rules, for instance, all Early Remediation Covered Companies (and many smaller banking entities) must publish summaries of their annual stress test results.[23] Market participants will be able to use such summaries, as well as other information provided in securities filings, to make appropriate assessments about Early Remediation Covered Companies' financial health and stability. As with bank examination reports, firms should not be required to disclose the substance of early remediation determinations.

VIII. Responses to Specific Questions[24]

Question 78: *The Federal Reserve recognizes that liquidity ratios can provide an early indication of difficulties at a covered company and seeks comment on the costs and benefits of including a quantitative liquidity trigger in the early remediation regime. If the Federal Reserve were to include a quantitative liquidity trigger in the regime, what quantitative liquidity trigger should be used and how should it be calibrated?*

See our comments in Part III.A.

Question 80: *The Federal Reserve seeks comment on the proposed mandatory actions that would occur at each level of remediation. What, if any, additional or different restrictions should the Federal Reserve impose on distressed covered companies?*

See our comments in Part IV.

Question 81: *The Federal Reserve seeks comment on the proposed risk-based capital and leverage triggers. What alternative or additional risk-based capital or leverage triggering events,*

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[23] Section 252.148(b).

[24] As noted in footnote 6 to the Comment Letter, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies.

if any, should the Federal Reserve adopt? Provide a detailed explanation of such alternative triggering events with supporting data.

See our comments in Part III.A.

Question 82: *What additional factors should the Federal Reserve consider when incorporating stress test results into the early remediation framework? Is the severely adverse scenario appropriately incorporated as a triggering event? Why or why not?*

See our comments in Part III.C.

Question 84: *The Federal Reserve seeks comment on the proposed approach to market-based triggers detailed below, alternative specifications of market-based indicators, and the potential benefits and challenges of introducing additional market-based triggers for levels 2, 3, or 4 of the proposed early remediation regime. In addition, the Federal Reserve seeks comment on the sufficiency of information content in market-based indicators generally.*

See our comments in Part III.D.

Question 85: *Should the Federal Reserve include market indicators described above in the early remediation regime? If not, what other forward-looking indicators should the Federal Reserve include?*

See our comments in Part III.D.

Question 86: *Are the indicators outlined above the correct set of indicators to consider? Should other market-based triggers be considered?*

See our comments in Part III.D.