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February 15, 2018

Via Electronic Mail

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Attention: Ann E. Misback, Secretary

Re: Large Financial Institution Rating System (Docket No. R-1569; RIN 7100-AE82)

Ladies and Gentlemen:

The Clearing House Association L.L.C.[1] appreciates the opportunity to comment on the Board of Governors of the Federal Reserve System's proposal to replace the current RFI/C(D) rating system with a new rating system for large financial institutions ("LFIs") that is composed of three component categories, Capital Planning and Positions, Liquidity Risk Management and Positions, and Governance and Controls, and utilizes a multi-level scale that is composed of (i) Satisfactory and Satisfactory Watch, a transitory rating used to convey supervisory concerns to be addressed by institutions, (ii) Deficient-1 and (iii) Deficient-2, where a Deficient rating would result in negative regulatory consequences.[2]

1 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.

2 Federal Reserve System, *Large Financial Institution Rating System; Regulations K and LL*, 82 Fed. Reg. 39049 (Aug. 17, 2017). Referenced throughout this letter as the "proposed LFI rating system" and, together with the supplementary information published in the Federal Register, the "proposal." LFIs would broadly include all bank holding companies with total consolidated assets of $50 billion or more; all non-insurance, noncommercial savings and loan holding companies with total consolidated

The proposal represents an important and positive step toward a clearer, more consistent, and more objective supervisory approach to ratings that is better aligned with fundamental matters of safety and soundness. Subject to certain improvements and refinements, we believe that the proposed framework would advance four key goals. First, it would more closely align the rating system structure and implementation with the actual supervisory processes the Federal Reserve has developed for LFIs since the financial crisis. Second, it would provide institutions with a period during which supervisory concerns may be raised by examiners and addressed by institutions without the loss of "well managed" status. Third, it would enhance the objectivity and transparency of the Federal Reserve's supervisory expectations and practices while allowing the application of those expectations to reflect the variety of ways in which firms may meet supervisory expectations in light of their different business models, activities, and risk profiles. And fourth, it would improve the communication of supervisory expectations, findings and implications to institutions and foster more robust dialogue between institutions and the Federal Reserve throughout the examination and ratings process. This comment letter is focused on a range of concrete recommendations that, if adopted, would result in an LFI rating system that better achieves these goals.

As context for these recommendations, we think it helpful to highlight at the outset the fundamental strength of the proposed LFI rating system—the fact that the system's purposes are clearly articulated and appropriate. In particular, we strongly support the purposes expressly identified by the Federal Reserve in the proposal: (i) to "provide[] a supervisory evaluation of whether a firm possesses sufficient financial and operational strength and resilience to maintain safe and sound operations through a range of conditions";[3] (ii) to "[e]nhance the clarity and consistency of supervisory assessments and communications of supervisory findings and implications";[4] and (iii) to "reduc[e] the probability of LFIs failing or experiencing material distress and reducing the risk to U.S. financial stability."[5] Importantly, these articulated purposes are directly focused on core questions of safety and soundness and core principles of regulatory clarity and certainty.

We are concerned, however, that certain aspects of the proposal may undermine the system's focus on safety and soundness, clarity, and consistency in practice. First, and most importantly, while we welcome *in principle* the proposed Satisfactory Watch rating as a transitory rating to be used to communicate supervisory concerns that must be remedied promptly in order to avoid a further downgrade and resulting regulatory consequences, the proposed *application* of the Satisfactory Watch rating appears problematic. This is because

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assets of $50 billion or more; and U.S. intermediate holding companies of foreign banking organizations established pursuant to the Federal Reserve's Regulation YY. 82 Fed. Reg. 39049, 39052.

3 *Id.* at 39050.

4 *Id*.

5 *Id.*

the proposal would establish a generally applicable timeframe in which issues must be remediated and which, if not met, would result in an automatic downgrade to Deficient-1 (which in turn would trigger significant negative consequences). The establishment *ex ante* of rigid timeframes for remediation is inappropriate, as the appropriate remediation period for an issue resulting in a Satisfactory Watch rating will and should be based on the particular facts and circumstances, periodically reassessed and, where appropriate, updated as part of the normal supervisory process. As long as a firm is making good faith efforts to remediate an issue and can demonstrate reasonable progress toward resolving the issue, the firm should not face the prospect of an automatic downgrade based solely on the remediation timeframe.

Second, although the elements of the proposed LFI framework are qualitatively appropriate, certain of them lack clearly articulated, transparent, objective and measurable standards. We therefore suggest a number of changes that would bring greater objectivity to the framework. In particular, we think that there are a variety of areas in which the Federal Reserve can and should expressly incorporate already-existing quantitative capital and liquidity requirements that were specifically designed to measure and promote adequacy of financial parameters that are at the core of the proposed LFI rating system. Similarly, we identify a number of areas where the Federal Reserve should articulate, through a notice and comment process, a clear description of the factors and standards against which firms will be measured under various aspects of the proposal.[6]

Third, certain aspects of the three proposed ratings components do not appear to be clearly or sufficiently linked to the articulated purposes and objectives of the rating system—namely, material matters of safety and soundness. We therefore highlight specific concerns and recommendations that are meant to better align supervisory evaluations under the proposed LFI rating system with those stated purposes and objectives.

Fourth and finally, we make a number of recommendations intended to enhance communication between the Federal Reserve and the institutions subject to the proposal and provide greater procedural safeguards available to institutions in the examination and ratings context.

Part I of this letter provides an executive summary of our comments; Part II discusses our comments on the overall framework for the proposed LFI rating system, and in particular the relevant standards and uses of the new ratings categories; Part III addresses our recommendations with respect to the elements of each of the three proposed components;

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6 Although the Federal Reserve has issued guidance that is relevant to some elements of the proposed LFI rating system (*see, e.g.*, Federal Reserve System, Division of Banking Supervision and Regulation, *Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms*, SR Letter 15-18 (Dec. 18, 2015); Federal Reserve System, Division of Banking Supervision and Regulation, *Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms*, SR Letter 15-19 (Dec. 18, 2015)), stakeholders have generally not had any opportunity to comment on such guidance prior to its issuance. To the extent the Federal Reserve intends to rely on such previously issued guidance in connection with the proposed LFI rating system, such guidance should be published for comment in advance of the implementation of the LFI rating system.

Part IV sets forth the reasons the Federal Reserve should implement the LFI rating system only after related guidance and standards have been finalized so that supervisory expectations are clear and the LFI rating system can be implemented on an informed basis; Part V presents suggested changes to the Federal Reserve's supervisory practices that would further the goal of enhancing the clarity and consistency of supervisory assessments; and Part VI presents our responses to certain specific questions raised in the proposal.

We also note that our comments herein are interrelated with those we are providing or intend to provide on two closely related proposals: (i) the Federal Reserve's proposed guidance on supervisory expectations for boards of directors (the "Board Effectiveness" proposal),[7] which is expected to be used in connection with supervisors' assessments of board effectiveness under the Governance and Controls component of the proposed LFI rating system; and (ii) the Federal Reserve's proposed guidance that would set forth core principles of effective senior management, the management of business lines, and independent risk management and controls for large financial institutions, which is expected to be used in connection with supervisors' assessments of management of business lines and independent risk management and controls under the Governance and Controls component (the "Risk Management" proposal).[8] We are today filing a separate comment letter in response to the former, and will comment on the latter prior to the closing of the comment period on March 15, 2018. Because of the interrelationship of all three proposals, our comments should be read together and understood collectively.

I. Executive Summary of TCH's Principal Recommendations.

- Although the proposal's introduction of the transitory Satisfactory Watch rating is a positive development, the criteria by which firms would be placed into or out of that category should be revised and clarified to better align its use with the emergence and remediation of material issues.

    - A firm rated Satisfactory Watch for one or more components should not be automatically downgraded to a Deficient-1 rating based solely on the passage of a general timeframe if it is working in good faith to remediate areas of supervisory concern and demonstrates reasonable progress toward fully resolving any outstanding issues relevant to the particular criticism(s) leading to the Satisfactory Watch rating.

    - A firm should not be downgraded so long as any identified issues can be resolved in a timely manner and do not present safety and soundness issues, even if resolution requires material changes to or investments in a firm's governance, risk management or internal control structures, practices, or capabilities.

[7] Federal Reserve System, *Proposed Guidance on Supervisory Expectation for Boards of Directors*, 82 Fed. Reg. 37219 (Aug. 9, 2017).

[8] Federal Reserve System, *Proposed Supervisory Guidance*, 83 Fed. Reg. 1351 (Jan. 11, 2018).

- A firm with a Deficient rating should be able to improve to a Satisfactory Watch rating once it has remediated identified deficiencies without having to first complete validation processes.

- Only MRAs or MRIAs that raise material concerns regarding the institution's safety and soundness should serve as the basis for a downgrade from Satisfactory to Satisfactory Watch.

➢ A firm's "well managed" status should be the result of a holistic assessment of the institution rather than an automatic consequence of any one component rating.

➢ The Federal Reserve should confirm that firms will not, as a matter of course, be designated as being in "troubled condition" as a result of a Deficient-1 rating for one or more components, which would represent a significant expansion of the Federal Reserve's current definition of "troubled condition."

➢ The Federal Reserve should clarify that proposals to engage in "new or expansionary activities" subject to Federal Reserve approval will be assessed under the applicable statutes and regulations, not by reference to the ratings system.

➢ The Capital Planning and Positions component should be better aligned with already-existing quantitative capital requirements, more objective, and more transparent.

- The "Capital Positions" portion of the Capital Planning and Positions component rating should be explicitly tied to the quantitative minimums under the capital plan rule and the Federal Reserve's capital rules, such that if an institution passes the CCAR quantitative assessment and meets the minimum capital adequacy standards (including applicable buffers), it would be rated Satisfactory for its Capital Positions—that is, the quantitative portion of the Capital Planning and Positions component.

- The Federal Reserve should revise the Capital Planning and Positions component rating to incorporate specific, objective and measurable criteria for qualitative assessments.

