



January 10, 2020

*Via Electronic Mail*

The Honorable Jerome Powell  
Chairman  
Board of Governors of the Federal Reserve System  
20th Street & Constitution Avenue NW  
Washington, DC 20551

The Honorable Jelena McWilliams  
Chairman  
Federal Deposit Insurance Corporation  
550 17th Street NW  
Washington, DC 20429

Re: Substantive Review & Revision of the Uniform Financial Institution Rating System<sup>1</sup>

Chairman Powell and Chairman McWilliams:

We thank the Federal Reserve and Federal Deposit Insurance Corporation (FDIC) for their request for information seeking public input on a fundamental aspect of how the federal banking agencies regulate and supervise banks, the Uniform Financial Institution Rating System (UFIRS).<sup>2</sup> In this letter, BPI offers general comments on the agencies' RFI that explain the need for a comprehensive, substantive review and revision of the UFIRS framework to take account both of its current, changed role in banking regulation and substantial changes in other regulations that it has failed to incorporate over the years. We intend to file later a letter with detailed responses to the questions posed in the RFI that focus on current supervisory practices and require more extensive consultation with our members.

As the rest of this letter will detail, since the Federal Financial Institutions Examination Council (FFIEC) adopted the framework in 1979, the purpose of CAMELS ratings has changed fundamentally; the consequences of poor CAMELS ratings have become significant, severe, and legally binding; and a regulatory revolution has occurred in terms of establishing more objective and accurate ways to assess certain CAMELS components. Despite these important developments, the UFIRS framework itself has changed remarkably little since its inception.

Compounding the need for a periodic review of the UFIRS is the fact that the banking agencies take the position that confidential supervisory information is the property of a bank's regulator, meaning that individual banks

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<sup>1</sup> 84 Fed. Reg. 58383 (Oct. 31, 2019).

<sup>2</sup> The Bank Policy Institute is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost 2 million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

are generally limited in their ability to discuss with a third party their institution-specific concerns with the use and design of the CAMELS framework. And, as we and others have previously highlighted, institutions are often reluctant to appeal supervisory determinations, given their fears over retaliation and the extremely low likelihood of succeeding in having an agency overturn its own determination.<sup>3</sup> The result has been an erosion of due process around governmental decisions that has had significant effects on banks and their customers and shareholders. This breakdown in process can be remedied, though, in conjunction with improvements in substance: that is, if the agencies re-establish that the UFIRS is intended to measure financial condition, and if CAMELS ratings become sufficiently objective to be reliable indications of that which they are intended to measure.

Thus, this letter provides recommendations for how the agencies should substantively revise the UFIRS framework to better reflect the purposes it now serves. Given the profound legal and policy importance of the UFIRS, this letter also serves as a petition by the Bank Policy Institute of the Federal Reserve and FDIC under section 553(e) of the Administrative Procedure Act to engage in a rulemaking to revise the framework consistently with our recommendations.<sup>4</sup>

Part I of this letter describes how changes in the consequences of CAMELS ratings since the establishment of the UFIRS warrant revisions to the framework. Part II includes BPI's specific recommendations for changes to the UFIRS and its component ratings. Finally, Part III discusses the need for further study and public disclosure of the effectiveness of the UFIRS as an evaluation tool – steps that should not delay the agencies from making sorely needed changes to the UFIRS in the near term.

## I. The Changed Purposes of the UFIRS Requires its Review and Revision

History shows clearly that the UFIRS was designed for one purpose, and is now serving at least four wholly different ones, for which its original and still current design is clearly inappropriate. Furthermore, there have been innumerable changes to how banks are regulated since the last revision to the UFIRS that make it outdated and substandard as a measure of financial condition.

### A. The UFIRS was designed to serve as a supervisory tool without formal legal consequence.

Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 established the FFIEC and required it to “establish uniform principles and standards and report forms for the examination of financial institutions.”<sup>5</sup>

Pursuant to this authority, the FFIEC in 1979 promulgated the UFIRS framework. Under the framework, examiners now evaluate a bank across six “CAMELS” categories – capital, asset quality, management, earnings, liquidity, and sensitivity to market risk (especially interest rate risk) – and assign a component rating for each category, as well as a composite rating, all on a scale of 1 (best) to 5. Other than the addition of the “S” component in 1996, the framework and its self-described purposes have remained largely the same since its establishment over 40 years ago.<sup>6</sup>

The original 1979 UFIRS issuance describes itself as “a general framework for evaluating the soundness of federally supervised banks and thrift institutions and their compliance with law” and referred to the scores as “grades.”<sup>7</sup> That document identified the UFIRS's underlying purposes as the following: (i) “to reflect in a

<sup>3</sup> See Greg Baer, President, BPI (formerly TCH), Testimony Before the U.S. House Financial Services Subcommittee on Financial Institutions and Consumer Credit (Apr. 6, 2017), available at <https://bpi.com/wp-content/uploads/2018/07/testimony.pdf>.

<sup>4</sup> The FFIEC would appear to be the appropriate body to coordinate such a rulemaking, given its statutory mandate to establish uniform principles and standards for the examination of financial institutions. See *infra* n. 5.

<sup>5</sup> See Public Law 95-630 (codified at 12 U.S.C. §§ 3301, 3305(a)).

<sup>6</sup> See 61 Fed. Reg. 67021 (Dec. 19, 1996) (hereinafter the “1996 Statement”).

<sup>7</sup> See, e.g., OCC Examining Circular 159 (Revised), 1, 1979 WL 27070 (Nov. 13, 1979).

comprehensive and uniform fashion an institution's financial condition, compliance with laws and regulations and overall operating soundness"; and (ii) "to help identify those institutions whose financial, operating or compliance weaknesses require special supervisory attention and/or warrant a higher than normal degree of supervisory concern."<sup>8</sup> Similarly, the Federal Register notice accompanying the 1996 changes to the UFIRS describes the rating system as an "internal supervisory tool for evaluating the soundness of financial institutions."<sup>9</sup>

Crucially, the UFIRS as designed circa 1979 and 1996 was not self-enforcing: that is, a poor CAMELS rating had no substantive legal consequence or effect on the bank.<sup>10</sup> To the extent an agency wished to compel the bank to redress an identified deficiency, it was required to issue an order under section 8 of the FDI Act upon determining that such deficiency constituted an unsafe or unsound banking practice or violation of law.<sup>11</sup> Given its self-described purpose and lack of legal effect, it is not surprising that the 1979 framework was issued as guidance, without notice and comment.

