BANK POLICY INSTITUTE

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Via Electronic Mail

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Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Tailoring the Federal Reserve's Supervisory Practices and Expectations for Banking Organizations

Ladies and Gentlemen:

The Bank Policy Institute[1] is writing to urge the Board of Governors of the Federal Reserve System to build upon its recent final rule to better tailor prudential regulatory standards by revising its supervisory practices and expectations for banking organizations to complement and align with those regulatory changes. The Federal Reserve has indicated its interest in process improvements to its supervisory framework, and we hope that this letter is helpful in identifying and implementing such changes.[2]

As we detailed in our comment letters dated January 22, 2019[3] and June 21, 2019,[4] the Federal Reserve's

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

2 *See* Federal Reserve, Opening Statement by Vice Chair for Supervision Randal K. Quarles (Oct. 10, 2019), https://www.federalreserve.gov/newsevents/pressreleases/quarles-opening-statement-20191010.htm.

3 Bank Policy Institute, *Comment Letter re: Regulatory Tailoring and DFAST Proposals* (Jan. 22, 2019) (the "Domestic Tailoring Comment Letter"), https://bpi.com/wp-content/uploads/2019/01/BPI-Comment-Letter-on-Regulatory-Tailoring-and-DFAST-Proposals-Final.pdf.

4 Bank Policy Institute, American Bankers Association, *Comment Letter re: Proposed Changes to Applicability Thresholds for Regulatory Capital Requirements for Certain U.S. Subsidiaries of Foreign Banking Organizations and Application of Liquidity Requirements to Foreign Banking Organizations, Certain U.S. Depository Institution Holding Companies, and Certain Depository Institution Subsidiaries (Docket ID OCC–2019-0009, RIN 1557-AE63; FRB Docket No. R1628B, RIN 7100-AF21; FDIC RIN 3064-AE96); Prudential Standards for Large Foreign Banking Organizations; Revisions to Proposed Prudential Standards for Large Domestic Bank Holding Companies and Savings and Loan Holding Companies (FRB Docket No. R-1658, RIN 7100-AF45)* (June 21, 2019), https://bpi.com/wp-content/uploads/2019/06/FBO-Tailoring-NPRs-Comment-Letter.pdf (the "FBO Tailoring Comment Letter").

rule[5] and related interagency rule[6] to tailor enhanced prudential standards and regulatory capital and liquidity requirements for both domestic and foreign banking organizations ("FBOs") represent a positive and significant step toward a regulatory framework for these firms that more appropriately aligns prudential regulatory standards and burdens with the diverse risk profiles, activities, and business models of these firms.

It is equally important, however, that these more tailored regulatory standards are promptly and consistently reflected in the supervisory environment, including:

- The Federal Reserve's supervisory expectations (as opposed to formal regulatory requirements) for different firms, both as articulated publicly (*e.g.*, through Supervision & Regulation Letters and other guidance documents) and nonpublicly;
- The cohorts of supervised firms into which the Federal Reserve organizes its supervision activities and establishes peer-level supervisory expectations; and
- The ratings system and other assessment tools (*e.g.*, horizontal reviews) by which the Federal Reserve assesses firms against these expectations.

Appropriate changes in each of these areas will be essential if regulatory tailoring for banking organizations is to be honored consistently and faithfully in the examination process. Absent such changes, there is significant risk that compliance with standards that are removed from the Federal Reserve's regulations are nonetheless imposed in the examination process through matters requiring attention, horizontal reviews, or rating decisions, with those standards instead cast as "best practices" or "supervisory expectations." Should that occur, the Federal Reserve's supervisory practices would conflict with the underlying policy objectives of the Tailoring Rules, as well as the Congressional intent of the Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA").

These risks can and should be mitigated through a public and explicit commitment by the Federal Reserve to ensure that tailored rules are followed by tailored supervision. To assist the Federal Reserve in implementing these critical changes to its supervisory regime, this letter provides specific and concrete suggestions for further tailoring of supervisory and examination activities and expectations in a manner consistent with the Tailoring Rules. These include, importantly, the specific alignment of the Large Financial Institutions ("LFI") ratings evaluations with the new contours of prudential standards that the Federal Reserve's regulations do (and do not) apply to different firms, and changes to both the peer groups and mechanics of the Federal Reserve's consolidated supervision framework so that they map to, rather than conflict with, the categories established under the Tailoring Rules. In each case, as described in more detail below, these changes should be effected through notice and comment processes to revise existing guidance or, where appropriate, establish new supervisory standards. In addition to the recommended changes, we believe it also is important that examination and supervisory staff be trained, as appropriate, to ensure appropriate understanding of the revisions to supervisory documents and procedures and to ensure unambiguous differentiation between the supervisory approaches and expectations applicable to firms in different categories.

Part I of this letter provides an executive summary of our comments. Part II presents suggested changes to the Federal Reserve's supervisory processes and cohorts that would align with, and promote consistency in

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5 Federal Reserve, *Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies*, 84 Fed. Reg. 59032 (Nov. 1, 2019), https://www.govinfo.gov/content/pkg/FR-2019-11-01/pdf/2019-23662.pdf (the "Federal Reserve Tailoring Rule").