- Once the "Capital Planning" portion of the Capital Planning and Positions component rating is implemented, the Federal Reserve's CCAR qualitative assessment for any CCAR firms will be particularly unnecessary.

➢ The Liquidity Risk Management and Positions category should be better aligned with already-existing quantitative and qualitative liquidity requirements, more objective, and more transparent.

- The Liquidity Risk Management and Positions component rating should be explicitly tied to compliance with the liquidity buffer requirements of the

Federal Reserve's Regulation YY and LCR, such that if an institution is compliant with applicable quantitative regulatory requirements, it would be rated Satisfactory for the quantitative portion of the Liquidity Risk Management and Positions component.

- The Liquidity Risk Management and Positions component rating should be explicitly tied to the results of the Federal Reserve's CLAR program, such that if an institution's liquidity risk management is reviewed favorably under CLAR, it would be rated Satisfactory for the qualitative portion of the Liquidity Risk Management and Positions component.

➢ The proposal should make clear that only those compliance matters that are materially related to the financial and operational strength and resilience of a firm will be relevant in assessing the Governance and Controls component.

➢ Recovery planning should not be an aspect of the Governance and Controls component for domestic LISCC firms in light of the significant overlap between recovery planning and the areas evaluated by the proposed LFI rating system.

➢ The Federal Reserve should not implement the LFI rating system until the Board Effectiveness and Risk Management proposals are finalized and institutions are provided with an appropriate phase-in period.

➢ The Federal Reserve should couple the implementation of the LFI rating system with refinements to its use of horizontal reviews and its appeals processes, so as to enhance the clarity, consistency, and fairness of supervisory assessments.

II. The Definitions and Uses of the Proposed New Ratings.

A. Although the proposal's introduction of the transitory Satisfactory Watch rating is a positive development, the criteria by which firms would be placed into or out of that category should be revised and clarified to better align its use with the emergence and remediation of material issues.

We support the establishment of the Satisfactory Watch rating, which would "indicate[] that the firm is generally considered safe and sound . . . [but with] certain issues [that] are sufficiently material that, if not resolved in a timely manner in the normal course of business, would put the firm's prospects for remaining safe and sound through a range of conditions at risk."[9] Because it appropriately focuses on only those issues that are material to the firm's safety and soundness, the Satisfactory Watch rating is a positive development to the extent it is used as a supervisory tool to convey supervisory concerns that an institution must address in order to avoid a further ratings downgrade and related regulatory implications. This would reflect a significant and positive change from the current approach, under which institutions may sometimes be subjected to ratings downgrades that have

[9] 82 Fed. Reg. 39049, 39060.

significant regulatory implications while remediation efforts to address an identified deficiency are underway. Thus, it would be beneficial if the Federal Reserve confirmed that, through the proposed LFI rating system, it seeks to create a rating system in which there are no immediate regulatory implications for firms with Satisfactory or Satisfactory Watch ratings, with firms in the latter category being expected to address issues that could "put the firm's prospects for remaining safe and sound . . . at risk" as promptly as possible given the facts and circumstances. Further, while we support the establishment of Satisfactory Watch as a transitory rating category, we believe several clarifications and modifications are necessary in order for the Satisfactory Watch rating to serve as a useful supervisory tool and meet the purpose and objectives of the proposed LFI rating system, as described below.

1. A firm rated Satisfactory Watch for one or more components should not be automatically downgraded to a Deficient-1 rating based solely on the passage of a general timeframe if it is working in good faith to remediate areas of supervisory concern and demonstrates reasonable progress toward fully resolving any outstanding issues relevant to the particular criticism(s) leading to the Satisfactory Watch rating.

The Federal Reserve states in the proposal that the Satisfactory Watch rating "is a conditional 'Satisfactory' rating" that "is not intended to be used for a prolonged period" and—more specifically—that a firm that receives a Satisfactory Watch rating would have a "specified timeframe to fully resolve issues leading to that rating . . . generally no longer than 18 months."[10] Following the specified time period, if the firm successfully resolves such issues, it would typically be upgraded to a Satisfactory rating, and if the firm failed to "timely remediate or mitigate [such] issues" the firm would typically be downgraded to a Deficient rating.[11] The proposal indicates that the Satisfactory Watch category will be assigned to firms that (i) need to resolve certain material issues "within a timely manner in the normal course of business" or (ii) were previously rated "Deficient" when circumstances warrant. There is an implication that, at the end of the specified period, the LFI's rating would move to either Satisfactory or Deficient-1.

We are concerned with the implication in the proposal that, at the end of the "specified timeframe" for remediation of an identified issue, the rating would automatically move to Deficient-1 if the remediation process were not "fully" complete. Indeed, the consequences of such an automatic trigger are particularly severe because, as proposed, a rating of less than Satisfactory Watch in any single component would result in the loss of the firm's "well managed" status and subject the firm to the various collateral consequences (discussed below) that accompany a Deficient-1 rating. Although the proposal does not specify what is meant for an identified issue to be fully resolved (*e.g.,* (i) remediated, (ii) remediated and validated internally, (iii) remediated, validated internally and confirmed by

[10] *Id.* at 39051.

[11] *Id.* at 39051-2.

supervisors, or (iv) remediated, validated internally and confirmed by supervisors over two examination cycles to demonstrate "sustainability"), it is likely that 18 months often would not be a realistic timeframe for an issue to be "fully resolved", in particular if a "full resolution" requires more than remediation. A longer time period may be necessary to effectively remediate certain issues (in particular for projects involving changes to information technology systems); of course, internal validation and confirmation by supervisors would require additional time. Even where a system or process has been remediated within 18 months, it may take longer to validate that a system or process is working as intended and for supervisors to close the related matters requiring attention ("MRAs") or matters requiring immediate attention ("MRIAs"). Indeed, validation processes often span multiple months or quarters in order to assess whether remediated systems and processes are sustainable. This process could take significantly longer if full resolution of an issue requires reexamination by the Federal Reserve—the timing of which a banking organization does not control.

For these reasons, automatic downgrades based on rigid timeframes are particularly inappropriate given the Satisfactory Watch's transitional function in the proposed system. It should not be the case that a firm taking longer than 18 months (or other specified period) to remediate MRAs/MRIAs would presumptively, much less automatically, receive a Deficient rating as a matter of course. Such rigid timeframes do not provide firms with any additional incentive to expeditiously address identified concerns, as the significant regulatory implications of a further downgrade already serve as a strong and sufficient incentive for expeditious remediation. In the final LFI rating system, the Federal Reserve should make clear that a firm will not face an automatic or presumptive rating downgrade based on the passage of a general timeframe if it is working in good faith to remediate an issue and demonstrates reasonable progress toward fully resolving the issue.

Likewise, an institution should not be downgraded because other issues emerge during the remediation period, provided that the institution is again working in good faith to remediate those other issues; unless the initially and any subsequently identified issues collectively either indicate that the firm is no longer "generally considered safe and sound"[12] or represent "deeper governance or risk management weaknesses",[13] the Satisfactory Watch rating should remain available. For the reasons noted above, achieving full remediation by an arbitrary and uniform timeline would not further the Federal Reserve's objective of having the firm satisfactorily and expeditiously address the identified areas of concern. Thus, when a firm is working in good faith to remediate the issue or issues leading to a Satisfactory Watch rating and demonstrates reasonable progress toward fully remediating the issue or issues, the Satisfactory Watch rating should remain available unless and until a Deficient rating is otherwise warranted.

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[12] *Id.* at 39059.

[13] *Id.* at 39060.

In addition, the Federal Reserve should confirm that examiners are expected to determine remediation timelines based on the particular facts and circumstances, with those timelines being periodically reassessed and, where appropriate, extended as part of the normal supervisory process. Because examinations for the purpose of assigning an LFI rating would be conducted throughout the year with ratings assigned each year (and more frequently as warranted), supervisors would always have the opportunity at least annually to review and reassess the appropriateness of the Satisfactory Watch rating. This automatic reassessment mechanism renders the specification of generally applicable remediation timelines particularly unnecessary.

2. A firm should not be downgraded so long as any identified issues can be resolved in a timely manner and do not present safety and soundness issues, even if resolution requires material changes to or investments in a firm's governance, risk management or internal control structures, practices, or capabilities.

The proposal identifies as issues that would lead to a Satisfactory Watch rating those that are "sufficiently material that, if not resolved in a timely manner in the normal course of business, would put the firm's prospects for remaining safe and sound through a range of conditions at risk."[14] The proposal also notes that the Federal Reserve would consider whether an issue is likely to be resolved in the normal course of business (and therefore merits a Satisfactory Watch rating) if it can be done "without material changes to, or investments in, a firm's governance, risk management or internal control structures, practices or capabilities."[15] The proposal does not make clear, however, what is meant in requiring that an issue leading to a Satisfactory Watch rating be capable of being resolved "in the normal course of business" and "without material changes to, or investments in a firm's governance, risk management or internal control structures, practices, or capabilities." Nor does the proposal explain why this consideration is relevant to the satisfactory remediation of any particular issue within a reasonable period of time from a safety and soundness perspective. The remediation process for any given issue could involve investments in or changes to structures, practices or capabilities that do not rise to the level of implicating the firm's safety and soundness. The final LFI rating system should provide that a firm may be assigned a Satisfactory Watch rating, and that a firm with that rating will not be downgraded, due to making prudent changes to or investments in controls or processes, even if material, where the issue being remediated does not represent a safety and soundness concern meriting a Deficient rating.

3. A firm with a Deficient rating should be able to improve to a Satisfactory Watch rating once it has remediated identified deficiencies without having to first complete validation processes.

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14 *Id.* at 39051.

15 *Id.*

Because the proposal indicates that the Satisfactory Watch rating would also be assigned to firms that were previously rated "Deficient" when circumstances warrant, the Federal Reserve should clarify how it would determine when a firm may improve from a Deficient-1 to a Satisfactory Watch rating. More specifically, the final LFI framework should clearly set forth the supervisory expectations for a firm with a Deficient-1 rating to receive a Satisfactory Watch rating. Given the definition of the Satisfactory Watch rating category, we believe it would be appropriate for a firm to be upgraded from Deficient-1 to Satisfactory Watch when remediation of the issues leading to the Deficient-1 rating is largely complete but before all internal and external validation processes have been finalized. Substantial completion of remediation may in many cases be achieved months before all necessary internal independent validation or audit processes have been completed. Firms will in most if not all circumstances provide periodic updates to the Federal Reserve through which the Federal Reserve will be able to gauge progress and determine when remediation is substantially complete.