The UFIRS's original function as a nonbinding supervisory tool is important because it meant that the agencies appropriately could – and actually did – design the UFIRS as a series of component ratings that were each subjectively determined, and then subjectively combined into a composite rating. This system, which would have been legally deficient if it had been a binding regulation with penalties attached, was, as a self-described "internal supervisory tool," unremarkable. And, of course, its approach was fully consistent with the statutory mandate under which the FFIEC first developed the UFIRS – that is, to prescribe "principles and standards." For this same reason, an institution's ability to seek review or appeal of an assigned CAMELS rating was also less important, as no substantive consequence attached.

As described below, however, the purpose, function, and consequences of UFIRS ratings have since shifted dramatically. A CAMELS rating now is self-enforcing, with dramatic and automatic consequences for the bank and its parent holding company, yet the evaluation criteria have remained largely static and subjective, resulting in a framework that is neither fit for purpose nor objective in practice.

## **B. The consequences of a CAMELS rating have become significant and legally binding.**

The consequences of a CAMELS rating under the UFIRS have changed dramatically due to intervening legal and regulatory developments occurring since 1979, and in particular the enactment of the Gramm-Leach-Bliley Act in 1999.

First, that law created a new "financial holding company" (FHC) construct, and stated that no firm could qualify for FHC status unless, *inter alia*, all of its depository institution subsidiaries remain "well managed," which in turn was defined as maintaining both (i) "a CAMELS composite rating of 1 or 2" and (ii) "at least a satisfactory rating for management, if such rating is given."<sup>12</sup>

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<sup>8</sup> *Id.* at 23.

<sup>9</sup> 1996 Statement at 67024-25. It went on to note that the UFIRS is used to ensure that "supervisory attention is appropriately focused on the financial institutions exhibiting financial and operational weaknesses or adverse trends . . . . The UFIRS also serves as a useful vehicle for identifying problem or deteriorating financial institutions, as well as for categorizing institutions with deficiencies in particular component areas. Further, the rating system assists Congress in following safety and soundness trends and in assessing the aggregate strength and soundness of the financial industry. As such, the UFIRS assists the agencies in fulfilling their collective mission of maintaining stability and public confidence in the nation's financial system." *Id.* at 67025.

<sup>10</sup> Certain procedural consequences to a poor CAMELS rating have emerged since 1979. *See* *infra* n. 20.

<sup>11</sup> *See* 12 U.S.C. § 1818. Subsequently, in 1991, Congress established the Prompt Corrective Action framework of section 38 of the FDI Act to provide the agencies with additional tools to address capital deficiencies and other safety and soundness concerns. In 1999, Congress established a mechanism under section 39 of the FDI Act for the issuance of orders to redress specific safety and soundness deficiencies.

<sup>12</sup> *See* 12 U.S.C. §§ 1843(j); 1841(d)(9). Similarly, the Gramm-Leach-Bliley Act also introduced the "financial subsidiary" construct, and provided that a less than satisfactory rating may also impact the ability of a national bank to conduct financial activities through

Second, in 2006 the FDIC revised its deposit insurance assessment pricing methodology to formally include the CAMELS composite rating and a weighted average of CAMELS component ratings as important determinants of a bank's assessment rate.<sup>13</sup> Thus, a downgrade in CAMELS ratings results in a direct financial cost to the bank.<sup>14</sup>

Third, a bank's composite CAMELS rating now determines whether it is eligible for primary credit at the discount window, which, in contrast to secondary credit, is generally available as of right, with "no questions asked," and at more favorable interest rates. Under Regulation A, primary credit is available to a bank in "generally sound financial condition in the judgment of the Reserve Bank,"<sup>15</sup> and 2003 guidance from the Federal Reserve provides that a bank will generally be eligible for primary credit if it has a composite CAMELS rating of 1, 2 or 3, unless supplementary information indicates its condition is not generally sound.<sup>16</sup> Likewise, under the Federal Reserve's Payment System Risk Policy, a bank's CAMELS ratings also affect whether, and in what amount, a Reserve Bank will grant a net debit cap to the bank to incur daylight overdrafts in its Reserve Bank account.<sup>17</sup>

Fourth, a bank's CAMELS ratings now determine whether it or its holding company can be approved to acquire another institution or expand across state lines. Under SR Letter 14-2, the Federal Reserve has announced that it generally does not approve M&A applications filed by banks with a 3, 4, or 5 composite rating or Management or Capital component rating. Additionally, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 required an agency reviewing a proposed interstate merger transaction or a de novo interstate branching proposal to determine that the resulting bank will be "adequately managed" for the proposal to be authorized notwithstanding state law that prohibits it;<sup>18</sup> the Dodd-Frank Act changed this standard to "well managed" in 2010.<sup>19</sup> While Riegle-Neal (as amended) does not define "well managed," as a practical matter the Federal Reserve and FDIC have generally required a bank to have a Management rating of 1 or 2 under the UFIRS to qualify.

Together, these changes mean that the UFIRS now serves four major legally binding functions for which it was never designed, each of which significantly affect the rights and interests of banks and their parent companies: (i) determining whether a bank holding company or savings and loan holding company may engage in financial activities (e.g., securities underwriting and dealing, insurance, and merchant banking); (ii) determining how much risk the bank poses to the Deposit Insurance Fund for assessment purposes; (iii) determining whether the bank is at risk

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a financial subsidiary. The OCC may limit the activities of a financial subsidiary and, if issues are not remediated, may require a national bank to divest control of the subsidiary. *See* 12 C.F.R. § 5.39(j).