6 Office of the Comptroller of the Currency, Federal Reserve, and the Federal Deposit Insurance Corporation, *Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements*, 84 Fed. Reg. 59230 (Nov. 1, 2019), https://www.govinfo.gov/content/pkg/FR-2019-11-01/pdf/2019-23800.pdf (the "Interagency Tailoring Rule," and together with the Federal Reserve Tailoring Rule, the "Tailoring Rules").

application of, the Tailoring Rules. Part III sets out our recommendations for modifications to the Federal Reserve's new rating system for LFIs[7] ("LFI Rating System") to align with the Tailoring Rules.

Finally, we note that similar need for supervisory tailoring for insured depository institutions by the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, (collectively, the "Agencies") arises in the context of the Interagency Tailoring Rule, which we address in a separate letter submitted to the Agencies.

I. Executive Summary

- The scope and substance of the Federal Reserve's framework for the consolidated supervision of large financial institutions, horizontal reviews, and supervisory expectations and guidance should be revised to reflect and align with the tailoring categorization and differentiation established in the Tailoring Rules.
  - The Federal Reserve's framework for the consolidated supervision of large financial institutions and use of horizontal reviews should be revised to reflect and align with the tailoring categories established under the Tailoring Rules.
    - The composition of the Large Institution Supervision Coordinating Committee ("LISCC"), Large Banking Organization ("LBO"), and Large Foreign Banking Organization ("Large FBO") cohorts as described by SR 12-17 should be amended to appropriately reflect the categorization and differentiation established in the Tailoring Rules, and SR 12-17 should be revised via notice and comment processes to memorialize those changes.
    - To the extent that horizontal reviews are used to evaluate banking organizations, whether for purposes of LFI ratings or otherwise, relevant cohorts should be separated by the categories laid out in the Tailoring Rules, reflecting the differing risk profiles and regulatory requirements applicable to each.
  - The scope and substance of the Federal Reserve's specific supervisory expectations for capital planning and positions of certain firms should be revised to appropriately reflect the categorization and differentiation established in the Tailoring Rules, and SR 15-18 and SR 15-19 should be revised via notice and comment processes to memorialize those changes.
  - The scope and substance of any Federal Reserve supervisory exercises specific to liquidity, including its Comprehensive Liquidity Assessment and Review ("CLAR"), should appropriately reflect the categorization and differentiation established in the Tailoring Rules.
- For purposes of evaluating a firm's LFI rating, the standard and scope of supervisory review should align with the standards included in the Tailoring Rules.
  - The Federal Reserve's evaluation of a firm's Liquidity Risk Management and Positions component of the LFI Rating System should be consistent with the liquidity regulatory requirements that apply to that firm.

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[7] LFIs broadly include all bank holding companies with total consolidated assets of $100 billion or more; all non-insurance, noncommercial savings and loan holding companies with total consolidated assets of $100 billion or more; and U.S. intermediate holding companies of foreign banking organizations established pursuant to the Federal Reserve's Regulation YY with total consolidated assets of $50 billion or more. Federal Reserve, *Large Financial Institution Rating System; Regulations K and LL*, 83 Fed. Reg. 58724 (Nov. 21, 2018), https://www.federalreserve.gov/newsevents/pressreleases/files/2018-25350.pdf;

  - For purposes of evaluating the Liquidity Risk Management and Positions component of a Category III or IV firm's LFI rating, the Federal Reserve's standard and scope of supervisory review should reflect the less stringent quantitative liquidity standards included in the Tailoring Rules.

  - For purposes of evaluating the Liquidity Risk Management and Positions component of a Category III or IV firm's LFI rating, the Federal Reserve's supervisory expectations for liquidity stress testing practices should reflect the Tailoring Rules.

- The Federal Reserve's evaluation of a firm's Capital Planning and Positions component of the LFI Rating System should be consistent with the capital regulatory requirements that apply to that firm.

  - A Category IV firm no longer subject to company-run stress testing requirements under Regulation YY should not be subject to supervisory expectations under the Capital Planning and Positions component of that firm's LFI rating that effectively impose the same or comparable requirements.

  - The Federal Reserve should clarify how the two-year Comprehensive Capital Analysis and Review ("CCAR") cycle, two-year supervisory stress testing cycle, and two-year company-run stress testing cycle will be factored into a firm's annual LFI rating.

- The Federal Reserve should clarify how firms in each of the categories established in the Tailoring Rules are evaluated for purposes of the Governance and Controls component of the LFI Rating System.

II. The scope and substance of the Federal Reserve's framework for the consolidated supervision of large financial institutions, horizontal reviews, and supervisory expectations and guidance should be revised to reflect and align with the tailoring categorization and differentiation established in the Tailoring Rules.