4. Only MRAs or MRIAs that raise material concerns regarding the institution's safety and soundness should serve as the basis for a downgrade from Satisfactory to Satisfactory Watch.

As noted above, we believe it is the intent of the Federal Reserve to establish a rating framework in which examiners may communicate supervisory concerns to institutions—without imposing a rating downgrade that has immediate regulatory implications—that, if not remedied in a relatively timely manner, could jeopardize the firm's safety and soundness. We are concerned, however, that the LFI rating system could be applied in a manner such that the existence of any MRAs or MRIAs, no matter how few in number or how insignificant in relation to a firm's safety and soundness, could result in a firm being downgraded from Satisfactory to Satisfactory Watch. In the final LFI rating system, therefore, the Federal Reserve should make clear that an institution would be downgraded from Satisfactory to Satisfactory Watch only where examiners have identified MRAs/MRIAs that, in aggregate, raise material safety and soundness concerns.

B. A firm's "well managed" status should be the result of a holistic assessment of the institution rather than an automatic consequence of any one component rating.

The current RFI/C(D) rating system designates the "R" or "Risk Management" rating as the "management" rating when making "well managed" determinations under section 2(o)(9)(A)(ii) of the Bank Holding Company Act.[16] In contrast, the proposed LFI rating system would not designate any of the three component ratings as a "management" rating, because each component "evaluates different areas of the firm's management."[17] A rating of "Deficient-1" or lower for *any* component would result in the firm not being deemed "well

[16] Federal Reserve System, Division of Banking Supervision and Regulation, *Bank Holding Company Rating System*, SR Letter 04-18 (Dec. 6, 2004).

[17] 82 Fed. Reg. 39049, 39052, n. 18.

managed."[18] This reflects the judgment of the Federal Reserve, as stated in the supplementary information in the proposal, that "an LFI is not in satisfactory condition overall", and thus does not merit "well managed" status, "unless it is considered sound in each of the key areas of capital planning and positions, liquidity risk management and positions, and governance and controls."[19] In other words, management is being separately assessed in, and "well managed" status is essentially a function of, each separate component rating category.

Rather than functioning as an automatic consequence of any one component rating, as is currently proposed, a firm's "well managed" status should be the result of a holistic assessment of the institution. The need for a holistic assessment to determine a firm's "well managed" status is particularly important in light of the subjective areas of evaluation in the proposed LFI rating system. An assessment under the Governance and Controls component category in particular is highly subjective, and it should not outweigh the other two component categories in determining whether a firm is "well managed," which could be the case if a less than satisfactory rating in any single component rating were the sole driver of a firm's well managed status. A holistic approach would in fact better meet the Federal Reserve's stated requirement that a firm be "in satisfactory condition overall" to merit "well managed" status than basing "well managed" status on any single component category rating. This approach would also afford examiners additional flexibility to downgrade a particular component rating under circumstances in which they view such downgrade as warranted, but do not view the underlying issues in that component category as also warranting the loss of a firm's "well managed" status.

The final LFI rating system could provide for such a holistic assessment in a number of ways. One option would be to retain a composite rating, which could be used as the basis for a firm's "well managed" status (provided, of course, that the composite rating does not default to the lowest rating for any individual component). Regardless of whether the Federal Reserve retains the composite rating to determine a firm's "well managed" status or establishes some other process for making such determinations, it is critical that the Federal Reserve also establish clear and objective criteria and parameters for making these determinations in furtherance of its goals of implementing consistent and predictable supervisory assessments and outcomes. In particular, in order for a Deficient rating in one component of the new rating system to override Satisfactory or Satisfactory Watch ratings in the other two components such that the institution loses its "well managed" status, examiners should be required to make a determination that the issues leading to the Deficient rating present such serious concerns regarding the institution's safety and soundness that the one Deficient rating outweighs the two Satisfactory or Satisfactory Watch ratings.

Whether or not the Federal Reserve incorporates a holistic assessment of a firm's "well managed" status into the LFI rating system, however, the Federal Reserve should

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18 *Id.*

19 *Id.*

revise its supervisory processes to provide additional procedural safeguards prior to a rating downgrade that would result in the loss of "well managed" status in light of the impact the loss of this status would have on a firm's operations and ability to pursue its strategic objectives. Under such a review process, before a downgrade that would result in loss of "well managed" status, the firm should be given notice and an explanation of the reasons for the potential downgrade, and the firm should have an opportunity to correct any factual misstatements and respond to any proposed adverse findings. As part of this review process, firms should have the opportunity to meet with the leadership and senior staff of the Federal Reserve's Division of Supervision and Regulation and Legal Division. Only after such a review is completed and the Federal Reserve has determined that loss of "well managed" status is warranted should the downgrade be finalized. Because this review process would be triggered specifically by advance notice and opportunity to respond to a potential rating downgrade that would result in the loss of "well managed" status, it would be separate from, but a complement to, the process we suggest below in Section V.B whereby a draft of the determination communicating ratings to the firm is provided—as a matter of course in each exam cycle—to the firm. The firm would then in the normal course be provided a reasonable period of time before the ratings letter is finalized and formally issued to correct factual errors or other issues.

C. The Federal Reserve should confirm that firms will not, as a matter of course, be designated as being in "troubled condition" as a result of a Deficient-1 rating for one or more components, which would represent a significant expansion of the Federal Reserve's current definition of "troubled condition."

The Federal Reserve's current definition of "troubled condition" applies only to an institution (i) with a composite rating of 4 or 5, (ii) that is subject to a cease and desist order or formal written agreement requiring action to improve the financial condition of the institution, or (iii) that is informed in writing by the Federal Reserve that it is in troubled condition as defined in the applicable regulations of the appropriate Federal banking agency.[20] In other words, a "3" rating under the current system would not result in "troubled condition" status unless the firm is specifically informed in writing by the Federal Reserve, in accordance with (iii) above. Accordingly, under the new system, only Deficient-2 should result in such status.

The proposal specifies in the supplementary information that a Deficient-1 rating *may* result in the designation of the firm as being in "troubled condition."[21] It is not clear from the proposal whether the implementation of the new rating system is intended to be a change in the Federal Reserve's approach to "troubled condition" designations. Imposing "troubled

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[20] The golden parachute provisions of 12 C.F.R. Part 359 refer to troubled condition "as defined in the applicable regulations of the appropriate Federal banking agency." The Federal Reserve's definition of "troubled condition" is codified at 12 C.F.R. § 225.71(d).

[21] 82 Fed. Reg. 39049, 39052. Under the proposal, the Deficient-2 rating *almost certainly* will result in the designation of the firm as being in "troubled condition."

condition" designations in all or many cases of Deficient-1 ratings would, however, represent a significant expansion of the Federal Reserve's current definition of "troubled condition." Such an expansion would be highly problematic in view of the ramifications of this designation on severance, retention and hiring—in particular, automatic application of the complex, stringent and often-ambiguous restrictions under the golden parachute regulation, and required preapproval of changes in board membership and senior management.[22] We therefore urge the Federal Reserve to confirm that only a Deficient-2 rating, and not a Deficient-1 rating, would result in a "troubled condition" designation. (We note, of course, that under its own rules the Federal Reserve has and would continue to have the ability to deem a firm to be in troubled condition for reasons other than its ratings under the second or third prong of its current definition).[23] This approach would comport with the proposal's focus on true safety and soundness concerns and the common understanding that "troubled" refers to "financially troubled."

D. The Federal Reserve should clarify that proposals to engage in "new or expansionary activities" subject to Federal Reserve approval will be assessed under the applicable statutes and regulations, not by reference to the ratings system.

The proposal explains in the supplementary information that a Deficient-1 component rating (for any component) "*could* be a barrier for a firm seeking the Federal Reserve's approval to engage in new or expansionary activities."[24] However, the statutes and regulations governing proposals to engage in such activities set forth the factors that the Federal Reserve must consider in its evaluation, which generally do not include explicit references to ratings. The Federal Reserve should specify in the final LFI rating system that proposals to engage in "new or expansionary activities" will be evaluated pursuant to the factors set forth in the relevant statutes and regulations. If the Federal Reserve believes that a firm's ratings should be considered in evaluating expansionary proposals beyond the limited universe in which ratings are currently referenced in the relevant statute or regulation, the

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22 12 C.F.R. Part 225, Subpart H.

23 *See* 12 C.F.R. § 225.71(d) (providing that a firm may be deemed to be in "troubled condition" (1) if it is subject to an enforcement order that requires action to improve the firm's financial condition or (2) on the basis of the firm's most recent report of condition, report of examination or inspection or other available information). The prospect of a "troubled condition" designation for a firm with a Deficient-1 rating presents yet another reason that the Satisfactory Watch category should remain available for a firm that is remediating issues that do not warrant a Deficient-1 rating simply due to the passage of a general timeframe. A firm rated Satisfactory Watch should not be under threat of being deemed in "troubled condition" for the sole reason that a single identified issue may take longer than 18 months (or some other specified, pre-set timeframe) to "fully resolve." The final LFI rating system should provide that a firm in the Satisfactory Watch category will not subsequently be deemed to be in "troubled condition" due to the expiration of a specified time period for remediating an issue that does not present a safety and soundness concern.

24 82 Fed. Reg. 39049, 39052. (emphasis added). The proposal also notes that the "Federal Reserve would be extremely unlikely to approve any proposal seeking to engage in new or expansionary activities from a firm with a 'Deficient-2' component rating." *Id.*

Federal Reserve should propose and seek comment on amendments in that regard to the relevant regulations.