<sup>13</sup> *See* 71 Fed. Reg. 69282 (Nov. 30, 2006); 12 C.F.R. § 327.16 (current regulation incorporating CAMELS ratings into assessment rate calculations). The FDIC had, however, informally used CAMELS composite ratings in determining a bank's risk category since 1992, when the agency adopted the risk-based pricing framework required under the Federal Deposit Insurance Corporation Improvement Act (FDICIA). *See* 71 Fed. Reg. 41910, 41910 ("In practice, the subgroup evaluations are generally based on [an] institution's composite CAMELS rating, a rating assigned by the institution's supervisor at the end of a bank examination, with 1 being the best rating and 5 being the lowest.")

<sup>14</sup> Likewise, the OCC revised its own assessment rules in 1997 to impose a surcharge on banks with a composite CAMELS rating of 3, 4, or 5. *See*, 62 Fed. Reg. 64135 (Dec. 4, 1997).

<sup>15</sup> 12 C.F.R. § 201.4.

<sup>16</sup> *See* Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management (July 23, 2003), available at <http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20030723/attachment.pdf>. Supplementary information for both domestic institutions and FBOs may include public debt ratings and information provided by examiners and market sources. *Id.*

<sup>17</sup> *See* Federal Reserve Policy on Payment System Risk, at 26 (Dec. 31, 2014), available at [http://www.federalreserve.gov/paymentsystems/files/psr\\_policy.pdf](http://www.federalreserve.gov/paymentsystems/files/psr_policy.pdf) ("In considering [an] institution's request [for additional daylight overdraft capacity], the Reserve Bank will evaluate the institution's rationale for requesting additional daylight overdraft capacity as well as its financial and supervisory information. The financial and supervisory information considered may include, but is not limited to, capital and liquidity ratios, the composition of balance sheet assets, CAMELS or other supervisory ratings and assessments, and SOSA rankings (for U.S. branches and agencies of foreign banks).").

<sup>18</sup> *See* Pub. L. 103-328, 108 Stat. 2347, § 102(a) & 103 (Sept. 29, 1994) (codified at 12 U.S.C. §§ 1831u(b)(4), 36(g)(2)(A), & 1828(d)(4)(B)(i)).

<sup>19</sup> *See* Pub. L. 111-203, 124 Stat. 1608, § 607(b) (July 21, 2010).

for default on credit extended by the Federal Reserve; and (iv) determining whether a bank or its parent may expand. And these four uses of CAMELS ratings are not the only ones that have emerged since 1979.<sup>20</sup>

**C. Major changes in the purpose and function of the UFIRS, together with the paradigmatic shifts in prudential regulation that have taken place since its development, require comprehensive review and revision of the framework.**

Major reform of the UFIRS is required to reflect these fundamental shifts in its role and its purpose, and revolutionary changes in the prudential regulatory framework of which it is a part. In the absence of such reform, the use of a rating system that was designed for an entirely different purpose and a completely different regulatory system is almost certain to be arbitrary as a matter of policy, capricious as a matter of practice, and deficient as a matter of administrative procedure and due process.

**1. Changes in function and purpose**

The original 1979 UFIRS framework was issued without public notice and comment; it was not until 1996, when the “S” component was introduced and other changes made, that the framework first went through a notice and comment process.<sup>21</sup> Even then, the UFIRS on which public comment was sought was a supervisory tool to which no legal consequences attached. It was never republished when the purpose and legal effect of the framework changed dramatically – not when the Gramm-Leach-Bliley Act made CAMELS ratings a fundamental linchpin of the FHC framework in 1999, nor when the FDIC formally made CAMELS ratings an essential determinant of deposit insurance in 2006, nor when the Federal Reserve made CAMELS ratings the standard for determining discount window availability in 2003. Simply put, neither the FFIEC nor its member agencies have ever sought notice and comment on the UFIRS framework in its current form as a binding determinant of important powers and costs.

<sup>20</sup> For example, a bank’s CAMELS rating impacts its ability to appoint directors or senior executive officers. Section 914 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 requires non-objection by a primary federal regulator for a director or senior executive officer at a bank that is in “troubled condition,” which the agencies have defined by regulation to include having a composite CAMELS rating of 4 or 5. *See, e.g.*, 55 Fed. Reg. 6787 (Feb. 27, 1990) (Federal Reserve rule codified at Subpart H of Regulation Y, 12 C.F.R. §§ 225.71–225.73). Since 1996, the same regulatory definition has determined whether a bank is subject to limitations on golden parachute payments. *See* 61 Fed. Reg. 5926 (Feb. 15, 1996) (codified at 12 C.F.R. § 359.1(f)(1)(C)). Additionally, for a period of time, a bank’s composite CAMELS rating determined its capital requirements, *see, e.g.*, 50 Fed. Reg. 11138 (Apr. 18, 1985) (FDIC Statement of Policy on Capital), and whether it could accept brokered deposits, *see* 57 Fed. Reg. 23933 (June 5, 1992) (codified at 12 C.F.R. § 337.6).

Further, as a procedural matter, since at least 1983, the agencies have provided for streamlined or delegated processing of proposals based on the UFIRS rating of the applicant bank. *See, e.g.*, 48 Fed. Reg. 27027 (June 13, 1983). Likewise, the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) amended the Bank Holding Company Act to provide for expedited processing of nonbanking proposals by well managed bank holding companies, and to adopt the current statutory definition of “well managed,” which requires subsidiary banks that have been subject to examinations to have a CAMEL composite rating of 1 or 2 (or equivalent rating under a comparable rating system). *See* Pub. L. 104-208, 110 Stat. 3009-409, § 2208 (Sept. 30, 1996) (codified at 12 U.S.C. § 1841(o)(9)). EGRPRA also amended the Federal Reserve Act to require a member bank to have a CAMEL composite rating of 1 or 2 (or equivalent rating under a comparable rating system) to be able to make certain investments in bank premises without obtaining prior regulatory approval. *See* Pub. L. 104-208, 110 Stat. 3009-405, § 2206 (codified at 12 U.S.C. § 371d). Additionally, in 1994, Congress provided for an 18 month examination cycle for certain small banks that are “well managed” and with a “composite condition” that was found to be outstanding or good; and streamlined audit requirements for certain banks with a CAMEL composite rating of 1 or 2 under UFIRS (or an equivalent rating under a comparable rating system). *See* Pub. L. 103-325, 108 Stat. 2217, 2222 §§ 306 & 314 (codified at 12 U.S.C. § 1820(d)(4) & 12 U.S.C. § 1831m(i)).

