



June 25, 2018

*Via Electronic Mail*

Ms. Ann Misback, Esq.  
Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street & Constitution Avenue, N.W.  
Washington, D.C. 20551

Re: Proposed Amendments to the Regulatory Capital, Capital Plan and Stress Test Rules  
(Docket No. R-1603; RIN 7100-AF2)

Ladies and Gentlemen:

The Clearing House Association L.L.C., the Securities Industry and Financial Markets Association, and the Financial Services Roundtable (together, the “**Associations**”)<sup>1</sup> appreciate the opportunity to comment on the Federal Reserve’s proposal<sup>2</sup> to establish a stress buffer framework that would create a single, integrated set of capital requirements by combining the supervisory stress test results of the Comprehensive Capital Analysis and Review program and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010<sup>3</sup> with the ongoing, “point-in-time” requirements of its Basel III regulatory capital rule for covered firms.<sup>4</sup> The Proposal represents a step forward toward much-needed measures to bring greater coherence and simplicity to the U.S. bank capital framework and to address long-standing flaws in the design

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<sup>1</sup> Descriptions of the Associations are provided in Annex A of this letter.

<sup>2</sup> Federal Reserve, *Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules*, 83 Fed. Reg. 18,160 (Apr. 25, 2018) ([link](#)).

<sup>3</sup> Pub.L. No. 111-203 (2010).

<sup>4</sup> As proposed, the Proposal would apply to bank holding companies with \$50 billion or more in total consolidated assets and U.S. intermediate holding companies (“**IHCs**”) of foreign banking organizations (“**FBOs**”) established pursuant to Regulation YY. The Associations assume that the Federal Reserve will adjust the \$50 billion threshold and scope of applicability to be consistent with the recently enacted Economic Growth, Regulatory Relief and Consumer Protection Act. Pub.L. No. 115-174 (2018) ([link](#)) (“**EGRRCPA**”). In this letter, we use the term “point-in-time” capital requirements to distinguish between a firm’s ongoing regulatory capital requirements under the capital rule and its requirements under the stress testing rules.

and mechanics of the Dodd-Frank Act supervisory stress testing (“**DFAST**”) and the CCAR exercise.

To the extent that elements of the Proposal support this objective, we strongly support them. For example, the Associations strongly support the proposal to eliminate from CCAR and DFAST the currently applicable assumption that firms’ balance sheets and risk-weighted assets (“**RWAs**”) grow under stressed conditions.<sup>5</sup> Under an actual stress scenario, firms’ balance sheets would be affected by a combination of effects on counterparty actions (including defaults, draw-downs on existing lines of credit and demand for new credit) as well as shocks to market prices and market-wide demand. It is unrealistic to assume that these effects would, in the aggregate, result in a firm’s balance sheet growing under stress, with a consequent growth in RWAs. As a result, removing the balance sheet and RWA growth assumptions from DFAST and CCAR, as proposed in the Proposal, is a significant and wise step towards aligning the assumptions in the supervisory stress testing framework with historical experience and empirical data.

The Associations, however, believe that further important changes to the Proposal and the capital, capital plan and stress testing framework are necessary to base it on more realistic scenarios and assumptions, reflect more accurate and updated measures of risk, and achieve the intended simplification and elimination of the quantitative objection to a firm’s capital plan for banking organizations covered by the Proposal.

## **I. Executive Summary**

- Integrating stress losses into point-in-time capital requirements through the proposed stress buffers would promote the transparency and simplification of the capital and stress testing framework; however, as empirically evidenced by the 2018 DFAST results, it would also heighten the urgency to address the volatility of estimated stress losses through increased transparency of supervisory models, a public notice-and-comment period for stress scenarios, and realistic scenario parameters for supervisory scenario design given the impact on point-in-time capital requirements under the Proposal.
- The Federal Reserve’s supervisory stress scenarios and scenario components used in CCAR and DFAST should be made available earlier each cycle and subject to public notice and comment, which would increase transparency and create a feedback mechanism to improve the plausibility and coherence of the supervisory scenarios.
- The Federal Reserve should establish scenario design principles incorporating transparent and realistic scenario parameters regarding the overall severity and change in severity of the supervisory stress scenarios, while maintaining the Federal Reserve’s flexibility to design scenarios that are appropriately countercyclical, and ensure coherence between its supervisory macroeconomic scenarios and its scenario components to avoid inconsistent and unrealistic assumptions.

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<sup>5</sup> Proposal at 18,166.

- The Federal Reserve should significantly enhance its disclosures about supervisory models to allow for greater model transparency, which would facilitate constructive feedback to improve the quality and credibility of supervisory models. Increased model transparency is essential for any stress buffer reconsideration procedure to be effective.
- The removal of the common stock dividend and share repurchase assumptions are an equally welcome and significant improvement over the currently applicable assumptions that these actions would continue throughout the planning horizon in all economic conditions and without regard to the stress firms face or whether those distributions would be permissible under the capital rule. The final stress buffer requirements should not, however, include an additional component for four quarters of planned common stock dividends (the “**dividend add-on**”) in light of the payout restrictions under the Federal Reserve’s capital rule, and changes should be made to the definition of eligible retained income and other mechanics of the payout restrictions to more realistically reflect the actions firms would take and to retain an appropriate measure of capital management flexibility for firms’ boards of directors under stressed conditions.
  - It is unnecessary under the Federal Reserve’s capital rule to include the dividend add-on in the calibration of the Stress Capital Buffer (“**SCB**”) and Stress Leverage Buffer (“**SLB**”) and together with the SCB the “**stress buffer requirements**”).
  - If the dividend add-on is retained, the Federal Reserve should allow it to function as a pre-capitalization of four quarters of common equity dividends (and also for assumed Additional Tier 1 capital dividends) that can actually be drawn down in times of stress.
  - Whether or not the dividend add-on is retained, the definition of eligible retained income should be modified to reflect the ability and practice of firms in normal circumstances to distribute their earnings, and the payout restrictions should more realistically reflect the actions firms would take.
  - The Proposal should be amended to take into account the different circumstances of the U.S. IHCs of FBOs.
- Consistent with the intended elimination of any quantitative objection to a firm’s capital plan, the Federal Reserve should amend the capital plan rule to fully eliminate any residual basis for a quantitative limitation on capital distributions, in accordance with the Federal Reserve’s respective expectations for a firm’s board of directors and senior management to be responsible for capital planning.
  - The Federal Reserve should eliminate the prohibition on a firm exceeding during the relevant period – as proposed, the fourth through seventh quarters of the planning horizon – the aggregate dollar amount of planned capital distributions in its capital plan, unless the firm receives the Federal Reserve’s specific prior approval (the “**Prior Approval Requirement**”).

- The Prior Approval Requirement is unnecessary in light of the establishment of the stress buffer requirements.
- Eliminating the Prior Approval Requirement would improve capital management.
- If the Prior Approval Requirement is retained, other features of the capital plan rule should be modified to permit firms more flexibility to adapt their capital plans to changing circumstances.
  - If the Prior Approval Requirement is retained, a firm should nevertheless have more flexibility to exceed the aggregate amount of its planned capital distributions to the extent consistent with its buffer requirements.
  - If the Prior Approval Requirement is retained, it should be modified to apply only on a net basis.
- The effective date of a firm's stress buffer requirements should be one year following notice of its calculated SCB, and the proposed reconsideration and mulligan procedures should be amended to fit together more coherently while providing additional flexibility to a firm in responding to a failure to maintain the full amount of its stress capital buffers and GSIB surcharge based on the Federal Reserve's supervisory models.
  - Stress buffer requirements should not become effective until one year after initial notice to avoid disruptions in capital markets.
  - If the dividend add-on component and Prior Approval Requirement are eliminated, the mulligan procedure is unnecessary.
  - If the dividend add-on component or the Prior Approval Requirement is retained, the mulligan and reconsideration procedures should be improved.
- Capital planning should be part of the normal supervisory process for all firms, and therefore the Federal Reserve's power to object to a firm's capital plan on qualitative grounds in CCAR should be eliminated.
- The treatment of the GSIB surcharge as additive to the SCB makes it all the more important to fundamentally reassess the framework and calibration of the GSIB surcharge and renders it unnecessary to deploy the countercyclical capital buffer ("CCyB").
- The Proposal's effective transition of the GSIB surcharge into a post-stress minimum requirement makes it imperative to review and reassess the U.S. implementation of the GSIB surcharge, which currently suffers from conceptual and methodological flaws and is inconsistent with the international framework, to put U.S. GSIBs on a level playing field compared to their international peers.

- The Federal Reserve should use the stress buffer requirements to incorporate countercyclical effects in capital requirements. The countercyclical nature of the supervisory scenario can be tailored to the specific economic circumstances that actually exist, while the CCyB is a blunt tool that is not designed to address specific risks.
- Risk-insensitive capital measures should not be part of stress buffer requirements.
- The Federal Reserve should make technical improvements and clarifications to the Proposal.

**II. Integrating stress losses into point-in-time capital requirements through the proposed stress buffers would promote the transparency and simplification of the capital and stress testing framework; however, as empirically evidenced by the 2018 DFAST results, it would also heighten the urgency to address the volatility of estimated stress losses through increased transparency of supervisory models, a public notice-and-comment period for stress scenarios, and realistic scenario parameters for supervisory scenario design given the impact on point-in-time capital requirements under the Proposal.**

The integration of stress losses into firms' point-in-time capital requirements and the intended elimination of the quantitative objection under CCAR would bring much needed transparency and simplification to the capital requirements. Implementing these changes, however, would exacerbate the capital management challenges created by the year-to-year variability of the Federal Reserve's supervisory scenarios and the lack of transparency of its supervisory models, which would invariably result in firms holding additional capital buffers to manage this regulatory uncertainty ("**operational buffers**").

The potential volatility in stress buffer requirements resulting from variability in the Federal Reserve's macroeconomic stress test scenarios and supervisory stress test results was demonstrated in the release of the DFAST results on June 21, 2018.<sup>6</sup> While all 35 participating firms were deemed to have sufficient post-stress capital to continue lending to businesses and households – despite the severity of the scenarios and scenario components – the variability and unpredictability of peak-to-trough losses<sup>7</sup> highlights the challenges presented to management and boards of directors under the stress buffer requirements, especially in undertaking effective and coherent capital management. If the Proposal was currently in effect, the 2018 DFAST results

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<sup>6</sup> Federal Reserve, *Dodd-Frank Act Stress Test 2018: Supervisory Stress Test Methodology and Results* (June 2018) ([link](#)).

<sup>7</sup> "Peak-to-trough stress losses" or the "stress losses component" refer to the difference between the level of the relevant capital ratio as of the final quarter of the previous capital plan cycle and the lowest projection of the relevant capital ratio in any quarter of the planning horizon under the DFAST supervisory severely adverse scenario. See Proposed Rule § 225.8(f)(2)(i)(A) and (B).

would likely have resulted in a sudden and sharp increase in the required level of capital for U.S. firms, which emphasizes the importance of effectively dealing with this issue.<sup>8</sup>

The Proposal's two new capital buffers for firms subject to the Federal Reserve's capital plan rule and supervisory DFAST requirements, namely, the SCB and SLB, would likely fluctuate annually as a function of the stress losses calculated under the Federal Reserve's supervisory stress tests. The annual fluctuations in a firm's capital buffer amounts invariably mean that, in order to avoid payout restrictions, a firm's minimum capital requirements will also fluctuate annually.

Capital requirements should be based on a framework with sufficient transparency to allow a firm to make well-informed decisions about how to manage its capital on an ongoing basis. To avoid turning a firm's capital management planning and capital requirements into guesswork about how much of an operational buffer to hold against the risk of excessive volatility in a firm's capital buffer requirements, the Associations believe that any final rule implementing the Proposal should address and appropriately mitigate the degree of variability and unpredictability in firms' stress losses resulting from year-over-year changes in the Federal Reserve's supervisory stress scenarios and the lack of transparency of how its supervisory models determine firms' stress losses. For example, one potential mechanism for mitigating year-to-year volatility would be for the Federal Reserve to take into account a firm's peak-to-trough losses over more than one CCAR/DFAST cycle in calibrating the firm's stress buffer requirements.

To address and mitigate the excessive variability of the Federal Reserve's severely adverse scenario, and to improve transparency, stakeholder feedback and the Federal Reserve's own accountability in the design and use of supervisory scenarios and models, the Associations also recommend:

- releasing the Federal Reserve's supervisory stress scenarios earlier in the capital planning and stress testing cycle and subjecting them to public notice and comment;
- establishing scenario design principles that incorporate realistic parameters for the design of supervisory stress scenarios;
- improving the internal coherence of the macroeconomic supervisory stress scenarios and their scenario components, such as the Global Market Shock ("GMS") and Counterparty Default components; and
- making the Federal Reserve's supervisory models significantly more transparent.

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<sup>8</sup> By one estimate, firms' SCBs under the Proposal would have increased from an average of 3.0 percent based on the 2017 DFAST results to an average of 3.9 percent based on 2018 DFAST results. For GSIBs, the SCBs would have increased from an average of 3.2 percent to an average of 4.3 percent (these percentages exclude the addition of each firm's GSIB surcharge). See Francisco Covas, Bill Nelson and Robert Lindgren, *An Assessment of DFAST 2018 Results through the Lenses of the SCB and eSLR Proposals* (June 22, 2018) ([link](#)).

***A. The Federal Reserve's supervisory stress scenarios and scenario components used in CCAR and DFAST should be made available earlier each cycle and subject to public notice and comment, which would increase transparency and create a feedback mechanism to improve the plausibility and coherence of the supervisory scenarios.***

The Federal Reserve has solicited comments on publishing for notice and comment the severely adverse scenario used in CCAR, DFAST and, as proposed in the Proposal, in calculating a firm's stress buffer requirements.<sup>9</sup> The Associations strongly believe that (1) the Federal Reserve's supervisory stress scenarios and scenario components should be subject to the public notice-and-comment process to increase transparency into scenario design and (2) final supervisory scenarios and scenario components should be published earlier in each capital planning cycle to allow firms additional time to plan for the next period's stress buffer requirements, particularly given their integration into firms' point-in-time capital requirements.

***1. The Federal Reserve's scenarios and scenario components should be subject to public notice and comment.***

Subjecting supervisory scenarios and scenario components to the notice-and-comment process would improve transparency and offer firms and other stakeholders – such as firms' customers and counterparties, members of the public, and academic researchers – the ability to provide feedback and help improve the Federal Reserve's scenario design process and assumptions. Firms would be particularly well positioned to comment on the coherence and plausibility of the annual scenarios, as well as any disproportionate impact of any changes in the scenarios on their capital positions and existing capital plans, and other market participants would be better informed regarding the potential scenarios. Utilizing the public notice-and-comment process would allow the Federal Reserve time to consider and implement constructive feedback in its supervisory scenarios and instructions prior to the beginning of that year's CCAR and DFAST process.<sup>10</sup>

The Associations believe that a 30-day comment period would be appropriate for public comment on the proposed stress scenarios and scenario components, as this would allow sufficient time for firms and other stakeholders to evaluate the potential effects of the proposed supervisory stress scenarios and to review whether they are coherent, plausible and appropriately calibrated or would have some unintended or disproportionate effects.