As part of its supervisory framework, the Federal Reserve uses a range of supervisory processes and tools that have become increasingly peer-based in nature in recent years. For example, horizontal reviews are now frequently used to evaluate and assess firms against their peer firms. Similarly, the Federal Reserve also has taken significant and formal steps to organize its supervisory teams based on groupings of purportedly similar firms; for example, the LISCC is tasked with overseeing the supervision of the "largest, most systemically important financial institutions in the United States."[8] The Federal Reserve also has sometimes issued guidance that articulates separate expectations (*e.g.*, SR 12-17) and regulatory requirements (*e.g.*, SR 15-18 and SR 15-19) based on specific groupings of firms.

The Tailoring Rules establish, for purposes of a wide range of prudential requirements, an approach to categorizing firms that is very likely to be inconsistent with the current cohorts the Federal Reserve uses to organize its supervisory activities and expectations, including horizontal reviews. Absent alignment, current supervisory processes and cohorts raise the significant risk that supervisory expectations will, in practice, reflect an alternative view of the differing risk profiles of firms that, in many cases, has never been subject to notice and comment and directly conflicts with the Tailoring Rules' carefully considered risk-based categories. Accordingly, the Federal Reserve should revise its current supervisory processes and cohorts to reflect the categories established in the Tailoring Rules, and should do so via a notice and comment process. This would, among other things, provide more transparency into the process by which the Federal Reserve conducts horizontal reviews among peer groups and

[8] *See* Federal Reserve, Large Institution Supervision Coordinating Committee, https://www.federalreserve.gov/supervisionreg/large-institution-supervision.htm (last visited Nov. 15, 2019).

organizes firms to separate supervisory activities and expectations. Importantly, alignment of the Federal Reserve's supervisory processes and cohorts should be a starting point, rather than end point, of supervisory tailoring. We encourage the Federal Reserve to continue to identify and implement further tailoring within such supervisory processes and cohorts as is appropriate to further reflect varying risk profiles, activities, and business models across different firms.

A. The Federal Reserve's framework for the consolidated supervision of large financial institutions and use of horizontal reviews should be revised to reflect and align with the tailoring categories established under the Tailoring Rules.

1. The composition of the LISCC, LBO and Large FBO cohorts as described by SR 12-17 should be amended to appropriately reflect the categorization and differentiation established in the Tailoring Rules, and SR 12-17 should be revised via notice and comment processes to memorialize those changes.

SR 12-17 lays out the Federal Reserve's framework for the consolidated supervision of large financial institutions.[9] The framework divides firms into three categories: (i) LISCC firms, the largest, most complex U.S. and foreign financial organizations subject to consolidated supervision by the Federal Reserve and nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve; (ii) LBOs, domestic bank and savings and loan holding companies with consolidated assets of $50 billion or more that are not included in the LISCC portfolio; and (iii) Large FBOs, FBOs with combined assets of U.S. operations of $50 billion or more that are not included in the LISCC portfolio.

This grouping of firms is plainly inconsistent with the new categories outlined in the Tailoring Rules. For example, in the LBO portfolio, firms with less than $100 billion in assets that are exempted from many of the Federal Reserve's requirements under EGRRCPA and the Tailoring Rules and, thus, should no longer be subject to SR 12-17. Moreover, certain Category II and III firms are included in the LISCC portfolio, while others are part of the LBO or Large FBO groups.

Consistent with SR 12-17's stated goal of supporting "a tailored supervisory approach that accounts for the unique risk characteristics of each firm, including the nature and degree of potential systemic risks inherent in a firm's activities and operations, as well as broader trends across firms," it should be revised to reflect the categories established in the Tailoring Rules.[10] By aligning the supervisory framework outlined in SR 12-17 with the Tailoring Rules, the Federal Reserve would create transparency and consistency between its supervisory expectations and its supervisory processes, and better reflect both the letter and spirit of EGRRCPA.[11] For example, to the extent that the Federal Reserve continues to use the LISCC framework to differentiate between its supervisory expectations for

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9 Federal Reserve, Division of Banking Supervision and Regulation, Division of Consumer and Community Affairs, *Consolidated Supervision Framework for Large Financial Institutions*, SR 12-17 / CA 12-14 (Dec. 17, 2012), https://www.federalreserve.gov/supervisionreg/srletters/sr1217.htm.

10 On October 22, 2019, the U.S. Government Accountability Office ("GAO") issued a letter concluding that SR 12-17 is a "rule" under the Congressional Review Act and therefore must be submitted to Congress and the Comptroller General for review before it may take effect. SR 12-17 has never been so submitted, nor has it ever been subject to notice and comment. In this regard, the GAO's recent determination further reinforces the importance and necessity of review and revision of SR 12-17, as well as other guidance documents we discuss in this letter, through notice and comment processes. *See* GAO, B-330843, Letter to Congressional Requesters, *Board of Governors of the Federal Reserve System—Applicability of the Congressional Review Act to Supervision and Regulation Letters* (Oct. 22, 2019), https://www.gao.gov/assets/710/702205.pdf.