III. The Capital, Liquidity and Governance and Controls Component Categories.

A. Capital Planning and Positions.

1. The "Capital Positions" portion of the Capital Planning and Positions component rating should be explicitly tied to the quantitative minimums under the capital plan rule and the Federal Reserve's capital rules, such that if an institution passes the CCAR quantitative assessment and meets the minimum capital adequacy standards (including applicable buffers), it would be rated Satisfactory for its Capital Positions—that is, the quantitative portion of the Capital Planning and Positions component.

Under the current CCAR[25] process implemented in connection with the Federal Reserve's capital plan rule,[26] the Federal Reserve conducts a quantitative assessment of the capital adequacy of each subject firm under a range of economic conditions. The Federal Reserve may object to a subject firm's capital plan if the firm has not demonstrated an ability to maintain capital above each minimum regulatory capital ratio on a pro forma basis under expected and stressful conditions throughout the planning horizon.[27] If the Federal Reserve objects to a firm's capital plan, the firm generally may not make any capital distributions without specific Federal Reserve approval. In addition, a firm must revise and resubmit its capital plan if it determines there has been or will be a material change in its risk profile (including a material change in its business strategy or risk exposures), financial condition or corporate structure since the firm submitted its capital plan.[28] The Federal Reserve may also require a firm to revise and resubmit its capital plan for those or other reasons, including if a stress scenario developed by the firm is no longer appropriate for its business model and

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[25] The Comprehensive Capital Analysis and Review ("CCAR") is the Federal Reserve's annual review of the capital plans of bank holding companies with total consolidated assets of $50 billion or more and of intermediate holding companies ("IHCs") established by foreign banking organizations ("FBOs") pursuant to Regulation YY. *See* Federal Reserve System, *Comprehensive Capital Analysis and Review 2018 Summary Instructions* (February 2018), at 1 and 3, *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180201a2.pdf (the "2018 CCAR Summary Instructions").

[26] 12 C.F.R. § 225.8.

[27] The "planning horizon" is the period of at least nine consecutive quarters, beginning with the quarter preceding the quarter in which the firm submits its capital plan, over which the relevant projections extend. 12 C.F.R. § 225.8(d)(12).

[28] *See* 12 C.F.R. § 225.8(e)(4)(i)(A).

portfolios or if changes in financial markets or the macroeconomic outlook that could have a material impact on the firm's risk profile and financial condition require the use of updated scenarios.[29]

The proposal explains in the supplementary information that while the current RFI/C(D) rating system was "not designed to readily accommodate the results of" CCAR and CLAR,[30] the "key conclusions" of these activities will be "directly reflected" in the Capital and Liquidity component ratings under the proposed LFI rating system.[31] The proposed LFI rating system itself, however, does not explicitly reference CCAR in the "Capital Positions" portion of its Capital Planning and Positions component rating criteria. Rather, the text of the proposed LFI rating system states as a condition of a Satisfactory rating for the Capital Planning and Positions component that "[a] firm's current and projected capital positions comply with regulatory requirements, and support its ability to absorb current and potential losses, to meet obligations, and to continue to serve as a financial intermediary through a range of conditions."[32] In place of this general description, the text of the final LFI rating system itself should be revised according to the statement in the supplementary information to "directly reflect" the results of the CCAR quantitative review such that the Capital Planning and Positions component is explicitly tied to the quantitative minimums under CCAR and the Federal Reserve's capital plan rule. If an institution receives no quantitative objection to its capital plan on the basis of the Federal Reserve's CCAR quantitative review (whether on the basis of its original or revised planned capital actions) and meets the minimum capital adequacy standards (including applicable buffers), it should be rated Satisfactory for the quantitative (or "Capital Positions") portion of the Capital Planning and Positions component under the final LFI rating system.

CCAR involves an intensive annual quantitative assessment of a firm's post-stress capital adequacy and, as described above, the capital plan rule requires a firm to revise and submit its capital plan in certain circumstances, including where there have been or will be material changes in its risk profile, financial condition or corporate structure. Firms also calculate whether they satisfy minimum capital adequacy standards (including applicable buffers) on an ongoing basis, with capital ratios reported on a quarterly basis in regulatory reports, such as the FR Y-9C. The Federal Reserve's framework for assessing firms' capital

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29 *See* 12 C.F.R. § 225.8(e)(4)(i)(B).

30 The Comprehensive Liquidity Assessment and Review ("CLAR") is "the Federal Reserve's annual, horizontal, forward-looking program to evaluate the liquidity position and liquidity risk management practices of LISCC firms." *See* Federal Reserve System, Division of Banking Supervision and Regulation, SR Letter 15-7, *Governance Structure of the Large Institution Supervision Coordinating Committee (LISCC) Supervisory Program* (Apr. 17, 2015).

31 The Clearing House has long advocated for additional transparency in CCAR. Directly reflecting the "key conclusions" from CCAR into the proposed LFI rating system provides yet another reason for increasing transparency: the lack of transparency in CCAR would further frustrate the objective of clarity, consistency and transparency in supervisory assessments.

32 82 Fed. Reg. 39049, 39060.

adequacy on an actual and post-stress basis provides for periodic evaluations and includes mechanisms for those evaluations to be updated. Accordingly, providing for a separate quantitative assessment of firms' capital adequacy through the Capital Planning and Positions component would not be appropriate. Moreover, any such separate quantitative assessment would result in substantial uncertainty regarding supervisory assessments of capital adequacy, as firms would face the prospect of receiving a non-Satisfactory component rating for quantitative reasons even if they both (i) receive no objection to their capital plans on the basis of the Federal Reserve's CCAR quantitative review and (ii) meet the minimum capital adequacy standards (including applicable buffers). As we have described elsewhere, uncertainty regarding supervisory expectations for capital adequacy inhibits lending, economic growth and liquid capital markets.[33]

We therefore urge the Federal Reserve to expressly provide that a firm would not be required to hold capital in excess of the minimum requirements plus applicable buffers in order to receive a Satisfactory rating for the quantitative (or "Capital Positions") portion of the Capital Planning and Positions component if the firm has also not received an objection based on the CCAR quantitative review (which currently requires that firms meet the minimum regulatory capital requirements—without applicable buffers—under stressed conditions).[34]

The Federal Reserve should also clarify that a firm in the process of remediating a Deficient-1 rating for the Capital Planning and Positions component would not become automatically subject to limits on capital distributions—automatic application of such limitations should be limited to the buffers framework in the capital rules and the framework of the capital plan rule/CCAR.

Finally, we note that because the results of the CCAR quantitative review will be reflected in an LFI's rating for the Capital Planning and Positions component under the LFI rating system, further revisions to the Federal Reserve's CCAR quantitative assessment to improve its transparency and risk-sensitivity would also promote the Federal Reserve's

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33 *See* The Clearing House, *Comment Letter re: Stress Testing Transparency Proposals (Dockets Nos. OP-1586, OP-1587 and OP-1588)* (January 22, 2018), *available at* https://www.theclearinghouse.org/-/media/tch/documents/tch%20weekly/2018/20180122_tch_comment_letter_re_stress_testing_transparency.pdf?la=en (the "Stress Testing Transparency Comment Letter").

34 For example, once the capital rules are fully phased in, a non-advanced approaches LFI that is not subject to the G-SIB surcharge should not be required to maintain a common equity tier 1 ratio above 7% (representing the 4.5% minimum requirement plus the 2.5% capital conservation buffer) to receive a Satisfactory rating for the quantitative (or "Capital Positions") portion of the Capital Planning and Positions component. Any future rulemakings relating to the CCAR quantitative assessment or the Federal Reserve's capital rules should take into account the interrelationship with and effects on the LFI rating system.

objective in designing the LFI rating system to "[e]nhance the clarity and consistency of supervisory assessments . . ." that produce clear and predictable outcomes.[35]

2. The Federal Reserve should revise the Capital Planning and Positions component rating to incorporate specific, objective and measurable criteria for qualitative assessments.

The Federal Reserve should revise the qualitative supervisory review under the proposed LFI rating system in several respects to promote the goal of consistent and transparent supervisory assessments. First, as discussed below, the Federal Reserve should directly reference the explicit set of capital planning and stress testing principles and expectations set forth in SR Letter 15-18 for LISCC[36] and large and complex firms and SR Letter 15-19 for large and noncomplex firms in the final LFI rating system. Further, on-site and horizontal examination teams should be required to use the publicly available capital planning and stress testing principles and guidance, currently set forth in SR Letters 15-18 and 15-19, to develop the expectations of the processes under review during the reviews of the capital planning process. Incorporating published guidance would tie the supervisory expectations relevant for the LFI rating system to published guidance such that, if expectations were to change, then the guidance or rating system would need to be updated accordingly. By incorporating a direct reference to the prevailing guidance and the principles therein into the final LFI rating system, the Federal Reserve would help firms understand regulatory expectations and help examiners consistently apply the rating system by providing an explicit set of principles and expectations in what can otherwise be a highly subjective area of supervisory expectations.

We also urge the Federal Reserve to review and revise, and issue for public comment, SR Letters 15-18 and 15-19 to provide more objective and measurable criteria for supervisors to apply to evaluate the Capital Planning and Positions component under the final LFI rating system.

Finally, the Federal Reserve should also make the qualitative reviews more consistent by coordinating supervisory expectations and findings among examiner teams conducting horizontal reviews and the on-site examiner teams reviewing capital plans at their respective supervised institutions.

3. The "Capital Planning" portion of the Capital Planning and Positions component rating should not be implemented in such a

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35 82 Fed. Reg. 39049, 39059. For a discussion of recommendations to improve CCAR, see, e.g., the Stress Testing Transparency Comment Letter. *See also* U.S. Department of the Treasury, *A Financial System that Creates Economic Opportunities: Banks and Credit Unions* (June 12, 2017) at 53-54 and 125 (presenting recommendations for improving CCAR), *available at* https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

36 "LISCC" firms are those firms subject to the Federal Reserve's Large Institution Supervision Coordinating Committee ("LISCC") framework.

way that it would effectively recreate the binary outcomes of the qualitative CCAR review.