<sup>21</sup> We note that the FFIEC issued the 1996 Statement after the Congressional Review Act took effect. That statute requires any rule – broadly defined so as to include statements of policy and other guidance documents – to be submitted to Congress under certain procedures before it may take effect. The GAO’s public records do not indicate that the FFIEC’s 1996 Statement was ever so submitted. *See* GAO Database of Rules, [https://www.gao.gov/legal/other-legal-work/congressional-review-act?fedRuleSearch=%22Uniform+Financial+Institutions+Rating+System%22&report=&agency=All&type=All&priority=All&begin\\_date=mm%2Fdd%2Fyyyy&end\\_date=12%2F19%2F2019&begin\\_eff\\_date=mm%2Fdd%2Fyyyy&end\\_eff\\_date=12%2F31%2F2020&begin\\_gao\\_date=mm%2Fdd%2Fyyyy&end\\_gao\\_date=12%2F19%2F2019&searched=1&Submit=Search#database](https://www.gao.gov/legal/other-legal-work/congressional-review-act?fedRuleSearch=%22Uniform+Financial+Institutions+Rating+System%22&report=&agency=All&type=All&priority=All&begin_date=mm%2Fdd%2Fyyyy&end_date=12%2F19%2F2019&begin_eff_date=mm%2Fdd%2Fyyyy&end_eff_date=12%2F31%2F2020&begin_gao_date=mm%2Fdd%2Fyyyy&end_gao_date=12%2F19%2F2019&searched=1&Submit=Search#database) (last accessed Dec. 20, 2019).

Thus, both in terms of sound policy and legal process, it is no longer tenable for the agencies to characterize the UFIRS as a supervisory tool of only minor legal consequence. If its four new functions are to remain (and by statute, one of them must), then the UFIRS framework must become focused – through public notice and comment rulemaking – on those purposes. This shift need not cause a major change in *what* the UFIRS ultimately measures (i.e., a bank's financial condition or viability), but it does seem to argue for major changes in *how it conducts that measurement*.

Fortunately, changes to banking regulation over the past 40 years also provide a means to change the UFIRS to become more focused and objective. Thus, the same changes that are procedurally required under the APA are also sound policy.

## 2. Changes to the regulatory context in which the UFIRS operates

The regulatory environment has changed dramatically since CAMELS' adoption. When it was first adopted in 1979, there was no capital regulation, no liquidity regulation, and no stress testing regulation. Since then, and particularly over the last ten years, detailed capital, liquidity and other rules have been expressly designed and deliberately calibrated to evaluate the key components of the CAMELS ratings. Capital adequacy is now subject to a panoply of quantitative minimum ratios and buffers. For large and some regional banking organizations, liquidity is subject to quantitative liquidity coverage ratio requirements at both the bank and holding company level as well as internal liquidity stress testing requirements at the holding company level. And capital adequacy, earnings, and asset quality are now subject to annual assessment at many of these banks and their holding companies via the agencies' stress testing programs. *Yet these relevant rules and measures are mentioned nowhere in the CAMELS framework.*

This state of affairs is at odds with the critical importance of the capital, liquidity, and other rules that have been developed since 1979, particularly post-crisis. Indeed, in its proposed amendments to the ratings system for Large Financial Institutions (which have since been finalized), the Federal Reserve acknowledged that the rating system for bank holding companies that had been in effect did not reflect that agency's use of those new rules and tools, and thus was outdated and in need of revision.<sup>22</sup> A similar acknowledgement with respect to the UFIRS is long overdue.

## II. Proposed Changes to the UFIRS

Modernizing the UFIRS does not require jettisoning its basic framework or how the agencies use ratings assigned thereunder. Rather, the agencies can and should engage in a rulemaking process to revise the framework so that it better serves its current functions. This section offers a series of concrete recommendations to achieve this goal.

### A. The stated purpose of the UFIRS should be revised to reflect its current functions and consequences.

The new roles that the UFIRS now serves argue for clarifying its purpose – in particular, by making clear that the purpose of the UFIRS is to assess the financial condition of the bank and, as a result, the likelihood that the bank will fail at a cost to its insurer or creditors, whether that be the Deposit Insurance Fund or the Federal Reserve as lender. This purpose seems clearly appropriate given the role that the UFIRS now plays in setting an appropriate deposit insurance premium and determining access to Federal Reserve credit.

Similarly, although the references to CAMELS ratings for purposes of the “well-managed” criterion of FHC eligibility in the Bank Holding Company Act and Home Owners' Loan Act do not have an explicitly stated purpose,

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<sup>22</sup> Federal Reserve System, *Large Financial Institution Rating System; Regulations K and LL*, 82 Fed. Reg. 39049 (Aug. 17, 2017).

they presumably serve to ensure that the organization has the ability to operate its depository institution subsidiaries in a safe and sound manner, so as to ensure their financial condition.

Thus, we propose that the agencies adopt by rule an explicit purpose for the UFIRS composite rating, and thus an implicit purpose for each of its component ratings: gauging the financial condition of the bank, and in particular the likelihood that it will fail at a cost to its creditors or insurer, or require significant financial support from its holding company to avoid doing so.

Notably, this purpose is consistent with the existing choice of components under the UFIRS regime; indeed, any third-party analyst assessing the financial condition of a bank would focus foremost on capital, asset quality, earnings, liquidity and sensitivity to market risk, including interest rate risk, as well as management capacity insofar as it specifically impacts those measures. Thus, for purposes of reforming the UFIRS, there is no reason to revisit those components as a categorical matter. But what *is* necessary, for several reasons, is to revisit and revise how each of those components, as well as the composite rating, is evaluated and measured.

- First, doing so will better align those components with the framework's current functions and purposes.
- Second, the severe and automatic consequences of a CAMELS rating of 3 or below argue for a more objective standard – in particular, one that a bank can know whether it is meeting and against which it can appeal an adverse determination, whether to the agency issuing the rating or a court.
- Third, as a policy matter, the UFIRS can and should reflect the numerous changes to regulation since 1996, which have profoundly changed how banks are evaluated by investors and regulators – but not in the context of CAMELS ratings.