11 The current standards the Federal Reserve uses to determine whether a firm is a LISCC firm are generally opaque and nonpublic, other than a generic statement on its website that it "takes into account a number of factors such as the size of the financial institutions, their interconnectedness, lack of readily available substitutes for the services they provide, their complexity, and their global (cross-jurisdictional) activities." Federal Reserve, Large Institution Supervision Coordinating Committee, https://www.federalreserve.gov/supervisionreg/large-institution-supervision.htm (last visited Nov. 15, 2019).

firms, the Federal Reserve should align the framework with the Tailoring Rules by including only Category I firms within the scope of the LISCC firms.

In grouping institutions that are FBOs for supervisory purposes, the Federal Reserve also should take into account the significant differences in business models and structures between FBOs and domestic institutions, and create an appropriately tailored supervisory framework for FBOs. We note that the Tailoring Rules made helpful progress in this regard by applying the Liquidity Coverage Ratio ("LCR") and Single Counterparty Credit Limits to an IHC based on its own footprints, rather than an FBO's combined U.S. operations ("CUSO") as originally proposed.

In general, the supervision of FBOs should be based on the scale and risk profile of activities conducted by their U.S. operations and commensurate to similarly situated domestic institutions. In recognition of an FBO's U.S. operations being part of a larger organization, a reasonable differentiation between FBO and domestic institution supervision is warranted. For example, the Federal Reserve should focus its monitoring of FBOs on compliance with U.S. regulatory restrictions that effectively prevent transmission of extraterritorial systemic risk to the U.S. financial system through FBOs. Conducting horizontal examinations that compare a large domestic institution to an FBO's U.S. branches or subsidiaries diminishes this objective, and results in significant resource burdens for FBOs as well as supervisors, without accounting for actual risks posed by the structure and operations of the FBO and the complementary relationship between home and host-country regulation.

2. To the extent that horizontal reviews are used to evaluate banking organizations, whether for purposes of LFI ratings or otherwise, relevant cohorts should be separated by the categories laid out in the Tailoring Rules, reflecting the differing risk profiles and regulatory requirements applicable to each.

In recent years, the Federal Reserve has made more frequent use and placed greater emphasis on horizontal supervisory assessments in a variety of supervisory areas including capital, liquidity, governance, and cybersecurity. Under the Federal Reserve's new LFI Rating System, horizontal reviews are likely to become even more important to the supervisory process.[12] When conducted appropriately, the use of 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—if not conducted properly. There is a risk that horizontal reviews (i) will be used not simply to gather information or assess compliance with existing policy, but instead to make and enforce new policy; and (ii) may result in the application of "one size fits all" supervisory expectations across banking organizations.

To the extent that firms are subject to horizontal reviews, the cohorts should be determined according to the categorization established by the Tailoring Rules. These cohorts should be overseen, and modified as necessary, by the Federal Reserve oversight bodies responsible for the supervision of all of the firms in that cohort (and not only the oversight bodies responsible for the supervision of the largest or most complex firms in that cohort). This would more appropriately align the scope and substance of the Federal Reserve's supervisory processes with the diverse

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12 *See* 83 Fed. Reg. 58724, 58724-25 ("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 large financial institutions 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."); 58728 ("A firm's capital rating under the LFI rating system will reflect a broad assessment of the firm's capital planning and positions, based on horizontal reviews and firm-specific supervisory work focused on capital planning and positions"); and regarding the Liquidity Risk Management and Positions rating: ("As for all component ratings, horizontal and firm-specific examination work conducted under the LISCC liquidity program, which is inclusive of the horizontal work covered under the CLAR, will represent a material input into a firm's liquidity rating").

activities, business models, and risk profiles of these firms. In addition, the Federal Reserve should seek comment or clarify how and when horizontals are used as a supervisory tool generally.

In addition to organizing the cohorts to reflect the categories in the Tailoring Rules, the Federal Reserve should actively ensure that it does not hold individual firms, even within the same cohort, to standards of other firms that may have different risk profiles, activities portfolios, or business models—best practices should be specific to the risk profile of the individual firm. For example, internal modeling assumptions or model risk governance used by one firm should not automatically be imposed or used as a benchmark for evaluating other firms in the cohort.

B. The scope and substance of the Federal Reserve's specific supervisory expectations for capital planning and positions of certain firms should be revised to appropriately reflect the categorization and differentiation established in the Tailoring Rules, and SR 15-18 and SR 15-19 should be revised via notice and comment processes to memorialize those changes.

SR 15-18[13] sets out the Federal Reserve's supervisory expectations for capital planning for bank holding companies ("BHCs") and U.S. intermediate holding companies ("IHCs") that are either (i) subject to the LISCC framework; or (ii) have total consolidated assets of $250 billion or more or consolidated total on-balance sheet foreign exposure of $10 billion or more. SR 15-19[14] sets out the Federal Reserve's supervisory expectations for capital planning for BHCs and U.S. IHCs that have total consolidated assets of at least $50 billion but less than $250 billion, have consolidated total on-balance sheet foreign exposure of less than $10 billion, and are not otherwise subject to the LISCC framework.

