June 25, 2018

Ann E. Misback, Secretary
Attention: Docket No. R-1603; RIN 7100-AF 02
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

VIA ELECTRONIC MAIL: regs.comments@federalreserve.gov

Re: Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules, 83 Fed. Reg. 18,160 (the "**Proposed Amendments**")

Dear Madam:

The Committee on Capital Markets Regulation (the "**Committee**") is grateful for the opportunity to comment on the Federal Reserve System's (the **"Fed"**) proposed amendments to the regulatory capital, capital plan, and stress test rules.[1]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-five leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

Under the current U.S. regime for capital regulation, bank holding companies ("**BHCs**") with assets of $50 billion or more must comply with two different assessments of capital adequacy.[2] First, all BHCs must maintain minimum risk-based capital ratios, including a capital conservation buffer, based on standards set by the Basel accords (the "Basel-based capital requirements"). Second, BHCs with more than $50 billion of assets must participate in the Fed's annual Comprehensive Capital Analysis and Review ("**CCAR**") in which they must demonstrate continued compliance with minimum capital requirements under stressed economic conditions ("**CCAR capital requirements**"). The

[1] 83 Fed. Reg. 18,160 (Apr. 25, 2018).
[2] *See* Board of Governors of the Federal Reserve System, Proposed Rule Regarding the Stress Buffer Requirements, Apr. 5, 2018.

Fed's Proposed Amendments aim to further integrate the two, the static Basel-based capital requirement and the dynamic CCAR capital requirement, into one requirement.[3]

To integrate the two, the Proposed Amendments would create a stress capital buffer ("**SCB**"), calculated as (i) the peak-to-trough decrease in a firm's common equity tier 1 risk-based capital ratio under the Fed's severely adverse scenario, based on the bank's losses in the stress test, plus (ii) planned dividends, which would further reduce capital, for the fourth through seventh quarters of the stress test horizon.[4] The SCB would replace the existing 2.5% capital conservation buffer required for all banks as part of the Basel-based capital requirements. The SCB would have a floor of 2.5% and an unbounded maximum. Based on the 2017 stress test results, the SCB would have ranged between 2.5% and 8% for applicable firms (i.e. firms with $50 billion or more of assets).[5] As part of this integration, the Fed would eliminate the quantitative objection to a firm's stress test results; firms will no longer "fail" a stress test for quantitative reasons.[6] Instead, they will simply be required to raise more capital if their existing capital levels are insufficient to meet the new capital requirements under the Proposed Amendment.

Under the Proposed Amendment, the SCB would replace the 2.5% capital conservation buffer only when calculating risk-based capital under the standardized approach.[7] The Fed's reasoning is that "the Board has not used or required the use of the capital rule's advanced approaches in the supervisory stress test due to the significant resources required to implement the advanced approaches on a pro forma basis and the complexity and opaqueness associated with introducing the advanced approaches in the supervisory stress test projections."[8] In other words, since the Fed only projects stress test losses under the standardized approach, it would only apply the SCB to capital measurements calculated under the standardized approach.

In addition to the creation of the SCB, the Proposed Amendments make certain revisions to the CCAR assumptions. Currently, as part of CCAR, the Fed assumes that firms would proceed with all planned capital distributions over the nine-quarter stress test horizon, even in the face of severe economic stress. Under the Proposed Amendment, the Fed would relax this assumption by narrowing the set of planned capital actions assumed

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[3] 83 Fed. Reg. 18,160 (Apr. 25, 2018) at 14 (noting "[t]he proposal would use the results of the annual supervisory stress test to size specific buffer requirements above minimum capital requirements that restrict capital distributions under the capital rule and establish a single approach to capital distribution limitations, effectively integrating the capital rule and the capital plan rule.")

[4] Id.

[5] Cleary Gottlieb Alert Memorandum, Federal Reserve Proposes "Stress Capital Buffer" and Scales Back Enhanced Supplementary Leverage Ratio, Apr. 16, 2018.

[6] Id.

[7] Risk-based capital requirements that are calculated under the advanced approach would continue to use the 2.5% capital conservation buffer and would not use the SCB.