## **B. Changes to the “Capital” component**

The current UFIRS was adopted prior to a wide range of comprehensive capital adequacy requirements, including:

- the development of the Basel I Accord in 1988, Basel II framework in 1999, and Basel III framework in 2010, which each resulted in the development of increasingly sophisticated, granular, and stringent capital adequacy regulations, including the definitions of (and deductions from) regulatory capital, the standardized and advanced approaches for calculating risk-weighted assets, operational risk capital, market risk capital, the conservation capital buffer, the countercyclical capital buffer, the supplementary leverage ratio and enhanced supplementary leverage ratio, and the G-SIB surcharge;
- the 1991 passage of FDICIA, which set forth a Prompt Corrective Action regime that requires the federal banking agencies to establish capital categories and impose increasingly stringent requirements on banks as they fall into lower categories;
- the post-2009 establishment of a multi-faceted capital stress testing regime that includes the CCAR, the Dodd-Frank Act Stress Tests, capital plan submission requirements, and the stress capital buffer; and
- the 2010 passage of the Dodd-Frank Act, including the so-called Collins Amendment, which requires the agencies' capital adequacy regulations to apply uniformly to banks and their holding companies, and standardized approach risk-weighted assets to serve as a floor to advanced approaches risk-weighted assets.

The Capital component should be significantly rewritten to reflect and incorporate this wide range of new, objective, and generally applicable capital adequacy measures. Specifically, we recommend the Capital component

be primarily based on the following three new considerations, which would largely replace the eight existing considerations:

1. Compliance by the institution with all applicable minimum regulatory capital requirements and buffers, including risk-based and leverage capital requirements under the Basel III capital rules. For purposes of this consideration, a bank should be presumed to be a “1” for these purposes if it meets all such requirements, absent demonstrable evidence that these measures do not capture important risks (e.g., concentration risk or idiosyncratic risk) to the bank’s ability to meet financial obligations.
2. Performance by the institution in any applicable capital adequacy stress testing requirements.
3. Market-based measures of capital adequacy. This would include, for example, measures of the trading performance of the bank’s outstanding debt.

We also recommend retaining the following considerations that are currently included in the UFIRS in some form, as they encompass other, useful information not otherwise reflected in the new considerations above:

4. The adequacy of the institution’s allowance for credit losses and other valuation reserves (current consideration #3). We support retaining this consideration, as adequacy of the loss allowance is not otherwise appropriately captured in quantitative risk-based capital measures.<sup>23</sup>
5. Asset concentration risk (current consideration #4). We support retaining this consideration, as concentration risk is not otherwise appropriately captured in quantitative risk-based capital measures.
6. Access to capital markets and other sources of capital, including potential support provided by a parent holding company (current consideration #8). We support retaining this consideration, as it is worth considering the ability of a bank to raise capital, which is not something necessarily reflected in capital regulations.<sup>24</sup>

#### **C. Changes to the “Asset Quality” component**

Asset quality is a traditional consideration in examination, and it should remain so. However, because all banks are now subject to risk-based capital requirements, which necessarily take into account the relative risk profile of a bank’s assets, some aspects of the current Asset Quality component have been subsumed by the Capital component. For that reason, we recommend that assessments of Asset Quality focus on elements otherwise not well reflected in the quantitative capital measures on which we suggest the Capital component be focused. For example, adequacy of the allowance for loan and lease losses and other asset valuation reserves (current consideration #3) is already appropriately included as part of the Capital component and need not be considered separately in Asset Quality.

#### **D. Changes to the “Earnings” component**

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<sup>23</sup> As we have discussed in prior comment letters, the agencies should ensure that they implement the current expected credit loss methodology (CECL) for determining loan loss reserves in a capital neutral manner. *See, e.g.*, BPI Comment Letter on Proposal to Implement the CECL into the Banking Agencies’ Capital and Dodd-Frank Act Stress Testing (DFAST) Rules (July 14, 2018), available at <https://bpi.com/recent-activity/bpi-files-comment-letter-on-proposal-to-implement-the-cecl-into-the-banking-agencies-capital-and-dodd-frank-act-stress-testing-dfast-rules/>.

<sup>24</sup> The agencies should revisit whether to include this consideration once they initiate a rulemaking process to implement the source of strength requirement set forth in section 616(d) of the Dodd-Frank Act.



The Earnings component largely captures important aspects of financial condition not otherwise captured through other components or post-1996 regulatory developments, and therefore we recommend it generally be retained in its current form. However, to provide greater objectivity and consistency across supervised banks, we suggest incorporating into the assessment framework one or more additional, quantitative considerations that are comparable across firms, such as:

1. Whether the institution is subject to regulatory restrictions on capital distributions due to insufficiency of earnings, including as a result of any applicable capital adequacy stress testing exercises.
2. If coverage exists, private sector analyst forecasts.

#### **E. Changes to the “Liquidity” component**

As with capital, liquidity regulation has been revolutionized since 1996, and in particular since Basel III liquidity standards were implemented in the U.S. in 2014. These subsequent developments, none of which are captured by the current UFIRS, include:

- the Liquidity Coverage Ratio, which is intended to promote short-term resilience of a large banking organization’s liquidity risk profile by requiring the organization to hold sufficient high-quality liquid assets to meet its liquidity needs during a 30-day stress scenario;
- internal liquidity stress testing requirements, which require large and certain regional banking organizations to hold highly liquid assets to meet net liquidity outflows, reflecting institution-specific vulnerabilities, business models, and estimations for haircuts and inflow and outflow rates; and
- resolution and recovery planning liquidity requirements, which require large and certain regional banking organizations to maintain sources of liquidity sufficient to meet the needs of affiliates that will operate as going concerns or be wound down in an orderly manner.