The Federal Reserve should revise the applicability thresholds for SR 15-18 and SR 15-19, and any supervisory expectations set forth in those guidance documents, to align them with the categories established in the Tailoring Rules via notice and comment processes, including removing references to the on-balance sheet foreign exposure threshold. The Federal Reserve (as well as the other Agencies) should also remove references to the $10 billion threshold for on-balance sheet foreign exposure from other regulations or guidance documents in order to be consistent with the categories established by the Tailoring Rules. Similarly, the use of particular supervisory cohorts should align with the categories established in the Tailoring Rules.

For example, the applicability threshold for SR 15-18 is tied to the prior advanced approaches thresholds and not to any statutory mandate. The Tailoring Rules essentially confirm the Federal Reserve's view that Category III firms are not deemed advanced approaches banking organizations. Moreover, Category III firms are not "large and complex firms"[15] and are far more similar in terms of business model and risk profile to firms in Category IV than firms in Category I or Category II. Accordingly, the Federal Reserve should modify SR 15-18 and SR 15-19 to expressly clarify that Category III firms are subject only to the expectations set forth in SR 15-19.

Consistent with EGRRCPA and recent action by the Agencies to modify regulatory standards to reflect the risk profile of firms with less than $100 billion in total consolidated assets (*e.g.*, exempting all banking organizations

13 Federal Reserve, Division of Banking Supervision and Regulation, *Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms*, SR 15-18 (Dec. 18, 2015), https://www.federalreserve.gov/supervisionreg/srletters/sr1518.htm.

14 Federal Reserve, Division of Banking Supervision and Regulation, *Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms*, SR 15-19 (Dec. 18, 2015), https://www.federalreserve.gov/supervisionreg/srletters/sr1519.htm.

15 *See* Press Release, *Statement on Proposals to Modify Enhanced Prudential Standards for Large Banking Organizations by Vice Chairman for Supervision Randal K. Quarles* (Oct. 31, 2018), https://www.federalreserve.gov/newsevents/pressreleases/quarles-opening-statement-20181031.htm ("[LCR] reduction of this magnitude is appropriate because most U.S. banking firms in [Category III] are not engaged in complex activities….").

with less than $100 billion in assets from company-run stress tests),[16] the Federal Reserve should also exclude Category IV firms from the supervisory expectations set forth in SR 15-19, and create targeted guidance for these firms to the extent it considers guidance necessary for that cohort.

C. The scope and substance of any Federal Reserve supervisory exercises specific to liquidity, including its Comprehensive Liquidity Assessment and Review, should appropriately reflect the categorization and differentiation established in the Tailoring Rules.

The Federal Reserve's approach to liquidity supervision is already appropriately tailored, and should serve as a model for more tailored capital and capital planning supervision. The CLAR is "the Federal Reserve's annual, horizontal, forward-looking program to evaluate the liquidity position and liquidity risk management practices of LISCC firms."[17] Only Category I firms should be subject to CLAR, and any similar exercises to which other firms may be subjected should be organized by, and evaluated against, cohorts of similarly situated banks that align with the categories outlined in the Tailoring Rules for liquidity risk management purposes.

III. For purposes of evaluating a firm's LFI rating, the standard and scope of supervisory review should align with the standards included in the Tailoring Rules.

In November 2018, the Federal Reserve finalized the LFI Rating System that is composed of three component categories, Capital Planning and Positions, Liquidity Risk Management and Positions, and Governance and Controls.[18] This new system replaces the RFI/C(D) rating system for covered firms, and became effective for BHCs and U.S. IHCs of FBOs that are subject to the LISCC framework in early 2019. The Federal Reserve will assign ratings using the LFI Rating System to BHCs with assets of $100 billion or more and U.S. IHCs of FBOs that are not subject to the LISCC framework in early 2020.[19]

The development of the LFI Rating System is an important and positive step toward a clearer, more consistent, and more objective supervisory approach to ratings that is better aligned with the goal of promoting safety and soundness. Yet potential ambiguity exists as to whether firms will be evaluated, and ratings assigned, on the basis of the revised regulatory requirements, or if instead firms will nonetheless be assessed against, or held to, requirements that the Tailoring Rules ultimately eliminated or modified for institutions in certain categories. It is therefore crucial that the Federal Reserve expressly confirm, via notice and comment revisions to the LFI Rating System document, that its supervisory expectations for purposes of evaluating the three component categories of the LFI Rating System will align and be consistent with the standards included in the Tailoring Rules.

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16 *See* Federal Reserve, FDIC and OCC, *Interagency Statement Regarding the Impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)* at 1-2 (July 6, 2018), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706a1.pdf.

17 *See* Federal Reserve, Division of Banking Supervision and Regulation, *Governance Structure of the Large Institution Supervision Coordinating Committee (LISCC) Supervisory Program,* SR 15-7 (Apr. 17, 2015), https://www.federalreserve.gov/supervisionreg/srletters/sr1507.htm.