[8] Board of Governors, Proposed Rule Regarding the Stress Buffer Requirements, Apr. 5, 2018.

to occur in the stress test. The Proposed Amendment eliminates all planned capital distributions, including repurchases and redemptions, over the nine-quarter horizon and replaces the assumption with only common stock dividend payments occurring in the fourth through seventh quarters of the stress test horizon in addition to continued preferred stock dividends throughout the stress test horizon. [9]

The current CCAR framework also assumes that firms will grow their balance sheets over the stressed horizon. Under these Proposed Amendments, the Fed would relax this assumption, instead assuming that the size of the balance sheet would remain constant over the stress test horizon.[10]

Finally, the Proposed Amendment would also introduce a new stress leverage buffer ("**SLB**") to be added to a firm's leverage ratio requirement. The SLB would be calculated as the firm's (i) maximum projected decline in its Tier 1 leverage ratio under the severely adverse stress scenario, *plus* (ii) its planned common stock dividends for the fourth through seventh quarters of the CCAR planning horizon in addition to continued preferred stock dividends throughout the stress test horizon. However, unlike the SCB, the SLB would not have a minimum floor.

The Fed predicts that the proposed revisions would generally decrease capital requirements for non-global systemically important banks ("**GSIBs**") and increase capital requirements for GSIBs.[11] For non-GSIBS, the reduction would be due to the modification of the assumptions regarding planned distributions and balance sheet growth.[12] For GSIBs, the reduction due to the modified assumptions would be more than offset by the increase from the addition of the GSIB surcharge. For example, suppose capital required under the prior stress test requirements for a GSIB were 9.5%, consisting of (i) minimum requirement of 4.5%, *plus* (ii) stress test losses of 2.75%, *plus* (iii) planned distributions and balance sheet growth of 2.25%.[13] Under the Proposed Amendments, the 2.25% due to planned distributions and balance sheet growth would be reduced significantly (not eliminated entirely since there is a remaining dividend assumption), but a GSIB surcharge would also be added. In cases where the GSIB surcharge exceeds the planned distribution reduction, the net effect will be an increase in capital required. Continuing the example, if the banks eliminated their dividends to 0.5% and the GSIB surcharge were 3.0%, the revised capital requirements would be 10.75% (4.5% minimum + 2.75% stress test losses + 0.5% dividends + 3.0% GSIB surcharge), an *increase* of 125 basis points.[14] The higher the GSIB surcharge, the greater the impact.

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[9] *See Id* at 15.
[10] *See Id* at 16.
[11] *See Id* at 32.
[12] Id.
[13] *See* Fed Staff memo dated Apr. 5, 2018.
[14] Id.

Overall, the Fed estimates that the net impact of the Proposed Amendments on capital for *all* banks (not just G-SIBs) would range from an aggregate $35 billion *reduction* in common equity tier 1 capital requirements (based on the 2017 CCAR results) to an aggregate $40 billion *increase* (based on the 2015 CCAR results).[15]

The Committee commends the Fed's proposal to relax the capital distribution and balance sheet assumptions in the CCAR stress tests, which we believe are positive revisions to the CCAR framework. However, the Committee is concerned with certain aspects of the Proposed Amendments' approach to integrating the results of the CCAR stress tests with the Basel-based capital requirements. First, we question the continued reliance on standardization versus internal models. Second, we continue to be concerned with the lack of CCAR transparency and disclosures regarding the adverse scenarios and the Fed's loss models. Third, we believe it is important to highlight the potential for double counting of the GSIB surcharge that may result from the proposed integration. Fourth, we believe the Fed should adjust the threshold for instituting mandatory capital distribution constraints. Fifth, we are opposed to the new stress leverage buffer becoming a binding capital constraint. Sixth, we believe the Fed should eliminate the mandatory portion of the resubmission process. Finally, we are concerned that the Fed has not disclosed details of any quantitative impact analysis that it conducted as part of these proposals.

Continued Reliance on Standardization[16]

In general, the Committee questions the continued reliance on standardized processes for determining capital requirements. The movement towards standardized versus internal-based models has roots in the Fed's implementation of Basel III, which was subject to the requirements of section 171 of the Dodd-Frank Act (the so-called Collins Amendment).[17] The Collins Amendment established two floors for risk-based capital requirements. Minimum risk-based capital requirements could not be less than (i) the generally applicable risk-based capital requirements that apply to all banks, nor (ii) quantitatively lower than the generally applicable risk-based capital requirements that were in effect as of July 21, 2010.[18] In its implementing rules, the Fed established the generally applicable risk-based capital requirements to be the Basel III standardized approach, making it the floor for all banks as a result of the Collins Amendment.[19] The Fed should reexamine whether the legislation compels the Fed to define the generally applicable risk-based capital requirement to be the Basel III standardized approach for all banks.