The "Capital Planning" portion of the component rating should avoid introducing binary outcomes based on subjective supervisory expectations, consistent with our recommendations for the overall LFI rating system framework. For example, the Federal Reserve recently tailored its capital plan rule to remove "large and noncomplex firms"[37] from the qualitative assessment process, thus eliminating an "unduly burdensome" element of CCAR that required large and noncomplex firms to commit excessive resources to the "development of large amounts of documentation and sophisticated stress test models."[38] The elimination was meant to "incentivize such firms to invest in capital planning processes that are appropriate for the risks of those firms."[39] The implementation of the proposed new LFI rating system has the potential to effectively recreate the binary outcomes of the CCAR qualitative assessment for large and noncomplex firms. To the extent any new LFI rating system maintains the "hair trigger" approach for ratings downgrades or includes a transitory rating that would result in automatic loss of "well managed" status at the end of an arbitrary time period, the LFI rating system would create new burdens on large and noncomplex firms by effectively requiring them to develop and maintain substantial data collection, reporting, governance, and other processes and procedures that are not warranted by their risk profile, business model and other characteristics but that would need to be implemented to guard against the risk of a Deficient-1 rating. In other words, the LFI rating system could reintroduce "unduly burdensome" elements of CCAR by replacing the binary outcome of the CCAR qualitative review with the binary nature of the Satisfactory vs. Deficient-1 ratings—the threat of a Deficient-1 rating would become the new form of a possible CCAR qualitative objection. Our recommendations in Sections II and V would prevent the proposed LFI rating system from effectively recreating the binary outcomes based on subjective supervisory expectations under the CCAR qualitative review.

4. The implementation of the "Capital Planning" portion of the Capital Planning and Positions component rating would further justify the Federal Reserve's elimination of the CCAR qualitative assessment for all CCAR firms.

As part of the CCAR qualitative assessment for LISCC and large and complex firms, the Federal Reserve evaluates the reliability of a firm's analyses and processes for capital planning, focusing on the areas that are most critical to sound capital planning, including how a firm identifies, measures, and determines capital needs for its material risks, as well as a

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[37] "Large and noncomplex firms" are bank holding companies or IHCs that (1) have average total consolidated assets of $50 billion or more, but less than $250 billion, (2) have average total nonbank assets of less than $75 billion, and (3) are not U.S. global systemically important banks.

[38] Federal Reserve System, *Amendments to the Capital Plan and Stress Test Rules*, 82 Fed. Reg. 9308, 9310 (Feb. 3, 2017).

[39] *Id.*

firm's controls and governance around those practices.[40] Because LISCC and large and complex firms would become subject to regular supervisory qualitative review as part of the Capital Planning and Positions component rating under the proposed LFI rating system in the same manner as large and noncomplex firms, the CCAR qualitative review should be eliminated for all CCAR firms.[41]

The Federal Reserve's proposal for the elimination of the qualitative assessment for large and noncomplex firms indicated that the Federal Reserve's rationale for retaining the qualitative assessment and objection framework for other firms that participate in CCAR is its view that those other firms "engage in more diverse activities and have a larger overall size and geographical scope than large and noncomplex firms."[42] It is unclear why such greater diversity or scope renders the normal supervisory and examination process inadequate—or put another way, why this greater diversity or scope would require a formal, annual qualitative assessment and objection framework *in addition* to those supervisory processes to appropriately oversee capital planning. The Federal Reserve has not provided analysis or evidence that suggests either.

The Federal Reserve typically evaluates banking organizations, including in areas of importance commensurate with capital planning, through the normal supervisory and examination process without subjecting them to public, binary determinations similar to the CCAR qualitative assessment and objection framework. Irrespective of whether the entire supervisory examination process should be far more transparent and objective (and whether the proposed LFI rating system would further those objectives), there is no reason to have the opacity of the CCAR qualitative assessment and the publicity of the objection framework applicable to only one supervisory judgment, particularly such a highly subjective one. Any benefits of the CCAR qualitative assessment and objection framework do not outweigh the related challenges, costs, subjectivity, inconsistency and unnecessary pressure on firm employees, as well as the potential reputational damage. Normal supervisory and examination processes (which, as contemplated by the proposal, would include horizontal reviews relating to capital planning) are sufficient to evaluate the capital planning processes of all firms subject to CCAR, including those that are not large and noncomplex.

Indeed, removing the qualitative assessment for all CCAR firms would only impact the mechanism by which supervisory expectations for capital planning are enforced, and not the supervisory expectations themselves. The elimination of the qualitative assessment

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40 Federal Reserve System, *Comprehensive Capital Analysis and Review 2017: Assessment Framework and Results* (June 2017) at iii.

41 *See* Governor Daniel K. Tarullo, Departing Thoughts (Apr. 4, 2017), *available at* https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm (noting that "I think the time may be coming when the qualitative objection in CCAR should be phased out, and the supervisory examination work around stress testing and capital planning completely moved into the normal, year-round supervisory process, even for the G-SIBs.")

42 Federal Reserve System, *Amendments to Capital Plan and Stress Test Rules*, 81 Fed. Reg. 67239, 67245 (Sept. 30, 2016).

would not alter in any way the Federal Reserve's actual supervisory expectations and requirements in this area. Nor is there anything about the examination process or the Federal Reserve's supervisory authority more generally that would limit its ability to qualitatively assess an LFI's capital planning processes through the ordinary examination and supervisory process. Indeed, the proposal would, if anything, regularize and enhance the Federal Reserve's ability to qualitatively assess a firm's capital planning processes through the ordinary examination and supervisory process. Eliminating the qualitative CCAR review for all firms would reduce challenges, costs, subjectivity and inconsistency of that highly subjective and binary determination without any reduction in regulatory effectiveness. The Federal Reserve has previously recognized the disadvantages of a public "pass-fail" regime when it revised the quantitative assessment to permit firms to make an adjustment to their planned capital actions prior to the release of CCAR results. The same issue is, because of the level of subjectivity, even more intense in the qualitative test. Accordingly, we urge the Federal Reserve to eliminate the qualitative assessment and objection framework entirely for all firms subject to CCAR.

For as long as the CCAR qualitative assessment continues to apply to LISCC and large and complex firms, however, these firms should not face the prospect of receiving a Deficient rating with respect to the qualitative portion of the Capital Planning and Positions component if they do not receive an objection on the basis of the CCAR qualitative assessment. The qualitative assessment is an intensive annual review of those firms' capital planning practices, focusing on governance, risk management, internal controls, capital policies, incorporating stressful conditions and events, and estimating the impact on capital positions.[43] Providing for a separate qualitative review and evaluation through the Capital Planning and Positions component would be unduly burdensome and inappropriate. Any such separate review would introduce further uncertainty into the highly subjective area of supervisory expectations regarding capital planning and related processes and controls. Accordingly, we urge the Federal Reserve to specify in the text of the final LFI rating system that LISCC and large and complex firms that do not receive an objection in the CCAR qualitative assessment will not receive a Deficient rating on account of the qualitative portion of the Capital Planning and Positions component.

B. Liquidity Risk Management and Positions.

1. The Liquidity Risk Management and Positions component rating should be explicitly tied to compliance with the liquidity buffer requirements of the Federal Reserve's Regulation YY and LCR compliance, such that if an institution is compliant with applicable quantitative regulatory requirements, it would be rated Satisfactory for the quantitative portion of the Liquidity Risk Management and Positions component.

[43] *See*, *e.g.*, 2018 Summary CCAR Instructions, at 17.

Large bank holding companies (that is, those with total consolidated assets of $50 billion or more) and IHCs established by FBOs pursuant to Regulation YY are required to maintain a liquidity buffer that is sufficient to meet the projected stressed cash flow need over a 30-day period under a number of stress scenarios.[44] Similarly, the liquidity coverage ratio ("LCR") is a quantitative liquidity standard that requires subject bank and savings and loan holding companies to hold a buffer of high-quality liquid assets ("HQLA") sufficient to cover net cash outflows during a 30-day stress scenario. The proposal states in the supplementary information that "applicable regulatory requirements" for a firm's liquidity position include both the liquidity risk management and stress testing requirements in Regulation YY and the LCR.[45] However, the text of the proposed LFI rating system itself makes no explicit reference to the Regulation YY liquidity metrics or the LCR, instead tying ratings 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."[46] To clarify the references to "current and projected liquidity positions" and to achieve consistency in supervisory assessments of a firm's liquidity position, the quantitative (or "Liquidity Positions") portion of the Liquidity Risk Management and Positions component rating should be explicitly tied, for firms subject to those requirements, to compliance with the liquidity buffer requirements of Regulation YY and to compliance with the LCR. Specifically, an LFI that satisfies its Regulation YY liquidity buffer requirement and that has an LCR of greater than 100 percent should be deemed to have "current and projected liquidity positions" that comply with regulatory requirements, and therefore have a Satisfactory liquidity position. The final LFI rating system should provide that if an institution is compliant with these quantitative metrics, as applicable, it would be considered Satisfactory for the quantitative portion of the Liquidity Risk Management and Positions component rating.

In addition, we request that the Federal Reserve confirm that temporary shortfalls in the Regulation YY liquidity buffer and/or LCR would not result in an automatic downgrade to Deficient rating for the quantitative (or "Liquidity Positions") portion of the Liquidity Risk

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[44] 12 C.F.R. § 252.35. Each stress test must include a number of scenarios and an overnight planning horizon, a 30-day planning horizon, a 90-day planning horizon, a one-year planning horizon, and any other planning horizons that are relevant to the firm's liquidity risk profile. The scenarios must include one reflecting adverse market conditions, one reflecting an idiosyncratic stress event for the firm, and one reflecting combined market stress and idiosyncratic stress. A "planning horizon" is the period over which the relevant stressed projections extend. The firm must use the results of the stress test over the 30-day planning horizon under each scenario to calculate the size of the liquidity buffer.

In parallel to the CLAR quantitative assessment, supervisors also examine the stress tests that each firm uses to make funding decisions and to determine its liquidity needs to help supervisors evaluate the reliability of firms' own risk measurement and management.

[45] 82 Fed. Reg. 39049, 39050, n. 9, 39052.

[46] *Id.* at 39061.