***2. The Federal Reserve's final scenarios and scenario components should be released earlier in the CCAR and DFAST process.***

The Associations believe that the Federal Reserve should publish the final supervisory scenarios, scenario components and CCAR/DFAST instructions no later than by the first week of January each year, assuming the other key dates in the capital planning and stress testing cycle are unchanged. This timing would provide firms with approximately one additional month,

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<sup>9</sup> Proposal at 18,172 (Question 23(ii)).

<sup>10</sup> This notice-and-comment process would also be consistent with administrative law requirements, in particular in light of the Proposal's integration of supervisory stress tests with the capital requirements under the Federal Reserve's capital rule.

relative to the February publication date under existing practices,<sup>11</sup> to evaluate the impact of the final supervisory stress scenarios. An additional month is appropriate in light of the added importance of the stress buffer requirements as point-in-time capital requirements under the Proposal, while the publication of final scenarios in January of each year would also allay concerns over any public perception that firms could “game” the process by engaging in transactions that would affect their balance sheet as of December 31, the initial balance sheet date for the stress tests and capital plan.<sup>12</sup> Depending on the length of time the Federal Reserve would need to consider public comments in finalizing the supervisory scenarios, this alternative timing would likely place the initial publication of proposed scenarios between mid-October and mid-November.<sup>13</sup>

For a timeline showing the proposed sequence of the publication for notice and comment of the scenarios, publication of the final scenarios and scenario components, and submission of the annual capital plans, please see Annex B attached to this letter.

***B. The Federal Reserve should establish scenario design principles incorporating transparent and realistic scenario parameters regarding the overall severity and change in severity of the supervisory stress scenarios, while maintaining the Federal Reserve’s flexibility to design scenarios that are appropriately countercyclical, and ensure coherence between its supervisory macroeconomic scenarios and its scenario components to avoid inconsistent and unrealistic assumptions.***

*1. The Federal Reserve should develop scenario design principles incorporating transparent and realistic scenario parameters.*

The Federal Reserve should develop and implement scenario design principles that incorporate realistic scenario parameters related to the overall severity, change in severity, and duration of the combined effect of all supervisory stress scenarios and their components. These supervisory scenario design principles and scenario parameters should be reflected in the Federal Reserve’s Stress Testing Policy Statement on the Scenario Design framework for Stress Testing (the “**Scenario Design Policy Statement**”)<sup>14</sup> and proposed Stress Testing Policy Statement<sup>15</sup> and in comparable policy statements for any applicable scenario components. The scenario parameters would serve as public and transparent standards against which each year’s supervisory stress scenario could be evaluated by firms and other stakeholders and would enhance both the transparency and the plausibility of the supervisory scenarios and scenario

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<sup>11</sup> 12 C.F.R. § 252.44(b).

<sup>12</sup> With respect to the GMS, the Federal Reserve could select an as-of date for the GMS that is before publication of the scenario component variables for notice and comment between mid-October and mid-November, as proposed above.

<sup>13</sup> This timing would correspond to a 15- to 45-day period for the Federal Reserve to consider public comments on the proposed supervisory scenarios.

<sup>14</sup> 12 C.F.R. Part 252, Appendix A; *see also* Federal Reserve, *Policy Statement on Scenario Design Framework for Stress Testing*, 82 Fed. Reg. 59,533 (Dec. 15, 2017) ([link](#)) (proposing amendments to the Scenario Design Policy Statement).

<sup>15</sup> Federal Reserve, *Stress Testing Policy Statement*, 82 Fed. Reg. 59,528 (Dec. 15, 2017) ([link](#)) (proposed).



components, as well as the Federal Reserve's justification for them and their impact on firms' capital requirements.

The purpose of these supervisory scenario parameters would be two-fold. First, the scenario parameters would be used to guide the supervisory scenarios toward appropriately severe, yet plausible, scenarios for individual economic and other variables – focusing not only on the severity but also the duration and “arc” of the change in the level of each variable over the CCAR planning horizon, taking into account the prevailing economic conditions. Second, the scenario parameters would be used to determine a plausible “worst case” economic environment, as judged by a number of economic and other variables and based on empirically grounded historical economic data, that would be used as an outer benchmark against which to measure any year's severely adverse scenario as a whole. These supervisory scenario parameters could reflect countercyclical principles, so that any year's scenarios and scenario components are not procyclical and are appropriately countercyclical, but at the same time reflect more plausible changes in their level of severity.

If both of these changes were implemented, each year's supervisory scenarios and scenario components, and the changes in the severity of the underlying assumptions and economic and other variables and conditions, would be more realistic and would avoid excessive and unrealistic volatility from year to year. This change in turn would allow firms to operate with more reasonable operational buffers, to engage more effectively in capital management and planning to comply with their point-in-time capital requirements and to more specifically comment on the supervisory scenarios and scenario components, effectively increasing the Federal Reserve's accountability. It would also provide greater credibility for the Federal Reserve's capital and stress testing framework.

Please see Annex C, Section 1, to this letter for a more detailed description of these proposed changes and for an illustrative example of how they could be implemented.

*2. The Federal Reserve's scenarios and scenario components should be designed to be coherent with one another.*

Under the Federal Reserve's current instructions for the use of the CCAR/DFAST supervisory scenarios and scenario components, the scenario components – GMS and Counterparty Default – are add-on components that require firms to calculate losses arising under these components separately and in addition to losses calculated under the supervisory adverse and severely adverse scenarios.<sup>16</sup> As a result, the changes in certain economic variables underlying the scenario components may unrealistically move in opposite directions from those underlying the macroeconomic scenarios and result in stress loss amounts that are materially higher than they would be in reality. The Federal Reserve should employ assumptions and elements underlying the supervisory economic scenarios and any related scenario components that are coherent with one another in order to create a more realistic set of stressed economic conditions and therefore a more realistic set of consequences and stress losses for each firm.

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<sup>16</sup> Federal Reserve, *Comprehensive Capital Analysis and Review 2018 Summary Instructions*, at 9–10 (Feb. 2018) ([link](#)).

These improvements would include:

- To achieve consistency with the proposed constant balance sheet and RWA assumptions, permitting the amounts of items deductible from CET1 capital to be calculated based not just on losses reflecting the macroeconomic scenarios, but also losses reflecting the GMS and Counterparty Default scenario components;
- Similarly allowing firms to recognize the ongoing effects of margin agreements and the rights of firms to collect additional collateral when calculating counterparty losses under the Counterparty Default scenario component;
- Avoiding duplication of stress losses across scenarios and scenario components; and
- Capping losses on individual exposures across scenarios and scenario components to the maximum possible loss under each of the scenarios or components.

Please see Annex C, Sections 2(a) through (d), to this letter for a more detailed description of these recommendations.

***C. The Federal Reserve should significantly enhance its disclosures about supervisory models to allow for greater model transparency, which would facilitate constructive feedback to improve the quality and credibility of supervisory models. Increased model transparency is essential for any stress buffer reconsideration procedure to be effective.***

As the Associations have consistently maintained,<sup>17</sup> the Federal Reserve’s supervisory models used in CCAR and DFAST should be subject to significantly greater transparency, which would allow firms and other stakeholders, as applicable, to (i) provide feedback on the factual basis for, operation of and assumptions underlying these models, (ii) effectively request reconsideration of their stress buffer requirements where appropriate (see Section IV.C.3 below) and (iii) have a better understanding of how the Federal Reserve estimates firms’ stress losses.

Transparency is fundamental to fair and effective rulemaking as well as the credibility of the process. Federal Reserve Vice Chairman Randal Quarles has noted in the context of improving post-crisis regulations that transparency is “a necessary precondition to the core democratic ideal of government accountability – the governed have a right to know the rules imposed on them by the government.”<sup>18</sup> The need for transparency would be even greater under the Proposal, as the supervisory models, by continuing to determine firms’ peak-to-trough stress losses, would now effectively determine firms’ point-in-time capital requirements.

The Associations believe that the proposed opportunity for reconsideration of a firm’s stress buffers (see Section IV.C.3 below) is fundamental to the fairness of the process of

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<sup>17</sup> See, e.g., The Clearing House, Letter re: Stress Testing Transparency Proposals, at 13–14 (Jan. 22, 2018) ([link](#)) (the “TCH Stress Testing Transparency Letter”).

<sup>18</sup> Vice Chairman for Supervision Randal Quarles, *Early Observations on Improving the Effectiveness of Post-Crisis Regulation*, Remarks at the American Bar Association Banking Law Committee Annual Meeting (Jan. 19, 2018) ([link](#)).

allowing a firm's point-in-time capital requirements to be determined by the use of the Federal Reserve's supervisory stress scenarios and supervisory models. Yet if this procedure is to afford a firm a meaningful opportunity to review and challenge the Federal Reserve's calculation of its stress losses, it is essential that a firm be provided sufficient information about how the Federal Reserve's supervisory models were applied to its balance sheet and exposures. The Associations' recommendations for the transparency of the supervisory models have been described in previous submissions and will be the subject of future comment as appropriate.<sup>19</sup>

**III. The removal of the common stock dividend and share repurchase assumptions are an equally welcome and significant improvement over the currently applicable assumptions that these actions would continue throughout the planning horizon in all economic conditions and without regard to the stress firms face or whether those distributions would be permissible under the capital rule. The final stress buffer requirements should not, however, include an additional component for four quarters of planned common stock dividends in light of the payout restrictions under the Federal Reserve's capital rule, and changes should be made to the definition of eligible retained income and other mechanics of the payout restrictions to more realistically reflect the actions firms would take and to retain an appropriate measure of capital management flexibility for firms' boards of directors under stressed conditions.**

Eliminating the assumption for purposes of calculating a firm's stress buffer requirements that a firm would continue to (i) repurchase its shares and (ii) pay dividends on Common Equity Tier 1 ("CET1") capital instruments at planned levels throughout the full planning horizon<sup>20</sup> is a positive step towards integrating capital planning and stress testing into ongoing, business-as-usual capital management and planning practices, as is the elimination of the heightened scrutiny of dividend payout ratios in excess of 30 percent.<sup>21</sup> These changes appropriately reflect the restrictions under the capital buffer framework implemented since the financial crisis, which automatically impose increasingly severe restrictions on a firm's ability to make distributions with respect to capital instruments and discretionary bonus payments to executive officers if its capital ratios drop below its buffer requirements ("payout restrictions").<sup>22</sup> These payout restrictions would restrict, and likely eliminate, a firm's ability to repurchase shares, for example, during a severe stress scenario.

The same rationale for eliminating the two assumptions above applies with equal force to the assumption built into the calibration of the SCB and SLB that a firm would pay four quarters of planned common stock dividends in stressed conditions.<sup>23</sup> The Federal Reserve should therefore remove the dividend add-on from the calibration of the SCB and SLB, and it should make other changes to the capital buffer framework to more realistically reflect the capital

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<sup>19</sup> See, e.g., the TCH Stress Testing Transparency Letter.

<sup>20</sup> Proposal at 18,165–66.

<sup>21</sup> Proposal at 18,163.

<sup>22</sup> 12 C.F.R. § 217.11.

<sup>23</sup> Proposal at 18,165–66; Proposed Rule §§ 225.8(f)(2)(i)(C) (SCB dividend add-on component) and (3)(iii) (SLB dividend add-on component).

actions that firms would take in stressed conditions and to preserve necessary capital management flexibility for firms' boards of directors.

***A. It is unnecessary under the Federal Reserve's capital rule to include the dividend add-on in the calibration of the SCB and SLB.***

The existing structure of Federal Reserve's capital buffer framework makes the dividend add-on unnecessary. Under the Proposal, a firm would be required to maintain the full amount of its SCB, plus any applicable GSIB surcharge and CCyB, to avoid payout restrictions.<sup>24</sup> The Proposal includes the dividend add-on in the calibration of firms' SCB and SLB requirements on the theory that doing so reflects the actions firms would take during a stress scenario, such as one similar to the last financial crisis.<sup>25</sup> But this theory neglects the fact that firms could be prohibited from using their pre-capitalized dividends in stressed conditions under the payout restrictions in the capital rule. Moreover, the Associations do not believe that it is the role of the Federal Reserve to ensure that firms protect the amount of their dividends.

The dividend add-on increases the amount of any firm's SCB and SLB and therefore increases the amount of capital a firm must maintain to avoid the payout restrictions. If the purpose of the dividend add-on were to pre-capitalize four quarters of planned common stock dividends, then logically the shortfall in a firm's capital buffer requirements would have to exceed the amount of the dividend add-on before a firm would be restricted from distributing those dividends: otherwise, why would a firm be required to pre-capitalize those dividends? In fact, however, even if the shortfall in a firm's capital buffer requirements is, for example, equal to 1 percent of its buffer requirement (in other words, the firm has 99 percent of the amount of its required capital buffers) and is less than the amount of one quarter of planned common stock dividends, under the Proposal the firm would be subject to a maximum payout ratio of 60 percent of its eligible retained income. Such a restriction at a minimum is likely to result in a firm being able to pay out less than the amount of its dividend add-on; but in fact, as explained in more detail below, it may prevent the firm from making any distributions at all. Such a result would be inconsistent with the stated purpose of the dividend add-on.

Nor does historical experience support the inclusion of the dividend add-on in the calibration of the SCB and SLB. Although a majority of financial institutions maintained some level of dividend distributions during the last financial crisis, firms' behavior at that time is not indicative of how firms would behave in a future stress scenario because in the last financial crisis there was no capital buffer framework incorporating the payout restrictions in place. The payout restrictions, had they then been part of the applicable capital rules, would have prevented firms from paying many of those dividends.

The Federal Reserve also justifies the dividend add-on as a means to incentivize firms to engage in disciplined, forward-looking capital planning.<sup>26</sup> However, the dividend add-on would unnecessarily discourage dividend continuity and, together with the lack of transparency about

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<sup>24</sup> Proposed Rule § 217.11(c)(1).

<sup>25</sup> Proposal at 18,165–66.

<sup>26</sup> Proposal at 18,165–66.

the calculation of the SCB and SLB under the Federal Reserve's supervisory models, would further remove capital management decision-making from firms' boards of directors. The capital rule's payout restrictions – which, under the Proposal, would be based on shortfalls relative to a firm's required capital buffers, including the SCB and SLB – already supply the necessary forward-looking incentive and formally prohibits payout ratios beyond the prescribed percentages.

Because the Federal Reserve has not explained why the payout restrictions under the capital buffer framework of the capital rule would be insufficient to satisfy the Federal Reserve's stated purposes, the dividend add-on should be eliminated from the SCB and SLB calibration. The SCB and SLB should thus reflect solely a firm's peak-to-trough stress losses in the severely adverse scenario. This change would integrate and simplify both the capital rule and the capital plan rule.