And, as with capital, the Liquidity component should be significantly rewritten to reflect and incorporate the new standardized quantitative measures for firms that are subject to them. Specifically, for that subset of firms, we recommend the Liquidity component be primarily based on the following new consideration, which would largely replace the eight existing considerations:

1. Compliance by the institution with all applicable standardized quantitative liquidity requirements (i.e., the LCR and, if adopted, the NSFR). For purposes of this consideration, a bank should be presumed to be a “1” for these purposes if it meets all such requirements, absent demonstrable evidence that these measures do not capture important risks (e.g., concentration risk or idiosyncratic risk) to the bank’s capital adequacy.

For that subset of firms subject to standardized quantitative liquidity requirements, we also recommend retaining the following considerations that are currently included in the UFIRS, as they encompass other, useful information not otherwise reflected in the new considerations above:

1. Access to money markets and other sources of funding (existing consideration #3);
2. The level of diversification of funding sources, both on- and off-balance sheet (existing consideration #4);
3. The trend and stability of deposits (existing consideration #5);

4. The ability to securitize and sell certain pools of assets (existing consideration #6).

**F. Changes to the “Sensitivity to Market Risk” component**

The Sensitivity to Market Risk component captures important aspects of financial condition not otherwise captured through other components or post-1996 regulatory developments, and therefore we recommend it generally be retained in its current form.<sup>25</sup>

**G. Changes to the “Management” component**

The Management component is most in need of reform. Over time, in our experience and that of our member banks, the Management rating has become increasingly subjective and increasingly disassociated from the proper purpose of the UFIRS – that is, it appears to have become a largely discretionary assessment of factors immaterial to a bank’s financial condition, rather than an objective assessment of management’s ability and resources to keep the bank’s financial condition sound. In particular, we are concerned that the Management component has increasingly become a mechanism to enforce a variety of laws, regulation or guidance unrelated to financial condition – laws for which, importantly, Congress has already and elsewhere established significant penalties and provided other tools to promote adherence to compliance responsibilities and mitigate attendant risks.

For example, and in contrast with current practice, the Management component should not be applied so as to effectively become a measure of: (i) compliance with federal consumer compliance, securities, tax, anti-money laundering,<sup>26</sup> sanctions, and other laws; or state law; (ii) the level of “reputational risk” in the bank’s lines of business;<sup>27</sup> or (iii) the bank’s Community Reinvestment Act (CRA) rating. Compliance or non-compliance with these laws generally (and perhaps in all cases) has no direct (or in most cases even indirect) effect on the financial condition of the bank – except, ironically, to the extent it currently affects the bank’s CAMELS ratings.

Including the bank’s CRA record, for example, in determining its CAMELS rating is no more appropriate than considering its capital levels when determining its CRA rating; downgrading a bank’s CAMELS rating for an AML violation is no more appropriate than reducing the size of a fine imposed under the Bank Secrecy Act because the bank maintains high capital levels. They are both important things; they are also different things.

None of this is to minimize the importance of compliance with these laws. In fact, Congress has set forth significant penalties for non-compliance with these laws.<sup>28</sup> *Congress, however, did not include among those penalties divestiture of non-bank affiliates, higher deposit insurance premiums, potential loss of access to Federal Reserve liquidity, or inability to engage in strategic transactions.* The agencies should not effectively amend those statutes to add additional penalties not authorized by Congress.

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<sup>25</sup> We note that banks subject to the market risk capital rule must maintain capital to address market risk arising from trading positions, which means that the Capital component of UFIRS implicitly considers market risk as to those positions. For those banks, the agencies should consider limiting the Sensitivity to Market Risk component of UFIRS to an analysis of nontrading positions.

<sup>26</sup> Under current agency policies, an enforcement order relating to AML controls presumptively leads to a downgrade of a bank’s Management rating. *See, e.g.*, OCC Bulletin 2012-30, BSA/AML Compliance Examinations: Consideration of Findings in Uniform Rating and Risk Assessment Systems (Sept. 28, 2012). This is the case notwithstanding the powerful and varied enforcement remedies available to federal regulators with respect to AML matters, including injunctive relief, civil penalties, and criminal penalties. *See, e.g.*, 31 U.S.C. §§ 5320, 5321(a), & 5322(a).

<sup>27</sup> *See, e.g.*, SR Letter 16-11 removing reputational risk as a standalone core risk category. The change recognizes that reputational risk is a secondary risk that results from control gaps in one or more of the primary risk categories.

<sup>28</sup> *See, e.g.*, 12 U.S.C. §§ 1818(b), (i) (enforcement authority with respect to violations of law); 1818(s)(3) (enforcement authority with respect to anti-money laundering violations). Moreover, in the case of federal consumer financial laws, Congress has established a separate agency (the Consumer Financial Protection Bureau) that was vested with exclusive authority to examine for, and enforce compliance with, such laws with respect to a bank with more than \$10 billion in total assets.

Furthermore, it is worth noting that abjuring consideration of non-financial factors would be consistent with the original purpose of the UFIRS. There is no specific mention of consumer compliance in the 1979 UFIRS release.<sup>29</sup> In fact, the following year, the agencies established a separate consumer compliance rating system – the Uniform Interagency Consumer Compliance Rating System – suggesting that the agencies intended the UFIRS and the consumer compliance rating system to focus on separate sets of issues. Lastly, keeping the Management component in its current form poses a real threat to the rule of law. It is through the Management rating that Operation Choke Point and other recent regulatory misadventures were actually effected, because the other CAMELS components ultimately focus on financial condition, not whether a bank’s practices pose a “reputational risk.”<sup>30</sup> Absent revisions by the agencies, in the future the Management component could become increasingly politicized in its application and more, not less, expansive and discretionary in the factors it purports to evaluate.

**1. The Management component should be eliminated, and the “well-managed” criteria for FHC eligibility should be revisited.**

In light of these fundamental issues with the Management rating, we recommend that the agencies eliminate the Management component altogether. The other components already assess whether a bank has sufficient managerial capacity to safeguard its financial condition, and indeed put a bank’s management in this regard to the ultimate test: whether or not the bank has attained and is likely to maintain a sound financial condition as rigorously measured by its capital, asset quality, earnings, liquidity, and sensitivity to market risk.