Management and Positions component rating. As we have noted previously,[47] the LCR can only support a banking organization in meeting its liquidity needs under stress if its HQLA can actually be used (that is, sold or used as collateral to borrow funds). However, use of the HQLA in a stress scenario could cause the firm's LCR to fall below 100 percent, and therefore constitute a shortfall under the LCR rule, which creates a problem of HQLA "usability." The same principles apply to the Regulation YY liquidity buffer. We are concerned that, absent clarification from the Federal Reserve, evaluation under the quantitative liquidity component of the proposed LFI rating system could further discourage firms from using HQLA or other highly liquid assets during times of stress, which could in turn impact firms' ability to supply credit to the economy and provide liquidity to the capital markets.

2. The Liquidity Risk Management and Positions component rating should be explicitly tied to the results of the Federal Reserve's CLAR program, such that if an institution's liquidity risk management is reviewed favorably under CLAR, it would be rated Satisfactory for the qualitative portion of the Liquidity Risk Management and Positions component.

The Federal Reserve has implemented CLAR for LISCC firms, an annual horizontal exercise that assesses both liquidity positions and risk management. Like CCAR, CLAR includes both quantitative and qualitative elements used by supervisors to assess the adequacy of LISCC firms' liquidity positions relative to their unique risks and test the reliability of these firms' approaches to managing liquidity risk.[48] The proposal states in the supplementary information that "key conclusions of . . . CLAR will be directly reflected within the . . . Liquidity component rating assignments."[49] However, the text of the proposed LFI rating system itself makes no explicit reference to CLAR in the Liquidity Risk Management and Positions portion or elsewhere. For LISCC firms, the qualitative (or "Liquidity Risk Management") portion of the Liquidity Risk Management and Positions component rating should be tied to CLAR. The final LFI rating system should provide that, if an institution's liquidity risk management practices receive favorable Federal Reserve review under CLAR, it would be considered Satisfactory for the qualitative portion of the Liquidity Risk Management and Positions component rating. Furthermore, there is currently no defined process for non-LISCC firms regarding how the horizontal review process—which, unlike CLAR, is not conducted on a regularly scheduled basis—will be used in the qualitative (or "Liquidity Risk Management") portion of the Liquidity Risk Management and

47 The Clearing House, "Unlocking the Liquidity Coverage Ratio" (June 7, 2017), *available at* https://www.theclearinghouse.org/eighteen53-blog/2017/june/07-hqla-usability.

48 Unlike CCAR, CLAR does not include a specific quantitative post-stress minimum; subject firms are required to meet the LCR and firms with weak liquidity positions under CLAR's liquidity metrics are directed to improve their practices and, as warranted, their liquidity positions, through supervisory direction, MRAs and MRIAs ratings downgrades, or enforcement actions.

49 82 Fed. Reg. 39049, 39052.

Positions component rating for firms that are not subject to CLAR. The final LFI rating system should therefore set forth clear and specific guidance for those firms in this regard.

In addition, we also believe it would be beneficial if the Federal Reserve provided detailed guidance on supervisory expectations regarding liquidity risk management. This guidance should be issued for comment and include objective and measurable criteria against which firms would be assessed for purposes of CLAR (for those firms that participate in CLAR) and the qualitative aspect of the Liquidity Risk Management and Positions component (for all firms subject to the LFI rating system). Importantly, this guidance, like the Federal Reserve's supervisory expectations for LFIs generally, should also be tailored to take into account the risk profile, business model and other relevant characteristics of firms.

C. Governance and Controls.

1. The proposal should make clear that only those compliance matters that are materially related to the financial and operational strength and resilience of a firm will be relevant in assessing the Governance and Controls component.

We are concerned that the proposal is somewhat ambiguous as to how and when compliance matters will impact a firm's Governance and Controls rating and leaves open the possibility that any compliance matter, whatever its impact on safety and soundness and whatever its materiality, may impact that rating. Although an institution's non-compliance with applicable laws and regulations certainly may, in some cases, have a material direct impact on its safety and soundness, that will clearly not always be the case. Thus, the Federal Reserve should make clear that only compliance issues that, individually or in the aggregate, meaningfully affect whether a firm "possesses sufficient financial and operational strength and resilience to maintain safe and sound operations through a range of conditions" will be considered in determining a firm's Governance and Controls rating. The Federal Reserve should also explain how compliance assessments by other regulators with specific examination authority (such as consumer compliance assessments by the Consumer Financial Protection Bureau) would be considered and reflected in rating determinations.

2. Recovery planning should not be an aspect of the Governance and Controls component for domestic LISCC firms in light of the significant overlap between recovery planning and the areas evaluated by the proposed LFI rating system.

As proposed, supervisory assessments in connection with the Capital Planning and Positions and Liquidity Risk Management and Positions components would already evaluate whether firms have effective capital and liquidity governance and planning processes to support their activities through a range of conditions. Likewise, the supervisory assessments in connection with the Governance and Controls component would evaluate whether firms have effective governance at the board, senior management and business line management levels, effective risk management and effective controls to support their activities through a range of conditions. Separately assessing domestic LISCC firms' recovery planning capabilities as an aspect of the Governance and Controls component would create undue duplication of supervisory assessments and inhibit the Federal Reserve's goal of enhancing the clarity and consistency of supervisory assessments. Indeed, the proposal does not explain how evaluations of the effectiveness of recovery planning would correspond to Satisfactory, Satisfactory Watch, Deficient-1 or Deficient-2 ratings.

In the supplementary information, the proposal notes that supervisory expectations regarding recovery planning are set forth in SR Letter 14-8.[50] However, as with other supervisory guidance, the text of the proposed LFI rating system does not expressly reference SR Letter 14-8. Moreover, SR Letter 14-8 was released without notice and public comment. If the Federal Reserve should decide to incorporate recovery planning into the assessment of the Governance and Controls component (which we oppose), the Federal Reserve should publish its existing recovery planning guidance for public comment and expressly reference the relevant supervisory guidance in the text of the final LFI rating system.

3. Our comments relating to the aspects of the Governance and Controls component regarding boards of directors and senior management, business line management, independent risk management and controls are or will be addressed in separate comment letters in response to the Federal Reserve's Board Effectiveness and Risk Management proposals.

We are separately submitting a comment letter in response to the Federal Reserve's Board Effectiveness proposal, which is expected to be used in connection with supervisors' assessments of board effectiveness under the Governance and Controls component. We also expect to submit a comment letter in response to the Risk Management proposal by the comment deadline of March 15, 2018. Because of the interrelationship of all three proposals, our comments should be read together and understood collectively. In addition, our comment letter on the Risk Management proposal may address the Governance and Controls component and expand upon our comments in this letter.

IV. Timing of Implementation.

The proposal provides that "if the LFI rating system is finalized before the additional governance and controls guidance is finalized, firms would be evaluated using existing supervisory guidance until such time that the additional governance and controls guidance is finalized."[51] This statement implies that firms would likely be evaluated on a new

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50 Federal Reserve System, Division of Banking Supervision and Regulation, *Consolidated Recovery Planning for Certain Large Domestic Bank Holding Companies*, SR Letter 14-8 (Sept. 25, 2014).

51 82 Fed. Reg. 39049, 39053. The recent Risk Management proposal likewise notes "If the proposed LFI rating system were finalized before this proposed guidance, the Federal Reserve would use existing supervisory guidance to help inform its evaluation of each firm's governance and controls for purposes of the proposed LFI rating system, until such time that this proposed guidance is finalized." 83 Fed. Reg. 1351, 1352.

component rating system by reference to potentially outdated or inconsistent existing supervisory guidance. Requiring firms to apply various sources of existing guidance in an attempt to measure performance under a new rating system that is predicated on the availability of guidance that has not yet been finalized would contradict a key characteristic of an optimal rating system noted above in the introduction—basing any revised rating system on clearly articulated and measurable standards that produce consistent and predictable supervisory assessments.

Given the importance and implications of a firm's examination ratings, the Federal Reserve should not issue the final LFI rating system in a bifurcated fashion whereby related supervisory expectations have not been finalized prior to the adoption of and issuance of initial ratings under the new system.[52] We therefore recommend that the Federal Reserve not adopt the proposed LFI rating system until the pending Board Effectiveness and Risk Management proposals are finalized and institutions are provided with an appropriate phase-in period. If the Federal Reserve should nevertheless decide to implement the LFI rating system before the related supervisory guidance has been finalized, rating determinations and the overall application of the rating system should not penalize firms for not adhering to such proposed guidance.

A. The Federal Reserve should not apply the LFI rating system to IHCs until it has clarified and sought comment on the supervisory expectations regarding boards of directors that will apply to IHCs.

Because the LFI rating system would apply to IHCs established by FBOs pursuant to Regulation YY, but the Board Effectiveness proposal states that the final guidance would not apply to IHCs, the Federal Reserve should not apply the proposed LFI rating system to IHCs until it has clarified, and sought comment on, the supervisory expectations that will apply to IHCs for purposes of evaluating the board-related aspects of the Governance and Controls component.[53]

B. Concurrently with finalizing the LFI rating system, the Federal Reserve should make conforming amendments and, where appropriate, rescind existing guidance and examination manuals so that supervisory expectations are clear, transparently communicated and consistently applied.

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52 As another example, the Governance and Controls component refers to senior management's role as including "compensation and performance management programs that promote and enforce prudent risk-taking behaviors and business practices." The proposal does not, however, address applicable supervisory expectations. We recommend that the Federal Reserve clarify that, in this regard, it will expect firms to meet the Federal banking agencies' 2010 principles-based "Guidance on Sound Incentive Compensation Policies" as well as the relevant requirements in the Federal Reserve's enhanced prudential standards.

53 82 Fed. Reg. 39049, 39049. As we note in our comment letter to the Board Effectiveness proposal, the application of the Board Effectiveness proposal to IHCs that are also BHCs is unclear, but the same comment applies if those IHCs are also not subject to the Board Effectiveness proposal.