***B. If the dividend add-on is retained, the Federal Reserve should allow it to function as a pre-capitalization of four quarters of common equity dividends (and also for assumed Additional Tier 1 capital dividends) that can actually be drawn down in times of stress.***

In the event that the dividend add-on is retained as part of a final rule implementing the Proposal, the Associations believe that the Federal Reserve should align the restrictions applicable to a firm that fails to maintain the full amount of its SCB or SLB and other applicable capital buffers with the stated purpose of the dividend add-on, namely, to pre-capitalize four quarters of common equity dividends. The Associations also believe that the Federal Reserve should implement a similar approach for the Additional Tier 1 capital dividends a firm is required to assume for purposes of CCAR and DFAST.

The dividend add-on is conceptually distinct from the stress losses component of the SCB and SLB, and thus a firm's failure to maintain the dividend add-on should not have the same consequences as its failure to maintain capital to cover its stress losses. As noted above, the Federal Reserve has justified the dividend add-on on the theory that it reflects the agency's experience with how firms paid dividends during the financial crisis<sup>27</sup> – meaning that the dividend add-on is in part a reflection of the Federal Reserve's expectation that firms would in fact seek to pay dividends during stress.

On this basis, the Federal Reserve should amend the Proposal to provide that a firm would not be subject to the payout restrictions unless and until any shortfall between the aggregate amount of its capital buffers and the aggregate amount of its capital buffer requirements (including the SCB and SLB, as applicable) exceeds the amount of the dividend add-on. If a firm has enough of a capital buffer to fully satisfy the stress loss (i.e., peak-to-trough loss) components of the SCB and SLB, together with any other applicable capital buffers, but maintains an additional amount of the capital buffer to pre-fund fewer than four quarters of planned dividends, it should not be subject to any payout restrictions unless and until its buffer shortfall exceeds all four quarters of planned dividends. In the event that it maintained less than the full amount of the dividend add-on but otherwise satisfied its capital buffer requirements, a firm should be required to notify the Federal Reserve of its partial shortfall so that the Federal

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<sup>27</sup> Proposal at 18,165–66.

Reserve could, to the extent appropriate, more closely review the firm's ongoing financial performance.

This approach would not only recognize the different purposes of the dividend add-on and stress losses components of the SCB and SLB, but would also be consistent with the Basel Committee on Banking Supervision's Basel III capital framework, as well as its implementation in other jurisdictions, including the European Union, and would level the playing field between the United States and those jurisdictions. For example, under the EU's Capital Requirements Directive IV ("CRD IV"), firms are subject to payout restrictions only upon the failure to maintain only the core buffer components (i.e., the 2.5 percent capital conservation buffer, any applicable GSIB surcharge and any applicable CCyB) of the Basel III capital framework, excluding certain firm-specific buffers established by other EU capital guidelines.<sup>28</sup>

The Federal Reserve should also extend this approach to the treatment of dividends on Additional Tier 1 capital instruments (i.e., preferred shares) under the Proposal. The Proposal would retain the assumption in CCAR and DFAST that firms would continue to make stated dividend, interest and principal payments, as applicable, throughout the planning horizon on Additional Tier 1 capital instruments and Tier 2 capital instruments.<sup>29</sup> Yet if a firm fails to maintain the full amount of its buffer requirements, the payout restrictions under the capital rule would apply not only to dividends on CET1 capital, but also on Additional Tier 1 capital instruments<sup>30</sup> – notwithstanding that the calculation of a firm's stress losses for purposes of the SCB and SLB assumes that such payments *would* be made. The Federal Reserve should eliminate this logical inconsistency by amending the capital rule to clarify that the payout restrictions would not apply to dividends on Additional Tier 1 capital instruments. In the alternative, dividends on Additional Tier 1 capital instruments should be treated as truly pre-capitalized, as described above for common stock dividends, and therefore the payout restrictions should apply only when a firm's buffer shortfall exceeds the aggregate amount of scheduled dividends on Additional Tier 1 capital and planned common stock dividends.

***C. Whether or not the dividend add-on is retained, the definition of eligible retained income should be modified to reflect the ability and practice of firms in normal circumstances to distribute their earnings, and the payout restrictions should more realistically reflect the actions firms would take.***

***1. The definition of eligible retained income should be modified to reflect the ability and practice of firms in normal circumstances to distribute their earnings.***

Regardless of whether the dividend add-on is retained, under the Proposal firms' point-in-time capital requirements will likely be higher than their current point-in-time capital requirements because of the integration of the stress buffer requirements. Because of this

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<sup>28</sup> See Directive 2013/36/EU of the European Parliament and of the Council on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms, 2013 O.J. L 176/338, art. 128(6) and 141; see also Bank of England Prudential Regulation Authority, *Statement of Policy: The PRA's Methodologies for Setting Pillar 2 Capital* (Apr. 2018), at Section II, part 9.

<sup>29</sup> Proposal at 18,165–66, 18,187; Proposed Rule § 252.44(c)(2).

<sup>30</sup> 12 C.F.R. § 217.2 (defining "distribution"); 12 C.F.R. § 217.11(a)(4)(i).

fundamental recalibration of the point-in-time requirements and because each firm faces the possibility of a sudden increase in its SCB and SLB each year, the chances are greater that a firm may inadvertently face a shortfall in its aggregate buffer requirements and thus be subject to payout restrictions. The Associations believe that the Federal Reserve should revisit the mechanics of the payout restrictions in light of the fundamental recalibration of the point-in-time capital requirements.

The payout restrictions under the existing capital rule are expressed as maximum payout percentages of a firm's eligible retained income and are graduated to become progressively more restrictive as the firm's capital buffers decrease as a percentage of its buffer requirements.<sup>31</sup> The definition of "eligible retained income" looks back to net income over the preceding four quarters and is net of any distributions not already reflected as expenses against net income.<sup>32</sup> This payout restrictions framework was developed in a post-financial crisis environment in which firms were rebuilding their capital ratios and therefore conserving significant portions of their earnings from quarter to quarter. In that environment, calculating eligible retained income as net income net of distributions over the previous four quarters may well have been a reasonable approach.

Under normal economic conditions, however, the backward-looking definition of eligible retained income can have anomalous and unintended consequences, imposing more severe payout restrictions on a healthy firm with a *de minimis* buffer shortfall than on a firm with a much larger shortfall and in the process of restoring its capital. Consider, for example, a healthy firm that in the preceding four quarters has experienced normal economic conditions, exceeded its aggregate buffer requirements and distributed the full amount of its earnings in each of the preceding four quarters, such that its eligible retained earnings in the current quarter are zero. If in the current quarter this healthy firm experiences a *de minimis* buffer shortfall of one basis point relative to its aggregate buffer requirement – for example, due to receiving an unexpectedly large SCB calibration – it could suddenly face a complete bar on *all* distributions, including dividends on Additional Tier 1 capital instruments. This punitive result would occur because even the least restrictive maximum payout ratio of 60 percent amounts to an effective payout ratio of 0 percent when eligible retained earnings are zero. Such a firm would be required to abruptly discontinue, among other distributions, its dividends on its CET1 and Additional Tier 1 capital instruments, including dividends that were already part of its previous capital plan. This event would obviously be a material disclosure event for the firm and could well affect the market for all bank capital instruments, especially if more than one firm were affected at the same time. This impact would be exacerbated by the Proposal's short time period (i.e., from the end of June until October 1) for the effectiveness of any increase in a firm's stress buffer requirements, as it would potentially require any affected firm to be in the market trying to issue new capital instruments in the same time period.

This harsh cliff effect for a healthy firm experiencing only a temporary, *de minimis* breach of its buffer requirements contrasts sharply with the treatment under the payout restriction

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<sup>31</sup> 12 C.F.R. § 217.11(a)(4) and Table 1 (maximum payout ratios of 60 percent, 40 percent, 20 percent and 0 percent, depending on shortfall between capital buffer amounts and capital buffer requirements).

<sup>32</sup> 12 C.F.R. § 217.11(a)(2)(i).

framework of a less healthy firm that is rebuilding its capital base. Consider, for example, a firm that has been in breach of its capital buffers for several quarters as a result of a large unexpected loss and has been rebuilding its capital base through retained earnings, with a maximum payout ratio over the previous four quarters of 20 percent. This firm, in contrast to the healthy firm in the previous example, would likely have a significant amount of eligible retained income as a base for its payout restrictions calculation. Thus, even if this firm had a significant shortfall relative to its aggregate buffer requirements such that its maximum payout ratio was 40 percent, the firm would nevertheless face *less* restrictive payout limitations than the healthy firm in the previous example. In short, the backward-looking nature of the eligible retained income definition, when coupled with the netting of recent distributions against recent earnings, inappropriately ties a firm's prospective payout restrictions to its retrospective payout ratios, which can have counterintuitive and overly punitive consequences for healthy firms that maintain payout ratios near 100 percent in normal economic circumstances.

In light of the increased importance of the point-in-time buffer requirements under the Proposal and the potential counterintuitive and disruptive consequences of the payout restrictions framework, the Federal Reserve should amend its definition of eligible retained income under the capital rule. The Associations support two alternative approaches to modifying this definition:

First, the Federal Reserve should modify the definition so that eligible retained income is calculated on a gross basis. Under this approach, the definition of eligible retained income would be amended to be equal to a firm's prior four quarters of earnings *gross of* distributions. This definition would be a closer proxy for the earnings capacity of a firm – which should be the base measure used to determine the amount of distributions a firm may make as a result of applying the applicable maximum payout ratio.

The second approach would be to eliminate the backward-looking framework for defining eligible retained income and instead adopt prospective payout restrictions based on earnings recognized since the end of the last quarter in which a firm failed to satisfy its full capital buffer requirements. This would be consistent with both the Basel Committee's Basel III capital framework and its implementation in the EU pursuant to CRD IV. Under CRD IV, for example, a firm that fails to maintain its combined buffer requirement is required to calculate and report to its relevant regulator its "maximum distributable amount," which is calculated based on interim and year-end earnings (in each case net of tax effects) "not included in [CET1] that have been generated *since* the most recent decision on the distribution of profits or [specified capital actions]" and multiplied by the applicable maximum payout ratio.<sup>33</sup>

2. *The payout restrictions should more realistically reflect the actions a firm would take in the event of a buffer shortfall.*

Regardless of whether the dividend add-on is retained, the Federal Reserve should in any event amend its capital rule to provide that the payout restrictions apply in a manner that more

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<sup>33</sup> Directive 2013/36/EU of the European Parliament and of the Council on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms, 2013 O.J. L 176/338, art. 141 (emphasis added).



realistically reflect the capital actions firms would actually take in stressed conditions, as explained in more detail in Annex D, Section 1, to this letter.

***D. The Proposal should be amended to take into account the different circumstances of the U.S. IHCs of FBOs.***

The U.S. IHCs of FBOs, unlike the top-tier bank holding companies of their U.S. peers, generally are not publicly traded and generally do not have public shareholders; their equity generally is owned entirely by their parent FBOs. As a result, the U.S. IHCs of FBOs generally do not face even the possibility of public market pressure to continue to pay dividends, nor would they need to repurchase shares in an effort to maintain the price stability of publicly traded shares. The justification offered by the Federal Reserve as one of the reasons for the dividend add-on is thus inapplicable to the U.S. IHCs of FBOs.<sup>34</sup> In addition, because U.S. IHCs of FBOs typically distribute capital through dividends and are not reliant on share repurchase programs, the relaxation of the share buyback assumption would not be as meaningful or beneficial for U.S. IHCs of FBOs as for their U.S. BHC counterparts. Without any relief from the dividend add-on, the Proposal's stress buffer requirements would lead to an unlevel playing field and conceptually inconsistent treatment between U.S. IHCs of FBOs and U.S. firms.

The Associations therefore recommend that the U.S. IHCs of FBOs should in any event be exempt from the dividend add-on in the calculation of their SCB and SLB requirements. These firms should similarly be exempt from having to include in the calculation of their stress losses the assumption of paying any discretionary dividends on any Additional Tier 1 capital instruments to the extent these securities are held by their FBO parents or other FBO affiliates because the Federal Reserve's rationale for including stated dividends on Additional Tier 1 capital instruments – marketplace incentives to maintain those dividends – does not apply to instruments issued by an IHC and held by its parent or affiliates. In the alternative, if the Federal Reserve maintains the dividend add-on with respect to U.S. IHCs of FBOs, it should reduce the calibration of the dividend add-on (e.g., by requiring only one quarter of CET1 or Additional Tier 1 dividends) for such firms. This change would reflect the fact that dividends are more similar to share repurchases for U.S. IHCs of FBOs than they are for U.S. BHCs and that, therefore, U.S. IHCs of FBOs generally would not be expected to continue paying dividends at planned levels in the event of firm-specific or systemic stress.

In any event, prior to the finalization of the SCB and SLB requirements of the Proposal for the U.S. IHCs of FBOs, the Federal Reserve should complete its analysis of the effect of the Proposal on these firms, taking into account the insufficient time and sample size it has acknowledged.<sup>35</sup> This analysis would not only better inform the calibration of the stress buffer requirements applicable to the U.S. IHCs of FBOs, but would also allow the Federal Reserve to make any other changes to recognize that not all of these firms have business models, risks and

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<sup>34</sup> Proposal at 18,166.

<sup>35</sup> Proposal at 18,167 n.39.

exposures comparable to those of the parent companies of U.S. bank subsidiaries, as explained more fully in Annex D, Sections 5 and 6, to this letter.<sup>36</sup>

**IV. Consistent with the intended elimination of any quantitative objection to a firm’s capital plan, the Federal Reserve should amend the capital plan rule to fully eliminate any residual basis for a quantitative limitation on capital distributions, in accordance with the Federal Reserve’s respective expectations for a firm’s board of directors and senior management to be responsible for capital planning.**

The Federal Reserve expects a firm’s board of directors to be “ultimately responsible and accountable for the firm’s capital-related decisions and for capital planning.”<sup>37</sup> Senior management is expected to “design and oversee the implementation of the firm’s capital planning process” and to “make informed recommendations to the board regarding the firm’s capital planning and capital adequacy, including post-stress capital goals and capital distribution decisions.”<sup>38</sup> The Federal Reserve reiterated its expectation that a firm’s board is central to maintaining “effective capital and liquidity governance and planning processes,” in its proposed guidance for boards of directors of large financial institutions (“**LFIs**”).<sup>39</sup> The Associations fully agree with these expectations for the roles and responsibilities of a firm’s board of directors and senior management.

