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Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, DC 20551
Docket No. R-1569

Via Electronic Mail/Electronic Submission

February 15, 2018

Re: Notice of Proposed Rulemaking – Large Financial Institution Rating System (Docket No. R-1569)(RIN 7100–AE82)

Ladies and Gentlemen:

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the proposed large financial institution (LFI) rating system (Proposal)[2] from the Board of Governors of the Federal Reserve System (Federal Reserve). The proposed rating system would apply to (a) all bank holding companies with total consolidated assets of $50 billion or more; (b) all non-insurance, noncommercial savings and loan holding companies with total consolidated assets of $50 billion or more; and (c) U.S. intermediate holding companies of foreign banking organizations established pursuant to the Federal Reserve's Regulation YY (collectively, Covered Institutions).

Though the proposed rating system is conceptually similar in many respects to other approaches used by the prudential regulators, ABA notes several areas of concern, which we urge the Federal Reserve to address in a final regulation:

- The proposed ratings categories should be defined in more detail, and the consequences of a single "Deficient" rating reconsidered.

- Capital component ratings as proposed are not fully consistent with regulators' current approach to those topics.

[1] The American Bankers Association is the voice of the nation's $17 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits, and extend more than $9 trillion in loans.
[2] Federal Reserve System, *Notice of Proposed Rulemaking*, 82 Fed. Reg. 39,049 (August 17, 2017).

- The liquidity component rating should be consistent with the numerous regulatory and reporting requirements related to liquidity risk management.

- Without clear direction in the final guidance, the new rating system could result in supervisory expectations being applied to all "large" institutions in a "one-size-fits-all" manner not reflective of individual risk profiles, business models, and other characteristics.

Ratings categories need more detailed definitions.

The proposed ratings categories are superficially similar to other supervisory ratings schemes. There are several parts of the proposal, however, that could be interpreted to result in unintended, and unjustifiably harsh, consequences.

First, a final rule should make clear that neither a "Satisfactory Watch" component rating, nor a "Deficient" rating in one component, means that a Covered Institution is no longer considered "well managed" under the Federal Reserve's Regulation Y and other relevant regulations. Though the Proposal treats all aspects of the LFI rating system as aspects of a "management" rating, it includes no composite rating. "Well managed" status under Regulation Y currently depends on both management and composite ratings, which cover many aspects of an institution's operations. The Proposal, in contrast, provides that a "Deficient" rating in any one component affects the status of the entire firm, an outsized outcome, much more drastic than the present system. This distortive result would be prone to present a picture of the firm inconsistent with the firm's true overall condition. This in turn would restrict, unjustifiably, the operational flexibility of a Covered Institution, inhibiting rather than supporting supervisory safety and soundness goals.

This concern is even greater because the proposed ratings would involve significant input based on horizontal reviews both of the firms subject to the Large Institution Supervision Coordinating Committee process (LISCC Institutions) and of other large institutions. Though the Proposal states that assessment of capital, liquidity, and governance and control practices currently rely on horizontal reviews as well as "firm-specific" examination work,[3] ABA stresses that the Federal Reserve should keep clearly in mind the significant differences that exist among similarly large Covered Institutions - differences in risk profiles, mix of businesses, etc.

That is to say, that the Federal Reserve should take care to avoid creating a supervisory standard that is inadequately tailored, forcing some banks to align their practices with institutions that are differently situated with regard to the relevant risks. We recommend that a final rule should expressly require the Federal Reserve to take into account the *materiality* of any deficiencies its examiners observe before assigning ratings. Materiality would appropriately be judged in the context of the Covered Institution's business model, mix of assets and product lines, risk profile, operational complexity, and other relevant factors. Expressly giving appropriate weight to these

[3] Proposal at 39,050-39,051.

considerations would make application of the new rating system more transparent for Covered Institutions and appropriately temper the impact of a horizontal review.

A similar concern arises under the Proposal's description of the Governance and Controls Rating Component. The Proposal states that this component rating would evaluate the effectiveness of a firm's (i) board of directors, (ii) management of core business lines and independent risk management and controls, and (iii) recovery planning (for domestic LISSC Institutions). This rating would assess a firm's effectiveness in aligning strategic business objectives with the firm's risk tolerance and risk management capabilities; maintaining strong, effective, and independent risk management and control functions, including internal audit; promoting compliance with laws and regulations, including those related to consumer protection; and otherwise providing for the ongoing resiliency of the firm.[4] The Proposal notes that firm-specific and horizontal examination work that is focused on a firm's corporate governance, independent risk management, controls, and lines of business, among other areas, would provide the basis for determining the Governance and Controls Rating Component.