In this connection, and concurrent with the elimination of the Management component, the Federal Reserve should reevaluate what constitutes a “well managed” depository institution for purposes of determining FHC eligibility and no longer treat this statutory criterion as synonymous with a 1 or 2 Management rating.

The statutory definition of “well managed” for purposes of the FHC eligibility criteria does not require the issuance of a Management rating as part of the UFIRS, and appears to reject the calibration adopted by the agencies. It reads as follows:

*The term “well managed” means—*

*(A) in the case of any company or depository institution which receives examinations, the achievement of—*

*(i) a CAMEL composite rating of 1 or 2 (or an equivalent rating under an equivalent rating system) in connection with the most recent examination or subsequent review of such company or institution; and*

*(ii) at least a satisfactory rating for management, if such rating is given;*

*(B) in the case of a company or depository institution that has not received an examination rating, the existence and use of managerial resources which the Board determines are satisfactory.<sup>31</sup>*

Notably, while prong (A)(i) specifically references a composite rating of 1 or 2 under the CAMEL system, prong (A)(ii) does not; rather, it refers to “at least a satisfactory rating for management, *if such rating is given.*”

<sup>29</sup> The inclusion of compliance with laws and regulations generally within the 1979 release appears to be predicated on a sweeping (and incorrect) notion that every applicable law and regulation is somehow connected to an institution’s ability to continue its financial viability, accommodate the demand for financial services, and promote economic stability and growth.

<sup>30</sup> See Julie Andersen Hill, Regulating Bank Reputational Risk, Ga. L. Rev. (forthcoming 2020), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3353847](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3353847).

<sup>31</sup> 12 U.S.C. § 1841(o)(9).

Obviously, Congress could have specified that a bank must have a Management rating of 1 or 2 under the CAMEL system, as it did for the composite rating, but it did not.<sup>32</sup> The agencies should give meaning to Congress's choice to use different language in different prongs of the same provision.<sup>33</sup> Indeed, prong (B) even makes clear that no management rating need be assigned and thus made relevant to the "well managed" definition.

The text of the statute thus strongly suggests that either (i) no standard in addition to the composite rating should be used to determine what it means to have a "satisfactory rating for management" under the statute, or (ii) a separate standard should be created for this purpose.

Of these options, we believe the more appropriate approach is the former. It is nearly axiomatic that a bank that performs well on all the other components is well managed. Stated differently, a bank's financial health – measured in particular by its capital and liquidity levels relative to risk – reflects sound management. This approach would be consistent with the 1979 UFIRS release's clear intended focus on the financial condition of a bank.

If, despite our recommendation, the agencies do retain a management-focused component, we recommend that such component presumptively reflect the average of other component ratings, unless there is substantial evidence that the bank's ability to appropriately manage its financial condition is not otherwise reflected in its other component ratings. Thus, for example, a management team that is demonstrably improving the financial condition of a distressed bank could receive a higher rating for management than the other components currently warrant, and a team that has seriously and tangibly threatened the condition of a bank with strong capital and liquidity levels could receive a lower rating than the average.<sup>34</sup>

Either of these steps would remove the Management rating from its current de facto role as first among equals in the UFIRS components (given its unique legal implications), and better reflect that fact that a bank should be considered "well managed" if, on balance, its management team, acting under the oversight of the board of directors, is appropriately managing the bank's capital position and practices, liquidity position and practices, asset quality, earnings and sensitivity to market risk. Under current practice, it often seems that the Management rating is the only one that has consequences, and the rest are effectively superfluous. A bank that has a 3 rating for Management and a 2 rating for every other component effectively disqualifies its parent from financial holding company status, which gives disproportionate weight to the Management rating and seems inconsistent with Congressional intent.

If, nevertheless, the agencies decide to retain a management-focused component within or outside the UFIRS framework that is not presumed to be a simple average of the other components, they should consider adopting, in lieu of a Management rating a "Governance and Controls" rating such as that in the Large Financial Institutions (LFI) rating system that the Federal Reserve recently adopted for large bank holding companies.<sup>35</sup> Importantly, however, should the agencies choose this approach, it would be essential that they clarify that such a

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<sup>32</sup> Likewise, because the Riegle-Neal Act does not define the term "well managed," it also does not require a Management rating of 1 or 2. *See* 12 U.S.C. § 1831u.

<sup>33</sup> *See, e.g.*, *United States v. Spelar*, 338 U.S. 217, 225 (1949) (Jackson, J., concurring) ("[W]e should pay Congress the respect of not assuming lightly that it indulges in inconsistencies of speech which make the English language almost meaningless.").

<sup>34</sup> In any event, given the varied nature of banks' businesses and organizational structures, the agencies should allow for enough oversight and organizational flexibility that boards of directors and management can oversee and manage risk effectively. *See, e.g.*, The Clearing House, *The Role of the Board of Directors in Promoting Effective Governance and Safety and Soundness for Large U.S. Banking Organizations* (May 2016), available at [https://www.theclearinghouse.org/-/media/action%20line/documents/volume%20viii/tch\\_report\\_the-role-of-the-board-of-directors-in-promoting-governance.pdf](https://www.theclearinghouse.org/-/media/action%20line/documents/volume%20viii/tch_report_the-role-of-the-board-of-directors-in-promoting-governance.pdf) (describing the appropriate performance of core board of director functions, such as oversight of risk management and control frameworks).

<sup>35</sup> Such a rating would need to be tailored for banks and thus omit consideration of matters, such as resolution planning, that are focused on structural issues at holding companies. Moreover, considerations addressed by other CAMELS components (e.g., Earnings, Sensitivity to Market Risk, Asset Quality) that are not specifically incorporated into the LFI rating system should not inappropriately fall under Governance and Controls.

rating is **not** a “management” rating for purposes of prong (A)(2) of the statutory definition of “well managed” – thereby properly focusing financial holding company status solely on the composite rating when considering the management of a holding company’s subsidiary banks.