Under the capital plan rule, however, much of the responsibility for a firm’s capital planning and capital decisions is subject to limitations imposed by, and is thus effectively vested with, the Federal Reserve. While the Proposal takes some steps towards shifting that responsibility back to a firm’s board of directors and senior management, the Associations recommend further amendments to the capital plan rule to more squarely align its requirements with the Federal Reserve’s expectations regarding these capital planning roles and responsibilities. In particular, the Associations recommend eliminating the requirement that a firm obtain the Federal Reserve’s prior approval for capital distributions that exceed the amount included in its capital plan. The integration of stress buffer requirements into a firm’s ongoing capital requirements under the capital rule and the elimination of the formal quantitative objection from the capital plan rule under the Proposal should logically mean that, as long as a firm exceeds its capital buffer requirements and its minimum capital requirements, not only should it be free of the payout restrictions under the capital rule, it should be free of *any* restrictions on *any* capital actions under the capital plan rule. Thus, as long as a firm exceeds its buffer and minimum capital requirements, a firm should be able to increase its capital distributions above and beyond those in its capital plan submitted to the Federal Reserve if, for

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<sup>36</sup> Although the Associations recommend delaying the SCB and SLB requirements of the Proposal for U.S. IHCs of FBOs, the Federal Reserve should implement the other elements of the Proposal – including the constant balance sheet and RWA and dividend payment assumptions, as well as the elimination of the quantitative objection – for all firms effective as of the 2019 CCAR cycle.

<sup>37</sup> SR 15-18: Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms, at 4 (Dec. 18, 2015) ([link](#)).

<sup>38</sup> *Id.* at 5.

<sup>39</sup> Federal Reserve, *Proposed Guidance on Supervisory Expectation for Boards of Directors*, 82 Fed. Reg. 37,219, 37,224 n. 10 (Aug. 9, 2017) ([link](#)).

example, the firm has increased its net income and retained earnings and can thus afford to pay more in capital distributions.

Of course, as part of its supervisory process the Federal Reserve would retain the authority to impose supervisory restrictions on a firm's ability to make distributions if, for example, it had material supervisory concerns with a firm's capital planning process. Absent such a supervisory concern, however, the Associations do not believe that there would be any continuing justification to impose the various quantitative constraints still embedded in the capital plan rule, such as the Prior Approval Requirement for aggregate capital distributions in excess of a firm's planned capital distributions in the capital plan or the net distribution limits.

Eliminating the remaining aspects of the capital plan rule's quantitative limits and objection framework beyond the various buffer requirements would promote the goal of integrating the stress losses component of CCAR into binding point-in-time capital requirements. Under this approach, a firm's board of directors and senior management would be able to dynamically adapt their capital management decisions subject to compliance with the firm's applicable point-in-time capital requirements, including its stress buffer requirements. Firms would no longer be limited by an artificially annualized capital planning process and yet would remain subject to appropriately rigorous constraints reflecting the firm-specific stress loss components of their capital requirements. This approach would also enable firms to plan the timing of strategic transactions based on what makes business sense as opposed to having to take into consideration where the firm is in the capital planning cycle.

***A. The Federal Reserve should eliminate the requirement that a firm obtain prior approval for capital distributions that exceed the aggregate dollar amount included in its capital plan.***

Under the Proposal, a firm subject to CCAR would, as under the current capital rule, continue to be subject to the Prior Approval Requirement, which would impose an overall quantitative limit on the dollar amount of a firm's actual aggregate capital distributions equal to the amount of a firm's final planned capital distributions during the relevant period – as proposed, the fourth through seventh quarters of the planning horizon – as set forth in its capital plan under the firm's baseline scenario.<sup>40</sup> The Federal Reserve invites comment on potential alternatives to the Prior Approval Requirement that would provide “additional flexibility for a firm to exceed the capital distributions included in its capital plan if its earnings and capital ratios are above those in its BHC baseline scenario,” and “additional flexibility to a firm to increase the planned capital actions above what was included in its original capital plan based on the results of the supervisory stress test or request for reconsideration.”<sup>41</sup>

In view of the proposed elimination of the quantitative objection under CCAR and the incorporation of the SCB and SLB into firms' point-in-time capital requirements, the Associations believe that the Prior Approval Requirement and the related quantitative limitation based on the BHC baseline scenario are unnecessary and should be eliminated. This approach

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<sup>40</sup> 12 C.F.R. § 225.8(g)(1)(iii); Proposal at 18,167; Proposed Rule § 225.8(k)(1)(iii).

<sup>41</sup> Proposal at 18,171 (Questions 23(iii) and (iv)).

would preserve incentives for prudent capital planning while giving a firm the flexibility to manage its capital actions and capital distributions each quarter by adapting them on a timely basis to its actual earnings and capital ratios. It would also provide more flexibility for strategic transactions because it is more difficult to justify a transaction that makes capital available for distribution if the firm's ability to make that distribution can be in question.

*1. The Prior Approval Requirement is unnecessary.*

The Proposal would make structural changes to the relationship between stress losses and the capital planning process that would render the Prior Approval Requirement under the capital plan rule unnecessary. The Proposal would eliminate the once-per-year possibility of a quantitative objection to a firm's capital plan under the capital plan rule and would instead subject the firm to progressive payout restrictions under the capital rule if it fails to maintain the full amount of its capital buffer requirements (i.e., the SCB and SLB, GSIB surcharge (if applicable) and any applicable CCyB).<sup>42</sup> Because a firm would be subject to these potential point-in-time limitations as of the end of each quarter, and because these limitations would include measures of stress losses through the SCB and SLB, as applicable, and would therefore generally be the most binding capital requirements a firm would face, these requirements would replace the prudential function of CCAR as a *de facto* post-stress quantitative capital requirement.<sup>43</sup> Instead, the prudential function of CCAR under the Proposal would shift to incentivizing firms to “engage[] in prudent capital planning” and to “plan to maintain capital levels above their minimum requirements plus relevant buffer requirements during normal economic periods. . . .”<sup>44</sup>

This incentivizing function of CCAR, however, would be better served through a combination of the point-in-time requirements under the capital rule, as amended by the Proposal, and the annual supervisory transparency into a firm's year-round capital planning process that an informational-only version of CCAR, without the Prior Approval Requirement, would continue to provide. Even without the Prior Approval Requirement, firms would have strong incentives under their point-in-time capital requirements to continuously monitor their capital ratios on a forward-looking basis and to adapt their capital actions accordingly.

*2. Eliminating the Prior Approval Requirement would improve capital management.*

Eliminating the Prior Approval Requirement under CCAR would also allow a firm to manage its capital actions and capital distributions on an ongoing basis in a more prudent and effective way than the artificially annualized CCAR process. If the Prior Approval Requirement were eliminated, each firm could adapt its capital actions and capital distributions on a timely basis to its actual current and forecasted earnings and capital ratios, as they change from quarter to quarter, rather than requiring each firm to be limited, absent specific Federal Reserve

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<sup>42</sup> Proposal at 18,167, 18177; Proposed Rule § 217.11, Table 1.

<sup>43</sup> Proposal at 18,167 (“This proposal would simplify and integrate [the point-in-time and post-stress CCAR] requirements, eliminating the need for firms to manage to both potential sources of limitations on capital distributions.”).

<sup>44</sup> Proposal at 18,167.

approval, by the planned capital distributions it submitted the previous April, which at the time of each distribution would have been based on projections the firm had developed up to five quarters earlier.<sup>45</sup> This approach would more naturally align with how firms continuously manage their actual capital levels against their effective capital requirements and, as explained above, would preserve the incentives to prudently manage capital on a forward-looking basis in light of the structural changes made by the Proposal to the point-in-time capital requirements.

By recognizing the flexibility of a firm to manage its capital and capital distributions on an ongoing basis, this change would also acknowledge that capital management and capital planning are strategic decisions for a firm's board of directors based on recommendations from senior management, which would be consistent with the Federal Reserve's LFI rating proposal and proposed guidance on board effectiveness and senior management.<sup>46</sup> In short, this change would return the responsibility for capital management and capital planning where it properly belongs, while preserving the Federal Reserve's authority to enforce the payout restrictions under the capital rule in the event a firm fails to maintain the full amount of its required capital buffers.

***B. If the Prior Approval Requirement is retained, other features of the capital plan rule should be modified to permit firms more flexibility to adapt their capital plans to changing circumstances.***

***1. If the Prior Approval Requirement is retained, a firm should nevertheless have more flexibility to exceed the aggregate amount of its planned capital distributions.***

If the Federal Reserve does not eliminate the Prior Approval Requirement, it should remove or revise the quantitative limit from the exemption for well-capitalized firms.<sup>47</sup> A well-capitalized firm should be permitted, without seeking prior approval of the Federal Reserve, to increase its capital distributions above its final planned capital distributions in the fourth through seventh quarters, to the extent that the firm's realized capital ratios in those periods exceeds the firm's projected capital ratios under the BHC baseline scenario. This approach would preserve some of the benefits mentioned above of eliminating the Prior Approval Requirement while preserving a role for this requirement and the related BHC baseline limitation and mulligan

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<sup>45</sup> Under the capital rule, a firm's regulatory capital instruments may not be redeemed or repurchased without the prior approval of the Federal Reserve. 12 C.F.R. § 217.20(b)(1)(iii) (CET1 capital), (c)(1)(vi) (Additional Tier 1 capital), (d)(1)(x) (Tier 2 capital). Under existing practice, a non-objection from the Federal Reserve under CCAR is treated as satisfying this prior approval requirement under the capital rule. If the Prior Approval Requirement under the capital plan rule were removed as the Associations recommend, the Federal Reserve could adopt a similar approach, whereby any redemptions or repurchases of a firm's regulatory capital instruments would be treated as pre-authorized for purposes of these capital rule requirements if the firm is, and would remain after such redemption, in compliance with its capital buffer requirements (including the stress buffer requirements). Under this approach, a firm would be required to seek specific prior approval for any redemption of its regulatory capital instruments if, after giving pro forma effect to the redemption, the firm would fail to maintain sufficient capital to satisfy all of its capital buffer requirements.

<sup>46</sup> See Federal Reserve, *Large Financial Institution Rating System; Regulations K and LL*, 82 Fed. Reg. 39,049, 39,050–51, 39,053 (Aug. 7, 2017); Federal Reserve, *Proposed Supervisory Guidance*, 83 Fed. Reg. 1,351, 1,353 (Jan. 11, 2018).

<sup>47</sup> 12 C.F.R. § 225.8(g)(2); Proposed Rule § 225.8(k)(2).

process under the Proposal. In effect, this alternative approach would eliminate the current limitation based on 0.25 percent of Tier 1 capital, which would be appropriate in light of the disciplining effect of the point-in-time capital requirements and the payout restrictions under the capital rule.

2. *If the Prior Approval Requirement is retained, it should be modified to apply only on a net basis.*

In addition, if the Federal Reserve does not eliminate the Prior Approval Requirement, this requirement should be modified to apply on only a net basis – i.e., considering the offsetting capital effects of capital-raising transactions and capital distributions. The Federal Reserve’s capital rule explicitly excludes from the definition of “distribution” any repurchase or redemption that is offset, within the same quarter, by a firm’s full replacement of the distribution through the issuance of another capital instrument that meets the same eligibility requirements for the relevant tier of capital.<sup>48</sup> In the event that a firm failed to maintain the full amount of a firm’s applicable capital buffers at the end of any one quarter, it would almost certainly be an unplanned and unforeseen circumstance, and, under the current capital rule, could be cured in the next quarter and thereby prevent any restrictions from applying to a firm’s distributions in that quarter, to the extent that a firm offset any such distributions through the issuance of new capital.

The capital plan rule does not contain a similar offset provision in its definition of “capital distribution” or “capital action.”<sup>49</sup> Instead, the general distribution limitation and net distribution limitation provisions exempt from the scope of these limitations only unplanned capital distributions on unplanned issuances of capital instruments, referring to certain “capital distributions arising from the issuance of a regulatory capital instrument eligible for inclusion in the numerator of [a] regulatory capital ratio.”<sup>50</sup> The Federal Reserve should expand these exemptions to provide a firm with the flexibility, to the extent it issues new regulatory capital instruments, to support the distributions it intends to make, whether or not those distributions were part of a firm’s final planned capital distributions. This approach would be useful, for example, in permitting a firm to refinance Additional Tier 1 or Tier 2 capital through offsetting issuances and redemptions or a parent company to issue capital instruments in order to offset the capital impact of a subsidiary’s payments to the external holders of its regulatory capital instruments (which are minority interests for the parent). The Associations believe that there is no justification for firms to be constrained in their ability to *raise* capital to avoid limitations on their distributions in any quarter as a result of any such limit on overall planned capital distributions contained in the capital plan rule.

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<sup>48</sup> 12 C.F.R. § 217.2 (defining “distribution”).

<sup>49</sup> 12 C.F.R. § 225.8(d)(4) (defining “capital action”) and (5) (defining “capital distribution”); *see* Proposal at 18,172.

<sup>50</sup> 12 C.F.R. § 225.8(g)(1), (3)(iii)(B).

***C. The effective date of a firm's stress buffer requirements should be one year following notice of its calculated SCB, and the proposed reconsideration and mulligan procedures should be amended to fit together more coherently while providing additional flexibility to a firm in responding to a failure to maintain the full amount of its stress capital buffers and GSIB surcharge based on the Federal Reserve's supervisory models.***

- 1. Stress buffer requirements should not become effective until one year after initial notice to avoid disruptions in capital markets.*

Changes to capital requirements, particularly firm-specific requirements, should be implemented deliberately and methodically, allowing individual firms sufficient time to adjust their capital positions accordingly. As noted above, capital planning and management are core responsibilities of a firm's board of directors and senior management.<sup>51</sup> The Proposal's three-month period between publication of the final stress buffer results and the effective date of a firm's new stress buffer requirements does not provide firms sufficient time to manage changes in their point-in-time capital requirements, particularly in light of the potential variability and unpredictability of these requirements. Such a short compliance timeline could have a number of unintended consequences, including (i) concentrating firms' capital-raising actions (to the extent needed, for example, because of an unexpectedly severe supervisory stress scenario) into a relatively short time period, potentially overwhelming market demand for bank capital instruments and disrupting the price discovery mechanism for such instruments, and (ii) potentially requiring firms to make large and sudden changes to their capital distributions, which could have an adverse effect on the market for bank capital instruments. To avoid these results, the Federal Reserve should set the effective date of increases in firms' stress buffer requirements to July 1 of the year following the related capital plan submission, which would provide firms with sufficient time (approximately one year) to raise additional capital on acceptable terms or otherwise manage their capital ratios to comply with any new stress buffer requirements.

A one-year period prior to the effectiveness of any firm's increased stress buffer requirements would also be consistent with the timing underlying the transition provisions for the GSIB surcharge and CCyB, as well as other transition provisions of the Federal Reserve's capital rule.<sup>52</sup> For example, GSIBs that become subject to a higher GSIB surcharge have a full year before the higher GSIB surcharge takes effect, whereas any decrease in the GSIB surcharge takes effect on January 1 of the year immediately following the calculation of the decreased surcharge; and any increase in the CCyB is generally effective 12 months from the date of announcement, while any decrease is generally effective on the day following announcement.<sup>53</sup> In order to facilitate compliance with the new capital buffer requirements, the timing of

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<sup>51</sup> The Federal Reserve's proposed rating system for large financial institutions explicitly recognizes this responsibility. *See* Federal Reserve, *Large Financial Institution Rating System; Regulations K and LL*, 82 Fed. Reg. 39,049, 39,050–51 (Aug. 7, 2017).