18 Federal Reserve, *Large Financial Institution Rating System; Regulations K and LL*, 83 Fed. Reg. 58724 (Nov. 21, 2018), https://www.federalreserve.gov/newsevents/pressreleases/files/2018-25350.pdf; Federal Reserve, *Large Financial Institution Rating System; Regulations K and LL*, 84 Fed. Reg. 4309 (Feb. 15, 2019), https://www.govinfo.gov/content/pkg/FR-2019-02-15/pdf/2019-02516.pdf. *See also* Federal Reserve, Division of Supervision and Regulation, Division of Consumer and Community Affairs, *Large Financial Institution (LFI) Rating System*, SR 19-3 / CA 19-2 (Feb. 26, 2019), https://www.federalreserve.gov/supervisionreg/srletters/sr1903.htm; Federal Reserve, Division of Supervision and Regulation, Division of Consumer and Community Affairs, *Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 billion*, SR 19-4 / CA 19-3 (Feb. 26, 2019), https://www.federalreserve.gov/supervisionreg/srletters/sr1904.htm.

19 Our discussion here is focused on the LFI Rating System given its recent issuance, but we note that similar issues are posed by, and similar changes should be made to, the Federal Reserve's RFI rating system for institutions to which it continues to apply.

A. **The Federal Reserve's evaluation of a firm's Liquidity Risk Management and Positions component of the LFI Rating System should be consistent with the liquidity regulatory requirements that apply to that firm.**

1. **For purposes of evaluating the Liquidity Risk Management and Positions component of a Category III or IV firm's LFI rating, the Federal Reserve's standard and scope of supervisory review should reflect the less stringent quantitative liquidity standards included in the Tailoring Rules.**

The Liquidity Risk Management and Positions component of the LFI Rating System requires an evaluation of "the sufficiency of a firm's liquidity positions to comply with applicable regulatory requirements and to support the firm's ongoing obligations through a range of conditions."[20] The Federal Reserve has indicated that it will evaluate "the firm's compliance with the liquidity risk management requirements of Regulation YY," including the liquidity risk management and stress testing requirements in Regulation YY,[21] in order to determine the firm's Liquidity Risk Management and Positions component rating.[22] Liquidity regulatory requirements in the scope of the Liquidity Risk Management and Positions component also include the Federal Reserve's LCR rule in Regulation WW, including both the "full" and "reduced", less stringent version of the LCR, as applicable.[23]

Because the Tailoring Rules eliminate LCR requirements for some firms and reduce them for others,[24] it is essential that evaluation of the Liquidity Risk Management and Positions component of a firm's LFI rating does not become a vehicle to reintroduce more stringent expectations in practice.

Category IV firms. Under the Interagency Tailoring Rule, Category IV firms with less than $50 billion in weighted short-term wholesale funding are no longer subject to the LCR. Accordingly, the Federal Reserve should confirm it will not use any form of the LCR as a proxy for determining the Liquidity component of the Liquidity Risk Management and Positions Component of such Category IV firm's LFI rating. Although Category IV banks, through their holding companies, remain subject to monthly FR 2052a reporting requirements, the Federal Reserve helpfully confirmed in the Federal Reserve Tailoring Rule that it will not use FR 2052a reporting to implicitly bind such Category IV banks to the LCR rule.[25]

Under the Tailoring Rules, Category IV firms with $50 billion or more in weighted short-term wholesale funding are subject to a reduced (70%) monthly LCR. The Federal Reserve should confirm that it will use the reduced LCR for determining the Liquidity Risk Management and Positions component of such Category IV firms' LFI rating.

Category III firms. Category III firms with less than $75 billion in weighted short-term wholesale funding ("qualifying Category III banks") are no longer subject to the full LCR, but are subject to a reduced (85%) daily LCR.

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[20] 83 Fed. Reg. 58724, 58734.

[21] 82 Fed. Reg. 39049, 39050, n. 9, 39052. *See* 12 C.F.R. §§ 252.34–35 and 252.156–157.

[22] 83 Fed. Reg. 58724, 58728.

[23] The Federal Reserve currently applies a less stringent, modified LCR requirement to bank holding companies and certain savings and loan holding companies with $50 billion or more, but less than $250 billion, in total consolidated assets and less than $10 billion in total on-balance sheet foreign exposure. *See* 12 C.F.R. part 249.

[24] We understand similar changes would be made to the proposed Net Stable Funding Ratio if and when that rule is finalized.

[25] 84 Fed. Reg. 59032, 59066.

The Federal Reserve should confirm that it will use the reduced LCR for determining the Liquidity Risk Management and Positions component of such qualifying Category III firms' LFI rating.

2. For purposes of evaluating the Liquidity Risk Management and Positions component of a Category III or IV firm's LFI rating, the Federal Reserve's supervisory expectations for liquidity stress testing practices should reflect the Tailoring Rules.