If the agencies nevertheless continue to incorporate a management-focused rating into FHC eligibility criteria, a 1, 2, *or* 3 rating for Management should be considered “well managed,” for several reasons. First, counting a 3 rating as satisfactory would be consistent with the text and structure of the statutory definition. The statute refers to “at least a satisfactory rating for management,” yet the UFIRS’s definition of a 3 rating for the Management component, as it has existed since Congress passed the “well managed” definition for purposes of FHC eligibility,<sup>36</sup> expressly does *not* require a determination of less than satisfactory management practices. Rather, UFIRS’s definition states that a 3 rating indicates “management and board performance that need improvement *or* risk management practices that are less than satisfactory given the nature of the institution’s activities” (emphasis added). In contrast, UFIRS’s definitions of 4 and 5 ratings plainly describe unsatisfactory performance. It thus appears that, to the extent the Congress considered CAMELS in adopting the second prong of the “well managed” definition, Congress would not necessarily have understood “at least a satisfactory rating” under the statute to be synonymous with a 1 or 2 rating for Management. Second, the statutory definition of “well managed” still requires a bank to have a composite rating of 1 or 2, which means that a bank could not meet the “well managed” standard if it had significant safety and soundness issues. Conversely, this approach would prevent a subjectively-determined management issue that does not affect the bank’s safety and soundness from unfairly resulting in divestiture of non-bank affiliates, limitations on the organization’s ability to engage in new activities or expand, imposition of higher deposit insurance premiums, and potential loss of access to Federal Reserve liquidity.

Finally, should the FHC eligibility criteria continue to require a 1 or 2 Management rating (even though such a rating is not required by statute), the definition of what constitutes a 3 rating for purposes of the Management component should be revised so as to require demonstrably unsatisfactory management practices that pose actual risk to the bank’s financial condition – that is, to require something akin to the level of management deficiency that currently triggers a 4 rating. Such an approach would be consistent with the LFI rating system, which includes just four ratings levels, only two of which represent a “deficient” condition. If the agencies take this approach, they should recalibrate the Management ratings of institutions that have a 3 rating under the current rubric. We would also support the adoption of four ratings levels as exists under the LFI rating system.

#### **H. Changes to the calculation of composite ratings**

With respect to the composite rating, the UFIRS currently states:

*The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors comprising that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution. Assigned composite and component ratings are disclosed to the institution’s board of directors and senior management.<sup>37</sup>*

The UFIRS also states:

*The ability of management to respond to changing circumstances and to address the risks that may arise from changing business conditions, or the initiation of new activities or products, is an*

<sup>36</sup> Congress adopted the definition in 1996 as part of EGRPRA. *See supra* n. 20.

<sup>37</sup> 62 Fed. Reg. 752, 752 (Jan. 6, 1997).

*important factor in evaluating a financial institution's overall risk profile and the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating.*<sup>38</sup>

From both a legal and policy perspective, this standard appears needlessly vague, and as a practical matter provides no meaningful standard at all, other than a heavy reliance on the most subjective and ill-defined component (Management) in setting the composite rating. Given that the composite rating is the most important of all of the ratings assigned, it is especially important that it be clear, objective, and consistent with the underlying purposes and functions of the CAMELS system. It is effectively impossible for composite ratings to be assigned consistently across banks, and assigned reasonably and predictably as to any one bank, where that composite rating is *by design* the function of an *ad hoc* exercise of supervisory discretion that is neither explained nor explainable by reference to any specific standard. Accordingly, we recommend that the composite rating presumptively be derived by calculating the simple average of the component ratings, rounded to the nearest whole number, absent a compelling reason to deviate.

### III. Further Study of the CAMELS Framework is Needed to Assess Whether it is an Effective Evaluation Methodology at All

When adopting the UFIRS in 1979, the agencies specifically stated that “the rating system is meant to assist the public and the Congress in assessing the aggregate strength and soundness of our financial system.” But while so much research attention is currently being paid to bank regulation, with agency economists releasing numerous staff papers on that subject, it seems remarkable that there has been no effort to determine whether CAMELS ratings are effective in identifying weakness at banks – for example, whether a “C” rating is more predictive of future capital strength than objective measures, or whether a composite rating is more predictive than CDS spreads or analyst consensus. (If the agencies have conducted such research outside of public view, we would urge them to make it public in some form.) Thus, while the agencies claimed in 1996 that “[o]ver the years, the UFIRS has proven to be an effective internal supervisory tool for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern,” we are aware of no evidence that existed at the time, or exists currently, to support such a conclusion.

Indeed, we are aware of no precedent in banking or other regulation in which an assessment methodology has been employed for four decades without a single attempt to evaluate, on the basis of that rich experience and data, whether the methodology has proven informationally accurate or useful in practice. This is difficult to understand given that the agencies’ original motivation in developing the UFIRS was to assist the public and Congress in understanding the safety and soundness of the banking system.

We have wanted to conduct this type of research, but doing so would require gathering CAMELS ratings over time. We requested this information from the agencies under the Freedom of Information Act, specifying that we sought only anonymized, aggregate ratings and nothing bank-specific, but each of the banking agencies denied the request.

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*Id.*

This petition is made pursuant to section 553(e) of the APA, which provides that “[e]ach agency shall give an interested person the right to petition for the issuance, amendment, or repeal of a rule,” a denial of which must be justified by a statement of reasons pursuant to section 555(e) of the APA and can be appealed to the courts under sections 702 and 706 of the APA.<sup>39</sup> We note that the APA requires that “[p]rompt notice ... be given of the denial in whole or in part” of any petition under 5 U.S.C. § 553, and that any denial shall include a “brief statement of the grounds for denial.”<sup>40</sup> If you have any questions, please contact the undersigned by phone at (202) 589-1933 or by email at greg.baer@bpi.com.

Respectfully submitted,

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<sup>39</sup> See 5 U.S.C. §§ 553(e), 555(e), 702, and 706; *see also* Auer v. Robbins, 519 U.S. 452, 459 (1997).

<sup>40</sup> The D.C. Circuit has opined that while there is “no per se rule as to how long is too long” to wait for an agency action, a reasonable time for agency action is “typically counted in weeks or months, not years.” *In re Am. Rivers & Idaho Rivers United*, 372 F.3d 413, 419 (D.C. Cir. 2004) (quoting *Midwest Gas Users Ass’n v. FERC*, 833 F.2d 341, 359 (D.C. Cir. 1987)).