<sup>52</sup> The Federal Reserve has consistently implemented transitional provisions to phase in any increases in firms' Basel III capital requirements. *See, e.g.*, 12 C.F.R. §§ 217.1(f) (capital ratios and RWA calculations), 217.300(a) (CCyB), (b) (deductions and adjustments to capital), and (d) (minority interests).

<sup>53</sup> 12 C.F.R. § 217.403(d) (GSIB surcharge); 12 C.F.R. § 217.11(b)(2)(v) (CCyB).

effectiveness of increases and decreases should be similar for all capital buffers. As a result, the Federal Reserve should adopt a comparable approach for the stress buffer requirements, under which a decrease becomes effective on July 1 of the same year in which the stress buffer requirements are calculated, while an increase becomes effective on July 1 of the following year.

2. *If the dividend add-on component and Prior Approval Requirement are eliminated, the mulligan procedure is unnecessary.*

If the dividend add-on component and Prior Approval Requirement are eliminated as the Associations recommend in Section IV.A above, a “mulligan” procedure would not be needed, as there would be no need to quantitatively constrain a firm’s planned capital distributions under CCAR’s BHC baseline scenario. By relying instead on the quantitative constraint of the point-in-time capital requirements, a firm would be free to adapt its planned capital distributions in each quarter on the basis of its forward-looking capital position relative to its currently effective point-in-time capital requirements and any other requirements imposing restrictions on capital distributions.

3. *If the dividend add-on component or the Prior Approval Requirement is retained, the mulligan and reconsideration procedures should be improved.*

If either the dividend add-on component or the Prior Approval Requirement is retained, the reconsideration and mulligan procedures are essential (especially in light of the variable and unpredictable nature of the stress losses component of the stress buffer requirements) to allow a firm the opportunity to make adjustments to its planned capital actions in order to come into compliance with its stress buffer requirements and to provide direct feedback on the Federal Reserve’s calculation of its peak-to-trough losses and the extent to which its calculation may be based on models and assumptions that deviate from those of the firm. The Associations believe, however, that the following improvements are necessary to make the mulligan procedure more useful and effective:

First, consistent with the recommendations in Section IV.A above, the Federal Reserve should not limit the only action that can be taken under the mulligan to a reduction of planned dividends,<sup>54</sup> but should also permit a firm to plan on issuing new amounts of regulatory capital to support its planned dividends and repurchases. This would be appropriate, for example, if a firm plans to issue new Additional Tier 1 capital instruments in a declining rate environment to support planned redemptions of higher cost instruments.

Second, the Federal Reserve should make a technical change to the mulligan procedure to allow firms to make any necessary adjustments to their capital distributions or to take any other capital actions as soon as they are notified of their new stress buffer requirements by the Federal Reserve, including in the second quarter (to the extent actually taken) or the third quarter of the planning horizon instead of only being able to take revised capital actions starting in the fourth

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<sup>54</sup> Proposal at 18,169–71, 18,184; Proposed Rule § 225.8(h)(3).



quarter.<sup>55</sup> This flexibility in timing would better position firms to comply with any increased stress buffer requirements as soon as possible.

***D. Capital planning should be part of the normal supervisory process for all firms, and therefore the Federal Reserve's power to object to a firm's capital plan on qualitative grounds in CCAR should be eliminated.***

Assessments and evaluations of a firm's capital planning process, as distinct from its actual capital adequacy and compliance with capital requirements, are fundamentally supervisory in nature, and thus should be conducted through customary supervisory channels (including the Federal Reserve's proposed LFI rating system), and subject to supervisory actions (e.g., MRAs, MRIAs, MOUs or, in extreme cases, written agreements). The Federal Reserve has already acknowledged this distinction in eliminating the qualitative objection from the capital rule for large and non-complex firms.<sup>56</sup>

The Associations believe the same rationale applies to all firms, including large and complex firms, and that it is unnecessary for the capital plan rule to continue to provide for a separate, binary pass/fail qualitative objection to any firm's annual capital plan by the Federal Reserve. CCAR firms have significantly more capital than when the capital plan rule and CCAR processes were first adopted in 2011, and they have made significant enhancements to their capital planning and stress testing processes.

At a minimum, if the Federal Reserve preserves the ability to make qualitative objections, it should clarify that no planned capital distributions would form the basis of any qualitative objection. Otherwise the ability of the Federal Reserve to make quantitative objections would not in fact be eliminated by the Proposal.

In addition, if the dividend add-on component remains in the SCB and SLB, the Federal Reserve should disclose which criteria it would use to monitor a firm's baseline projections compared to actual results and under which circumstances a divergence between a firm's baseline projections and actual results would form the basis for a qualitative objection or a supervisory concern.

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<sup>55</sup> *Id.*

<sup>56</sup> Proposal at 18,161, n. 5, 18,184; *See* Proposed Rule § 225.8(i)(1).

**V. The treatment of the GSIB surcharge as additive to the SCB makes it all the more important to fundamentally reassess the framework and calibration of the GSIB surcharge and renders it unnecessary to deploy the CCyB.**

***A. The Proposal's effective transition of the GSIB surcharge into a post-stress minimum requirement makes it imperative to review and reassess the U.S. implementation of the GSIB surcharge, which currently suffers from conceptual and methodological flaws and is inconsistent with the international framework, to put U.S. GSIBs on a level playing field compared to their international peers.***

The Proposal effectively makes the GSIB surcharge a new post-stress minimum requirement for GSIBs, as covered firms must maintain their GSIB surcharge in addition to their minimum requirements and their stress losses incorporated into the SCB.<sup>57</sup> In light of the impact of incorporating the GSIB surcharge into post-stress minimum requirements on U.S. GSIBs,<sup>58</sup> the Associations believe that it is imperative for the Federal Reserve to revisit and reassess the framework and calibration of the GSIB surcharge to remove any U.S. gold-plating, address flaws in the GSIB surcharge methodology, and create a truly level playing field compared to international standards applicable to GSIBs outside the United States.

*1. A fundamental review of the GSIB framework and calibration is warranted to reflect changes in firms' resiliency and resolvability.*

The Federal Reserve has stated that the GSIB surcharge is “designed to reduce a GSIB’s probability of default such that a GSIB’s expected systemic impact is approximately equal to that of a large, non-systemic bank holding company.”<sup>59</sup> In view of this purpose, regulatory changes and industry actions that reduce the systemic impact of a GSIB’s failure should logically be reflected in the framework and calibration of the GSIB surcharge.

Since the last financial crisis and the finalization of the international and U.S. GSIB framework, regulatory bodies and the banking industry itself have taken significant steps to enhance the resiliency and resolvability of U.S. banking organizations, resulting in a material reduction of the systemic risk posed by U.S. GSIBs. From a public policy perspective, there have been numerous reforms that reduce systemic risk, including new regulatory requirements and heightened supervisory expectations for recovery and resolution planning and preparedness; the development of credible resolution plans and the single point of entry resolution strategy in

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<sup>57</sup> See Proposed Rule § 217.11(c)(1)(iii)(A) (including the GSIB surcharge in the standardized approach capital conservation buffer, which includes the SCB).

<sup>58</sup> See Testimony of former Federal Reserve Chair Janet Yellen before the Committee on Financial Services, U.S. House of Representatives (Sept. 28, 2016) ([link](#)) (“For the eight U.S. GSIBs, the move to the stress loss buffer – which would be similar in effect to including the GSIB capital surcharge in the CCAR post-stress minimum – would result in a significant aggregate increase in capital requirements.”); Proposal at 18,167 (estimating that the Proposal would increase CET1 capital requirements for GSIBs by up to \$50 billion in the aggregate).

<sup>59</sup> Federal Reserve, *Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies*, 79 Fed. Reg. 75,473, 75,475 (Dec. 18, 2014) ([link](#)); see also Proposal at 18,164 (“The GSIB surcharge is designed to mitigate the risk posed to financial stability by certain large and systemic financial institutions, and is calibrated based on the externalities posed by these firms as measured by factors such as size, interconnectedness, and complexity.”).

conduction with large firms becoming subject to resolution planning requirements, including guidance on resolution planning capital and liquidity metrics; new protocols that mitigate the contagion effects of derivative cross-defaults and close-outs; increased central clearing and margining of derivatives; and new or more stringent requirements relating to total loss-absorbing capital (“**TLAC**”) requirements, capital, liquidity, stress testing and counterparty exposure limits.

Large U.S. banks have also made significant progress in reducing their systemic risk profiles. As Federal Reserve Vice Chairman Quarles noted in recent congressional testimony, the U.S. banking system has strengthened considerably over the past decade. The largest U.S. banking organizations – those for which failure would pose the greatest risk to the financial system and thus are subject to the Federal Reserve’s stress testing framework – have increased the size of their loss-absorbing common equity capital by more than \$700 billion since 2009, more than doubling their common equity capital ratios from approximately 5 percent to more than 12 percent. In addition, the eight U.S. GSIBs have developed significantly more stable funding positions as their reliance on short-term debt – including repurchase agreement, or repo, financing – has decreased by more than half since 2007 and now is equal to less than 15 percent of their total assets. The GSIBs now also hold approximately \$2.4 trillion in high-quality liquid assets (“**HQLAs**”), representing an increase of more than 60 percent since 2011.<sup>60</sup>

These enhancements to the regulatory framework applicable to, and the increased resilience of, GSIBs have already served to reduce the potential impact of GSIB failure, both by decreasing the probability of failure of a GSIB and simultaneously reducing the systemic impact of failure were it nevertheless to occur. The current U.S. GSIB framework and calibration should be reassessed to reflect this reality.

## *2. The U.S. GSIB framework and calibration are flawed.*

Under current Federal Reserve rules, U.S.-based GSIBs are required to calculate risk-based capital surcharges under two methods and use the higher of the two surcharges. Method 1 is based on the framework agreed to by the Basel Committee and uses five broad categories that are correlated with systemic importance—size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity. Method 2 is a U.S.-only methodology that uses similar inputs, but is calibrated to result in significantly higher surcharges and replaces substitutability with a measure of the firm’s reliance on short-term wholesale funding.<sup>61</sup>

As the Associations have repeatedly noted over the years, both Methods 1 and 2 are flawed conceptually and in calibration, including, for example:

- Method 1’s design as a relative measure whereby a firm’s systemic indicators are measured relative to the corresponding aggregate global indicator amounts without reference to any absolute changes in a firm’s indicator amounts;

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<sup>60</sup> Testimony of Federal Reserve Vice Chairman Randal K. Quarles before the Committee on Financial Services, U.S. House of Representatives (April 17, 2018) ([link](#)).

<sup>61</sup> See 12 C.F.R. §§ 217.404–06.

- the calibration of Method 2 such that it is always produces a higher indicator amount than Method 1;
- the failure of the short-term wholesale funding component of Method 2 to properly distinguish between runnable liabilities and more stable sources of funding;
- the double counting of various components within Method 1 and Method 2; and
- the impact of short-term fluctuations in foreign exchange rates on the volatility of indicator scores under both Method 1 and Method 2.<sup>62</sup>

In addition, in light of the introduction of the SCB under the Proposal, the Federal Reserve should reassess the degree to which the indicator components in Method 1 and Method 2 overlap with or are addressed by the calibration of the GSIBs' peak-to-trough losses.

Addressing these flaws is important not only to establish greater confidence in the Federal Reserve's capital and stress testing framework but also to create a precedent for global regulatory capital standards.

The Associations believe that the Federal Reserve should revisit and reassess the framework and calibration of the GSIB surcharge to address all of the changes in U.S. GSIBs' resiliency and resolvability, and the flaws in Method 1 and Method 2, through a separate notice of proposed rulemaking ("NPR") and publication of an updated GSIB methodology white paper that includes quantitative analysis justifying any recalibrations.<sup>63</sup> As noted in Section IV.C above, the Associations recommend delaying the effectiveness of firms' first stress buffer requirements, assuming a final rule implementing the Proposal becomes effective in time for the 2019 CCAR and DFAST cycle, until July 1, 2020. The Associations urge the Federal Reserve to publish a GSIB surcharge NPR for notice and comment, and implement a final rule reflecting the results of this process, in time for any changes to the framework and calibration of the GSIB surcharge to be reflected at the same time as the effectiveness of the first stress buffer requirements under the Proposal.

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<sup>62</sup> Francisco Covas, The Clearing House Blog, *Why Aren't the Largest U.S. Banks Lending More? An Analysis of the Impact of a Reduction in Equity Payouts on the GSIB Surcharge* (Oct. 6, 2017) ([link](#)); The Clearing House, Letter Re: Consultative Document – Global Systemically Important Banks – Revised Assessment Framework (June 27, 2017) ([link](#)); Greg Baer, The Clearing House Blog, *Recent Reports that the Basel Committee Found U.S. Banks to Present More Systemic Risk Are Extremely Misleading* (Nov. 22, 2016) ([link](#)); The Clearing House, Letter Re: Incorporation of the GSIB Surcharge into CCAR (June 2, 2016) ([link](#)); The Clearing House, *Overview and Assessment of the Methodology Used to Calibrate the U.S. GSIB Capital Surcharge* (May 2016) ([link](#)); The Clearing House, SIFMA, Financial Services Roundtable, Letter Re: Risk-Based Capital Guidelines – Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies (Apr. 2, 2015) ([link](#)); The Clearing House, Institute of International Bankers, Letter Re: Assessment Methodology and Application of Surcharges to Global Systemically Important Banks (Aug. 26, 2011) ([link](#)). See also U.S. Department of the Treasury, *A Financial System that Creates Economic Opportunities: Banks and Credit Unions*, at 54–56 (June 2017) ([link](#)) (supporting recalibrating the GSIB surcharge, including its focus on short-term wholesale funding reliance, to no longer exceed the international standard).

<sup>63</sup> See Federal Reserve, *Calibrating the GSIB Surcharge* (July 20, 2015) ([link](#)).