The Liquidity Risk Management and Positions component also requires an evaluation of "the effectiveness of a firm's governance and risk management processes used to determine the amount of liquidity necessary to cover risks and exposures, and to support activities through a range of conditions."[26] This may include, for example, an evaluation of the firm's liquidity stress testing practices, including those designed to meet the liquidity risk management and stress testing requirements articulated in Regulation YY.[27] As a general matter, the Federal Reserve's evaluation of the Liquidity Risk Management and Positions component should take into account a firm's *entire* liquidity governance and risk management processes, and not be limited to an evaluation of the firm's compliance with the LCR. In particular, the Federal Reserve should not evaluate a firm's internal, company-designed liquidity stress testing assumptions against the standardized, supervisor-designed outflow and inflow rates of the LCR. Together, these two liquidity requirements create a robust and complementary liquidity stress testing and risk measurement framework. However, they were designed to serve two different purposes: one a uniform benchmark of liquidity adequacy (the LCR), the other an internal measure of idiosyncratic risk (Regulation YY). To the extent that the Federal Reserve uses the LCR in evaluating the Liquidity Risk Management and Positions component of the LFI rating for Category III or IV firms, it should take into account whether, as a result of the Tailoring Rules, the firm is subject to the full LCR, the reduced LCR, or is not subject to the LCR at all.

Because most Category IV firms are no longer subject to any form of LCR or other quantitative liquidity requirements, the Federal Reserve should confirm that a Category IV firm's liquidity stress testing assumptions will not be evaluated against (or by comparison to) the standardized outflow and inflow rates of the LCR when evaluating the Liquidity Risk Management and Positions component of a firm's LFI rating. Similarly, the Federal Reserve should confirm that it will not evaluate a qualifying Category III firm's liquidity stress testing assumptions against (nor compare them to) the standardized outflow and inflow rate of the full LCR. Instead, the Federal Reserve should evaluate those assumptions against the reduced LCR to which Category IV and qualifying Category III firms will be subject. Moreover, the Federal Reserve should confirm that it will use any data it collects from a Category IV firm in connection with its supervisory review of the firm's liquidity risk management practices only to evaluate the firm's liquidity stress testing assumptions.

B. The Federal Reserve's evaluation of a firm's Capital Planning and Positions component of the LFI Rating System should be consistent with the capital regulatory requirements that apply to that firm.

1. A Category IV firm no longer subject to company-run stress testing requirements under Regulation YY should not be subject to supervisory expectations under the Capital Planning and Positions component of that firm's LFI rating that effectively impose the same or comparable requirements.

In evaluating the Capital Planning and Positions component, the Federal Reserve evaluates "the extent to which a firm maintains sound capital planning practices through effective governance and oversight; effective risk management and controls; maintenance of updated capital policies and contingency plans for addressing potential

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[26] 83 Fed. Reg. 58724, 58734.

[27] 82 Fed. Reg. 39049, 39050, n. 9, 39052.

shortfalls; and incorporation of appropriately stressful conditions into capital planning and projections of capital positions."[28]

The Federal Reserve has indicated that "[a]ny findings from supervisory stress testing, such as CCAR or similar activities, will represent inputs into the Capital Planning and Positions component rating."[29] Under the Tailoring Rules, Category IV firms are no longer subject to company-run stress testing requirements under subpart B of Regulation YY; they do, however, remain subject to CCAR on a two-year cycle, supervisory stress testing on a two-year cycle, annual capital plan submissions, and FR Y-14 reporting requirements. It is therefore important that evaluation of the Capital Planning and Positions component of a Category IV firm's LFI rating does not become a vehicle to effectively reintroduce, in practice, the company-run stress testing requirements currently imposed on these firms under subpart B of Regulation YY.

The Federal Reserve indicated that, as part of a separate rulemaking on the capital plan rule (12 C.F.R. § 225.8) and CCAR, the Federal Reserve may propose to allow Category IV firms to include in their annual capital plan submissions under the capital plan rule, estimates of revenues, losses, reserves and capital levels based on a forward-looking analysis, taking into account the firm's idiosyncratic risks under a range of conditions, but would *not* require those firms to submit the results of company-run stress tests on the FR Y-14A.[30] As noted in our Domestic Tailoring Comment Letter, it is important that the Federal Reserve make clear in the capital plan proposal that the requirement that submissions under the capital plan rule take into account "the firm's idiosyncratic risks under a range of conditions" is intended to be distinct from the current requirement in the capital plan rule that capital plans must include projections "under expected conditions and a range of scenarios,"[31] and that the Federal Reserve would not apply this requirement to Category IV firms in a manner that effectively demands that they perform and include the results of company-run stress tests akin to those currently required under subpart B of Regulation YY in their capital plan submissions.[32]

Helpfully, the Federal Reserve acknowledged this potential concern in the final Federal Reserve Tailoring Rule and indicated that it plans to propose changes to the capital plan rule as part of a separate proposal, "including providing firms subject to Category IV standards additional flexibility to develop their annual capital plans."[33] In doing so, the Federal Reserve should be clear that its expectations for Category IV firms under the capital plan rule will not effectively nullify the relief granted to these firms with respect to company-run stress testing under Regulation YY. Specifically, the Federal Reserve should clearly state in the capital plan proposal that Category IV firms would not be required to conduct any formal company-run stress test along the lines of what is currently required under Regulation YY as part of the forward-looking analysis. This would be consistent with the policy objectives of the EGRRCPA and the elimination of company-run stress testing requirements for Category IV firms.