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[15] 83 Fed. Reg. 18,160 (Apr. 25, 2018) at 33.
[16] One member wished to state that it does not favor the recommendations in this section regarding the increased use of internal models.
[17] 12 U.S. Code 5371.
[18] Id.
[19] 78 Fed. Reg. 62,018 (Oct. 11, 2013).

We would also favor the Fed's suggestion of giving models more say in scaling the SCB. In its proposing release, the Fed acknowledges the inconsistency in applying the SCB only to the standardized approach and suggests an example of an alternative approach (by way of question posed to commenters). The alternative would "scal[e] the stress capital buffer requirement by the ratio of a firm's standardized total risk-weighted assets to its advanced approaches total risk-weighted assets in cases where the firm's advanced approaches capital ratio calculations are lower than its standardized capital ratio calculations."[20] The Fed would then apply the scaled-SCB to the advanced approaches methodology.

For example, suppose a firm's SCB is calculated to be 2.75%. Further suppose that under the advanced approach a firm's risk-weighted assets are 80% of its standardized risk weighted assets (i.e. advanced RWA / standardized RWA = 0.8). Then for purposes of its advanced approaches capital measurement, the SCB would be (0.8 x 2.75%) or 2.20%, as opposed to 2.75% under the standardized approach.

Additionally, with regard to the SCB, the Fed should model losses using firm-specific internal models with any Fed supervisory model serving as no more than a backstop. In other words, when assessing losses due to adverse economic scenarios the Fed should compare the losses produced by their own model to the losses produced by bank models from the same scenario. The Fed should then determine the appropriate losses (and ultimately the SCB) by taking the losses from each (the bank models and the Fed's model) into consideration. We note that a similar approach is presently used for calculating losses from stress tests by the Bank of England.[21] In conjunction with this, the Fed should relax the current requirement that bank stress scenarios be "at least as severe as the Federal Reserve's severely adverse scenario, measured in terms of its effect on net income and other elements that affect capital."[22]

The Committee supports determining minimum capital requirements based on banks' modeling of risk because this produces a diversity of risk-weights and thus partly addresses concerns that banks will herd into certain asset classes. Such herding can distort lending and asset prices, thereby creating unnecessary risk. However, at the same time, we note that unfettered reliance on bank models can also produce unintended consequences, as bank models may underestimate the appropriate minimum capital requirements for certain assets. We therefore believe that the best approach may be a middle ground whereby bank internal models are subject to oversight and approval by the Federal Reserve, both

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[20] 82 Fed. Reg. 18,160 (Apr. 25, 2018).
[21] *See* Rohan Churm, Presentation: Stress Test Modeling at the Bank of England: Past, Present and Future at 14-15 (Mar. 9, 2017); *and see* The Bank of England's Approach to Stress Testing the U.K. Banking System at 15-16 (Oct. 2015), https://www.bankofengland.co.uk/-/media/boe/files/stress-testing/2015/the-boes-approach-to-stress-testing-the-uk-banking-system.pdf.
[22] Federal Reserve SR 15-18.

for the advanced approach and determining stress test losses. The Fed can ensure that bank models do not excessively underprice the risk of an asset or losses from a stress event.

Continued Lack of CCAR Transparency

The Federal Reserve's stress test models that are used to estimate losses under the severely adverse scenario, which will determine the SCB and SLB requirements under this proposal, continue to lack adequate transparency and disclosures. In its December 2017 proposal, the Fed did aim to provide more transparency and disclosures regarding the loss models and economic scenarios.[23] In our January 2018 comment letter, while we commended the Fed for moving toward increased transparency, we noted our view that the Fed had not done nearly enough in this respect.[24] We believe the current Proposed Amendments fail to address our continuing concerns about stress test transparency.

As the Committee previously stated, the Fed's December 2017 proposals did not "go far enough because they do not provide the public the opportunity to comment on the scenarios and models before they are finalized and applied in the annual stress tests...."[25] We remain concerned about the lack of transparency and disclosure, particularly given the heightened importance of the stress test losses under the Proposed Amendments. Furthermore, as the Committee has previously asserted, the opaque process through which the scenarios and models are developed could be in violation of the Administrative Procedure Act.[26]