Especially in light of the consequences under the Proposal for the rating of any one component as "Deficient" (i.e., the Covered Institution would no longer be considered "well-managed"), the Federal Reserve should avoid the use of vague, qualitative language, such as "strong" risk management and control functions. It would be appropriate and advisable in all cases to assess whether risk management, control functions, and other aspects of the rating component are effective. If these aspects of Covered Institution management and operations are determined to be "effective" in light of the Covered Institution's risk profile, mix of businesses and products, and operational complexity (and if they are independent as contemplated by Regulation Y), a Satisfactory rating should require no further finding as to whether they are "strong." Management of these activities that is effective (in the common-sense meaning of the term) is precisely what safety and soundness would require. What would be meant by being *more than effective*?

This component's proposed assessment of management's "promot[ion of] compliance with laws and regulations, including those related to consumer protection" should also provide greater transparency about the materiality and extent of findings that could result in a rating downgrade. A Covered Institution's "well-managed" status should be compromised only by findings of deficiencies in compliance that are material in severity and number in relation to the institution's safety and soundness condition.

The Proposal notes that the Federal Reserve's proposed Guidance on Supervisory Expectation for Boards of Directors[5] (BE Guidance) will be used in the assessment of board governance when the Proposal is implemented. Under that approach, it will be critical that the Federal Reserve implement the two proposals consistently and remain faithful to the BE Guidance and its expressed goal of returning boards of directors to their core oversight role, as opposed to more detailed duties better suited for management. Otherwise, boards, given that they now will be receiving a governance-focused rating, may feel pressure to continue to take on management-

[4] Proposal at 39,051.
[5] 82 Fed Reg. 37,219 (August 9, 2017).

type efforts that go well beyond an oversight role. That would seem to defeat the Federal Reserve's purpose in updating its board assessment criteria.

Capital ratings should be made consistent with regulators' current approach.

The Capital Planning and Positions component rating would encompass assessments of (i) the effectiveness of the governance and planning processes used by a Covered Institution to determine the amount of capital necessary to cover risks and exposures, and to support activities through a range of conditions; and (ii) the sufficiency of a Covered Institution's capital positions to comply with applicable regulatory requirements and to support the institution's ability to continue to serve as a financial intermediary through a range of conditions. As part of this review, findings from the comprehensive capital analysis and review process (CCAR) would represent a material portion of the work that would be conducted to determine the Capital Planning and Positions Component rating. ABA is supportive of the use of CCAR to inform the component rating if the CCAR findings are used in an appropriate manner and the qualitative assessment is eliminated from the CCAR.

Removal of qualitative assessment in CCAR.

As part of the CCAR qualitative assessment, the Federal Reserve evaluates the capital planning processes of large and complex banking organizations. The proposed LFI rating system would evaluate the same capital planning processes. As a result, the CCAR qualitative assessment should be eliminated, because it would become unnecessary and redundant following the implementation of the proposed LFI rating system.

Similarly, ABA is concerned that conditioning a Covered Institution's "well managed" status on its capital planning component rating could undo some of the tailoring that the Federal Reserve has implemented when it removed the qualitative review component of CCAR for large noncomplex firms. Noncomplex banking organizations would be less likely to avail themselves of any differentiated expectations for capital planning if their supervisory rating carries such significant repercussions. This possibility also underscores the need for the Federal Reserve to reconsider the proposed consequences of a single "Deficient" rating as discussed above. More broadly, the Federal Reserve should also make clear that the LFI framework does not create any new qualitative standards for capital planning.

The "Capital Positions" portion of the component should directly reflect compliance with quarterly capital requirements and capital plan rules.

Regulatory capital today is measured in too many ways for proficient bank supervision and management. Today there are at least eight regulatory capital ratios applied in the United States, to which are added requirements for various minimums, stress tests, buffers, and surcharges. The proposed LFI framework should not create another framework for measuring of capital. Instead, the LFI framework should directly rely upon existing capital measurements. If an institution meets the required quarterly capital requirements and has not received an objection on the quantitative portion of CCAR, then that institution should be rated Satisfactory for the

Capital Positions portion of the Capital Planning and Positions Component. The LFI framework should never be abused by requiring institutions to hold amounts of capital in excess of the rule-based capital requirements.