The proposal states in the supplementary information that "upon finalizing the LFI rating system, the Federal Reserve expects to issue supervisory guidance to update and align the consolidated supervisory framework, including SR Letter 12-17, to be fully consistent with any modifications made through the final adoption of the LFI rating system . . ."[54] In line with our recommended revisions to the proposed LFI rating system, concurrently with finalizing the new rating system (and not prior to), the Federal Reserve should publish updated SR Letters and examination manuals so that (i) supervisory expectations are transparently communicated to firms, and (ii) the new rating system is applied, and examinations conducted, consistently across Federal Reserve districts as well as by horizontal and local examination teams.

Further, the final LFI rating system should not be implemented—even on an interim basis—for a minimum of one year after the proposed system (including the pending Board Effectiveness and Risk Management proposals) is finalized. Providing a reasonable time frame for implementation will allow the Federal Reserve sufficient time to revise its supervisory processes and to undertake the necessary examiner education. For example, no horizontal review programs similar to CLAR are currently in place for non-LISCC firms with respect to the Liquidity Risk Management and Positions components, nor is there any horizontal review process in place for LISCC or non-LISCC firms with respect to the Governance and Controls component. This further suggests that additional time is needed for the Federal Reserve carefully to consider how best to address this gap, particularly considering the extent to which the proposed LFI rating system would rely on horizontal reviews in making rating determinations. This extended implementation timeframe would also allow firms time to consider and appropriately respond to the expectations outlined in the proposal, for which related supervisory guidance has not previously been subject to public comment.

C. The Federal Reserve should incorporate direct references to the applicable supervisory guidance in the proposed LFI rating system so that the principles and expectations against which firms are evaluated will be explicit and clear.

The supplementary information in the proposal refers to guidance that is or will be used to assess firms, including SR Letter 15-18 (for LISCC firms and large and complex firms) and SR Letter 15-19 (for large and noncomplex firms),[55] as well as the pending Board Effectiveness and Risk Management proposals. The text of the proposed LFI rating system itself does not, however, refer with any specificity as to how this guidance would form the basis for evaluating firms and determining ratings.

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54 *Id.* at 39056.

55 *See* Federal Reserve System, Division of Banking Supervision and Regulation, *Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms*, SR Letter 15-18 (Dec. 18, 2015); Federal Reserve System, Division of Banking Supervision and Regulation, *Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms*, SR Letter 15-19 (Dec. 18, 2015).

The Federal Reserve should revise the proposed LFI rating system directly and expressly to identify and reference the guidance that would be used for evaluating firms *and seek specific public comment on any such guidance*. Such direct and express references would promote the objective of enhancing the clarity and consistency of supervisory assessments and communications of supervisory findings and implications. By including direct references to the applicable guidance in the final LFI rating system, the Federal Reserve would help firms prepare for examinations, and help examiners achieve consistent supervisory outcomes, by providing an explicit set of principles and expectations, which is of particular importance given the proposed LFI rating system's focus on processes, governance and other areas in which supervisory expectations are highly subjective.

V. Recommended Refinements to the Federal Reserve's Supervisory Process.

The proposed new system aims to formalize the post-crisis supervisory focus on the governance frameworks surrounding capital and liquidity management as well as the broader category of "governance and controls" as part of its ratings determinations. The text of the proposed LFI rating system, however, does not identify what examiners would consider with respect to each category and would thus provide Federal Reserve examiners with substantial discretion in assigning examination ratings. In this regard, the proposal does not address the fact that examination ratings are often perceived as arbitrary and inconsistent (a longstanding and significant concern), nor does it promote the Federal Reserve's goal of enhancing the clarity and consistency of supervisory assessments.

As discussed in greater detail below, although some degree of examiner discretion in assigning ratings is important and appropriate to allow on-site exam teams that are most familiar with a given firm's business model and risk profile to appropriately consider how those factors bear on the firm's safety and soundness, the parameters of examiner discretion and the framework within which examiners exercise discretion should be clear in order to promote consistency and appropriate tailoring of supervisory assessments and outcomes.

A. The horizontal review process should inform an assessment of compliance with pre-articulated standards rather than form the basis of new policy without prior notice, and should not create new, one-size-fits-all supervisory expectations by mandating uniform practices across firms that are not similarly situated.

In recent years, the Federal Reserve has made more frequent use and placed greater emphasis on horizontal supervisory assessments. Given the increased focus under the proposed LFI rating system on capital planning and liquidity risk management—complex and technical subjects that require specialized expertise among supervisory teams—the importance of horizontal reviews is likely to become even greater. When conducted appropriately, the use of such horizontal reviews as a supervisory tool can produce meaningful benefits – in particular, they can both promote consistent supervisory assessments by on-site exam teams and communications of supervisory findings and facilitate supervisors' understanding of the broader industry. At the same time, however, the use of horizontal assessments can pose significant risks in practice, which we encourage the Federal Reserve to address both within and outside the LFI ratings context.

First, if not conducted properly, there is a risk that horizontal reviews will be used not simply to gather information or assess compliance with existing policy, but instead to make and enforce new policy. The latter is, of course, inconsistent with a cardinal rule of both administrative law and sound supervision—the notion that firms should have notice of new requirements before they are applied and enforced. For example, a firm may receive an MRA/MRIA if supervisors consider it to be "behind its peers" on the basis of the horizontal reviews, potentially without having given adequate consideration to whether the firm's practices are appropriate to its circumstances or satisfy pre-existing supervisory guidance and expectations with respect to safe and sound operations. Horizontal reviews should be used to gather information and assess compliance with already articulated standards and to bring to bear subject-matter expertise from across the Federal Reserve System on complex supervisory topics. To the extent those reviews lead the Federal Reserve to conclude that new binding standards are needed, they should be established via notice and comment rulemaking and enforced thereafter, rather than *ex post* and retroactively. We urge the Federal Reserve to address these shortcomings, in particular because horizontal examination work would be a significant factor for determining each of the component ratings.[56]

Second, if not conducted properly, there is also the risk that horizontal reviews may result in the application of "one size fits all" supervisory expectations across banking organizations. Such expectations do not sufficiently account for different firms' business models, risk profiles and other characteristics, but rather, are based on supervisory assessments of best practices at other firms.

Indeed, the proposal may inadvertently create or exacerbate a situation, which may already exist, in which ratings are assigned on a "curve", with some risk that those below the midpoint of, or some other point in, the curve will not "pass." In particular, this could exacerbate the issue of firms' receiving MRAs/MRIAs not because they have violated any existing requirement, but instead because they are perceived to be "behind their peers." An assessment as to whether a firm is operating in a safe and sound manner should be based on the firm's business model and risk profile and other unique characteristics. The assessment should be against clear, pre-existing supervisory standards and expectations, not a relative

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56 *See* 82 Fed. Reg. 39049, 39050 ("The LISCC supervisory program conducts annual horizontal reviews of LISCC firms and firm-specific examination work focused on evaluating a firm's (i) capital adequacy under normal and stressed conditions; (ii) liquidity positions and risk management practices; (iii) recovery and resolution preparedness; and (iv) governance and controls. For LFIs that are not LISCC firms, the Federal Reserve performs horizontal reviews and firm-specific supervisory work focused on capital, liquidity, and governance and control practices, which are tailored to reflect the risk characteristics of these institutions."); 39050-51 ("The Liquidity Risk Management and Positions component rating would be based on findings of coordinated examinations of liquidity positions and risk management practices conducted across several firms (horizontal examinations). . ."); 39051 ("Firm-specific and horizontal examination work 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 component rating.").

evaluation against other firms. While a horizontal review of industry practice can be a useful tool to add greater objectivity and consistency to supervisory examinations, whether a firm "passes" an assessment of its safety and soundness should not depend on a benchmarking of a firm against the operations of other institutions or some other relative measure, but rather on a benchmarking to the one, absolute measure that actually matters—whether the firm is operating in a safe and sound manner consistent with its risk profile.

Given the confidential and subjective nature of supervisory requirements in areas such as capital planning, liquidity risk management and governance, it can be difficult for banking organizations precisely to benchmark all practices against their peers. Assigning component ratings "based on findings of . . . horizontal examinations"[57] may therefore require the development of a process by which firms will be informed by the Federal Reserve of supervisory expectations arising out of horizontal reviews and have a reasonable period of time to make appropriate revisions to their practices.[58] The Federal Reserve can provide this advance opportunity by articulating, after notice and comment, a range of acceptable practices—appropriately tailored to firms' risk profiles, business models and other relevant characteristics—in a formal release on supervisory expectations following the conclusion of the horizontal review. Specifically, the Federal Reserve should formalize its guidance and expectations resulting from horizontal reviews and publicly release those expectations for comment prior to finalizing them and using them as a basis for assigning component ratings. As part of this process, the Federal Reserve should provide firms with a reasonable period (at least one examination cycle but, in any case, no fewer than 12 months) during which to implement the new guidance and to correct any deficiencies as compared to the newly formalized standards before receiving adverse supervisory findings or determinations (such as MRAs or ratings downgrades) on the basis of a horizontal examination.

Given the greater emphasis the LFI rating system would place on horizontal reviews, it is also critical that the Federal Reserve establish clear guidelines for its examiners to apply its supervisory expectations across the range of firms in the LFI portfolio. In this way, horizontal reviews will promote consistent and transparent supervisory assessments and communications of supervisory findings without requiring uniform practices across banking organizations that do not take into account meaningful differences among firms.

Implementation of the new rating system should be conducted in conjunction with a comprehensive review of the horizontal review approach, because the new rating system will almost inevitably lead to increased utilization of horizontal reviews. In these circumstances,

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57 *Id.* at 39050.

58 Although the supervisory expectations are often styled as guidance and not rulemakings subject to the Administrative Procedure Act, the Federal Reserve now proposes to use the results of formal horizontal reviews as the standards against which firms are assessed under a rating system that would be adopted pursuant to a formal rulemaking. Results of horizontal reviews would thus not merely suggest leading practices, but would be used as a basis for assigning examination ratings that can in turn directly affect the business activities of banking organizations, often at a material cost.

we believe that the basic framework and purpose of horizontal reviews requires careful reconsideration.