***B. The Federal Reserve should use the stress buffer requirements to incorporate countercyclical effects in capital requirements. The countercyclical nature of the supervisory scenario can be tailored to the specific economic circumstances that actually exist, while the CCyB is a blunt tool that is not designed to address specific risks.***

Under the current design and implementation of the Federal Reserve’s macroeconomic scenarios for CCAR and DFAST, the stress buffer requirements would have a countercyclical effect, because key economic measures under the severely adverse scenario are calibrated to shift to an absolute level under stress, irrespective of the prevailing economic environment. For example, at times when the economy is near full employment, the Federal Reserve’s severely adverse scenario will tend to assume *greater* increases in unemployment relative to when such scenarios are designed in less favorable economic environments. The Associations believe that this is appropriate so long as the countercyclical elements of the scenario are tailored to reflect the specific risks to the U.S. financial system at any particular point in time. The countercyclical element to the scenarios and scenario components, and the resulting stress buffer requirements, would generally make it unnecessary to deploy the CCyB to avoid duplicating this effect. The Associations also believe that incorporating countercyclicity through scenario design is more appropriate than doing so through the CCyB precisely because the former can be appropriately tailored to address specific areas of risk in the financial system, while the latter is more of a blunt tool that is not designed to address such specific risks. Consequently, the Federal Reserve should revise its Framework for Implementing the Countercyclical Capital Buffer to explicitly avoid any duplication between the countercyclical elements of the stress buffer framework and the CCyB.<sup>64</sup>

In any event, the Associations strongly reject the assumption implicitly made in the Federal Reserve’s Question 5 – which requests comment on how the Federal Reserve should “contemplate the appropriate level of the countercyclical buffer in light of the proposal”<sup>65</sup> – that the CCyB could be deployed to “compensate” for any change in firm-specific capital levels as a result of the Proposal. The CCyB is intended to be deployed to respond to market conditions and not firm-specific risks or capital requirements. As noted in the preamble to the Proposal, the CCyB “allow[s] the Board to raise capital standards when credit growth *in the economy* becomes excessive,”<sup>66</sup> raising the cost of credit in the economy generally by requiring firms to maintain additional capital in response to overheated market conditions and asset bubbles. It would not be appropriate to deploy the CCyB – or reconsider when to deploy the CCyB – in response to changes in firm-specific capital requirements or for any reason other than its intended purpose. In addition, deploying the CCyB in response to adjustments made to CCAR/DFAST to remove its excessively conservative and counterfactual elements would be at

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<sup>64</sup> See 12 C.F.R. pt. 217, Appendix A; *see also* The Clearing House, Letter Re: Regulatory Capital Rules: The Federal Reserve Board’s Framework for Implementing the U.S. Basel III Countercyclical Capital Buffer (Mar. 21, 2016) ([link](#)).

<sup>65</sup> Proposal at 18,165.

<sup>66</sup> Proposal at 18,164 (emphasis added).

odds with the Federal Reserve's goal of making the CCAR/DFAST exercise more realistic and predictable.<sup>67</sup>

## **VI. Risk-insensitive capital measures should not be part of stress buffer requirements.**

The Associations support the exclusion of the supplementary leverage ratio (“SLR”) from the SLB requirement and with it the elimination of a post-stress SLR requirement. The exclusion of the SLR from the SLB is appropriate to avoid a risk-insensitive measure of capital becoming a binding capital constraint in stressed conditions, which is precisely when it is most essential for a firm's capital requirements to be determined by measures that best reflect its risk profile as determined by its RWAs. The Associations believe that the Federal Reserve should go further to ensure that no risk-insensitive capital measure, whether the SLR or the Tier 1 leverage ratio, ever becomes a binding capital constraint for purposes of CCAR or DFAST by removing any risk-insensitive capital measure from being part of any firm's stress buffer requirements.

CCAR and DFAST are fundamentally designed to subject firms' balance sheets and exposures to significantly increased risk of losses arising from adverse economic, credit and market conditions – i.e., increased risks that primarily affect firms' risk profiles and thus that are primarily reflected in firms' RWAs for credit, market and operational risk. The SLB, on the other hand, because it is based on a firm's Tier 1 leverage ratio requirement plus a buffer calibrated based on a firm's peak-to-trough changes in its Tier 1 leverage ratio, is a risk-insensitive, on-balance sheet measure that measures only a firm's Tier 1 capital relative to the overall size of its balance sheet. As a result, it is a measure that by definition does not reflect changes in a firm's profile as measured by the riskiness of its balance sheet and off-balance sheet exposures – those changes are captured primarily by changes in a firm's RWAs and thus its risk-based capital ratios. This is as it should be. The Associations fundamentally believe that a firm's capital requirements should be determined by a firm's risk profile.

By mixing the effects in CCAR and DFAST of changes in firm's risk profiles with a risk-insensitive capital measure such as the SLB, the Federal Reserve is simply increasing the probability that a firm's binding post-stress capital constraint would be its SLB requirement rather than its risk-based capital buffer and minimum requirements. The sole purpose of the SLB is, according to the Federal Reserve, to “provide a sufficient backstop”<sup>68</sup> and not be a firm's primary binding capital constraint. The Associations believe that this backstop function can be performed by the ongoing, point-in-time Tier 1 leverage ratio as measured under the economic conditions prevailing at the time of its ongoing calculation and that it not necessary to create a stressed measure of the Tier 1 leverage ratio.

Finally, if the SLB is retained, the Federal Reserve should revise the Proposal to ensure that the SLB truly acts as a backstop to the SCB and does not inadvertently result in payout restrictions for firms in scenarios where a firm's on-balance sheet assets may increase without a concomitant increase in RWAs. The SLB may actually contribute to the creation of an inadvertent capital constraint precisely because a firm is continuing to provide services such as

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<sup>67</sup> See Proposal at 18,162–63.

<sup>68</sup> Proposal at 18,164.

custody, client clearing and providing liquidity to markets in stressed conditions. The continued provision of such services under stressed conditions, as well as a general “flight to safety” effect, would likely result in an increase in deposits and other client-driven assets and liabilities, which in turn would result in corresponding increases in such assets as cash, initial margin for clearing purposes, and cash equivalents such as U.S. Treasuries. Because the Tier 1 leverage ratio (and any SLB on top of the Tier 1 leverage ratio) are risk-insensitive measures, any increase in a firm’s assets as a result of these services and “flight to safety” effect, as well as any increase in a firm’s HQLAs for liquidity purposes, would correspondingly increase the risk of a breach of a firm’s SLB requirement. To avoid disincentivizing firms from continuing to provide client-driven services in a “flight to safety” stress scenario or improving its liquidity position, the Associations recommend that, in the final rule implementing the Proposal, the Federal Reserve should provide that a breach of the SLB requirement would only result in payout restrictions if a firm also concurrently breaches its SCB requirement. Of course, a firm would still face consequences for breaching its SLB requirement even if it continued to maintain its SCB requirement; for example, the Federal Reserve could subject a firm that breaches its SLB requirement to heightened scrutiny through the Federal Reserve’s ongoing supervisory process, including through the proposed LFI rating system and/or require the firm to restore the full amount of its SLB requirement over a reasonable time period.

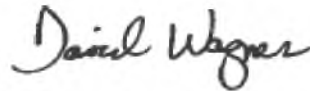
**VII. The Federal Reserve should make technical improvements and clarifications to the Proposal.**

In addition to the foregoing recommendations, the Associations believe that there are a number of technical amendments, improvements and clarifications that the Federal Reserve should make to the Proposal. These recommendations are described in Annex D to this letter.

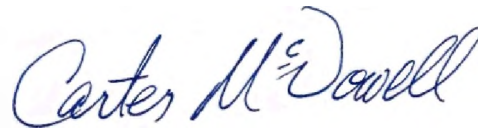
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The Associations appreciate the opportunity to comment on the proposal. If you have any questions, please contact David Wagner at (212) 613-9883 (*David.Wagner@theclearinghouse.org*), Carter McDowell at (202) 962-7327 (*cmcdowell@sifma.org*) or Anthony Cimino at (202) 589-2533 (*anthony.cimino@fsround.org*).

Respectfully submitted,



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cc: Mark E. Van Der Weide  
Michael S. Gibson  
Board of Governors of the Federal Reserve System



## **ANNEX A: The Associations**

The Clearing House is a banking association and payments company that is owned by the largest commercial banks and dates back to 1853. The Clearing House Association L.L.C is a nonpartisan organization that engages in research, analysis, advocacy and litigation focused on financial regulation that supports a safe, sound and competitive banking system. Its affiliate, The Clearing House Payments Company L.L.C., owns and operates core payments system infrastructure in the United States and is currently working to modernize that infrastructure by launching a new, ubiquitous, real-time payment system. The Payments Company is the only private-sector ACH and wire operator in the United States, clearing and settling nearly \$2 trillion in U.S. dollar payments each day, representing half of all commercial ACH and wire volume.

The Securities Industry and Financial Markets Association (SIFMA) is the voice of the U.S. securities industry. It represents the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$18.5 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. 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 <http://www.sifma.org>.

The Financial Services Roundtable represents the largest banking and payment companies financing the American economy. Member companies participate through the Chief Executive Officer (CEO) and other senior executives nominated by the CEO.

**ANNEX B: Example Timeline of the Proposed  
Sequence of Supervisory Scenario Publication and Finalization**

1. October 15, 20X1: Federal Reserve publishes CCAR/DFAST supervisory scenarios, including the details of all scenario components (including the as-of date for the GMS component), for public notice and comment with a 30-day comment period.
2. November 14, 20X1: Comments deadline. Federal Reserve begins consideration of comments received.
3. First week of January 20X2: Federal Reserve completes consideration of comments and publishes final CCAR/DFAST supervisory scenarios, all scenario components and related instructions.
4. April 5, 20X2: Due date for capital plan submissions.

## ANNEX C: Recommended Enhancements to the Scenario Design and Stress Testing Policy Statements

As discussed in Section II.B of the comment letter, the Associations recommend that the Federal Reserve make the following improvements to the design and implementation of its CCAR/DFAST supervisory stress scenarios, scenario components and instructions:

- establish supervisory scenario design principles incorporating transparent and realistic scenario parameters regarding the severity of supervisory stress scenarios that explicitly take into account both historical experience and current market conditions; and
- improve the internal coherence of the supervisory stress scenarios and scenario components.

***1. The Federal Reserve should establish supervisory scenario design principles incorporating transparent and realistic scenario parameters regarding the severity of supervisory stress scenarios.***

As noted in Section II.B of the comment letter, the Federal Reserve should develop and implement scenario design principles incorporating transparent and realistic scenario parameters related to the overall severity, change in severity, and duration of the combined effect of all supervisory stress scenarios and their scenario components. The Associations believe that this could be accomplished through the following four main recommendations:

First, the Federal Reserve should develop scenario design principles and scenario parameters that are intended to achieve an overall coherent and plausible set of supervisory scenarios and scenario components. These principles and parameters would be based on long-term historical market and macroeconomic experiences and would also include mechanisms to relate to market and macroeconomic conditions prevailing at the time of each CCAR/DFAST cycle. They would also be designed to reflect that, when the macroeconomic scenarios and their scenario components are integrated into a single set of scenarios and scenario components applicable to any one CCAR or DFAST cycle, the scenarios form a coherent and plausible whole and do not reflect inconsistent assumptions or operate at cross-purposes in ways that would either exacerbate or reduce stress losses. For example, the 2018 severely adverse scenario showed short-term interest rates decreasing over the nine quarter planning horizon,<sup>69</sup> whereas the 2018 GMS included an increase in short-term interest rates.<sup>70</sup> The Federal Reserve's scenario design principles and scenario parameters should be designed to avoid such inconsistencies or justify them based on historical experiences with any different movements in rates over specified time frames and their potential applicability based on prevailing economic conditions.

Second, under such a scenario design and parameter framework, long-term historical experiences could be used to calibrate both the overall severity and parameters for the magnitude of the changes to specific macroeconomic variables – such as real GDP growth, unemployment

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<sup>69</sup> Federal Reserve, *2018 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule*, at 5 (Feb. 2018) ([link](#)).

<sup>70</sup> *Id.* at 7.

rates, credit spreads, equity volatility, U.S. Treasury yields, interest rates, FX rates, commodity and housing prices, among other variables – as well as the duration of the stress for each variable over the planning horizon. By basing these parameters on historically observed absolute levels as well as historically observed changes in the level of severity, these parameters would ensure that any year’s economic scenarios and scenario components would ultimately reflect realistically plausible, yet severe, economic and market conditions.<sup>71</sup>

Third, by reflecting a more realistic relationship between the parameters of the economic scenarios and the economic conditions prevailing around the time of the CCAR/DFAST cycle, the benchmark frameworks could effectively integrate built-in countercyclical mechanisms into the scenario design framework while avoiding excessive and unrealistic changes in the severity of the various economic and other variables underlying the scenarios. This approach would be designed to ensure that, unless historically observed data, when applied to prevailing economic and market conditions, justified a magnified change in the level of severity from the prior year’s CCAR and DFAST cycle, the changes in scenarios and scenario components from year to year would not reflect excessive volatility and thus would not lead to excessive swings in firms’ point-in-time capital requirements.

As an example of how the scenario parameters developed by the Federal Reserve for various economic and other variables would more realistically relate to the economic conditions prevailing at the time of a particular CCAR/DFAST cycle, the Federal Reserve could develop a methodology of applying historically-based shocks to certain variables based on a look-back period of recent observations of market or macroeconomic conditions. Under such an approach, the historical shocks could be defined not only by the severity of the shock but also the duration and arc of the change in the level of the variable over the planning horizon, and the “starting” measure of each variable could be determined based on this look-back period, rather than based on the spot measure as of the first date of the planning horizon (i.e., December 31).

Fourth, the Federal Reserve should reflect its supervisory design principles and scenario parameters in its Scenario Design Policy Statement and, for the GMS and Counterparty Default components or any other applicable component, in separate policy statements specific to each component. Although the Associations support the Federal Reserve’s proposal to amend its Scenario Design Policy Statement,<sup>72</sup> the proposed amendments do not sufficiently address the principles for calibration of the GMS component. The purpose of a separate GMS Component Policy Statement would be to provide more tangible, empirically based GMS scenarios. A more clearly articulated and empirically based design principle for the GMS would provide a more transparent basis upon which the Federal Reserve and public commenters could separately evaluate a proposed calibration of this scenario component.

Overall, the foregoing recommendations would serve to significantly increase the transparency of the drivers of the Federal Reserve’s supervisory stress scenarios and their

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<sup>71</sup> In connection with adopting such a framework, the Federal Reserve should clarify that so long as a firm’s own severely adverse scenario was based on similar parameters, it would satisfy the requirement in SR 15-18 related to the severity of a firm’s severely adverse scenario.

<sup>72</sup> Federal Reserve, *Policy Statement on Scenario Design Framework for Stress Testing*, 82 Fed. Reg. 59,533 (Dec. 15, 2017) ([link](#)).

components and thus would enable firms and other stakeholders to obtain a better understanding of the Federal Reserve’s rationale in determining each year’s scenarios and scenario components and to provide better informed feedback to the Federal Reserve through the public notice-and-comment process. This process would enhance the substantive and procedural discipline underlying the scenarios and their components and ultimately their impact on firms’ capital levels. The Associations believe that this can only result in an improved CCAR and DFAST process and thus in an improved process for determining firms’ capital requirements.