The Fed's stress test loss models are a "black box," making it nearly impossible for financial institutions to anticipate their SCB with any meaningful confidence. The SCB will have ongoing implications for firms, since they must incorporate the SCB into their Basel calculations which will be the new binding constraint. Therefore, the calibration of the SCB is vitally important to a firm for strategic planning purposes,[27] so transparency (and accountability) of the Fed's loss models and severely adverse economic variables becomes all the more important. Moreover, the lack of transparency is even more problematic given the potential volatility of SCB calculations year over year. Since banks cannot accurately estimate stress test losses (due to the opaqueness of the model), they will be forced to hold even more capital as a "volatility buffer" against the uncertainty of the SCB. Additionally, we recommend that the Fed subject the severely adverse economic variables to some form of public notice and comment, using a well-defined and quantifiable

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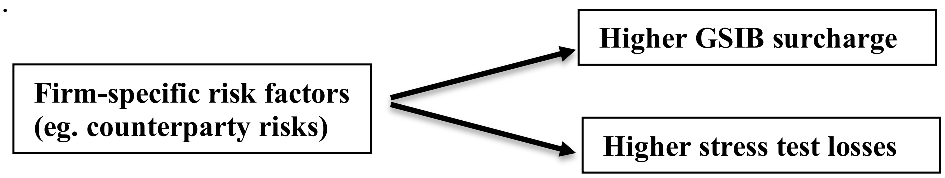
[23] *See* 82 Fed. Reg. 59,547 (Dec. 15, 2017); 82 Fed. Reg. 59,528 (Dec. 15, 2017); and 82 Fed. Reg. 59,533 (Dec. 15, 2017).
[24] *See* Committee on Capital Markets Regulation, comment letter dated Jan. 19, 2018, *available at* https://www.capmktsreg.org/wp-content/uploads/2018/01/1_19_18_CCMR-FINAL_Comment_Letter_Fed-Stress-Test-Proposals.pdf.
[25] *Id* at 2.
[26] Committee on Capital Markets Regulation, The Administrative Procedure Act and Federal Reserve Stress Tests: Enhancing Transparency (Sept. 2016), (Deutsche Bank and ICBA dissented from the report).
[27] *See* Cleary Gottlieb Alert Memorandum, Federal Reserve Proposes "Stress Capital Buffer" and Scales Back Enhanced Supplementary Leverage Ratio, Apr. 16, 2018.

severity framework, such that the public can easily understand and have an opportunity to comment on the relative severity from year to year.

Double Counting of the GSIB Surcharge

The Committee is also concerned that the integration of the SCB requirement with ongoing risk-based capital requirements, which already includes a U.S. gold-plated GSIB surcharge, will result in "double counting" of the GSIB requirement. Under the Proposed Amendments, CCAR firms will be required to maintain ongoing capital levels that include (i) minimum capital requirements, *plus* (ii) the stress capital buffer ("SCB"), *plus* (iii) the "gold-plated" U.S. G-SIB surcharge. Since the SCB and the GSIB surcharge are additive, the potential for double counting arises if the same firm-specific risks that are factored into the GSIB surcharge are also captured in the secretive CCAR loss models (used to calculate the SCB).



Since the opaqueness of the stress test loss models prevent a complete comparison between the CCAR loss framework and the GSIB surcharge calibration, the Committee strongly urges the Fed to use caution to avoid double counting of the risks that are unique to the largest financial institutions.

The Clearing House has previously noted that "the existing CCAR framework already includes unique, incremental assumptions that increase stress loss estimates that apply *only* to GSIBs."[28] In particular, factors that serve to increase a firm's GSIB surcharge significantly overlap with the factors incorporated into the "market shock and counterparty failure scenarios" of the stress tests.[29] Therefore, it is likely that the same firm-specific factors that lead to higher capital requirements for a GSIB *directly* though the GSIB surcharge will also *indirectly* impose additional capital requirements through the SCB. For example, suppose certain counterparty risks lead to a higher GSIB surcharge. If those same counterparty risks also lead to higher losses in the Fed's loss model, then the SCB will also be higher as a result. Effectively, the single set of counterparty risks will be double counted for purposes of the firm's capital requirements (once through the GSIB surcharge and once through the SCB).

Certain financial assets, such as derivatives and repurchase agreements, can also count heavily in various GSIB factors, including complexity and interconnectedness, which can lead to a higher GSIB surcharge. At the same time, these assets are also subject to significant losses in the stress test's severely adverse scenario. As a result, exposure to these financial assets will result in further double counting. Therefore, the Committee

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[28] The Clearing House, comment letter re: Incorporation of the GSIB Surcharge into CCAR, dated Jun. 2, 2016.
[29] Id.

strongly recommends that the Fed calibrate the GSIB surcharge and stress test loss models appropriately so as to avoid the potential for double counting.