In our view, horizontal reviews should be used to provide consistency and objectivity in the examination process and to determine which practices are most effective in terms of promoting safety and soundness and which are not. Horizontal reviews should not be used as a relative grading system, or grading curve, to determine which firms should "pass" and which should fail. In other words, firms should be graded against objective safety and soundness standards, and not against each other. Properly applied, a horizontal review system could result in every institution subject to the review receiving a passing grade.

B. A more effective process for firms to challenge and seek review of examiner findings, criticisms and determinations (including ratings) on both an informal and formal basis would help to promote the consistency and objectivity of supervisory evaluations under the proposed LFI rating system.

In 1995, the Federal Reserve released guidelines for its intra-agency appeals process applicable to Federal Reserve-supervised institutions, including LFIs.[59] The Federal Reserve's appeals process, however, has not proven to be an effective avenue for Federal Reserve-supervised institutions to seek review of supervisory determinations, as clearly evidenced by the scarce use of the appeals process by financial institutions.[60] For example, while initial appeals are reviewed by the Reserve Banks, the Federal Reserve has not mandated that the Reserve Banks apply a uniform standard of review in considering material supervisory determination appeals.[61] Thus, each Reserve Bank may review initial appeals under a different process based on a different set of policies or guidelines. Nor are institutions able to appeal material supervisory determinations directly to the Federal Reserve's ombudsman.[62] We therefore urge the Federal Reserve to conduct a comprehensive

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59 Federal Reserve System, *Internal Appeals Process*, Final Guidelines, 60 Fed. Reg. 16470, 16473 (Mar. 30, 1995), *available at* https://www.gpo.gov/fdsys/pkg/FR-1995-03-30/pdf/95-7795.pdf.

60 *See* Julie Andersen Hill, *When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations*, 92 Wash. U. L. Rev. 1101, 1143-1148, 1165-1167 (2015) (noting that there are "few [intra-agency] appeals" by banks, that banks "rarely win" appeals, and that use of financial institution intra-agency appeals processes is limited by the fact that "[s]ome financial institutions believe that appealing is futile [and] [o]thers fear retaliation"). Indeed, although thousands of financial institutions have been examined since the appeals process was put in place in 1995, the Federal Reserve had decided only 25 appeals from in the period from 2000 to 2015. (Data from 1995-2000 are unavailable.) *See id*.

61 *See* 60 Fed. Reg. 16470, 16472-3 ("Each Reserve Bank shall make these guidelines and the Reserve Bank's process for selecting a review panel available to each institution in its district, any institution appealing a material supervisory determination, and any member of the public who requests them.").

62 *See id*., at 16472 ("Any appeal shall be . . . filed in writing with the Secretary of the Reserve Bank or other appropriate Reserve Bank official . . ."); *see also* Federal Reserve System, *Ombudsman Policy Statement* (Aug. 2, 1995) ("When a problem is brought to the attention of the Ombudsman for which there is an existing avenue of appeal or another appropriate forum for resolution, the Ombudsman will

review of the current appeals process and revise it so that LFIs and other Federal Reserve-supervised institutions have effective and prompt mechanisms to challenge and seek review of examiner findings, criticisms and determinations, including ratings. In particular, the Federal Reserve should consider allowing financial institutions to appeal directly to the ombudsman or another independent party outside of the supervisory and examination function. The Federal Reserve also should adopt a uniform and transparent standard of review and release aggregated, anonymous information about decisions made through the appeals process. The Federal Reserve should also make clear that any retaliation against a bank holding company for engaging in an appeal process is unacceptable and would be subject to disciplinary action.

It is of equal, if not greater, importance that firms have meaningful opportunities to engage with Federal Reserve staff—both the on-site examiners and Federal Reserve Board subject-matter experts—on a regular basis throughout the supervisory cycle, as described previously. For example, in light of the fact that the Federal Reserve has determined that LISCC firms should be subject to enhanced supervision (relative to other firms) under the LISCC framework, LISCC firms should be granted the opportunity to meet, on a regular basis, with senior LISCC Federal Reserve Board staff. Firms outside of the LISCC portfolio should be granted similar access to senior Federal Reserve Board staff.

In its 1995 release adopting the final guidelines for its appeals process, the Federal Reserve noted that it "continues to believe that questions about or objections to supervisory determinations made during the course of an inspection or examination are most effectively handled through the longstanding Federal Reserve practice of resolving any problems informally during the course of an inspection or examination."[63] We suggest that the Federal Reserve institute a process by which institutions are provided with frequent and regular interim updates by on-site examiners and Federal Reserve Board subject-matter experts during the course of examinations. Such updates would allow firms to clarify factual misunderstandings and remediate issues in real time, as opposed to deferring all findings to the end of the examination cycle. For example, one possible approach may be for the Federal Reserve to require that the senior supervisory officer ("SSO") for each firm provide a draft of the determination communicating ratings to the firm a reasonable period of time (for example, four weeks) before the ratings letter is formally issued. The draft would be provided with the understanding that the firm would be permitted to correct any factual misstatements, to respond to any proposed adverse findings, and to request that the SSO reconsider any specific component ratings before the letter and ratings are formally issued. This process would mitigate the risk that a component rating may be based on a

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explain the process to the complaining party, and direct the party to the appropriate appeals process or forum for the complaint. The [Federal Reserve]'s rules provide existing mechanisms for resolutions of complaints in many instances, such as: material supervisory determinations . . . The Ombudsman will not have decision making authority regarding complaints and will not independently review [Federal Reserve] or Reserve Bank regulatory action."), *available at* https://www.federalreserve.gov/aboutthefed/ombpolicy.htm.

[63] 60 Fed. Reg. 16470, 16471.

misunderstanding of the underlying facts or otherwise unjustified. This process would also provide a more informal process—in line with the Federal Reserve's previously expressed preferences noted above—for resolution of ratings-related issues outside a formal appeals process.

VI. Responses to Certain Specific Questions Raised in the Proposal.

A. The LFI rating system should not in the future include a separate rating component to assess the sufficiency of a firm's resolution planning.

Sound resolution planning processes, which are designed to improve the efficient resolution of a firm in the event of its material financial distress or failure,[64] are not themselves likely to be predictive in assessing the safety and soundness of an institution as a going concern. In light of the fact that a firm's resolution planning efforts are already assessed by regulators under a separate and detailed process with its own remediation framework, the inclusion or introduction of such an evaluation in a separate component of the LFI rating system would be duplicative of that process. Additionally, firms have embedded resolution preparedness capabilities into their business-as-usual activities, including their capital planning and liquidity risk management processes as well as their governance and control frameworks. Accordingly, the Federal Reserve's evaluations in connection with the proposed Capital Planning and Positions, Liquidity Risk Management and Positions and Governance and Controls components would encompass evaluations of firms' resolution preparedness capabilities, further making a separate resolution planning component duplicative of the other proposed LFI rating system components. Resolution planning therefore should not, in our view, be included as a separate component[65] of the LFI rating system.

B. The Federal Reserve should make other revisions to its supervisory processes to promote the consistency and objectivity of supervisory evaluations under the proposed LFI rating system.

The Federal Reserve specifically requests comments on a question as to whether there are "options that should be considered to enhance the transparency of LFI ratings in order to incent more timely and comprehensive remediation of supervisory deficiencies or issues."[66]

We recommend that the Federal Reserve:

- Require examiners to clearly identify, when issuing a rating, specific practices that must be revised or benchmarks that must be met for a firm to address

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[64] *See* Federal Reserve System and Federal Deposit Insurance Corporation, Resolution Plans Required, Final Rule, 76 Fed. Reg. 67323, 67323 (Nov. 1, 2011).

[65] 82 Fed. Reg. 39049, 39056.

[66] *Id.* at 39057.

supervisory findings, transition from Satisfactory Watch to Satisfactory, or receive a rating upgrade from Deficient-1;

- Require examiners to provide a clear articulation of how areas of supervisory concern represent material issues that relate to safety and soundness prior to a firm's receiving a rating downgrade;

- Revise its internal review processes to include coordinated and centralized review and approval of the ratings proposed by on-site examination teams, while continuing to balance an appropriate level of examiner discretion; and

- Undertake a robust and extensive training program for examiners prior to implementation of the new LFI rating system (including on how the various qualitative and quantitative factors should be weighted and reconciled within each category and on how to appropriately tailor, based on, among other factors, business model and risk profile, and the Federal Reserve's supervisory expectations for the range of firms in the LFI portfolio).

We also believe that the Federal Reserve should clarify how certain elements of the existing RFI/C(D) rating system, noted below, will be assessed within the three new component rating categories under the proposed LFI rating system.

- The Federal Reserve states in the proposal that "[a]lthough asset quality and earnings are not rated separately, they continue to be important elements in assessing a firm's safety and soundness and resiliency, and are *important considerations within each of the LFI component ratings*."[67] It is particularly important to understand how these areas will be assessed within the proposed components as currently defined. The Federal Reserve should make clear in the final LFI rating system precisely how these items will be factored into each of the LFI component ratings or, absent such clarification, include additional component categories commensurate with the current system to appropriately consider these important items in their own right.

- The proposal indicates that "[a]lthough a separate 'Impact' rating would not be assigned, the LFI rating system would assess a firm's ability to protect the safety and soundness of its subsidiary depository institutions, including whether the firm can provide financial and managerial strength to its subsidiary depository institutions."[68] Additional specificity is needed regarding how this would be assessed. In particular, the Federal Reserve should indicate in the final LFI rating system whether it would continue to evaluate this area according to the outline in SR Letter 12-17 or whether it plans to propose additional guidance specific to its incorporation into the new LFI rating system.

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67 *Id.* (emphasis added).

68 *Id.*

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The Clearing House appreciates the opportunity to comment on the proposal. If you have any questions, please contact the undersigned by phone at (202) 649-4619 or by email at paige.pidano@theclearinghouse.org.

Respectfully submitted,

Paige E. Pidano

Paige E. Pidano
Managing Director and Senior Associate
General Counsel
The Clearing House Association L.L.C.
1001 Pennsylvania Avenue, NW
Suite 720 North Tower
Washington, D.C. 20004