**2. *The macroeconomic stress scenarios should be aligned with the GMS and Counterparty Default components to form a coherent stress scenario.***

All aspects of the Federal Reserve’s supervisory stress scenarios and scenario components should work together to form a coherent and plausible stress scenario. This approach would align with the goal of evaluating firms’ capital adequacy under realistic, severe stress and establishing stress buffer requirements that are calibrated to reflect how firms’ balance sheets would react to plausible stress scenarios. For example, the Federal Reserve should consider the following targeted improvements to the coherence within and among the macroeconomic stress scenarios, the GMS component and the Counterparty Default component:

- a. *Deductions from post-shock pro forma capital ratios in CCAR should be made based on calculations that measure deduction-eligible assets on a post-shock basis.*

The capital rule requires firms to make certain deductions from regulatory capital when calculating firms’ capital ratios,<sup>73</sup> in some cases only if those assets exceed certain thresholds measured against base amounts. For example, a firm must deduct the amount of its significant investments in the capital of unconsolidated financial institutions (“**significant UFI investments**”) that exceed 10 percent of its CET1 capital (after making certain other adjustments and deductions), or, when aggregated with certain other deductible items, 15 percent of its CET1 capital (after making certain other adjustments and deductions).<sup>74</sup> If a firm has \$10 million of significant UFI investments and \$100 million of provisional CET1 capital, and the aggregate amount of its significant UFI investments and other items subject to the threshold deduction approach does not exceed \$15 million, it would not be required to deduct any significant UFI investments under this provision.

Currently under CCAR, a firm subject to the GMS is required to make deductions from its pro forma capital ratios during the planning horizon by measuring its *pre*-shock amount of deduction-eligible assets against the relevant base amount, calculated on a *post*-shock basis.<sup>75</sup> To extend the example above, imagine that under CCAR the firm’s significant UFI investments decrease in value to \$5 million (\$1 million as a result of macroeconomic stress plus \$4 million as

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<sup>73</sup> See 12 C.F.R. § 217.22.

<sup>74</sup> 12 C.F.R. § 217.22(d).

<sup>75</sup> In this context, “pre-shock” amounts refer to balance sheet measurements that do not reflect the instantaneous and exogenous effects of the GMS, whereas “post-shock” amounts do reflect such effects. Pro forma amounts would in all cases reflect the projected effects of the macroeconomic stress environment under the applicable supervisory scenario.

a result of the GMS) and its CET1 capital decreases to \$60 million as a result of both macroeconomic stress and the GMS. The firm would be required to measure its \$9 million of *pre*-shock significant UFI investments against its \$60 million of *post*-shock CET1 capital – and therefore make a \$3 million deduction (equal to \$9 million – 10 percent × \$60 million). This disparate treatment is not justified, particularly as the two impacts will generally be related, and reflects the use of inconsistent assumptions, with a static approach being taken for the general denominator assumptions (i.e., static balance sheet and RWAs) and a dynamic approach being taken for numerator deductions and adjustments.

To address this inconsistency, the Federal Reserve should amend, as applicable, the capital plan rule and instructions and any applicable scenario design policy statements to provide that deductions from post-shock pro forma capital ratios are made based on measurements of both deduction-eligible assets and the relevant base amount on an equivalent post-shock basis. The Proposal would revise the balance sheet and RWA assumptions to reflect the sensible position that firms’ stress losses should be measured against a static denominator. The use of pre-shock values for deduction-eligible assets in calculating post-shock pro forma capital ratios, however, has an outsize effect in deviating from this principle, as these deductions are made not only from the denominator but also from the *numerator* of firms’ capital ratios. The Federal Reserve has not justified such a significant departure from the principle of static pro forma capital ratio denominators and should instead adopt a more internally coherent approach with respect to deduction-eligible positions such as significant UFI investments and any other deductible items to the extent they are affected by the GMS – in the case of these items, the amount reflected in the numerator should be calculated and held constant on a post-shock basis as well.

- b. CCAR/DFAST should be amended to allow firms to recognize the ongoing effects of margin agreements when calculating the Counterparty Default component.*

Under the Counterparty Default scenario component, certain firms are required to calculate and assume the instantaneous and unexpected default of the counterparty that would generate the largest losses across its derivatives and securities financing transactions under the GMS.<sup>76</sup> The Federal Reserve’s capital rule<sup>77</sup> and the preamble to the Federal Reserve’s uncleared swap margin rule<sup>78</sup> recognize that margining reduces counterparty risks and achieves additional regulatory objectives such as increasing transparency and promoting market integrity.<sup>79</sup> The Counterparty Default component does not, however, allow firms to recognize the ongoing effect of margining agreements, including the right to demand additional variation margin on a daily basis, when determining the losses that would arise due to instantaneous counterparty defaults.

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<sup>76</sup> See, e.g., Federal Reserve, *Comprehensive Capital Analysis and Review 2018 Summary Instructions*, at 10 (Feb. 2018) ([link](#)).

<sup>77</sup> See 12 C.F.R. § 217.37.

<sup>78</sup> This rule was jointly issued by the Office of the Comptroller of the Currency (“OCC”), Federal Reserve, Federal Deposit Insurance Corporation (“FDIC”), Farm Credit Administration and Federal Housing Finance Agency (collectively, the “Prudential Regulators”).

<sup>79</sup> Prudential Regulators, *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74,840, 74,841–42 (Nov. 30, 2015) ([link](#)).

This inconsistency between rules produces unrealistically high stress losses under the Counterparty Default component because a firm must unrealistically assume that its counterparty exposures would be undercollateralized in that they would not reflect the firm's right to require additional collateral or otherwise reduce its exposure as a counterparty's creditworthiness deteriorates. To avoid such an unrealistic result, the Federal Reserve should amend the Counterparty Default component to allow firms to recognize the ongoing right to collect variation margin from counterparties (subject to any applicable contractual limitations or thresholds) and thus to calculate their net stressed losses on the basis of having realistically collateralized exposures as of the counterparty default date. This approach would not only result in more realistic stress loss estimates (and therefore SCB and, if retained, SLB calibrations) due to the risk-reducing effect of variation margin, but would also further incentivize firms to enter into or maintain margining agreements, especially with their largest counterparties, which the Federal Reserve recognizes would promote market integrity.<sup>80</sup>

- c. Supervisory models should avoid duplication of stress losses by applying, on an exposure-by-exposure basis, the "worst of" the losses under the GMS component and macroeconomic stress scenarios, rather than adding these stress losses together.*

The Federal Reserve's instructions for the submission of a firm's estimates of stress losses based on the supervisory scenarios permit the firm to eliminate duplicative losses where the stress losses arise separately from the GMS and the macroeconomic stress scenarios, for the same asset or position (i.e., for securities, at the level of each separate CUSIP number). For these positions, the firm is permitted to eliminate duplicative losses by recognizing the greater of the stress loss under the GMS and the macroeconomic stress scenario.<sup>81</sup> This approach is sensible and improves the accuracy and risk sensitivity of a firm's estimated stress losses.

The Associations recommend that the Federal Reserve either clarify or formally adopt a policy that it will apply the same approach when determining its estimates of a firm's stress losses. Firms would submit underlying documentation evidencing the duplication of losses under GMS and the macroeconomic scenario. These submissions could be made in connection with the filing of the FR Y-14A documentation.

- d. Losses on securities, securitization exposures and similar positions should be capped at the maximum possible loss to avoid excessive double-counting of various scenario effects such as the interaction of the GMS with their general RWA treatment*

The GMS and RWA treatment of certain securities, securitization exposures and similar positions can be excessively duplicative, sometimes resulting in positions for which firms are effectively required to hold more in capital than the maximum loss that could be incurred. For example, securitized products can generate losses close to twice the exposure amount, after aggregating GMS losses and RWAs.

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<sup>80</sup> *Id.*

<sup>81</sup> Federal Reserve, *Comprehensive Capital Analysis and Review 2018 Summary Instructions*, at 9 (Feb. 2018) ([link](#)).

To avoid these excessively duplicative results, the Federal Reserve should, at a minimum, cap the total amount of capital required to be maintained for each position at the maximum possible loss on each position (i.e., up to the amount of the investment). This change would reduce the double-counting of risks across the capital framework.



## ANNEX D: Technical Amendments, Improvements and Clarifications

The Associations recommend that the Federal Reserve should make the following amendments, improvements or clarifications to various provisions and aspects of the Proposal.

***1. The payout restrictions under the capital rule should be amended to more realistically reflect the actions firms would take in stressed conditions.***

Regardless of whether the dividend add-on is retained, the Federal Reserve should amend its capital rule to provide that the payout restrictions apply first to restrict only share repurchases, to reflect how firms would actually act to preserve capital in stressed conditions. Share repurchases are distinguishable from dividends, as firms generally have greater flexibility to reduce or suspend share repurchases during periods of firm-specific or systemic stress, reflecting different marketplace implications. In light of this fact, firms facing stress would be expected to curtail planned share repurchases before limiting dividends.

Consequently, the Associations believe that the Federal Reserve should amend the payout restrictions table under the capital rule<sup>82</sup> to first restrict share repurchases before restricting dividends or other payouts. For example, the first band of the payout restrictions table – under which a firm’s maximum payout ratio is 60 percent of eligible retained income – could apply only to share repurchases. Additional restrictions, i.e., on dividends and other payouts, would apply only to the lower bands of maximum payout ratios – for example, the 40 percent payout ratio band and below – and potentially could delay the application of the restrictions to distributions on Additional Tier 1 capital to the last band (the zero percent payout ratio band). This approach would more realistically reflect the actions firms would actually take in stressed conditions under their capital management plans and policies, where share repurchases would be curtailed before dividends and dividends on common stock would likely be curtailed before dividends on preferred shares.

This approach would also help to mitigate the otherwise counterintuitive and overly punitive impact of these restrictions if the definition of eligible retained income is not changed, because otherwise even a capital buffer shortfall of one basis point compared to a firm’s buffer requirements could prevent it from making any distributions or other payouts whatsoever for at least the entire current quarter following the shortfall.

***2. The SCB should only be incorporated into firms’ capital buffer requirements under the standardized approach for calculating RWAs, as this reflects the Federal Reserve’s current approach in CCAR and DFAST.***

The Associations believe that the SCB should be incorporated into firms’ capital buffer requirements under the standardized approach for calculating RWAs, as proposed, but not the advanced approaches. This approach would be consistent with the Federal Reserve’s current practice of calculating firms’ pro forma capital ratios under CCAR and DFAST only as measured against firms’ standardized approach RWAs. Because the SCB would be calibrated based primarily on firms’ peak-to-trough stress losses under CCAR and DFAST, incorporating the

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<sup>82</sup> 12 C.F.R. § 217.11, Table 1.

SCB into a buffer requirement with respect to firms' advanced approaches RWAs (for firms subject to the advanced approaches requirement) would unnecessarily require firms and the Federal Reserve to develop models that would dynamically adjust applicable risk-weights to reflect the changing riskiness of certain assets and exposures throughout a supervisory stress scenario. The difficulty of doing so, especially when considered against the attendant uncertainty and variability inherent in any such model, would make such an approach inappropriately burdensome given the minimal value any advanced approaches SCB requirement may provide.

***3. The day-one capital impact of a planned merger or acquisition should be deducted from the calibration of the SCB and (if retained) the SLB.***

Under the Proposal, the SCB and SLB would be calibrated in a manner that effectively double counts the day-one capital impact of planned M&A transactions. To the extent an M&A transaction is executed without the issuance of new capital, a firm must maintain sufficient capital levels prior to the transaction in order to maintain sufficient capital ratios after the transaction is executed to satisfy the firm's point-in-time capital buffer and minimum capital requirements. Under the Proposal, the stress losses component of the SCB and SLB would be calibrated to include – as part of the capital planning horizon – the day-one capital impact of the same transaction by requiring a firm to include the balance sheet and RWA impact of the proposed transaction.<sup>83</sup> Consequently, a firm would be required to maintain sufficient capital to absorb the day-one capital impact of an M&A transaction both as part of its SCB and SLB requirements and also as an additional amount above these stress buffer requirements and other applicable buffer and minimum requirements. Although M&A transactions may affect the risk profile of a firm and these changes should be evaluated as part of a firm's stress tests, the day-one capital impact of these transactions should be excluded from the calibration of the SCB and (if retained) SLB to avoid double counting.

***4. The capital distribution measurement window referred to in the well-capitalized exemption from the Prior Approval Requirement should be aligned to the fourth through seventh quarters of the planning horizon – i.e., October 1 through September 30.***

Under the Proposal, a firm would be eligible to make a capital distribution in excess of the firm's final planned capital distributions if, among other things, the firm is (and would remain) well capitalized, as defined under Regulation Y,<sup>84</sup> and the aggregate annual dollar amount of all capital distributions from July 1 of a calendar year through June 30 of the following year would not exceed the total dollar amount of the firm's final planned capital distributions by a certain percentage.<sup>85</sup> If the Prior Approval Requirement is maintained, the Associations believe that the Federal Reserve should change this annual capital distribution

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<sup>83</sup> Proposal at 18,166; Proposed Rule § 225.8(e)(2)(iv) (requiring capital plans to include a discussion of expected changes to firms' business plans that are likely to have a material impact on capital adequacy or liquidity, including a planned M&A transaction). The Federal Reserve's annual CCAR instructions have required firms to reflect planned acquisitions in their projections.

<sup>84</sup> See 12 C.F.R. § 225.2(r).

<sup>85</sup> Proposed Rule § 225.8(k)(2).

measurement window to run from October 1 of a calendar year through September 30 of the following year. This revised window would match the four quarters during which a firm's stress buffer requirements are in effect, as well as the fourth through seventh quarters of the planning horizon, when a firm must confirm its planned capital distributions would be consistent with effective capital distribution limitations under the firm's baseline scenario.<sup>86</sup>

***5. The Federal Reserve has not gathered sufficient data to justify imposing the SCB and SLB on U.S. IHCs of FBOs at this time, and as a result it should delay implementation of the stress buffer requirements for these firms until it has completed its analysis of the effects of the Proposal.***

As the Federal Reserve noted in the preamble to the Proposal, it had neither sufficient time nor a sufficient sample size to analyze the effect of the Proposal on required capital levels for U.S. IHCs of FBOs because not all of these firms have been subject to CCAR for a sufficient length of time.<sup>87</sup> Not having done this analysis, the Federal Reserve risks applying the stress buffer requirements calibrated for domestic BHCs to U.S. IHCs of FBOs, which in many cases operate under different business models and maintain different structures than their U.S. peers.

In order to avoid applying a one-size-fits-all requirement in a manner that may be miscalibrated with respect to U.S. IHCs of FBOs, the Federal Reserve should delay the implementation of the SCB and SLB requirements of the Proposal for these firms until it has completed its analysis of the effect of the Proposal on the U.S. IHCs of FBOs using the most recent CCAR/DFAST results and information gathered through its ongoing supervisory process.<sup>88</sup> The ability to analyze more current results of CCAR/DFAST, including the GMS component to the extent applicable, for these firms should provide the Federal Reserve with sufficient information to measure and analyze the effect the SCB and SLB would have on the capital requirements of U.S. IHCs of FBOs, at which point the Federal Reserve could finalize the stress buffer requirements for these firms.