Of course, certainty that double counting is not occurring can only be verified with increased transparency of the stress test models, further supporting the need for enhanced disclosures regarding the loss models. If the Fed intends to integrate the GSIB surcharge and the stress test losses, as is proposed here, the Fed must be more transparent about its CCAR models and its selection of the adverse scenario variables.

In addition to the GSIB surcharge, the Fed should also address other areas of double counting in the proposed framework. For example, the CCAR scenarios contain countercyclical elements, yet the Fed has maintained its ability to activate the countercyclical capital buffer which would apply in addition to the SCB. Therefore, the Fed should consider eliminating any possibility of a countercyclical capital buffer upon introducing the SCB.

Mandatory Capital Distribution Constraints

Under the current rules, mandatory payout restrictions are imposed if a firm's capital falls below the capital conservation buffer, which is based on the dynamic SCB. However, the Committee believe that mandatory payout restrictions should only apply if the firm breaches the existing static Basel-based capital buffer of 2.5%. This certainty would help to mitigate the transparency concerns outlined above and also ensure that the SCB is not gold-plated as compared to the Basel-based capital requirements and other jurisdictions' implementation of stress buffer requirements (for example, Pillar 2G in the EU and Pillar 2B in the UK). Firms should not be required to reduce common and preferred dividends to the extent they are meeting the static 2.5% capital conservation buffer but are below the full SCB. Breaches of any incremental amounts above the Basel buffers should require submitting a capital plan with mitigating actions to address the shortfall, but no mandatory distribution restrictions.

Stress Leverage Buffer as a Binding Capital Constraint

As we have commented in the past, the Committee continues to believe that leverage ratios should operate as a capital backstop with risk-based capital guidelines serving as the primary means of capital regulation.[30] Therefore, we urge the Fed to use caution in calibrating the stress leverage buffer to ensure that it does not become a binding capital constraint, as we strongly believe that a simple leverage ratio should not be the

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[30] *See* Committee on Capital Markets Regulation, comment letter re: Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions, dated Oct. 21, 2013, *available at* http://www.capmktsreg.org/wp-content/uploads/2013/10/CCMR-supp.leverage.comment.ltr-10-21-2013.pdf.

binding capital requirement on a financial institution. The Committee supports the Fed and OCC's recent proposal to scale back the enhanced supplementary leverage ratio,[31] which we consider a positive development in ensuring that the leverage ratio is not a binding constraint. The Fed should be careful not to undo this progress through an overly burdensome stress leverage buffer.

Elimination of Mandatory Resubmissions

Under the current rules, the Fed may require a firm to resubmit its capital plan if the Fed determines that the firm has "materially underperform[ed] its projected capital ratios…."[32] A firm that is required to resubmit its capital plan is prohibited from making any capital distributions until the Fed has approved the revised plan.[33] The Committee believes that the Fed should eliminate mandatory resubmissions. Under the proposed integration, firms will be subjected to daily checks on its capital ratio and are further subjected to maximum payout ratios based on meeting the SCB buffer. Therefore, mandatory resubmissions demanded by the Fed become unnecessary and only serve to complicate the regulatory regime, while also frustrating the ability of firms to manage their own capital.

Disclosure of Impact Analysis

Finally, the Committee strongly urges the Fed to disclose the details of its estimated impact analysis. In its proposing release, the Fed states:

> "[T]he Board estimates that non-GSIBs subject to CCAR would generally need to hold less capital under the proposal, as compared with the current supervisory post-stress capital assessment in CCAR, which is the binding constraint for most firms. In contrast, the Board estimates based on the most recent CCAR results the proposal would generally maintain or in some cases increase CET1 capital requirements for GSIBs."[34]

While the Committee appreciates the estimated impacts provided by the Fed, we strongly urge the Fed to be more transparent about its analysis by providing greater details about its estimation process. The Fed has conducted detailed, transparent quantitative impact analyses in prior rulemakings, and we believe the Fed should do the same for these Proposed Amendments.

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[31] 78 Fed. Reg. 17,317 (Apr. 19, 2018).
[32] 83 Fed. Reg. 18,160 (Apr. 25, 2018).
[33] Id.
[34] 83 Fed. Reg. 18,160 (Apr. 25, 2018) at 17.

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Thank you very much for your consideration of the Committee's views. Should you have any questions or concerns, please do not hesitate to contact the Committee's Director, Prof. Hal S. Scott (hscott@law.harvard.edu), or Executive Director of Research, John Gulliver (jgulliver@capmktsreg.org), at your convenience.

Respectfully submitted,

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