More specifically, ABA notes that the proposed rating system suggests that the quantitative portion of the capital rating will take into consideration whether a "firm's current and projected capital positions … support its ability to meet current and prospective obligations and serve as a financial intermediary through a range of conditions."[6] The meaning of this language is somewhat confusing as it relates to current capital requirements. ABA requests that the Federal Reserve state explicitly that a firm satisfies the quantitative aspect of the capital component (including with respect to "current and projected capital positions") so long as the firm complies with the requirements of Regulation Q.

Application of any final liquidity risk management component should be consistent with numerous other standards relating to liquidity risk.

Under the Proposal, the Federal Reserve would establish a rating component for Covered Institutions' Liquidity Risk Management and Positions. Since the financial crisis the banking agencies have introduced a number of regulatory standards and data collections to assess and mitigate bank liquidity risk, including the Liquidity Coverage Ratio (LCR), the Comprehensive Liquidity Assessment and Review (CLAR), the Method 2 G-SIB surcharge calculation, complex institution liquidity reporting (Form FR 2052a), liquidity stress testing and other requirements of Section 165 of the Dodd-Frank Act (including resolution plans). As part of its own efforts to improve liquidity risk management and in response to these regulatory initiatives, the banking industry has worked hard to make liquidity risk monitoring and mitigation significantly more robust.

Given these new liquidity standards, we urge the Federal Reserve to maintain consistency between the liquidity rating comments and compliance with the current suite of regulations and supervisory programs related to managing and monitoring liquidity risk. In this connection, similar to the discussion of the Proposal's capital component, the Proposal indicates that the quantitative portion of the liquidity rating will be tied to whether a "firm's current and projected liquidity positions comply with regulatory requirements, and support its ability to meet current and prospective obligations and to continue to serve as a financial intermediary through a range of conditions."[7] As in the capital component discussion, the meaning of this language is somewhat confusing as it relates to current liquidity requirements. ABA requests that the Federal Reserve state explicitly that a firm satisfies the quantitative aspect of the liquidity component (including the reference to "current and projected liquidity positions") so long as the firm complies with the LCR and with the liquidity buffer requirements of Regulation YY.

[6] Proposal at 39,060, which implies that this assessment would be considered in assigning a "Deficient-2" rating.
[7] Proposal at 39,061.

The Federal Reserve should consider alternative measures to define LFIs and clarify that standards will be tailored to differentiate between firms with different characteristics.

The Proposal would group all Covered Institutions with at least $50 billion in assets into a single "LFI" category. The Proposal cites the "systemic risks posed by LFIs" as a driving factor in adopting a new specialized rating system.[8] Use of an overly simplistic $50 billion asset threshold to define systemically significant financial institutions is not consistent with the Treasury Department's recommendations in its report under Executive Order 13772 on Core Principles for Regulating the U.S. Financial System.[9] The Treasury Department found that certain key aspects of heightened supervisory requirements that underpin the Federal Reserve's current supervisory programs for large financial institutions (e.g., CCAR, enhanced prudential standards, the liquidity coverage ratio, resolution planning, etc.) should be applied based on an assessment of risk rather than merely on asset size. This finding was recently supported by the Office of Financial Research in a white paper entitled, "Size Alone is Not Sufficient to Identify Systemically Important Banks."[10] The Federal Reserve should consider alternative measures to define Covered Institutions or delay implementation of a new rating system until after recommended reforms to realign supervisory thresholds have been fully considered and incorporated.

The final rule should also be clear that supervisors will apply the LFI framework in a manner that accounts for differences among institutions. Grouping firms into a single category of "large" institutions could exacerbate problems with "one-size-fits-all" supervisory approaches, under which Covered Institutions may be held to standards that overweight peer comparisons, horizontal reviews, or "best practices," inconsistent with the actual conditions and risks and therefore resulting in suboptimal supervision. Any supervisory rating system must take into account the unique characteristics of a firm, including its relative size, business model, and risk profile, among other factors. The final rule should state explicitly that the standards examiners will use to assess a Covered Institution's practices and condition will be applied proportionately, with differentiated expectations where appropriate, based on risk profile, complexity, and other relevant characteristics of the company.

[8] Proposal at 39,050.
[9] *See* U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities, Banks and Credit Unions*, p.52 (June 2017).
[10] Office of Financial Research, Viewpoint (October 2017).

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Thank you for the opportunity to respond to your request for comments. Should you have any questions or desire further discussion, please do not hesitate to contact the undersigned at (202) 663-5042 or hbenton@aba.com.

Very truly yours,

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