***6. The Federal Reserve should tailor the Proposal to appropriately reflect the business models, risks and exposures of U.S. IHCs of FBOs that do not have banking subsidiaries.***

Some U.S. IHCs of FBOs do not have (or have limited) U.S. banking subsidiaries, but the Proposal would impose a one-size-fits all capital adequacy regime designed for U.S. institutions with significant commercial banking operations on such IHCs as if they would be subject to the same market effects and act the same under stress as commercial banking institutions. The existing capital adequacy framework – including capital buffer requirements and CCAR / DFAST – already has a disproportionate impact on U.S. IHCs of FBOs that do not have banking

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<sup>86</sup> Proposed Rule § 225.8(h)(3)(i).

<sup>87</sup> Proposal at 18,167 n.39. We note that the U.S. IHCs of FBOs have only been subject to CCAR since the 2017 cycle, although the U.S. BHC predecessors of some U.S. IHCs have been subject to CCAR since the 2014 cycle.

<sup>88</sup> Although the Associations recommend delaying the SCB and SLB requirements of the Proposal for U.S. IHCs of FBOs, the Federal Reserve should implement the other elements of the Proposal – including the constant balance sheet and RWA and dividend payment assumptions, as well as the elimination of the quantitative objection – for all firms effective as of the 2019 CCAR cycle.

subsidiaries. In addition, U.S. IHCs of FBOs that do not have banking subsidiaries are subject to assumptions in CCAR and DFAST that were designed for firms with commercial banking operations evaluated at the parent holding company level. In order to restore a level playing field between U.S. IHCs of FBOs and their U.S. GSIB and U.S. broker-dealer peers, the Federal Reserve should tailor the assumptions and process under the Proposal to recognize that stress testing applied to a U.S. banking organization at the parent company level is inherently different than that applied to a U.S. IHC of an FBO with a large broker-dealer subsidiary.

***7. The Federal Reserve should holistically evaluate the adverse effects and complexity of incorporating CECL into CCAR and revise its capital planning and stress testing frameworks to mitigate those effects and develop a simple approach to incorporating CECL into CCAR.***

The current expected credit loss methodology (“CECL”) will result in the earlier recognition of credit losses by requiring that credit loss allowances reflect expected credit losses over the lives of many financial assets. CECL will effectively raise firms’ capital requirements by increasing the provisions and overall allowances for credit losses and, therefore, decrease CET1 capital. CECL will also have procyclical effects due to the accelerated recognition of losses as economic conditions worsen and result in more volatility in credit loss allowances and regulatory capital. As a result, many expect CECL to have a number of negative effects on banks and the broader economy, including reductions in banks’ ability to lend and changes to the pricing, terms and even availability of many products, in particular longer-dated products (such as residential mortgage loans) and loans to non-prime customers and small businesses. Applying CECL in CCAR will significantly exacerbate these adverse effects and directly impact the stress buffer requirements. Moreover, incorporating CECL into CCAR could result in undue complexity in capital stress testing, especially if firms are required to develop numerous CECL-based projections over the planning horizon. We expect to address our concerns and recommendations regarding the incorporation of CECL into CCAR in greater detail in our comment letter on the Federal Reserve and other banking agencies’ recent proposal regarding CECL, the capital rules and DFAST.<sup>89</sup>

***8. The Federal Reserve should eliminate the adverse scenario in CCAR to align its CCAR requirements with the DFAST requirements as recently amended by Congress.***

The recently enacted EGRRCPA amended Section 165(i) of the Dodd-Frank Act to eliminate the adverse supervisory stress scenario from both supervisory and company-run DFAST requirements.<sup>90</sup> The Federal Reserve should exclude the adverse scenario from CCAR as well. This change would rationalize CCAR and DFAST requirements, while at the same time acknowledging that the adverse scenario is unnecessary and unduly burdensome in light of the fact that this scenario does not produce any binding requirements on firms’ capital under CCAR and would not do so under the Proposal either.

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<sup>89</sup> OCC, Federal Reserve and FDIC, *Regulatory Capital Rules: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations*, 83 Fed. Reg. 22,312 (May 14, 2018) ([link](#)).

<sup>90</sup> EGRRCPA § 401(a)(5).

**9. *The Federal Reserve should fix the asymmetry inherent in its treatment of employee stock issuances in the Proposal by allowing employee stock issuances to be reflected in firms' pro forma balance sheets during the supervisory stress scenarios.***

Under the Proposal, firms would be required to incorporate equity compensation expenses under the supervisory stress scenario but would not be allowed to recognize the balance sheet effects of equity created through the issuance of employee stock compensation – because the Proposal would remove the issuance of common or preferred stock relating to compensation from a firm's capital plan.<sup>91</sup> The Federal Reserve should amend the Proposal to allow firms to incorporate the balance sheet effects of employee stock issuances when calculating firms' peak-to-trough stress losses (and thereby calibrating firms' stress buffer requirements). This change would promote a balanced pro-forma balance sheet throughout the planning horizon and would appropriately incentivize stock-based compensation, which actually increases capital in stress.

**10. *The Federal Reserve should amend the proposed FR Y-9C Instructions to clarify that a firm would not be required to report amounts relating to their maximum payout ratios (line items 57 through 60) unless it is subject to the payout restrictions under the capital rule.***

The instructions to the FR Y-9C require a firm to report its eligible retained income (line item 47) and distributions and discretionary bonus payments (line item 48) during a quarter only if it is subject to payout restrictions under the capital buffer framework.<sup>92</sup> The proposed changes to the FR Y-9C to align to the Proposal would require disclosure of a firm's eligible retained income (line item 57), maximum payout ratio (line item 58), maximum payout amount (line item 59) and distributions and discretionary bonus payments during the quarter (line item 60).<sup>93</sup> It is unnecessary for the Federal Reserve to collect these line items through the FR Y-9C unless the reporting firm is subject to the payout restrictions under the capital framework, because these line items do not generally implicate the requirements of the capital rule except for firms subject to the payout restrictions. Furthermore, to the extent there is a public or investor interest in these line items, their public disclosure would be more appropriately addressed through the SEC's securities law disclosure framework. These proposed changes should therefore be amended to provide that, as under the current instructions, firms would only be subject to these reporting requirements if they are subject to the payout restrictions under the capital buffer framework.

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<sup>91</sup> See Proposal at 18,166 n. 33.

<sup>92</sup> Federal Reserve, *Instructions for Preparation of Consolidated Financial Statements for Holding Companies: Reporting Form FR Y-9C*, at HC-R-33 ([link](#)).

<sup>93</sup> Federal Reserve, *Draft Instructions or Preparation of Consolidated Financial Statements for Holding Companies: Reporting Form FR Y-9C*, at HC-R-38–39 ([link](#)).

***11. If the Prior Approval Requirement is retained, the Federal Reserve should clarify how the payout restrictions would apply on a pro forma basis for the purpose of a firm confirming its planned capital distributions would be consistent with effective capital distribution limitations under the firm's baseline scenario.***

The Proposal provides that payout restrictions would apply if a firm's capital ratios as of the end of the previous quarter are lower than the firm's minimum capital requirements plus its capital buffers (including the SCB, its GSIB surcharge, if applicable, and CCyB, if applicable), and if a firm were to be subject to distribution restrictions, its maximum payout ratio would be based on its eligible retained income, which in turn would be determined based on the firm's net income from the previous four quarters.<sup>94</sup> Although the Associations believe that it is clear that these distribution requirements would apply on an ongoing quarterly basis, the Federal Reserve should clarify that the same distribution restrictions would apply when, in the two days after receiving its stress buffer requirements from the Federal Reserve, a firm is determining whether its planned capital distributions for the fourth through seventh quarters of the planning horizon under the firm's baseline scenario would be "consistent with effective capital distribution limitations."<sup>95</sup> For example, the Federal Reserve should clarify that when determining the effective capital distribution limitations during quarter six of the planning horizon, a firm's maximum payout ratio would be based on its capital ratios as of the end of quarter five of the planning horizon, and its eligible retained income would be based on its net income for quarters two through five of the planning horizon – all under the firm's own baseline scenario.

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<sup>94</sup> Proposal at 18,171.

<sup>95</sup> Proposed Rule § 225.8(h)(3)(i).

**ANNEX E: Mapping of Requests for Comment to Comment Letter**

Ref.	Question	Response
1.	What are the advantages and disadvantages of incorporating the stress capital buffer and stress leverage buffer requirements into the capital rule? How well does the proposal enhance regulatory simplicity, transparency, and efficiency for firms subject to the capital plan rule? What refinements or additional approaches should the Board consider to enhance these goals, and why? Please provide data on the impact of any proposed refinements or additional proposals.	Introduction; Section II
2.	What are the advantages and disadvantages of including or excluding the stress capital buffer requirement from the advanced approaches capital conservation buffer requirement when considered in combination with other elements of the proposal or alternatives to the proposal? What if any, alternatives should the Board consider and why? For example, should the Board consider scaling 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? What are the advantages or disadvantages of such an approach?	Annex D, Section 2
3.	What are the advantages or disadvantages of not extending the stress buffer concept to the supplementary leverage ratio?	Section VI
4.	Would modifications to the enhanced supplementary leverage ratio standards impact the responses to the questions above or any other aspect of the proposal, and if so how?	N/A
5.	How should the Board contemplate the appropriate level of the countercyclical capital buffer in light of the proposal?	Section V.B
6.	What aspects of the calculation of the stress buffer requirements could be modified to increase the effectiveness of the proposal in ensuring that firms maintain stress buffer requirements that are appropriately sized to withstand stressful economic and financial conditions while permitting such firms to continue lending and supporting the real economy? Please describe the advantages or disadvantages of any alternative approach.	Section III; Annex D, Section 3
7.	Besides stated payments on regulatory capital instruments and issuance of common or preferred stock associated with a merger or acquisition, what, if any, other types of planned	Annex D, Section 9

Ref.	Question	Response
	capital actions should the Board incorporate into the supervisory stress test for the purposes of calculating the stress buffer requirements, and why?	
8.	What are the advantages and disadvantages of including or excluding dividend payouts and certain other planned capital actions in the calculation of the stress buffer requirements when considered in combination with other elements of the proposal or alternatives to the proposal?	Section III
9.	What, if any, additional factors beyond a planned divestiture, merger, or acquisition, should the Board incorporate into its projected changes in a firm's balance sheet or risk-weighted assets over the planning horizon and why?	Annex C, Section 2
10.	What are the advantages and disadvantages of integrating the distribution assumptions used in calculating a firm's stress buffer requirements with those used in the supervisory stress test?	Section III
11.	What if any operational complications or challenges to capital planning processes would the proposed effective dates create, and how might the Board address these issues consistent with the goals of the proposal?	Section II.A; Section IV
12.	What advantages or disadvantages are associated with making the rule effective on December 31, 2018 and generally making the stress buffer requirements effective on October 1, 2019?	Section IV.C
13.	What are the advantages and disadvantages of not requiring a firm to project and meet the limitations of the capital rule regarding discretionary bonus payments on a pro forma basis?	N/A
14.	What, if any, modifications should the Board make to the definition of BHC baseline scenario?	N/A
15.	What are the advantages and disadvantages of not requiring a firm to make BHC baseline scenario projections that would enable it to evaluate whether its planned capital actions would be consistent with advanced approaches-based capital distribution restrictions, such as the advanced approaches capital conservation buffer requirement or the total loss absorbency capacity buffer requirements?	Annex D, Section 2
16.	The proposal would maintain the Board's current practice of providing firms with two business days to make any adjustments to planned capital actions to minimize the time when a firm has material nonpublic information. What if any	N/A



Ref.	Question	Response
	challenges are posed by this timeframe for a firm to adjust its planned capital actions?	
17.	What are the advantages or disadvantages of the proposed transition from the current process to the proposed process? What if any alternative transition processes should the Board consider and why?	Section IV.C Annex D, Section 5
18.	What are the advantages and disadvantages of the proposed procedures for requesting reconsideration of a qualitative objection to a capital plan or any of the stress buffer requirements? What, if any, modifications would enhance the proposed procedures?	Section II.C; Section IV.C
19.	During the pendency of a request for reconsideration, a firm's stress buffer requirements or objection to a firm's capital plan would not go into effect and a firm generally would continue to be bound by existing limitations on capital distributions. What are the advantages and disadvantages of this approach?	N/A
20.	The proposal would require a firm to submit a request for reconsideration within 15 calendar days of receiving notice of a qualitative objection to its capital plan or any of its stress buffer requirements. What if any challenges are posed by this proposed timeframe?	N/A
21.	The Board has not received any requests for an informal hearing under the capital plan rule. What are the advantages and disadvantages of continuing to provide an opportunity to request an informal hearing? What information would not be adequately addressed in a written reconsideration process that would be better addressed in an informal hearing? Discuss and provide examples of any issues that are likely to be raised in an informal hearing that would not be adequately presented through a written submission.	N/A
22.	Under the proposal, the Board may recalculate a firm's stress buffer requirements if the firm resubmits its capital plan. Accordingly, the Board also would recalculate the firm's stress buffer requirement using an updated severely adverse scenario. What are the advantages or disadvantages of using an updated severely adverse scenario to recalculate a firm's stress buffer requirements?	N/A
23.	What, if any, other changes to CCAR or the capital plan rule should the Board consider? For example, what advantages or disadvantages would be associated with:	Section II.A; Section IV.A; Section IV.D

Ref.	Question	Response
	<ul style="list-style-type: none"> <li data-bbox="310 268 1073 390"><i>i.</i> Removing or adjusting the provisions that allow the Board to object to a large and complex or LISCC firm's capital plan on the basis of qualitative deficiencies in the firm's capital planning process;</li> <li data-bbox="310 394 1073 485"><i>ii.</i> Publishing for notice and comment the severely adverse scenario used in calculating a firm's stress buffer requirements;</li> <li data-bbox="310 489 1073 579"><i>iii.</i> Providing additional flexibility for a firm to exceed the capital distributions included in its capital plan if its earnings and capital ratios are above those in its BHC baseline; or</li> <li data-bbox="310 583 1073 705"><i>iv.</i> Providing additional flexibility to a firm to increase the planned capital actions above what was included in its original capital plan based on the results of the supervisory stress test or request for reconsideration?</li> </ul>	
24.	<p data-bbox="277 730 1089 905">What are the advantages or disadvantages of maintaining the current definitions of distribution and capital distribution in the capital rule and capital plan rule, respectively, or of amending the definition of capital distribution in the capital plan rule to match the distribution in the capital rule or vice versa?</p>	Section III.C
25.	<p data-bbox="277 934 1089 1249">The proposal would require all firms subject to the stress buffer requirements to report their eligible retained income and capital distributions and discretionary bonus payments each quarter on the FR Y-9C, which is publicly available. What concerns, if any, are raised by making this reporting mandatory? What concerns, if any, are raised by making this reporting public as opposed to including this information in a confidential information collection?</p>	Annex D, Section 10