For consistency, the Federal Reserve should also confirm that it will not expect a Category IV firm, as a matter of evaluating its Capital Planning and Positions component, to produce company-run stress test results or stress projections.

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28 83 Fed. Reg. 58724, 58735.

29 83 Fed. Reg. 58724, 58728.

30 Federal Reserve, *Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies*, 83 Fed. Reg. 61408, 61421 (Nov. 29, 2018), https://www.govinfo.gov/content/pkg/FR-2018-11-29/pdf/2018-24464.pdf

31 12 C.F.R. § 225.8(e)(2)(i)(A).

32 Domestic Tailoring Comment Letter at 13–14.

33 84 Fed. Reg. 59032, 59052.

2. The Federal Reserve should clarify how the two-year cycle Comprehensive Capital Analysis and Review cycle, two-year supervisory stress testing cycle, and two-year company-run stress testing cycle will be factored into a firm's annual LFI rating.

As noted above, the Tailoring Rules make changes to the frequency of stress testing requirements for Category IV firms, requiring a quantitative review of capital plans under CCAR and supervisory stress testing on a two-year cycle. The Tailoring Rules also reduce the frequency of Category III firms' company-run stress tests; such firms are required to submit internal stress test results to the Federal Reserve as part of its annual capital plan submission, but are required to publicly disclose its company-run Dodd-Frank Act Stress Test results only once every two years.

In finalizing the LFI Rating System, the Federal Reserve noted that firms that are not LISCC firms will receive all three component ratings under the LFI rating system in early 2020; following the initial rating assignment, the Federal Reserve may assign and communicate updates to individual rating components to firms on a rolling basis, but at least annually.[34] Given the annual (or rolling) cycle of the LFI Rating System, it is not clear how the two-year CCAR cycle, two-year supervisory stress testing cycle, and two-year company-run stress testing cycle will be factored into a Category III or IV firm's annual LFI rating. However, if the Federal Reserve ultimately decides to evaluate the results of the two-year cycle stress tests in a firm's annual LFI Rating, it should ensure as a supervisory matter that its approach is consistent and aligned with the categories established in the Tailoring Rules.

C. The Federal Reserve should clarify how firms in each of the categories established in the Tailoring Rules are evaluated for purposes of the Governance and Controls component of the LFI Rating System.

As with capital and liquidity matters, the Federal Reserve should be more specific as to how firms in each of the categories established in the Tailoring Rules are evaluated for purposes of the Governance and Controls component of the LFI Rating System. For example, we note that the Federal Reserve has two outstanding proposals that would articulate the Federal Reserve's supervisory expectations related to the core responsibilities of the largest firms' boards of directors and risk management functions, respectively.[35] In finalizing that guidance, the Federal Reserve should use the categories established in the Tailoring Rules to specify and differentiate its expectations for different firms subject to the guidance.

The Federal Reserve also should review existing relevant guidance and make revisions via notice and comment processes to reflect the tailoring categories and ensure that, in practice, its supervisory expectations for firms are consistent with the categories established in the Tailoring Rules. For example, a firm's internal audit function and internal audit practices, including whether it is appropriate for the firm to outsource some or all of the internal audit function, vary significantly depending on the size and risk profile of the particular firm. Accordingly, the Federal Reserve should consider updating its Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing[36] to reflect the categories established in the Tailoring Rules. Similarly, the Federal Reserve's Guidance

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34 83 Fed. Reg. 58724, 58726 n. 15.

35 Federal Reserve, *Proposed Guidance on Supervisory Expectations for Boards of Directors*, 82 Fed. Reg. 32719 (Aug. 9, 2017), https://www.govinfo.gov/content/pkg/FR-2017-08-09/pdf/2017-16735.pdf; Federal Reserve, *Proposed Supervisory Guidance*, 83 Fed. Reg. 1351 (Jan. 11, 2018), https://www.govinfo.gov/content/pkg/FR-2018-01-11/pdf/2018-00294.pdf.

36 Federal Reserve, Division of Banking Supervision and Regulation, Division of Consumer and Community Affairs *Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing*, SR 13-1 / CA 13-1 (Jan. 23, 2013), https://www.federalreserve.gov/supervisionreg/srletters/sr1301.htm.

on Model Risk Management[37] should be updated to reflect the Tailoring Rules, as firms' model risk management practices and supervisory expectations do and should vary based on the firm's risk profile.

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The Bank Policy Institute appreciates the opportunity to comment on the Tailoring Rules. If you have any questions, please contact the undersigned by phone at (202) 589-2424 or by email at dafina.stewart@bpi.com.

Respectfully submitted,

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[37] Federal Reserve, Division of Banking Supervision and Regulation, *Guidance on Model Risk Management*, SR 11-7 (Apr. 4, 2011), https://www.federalreserve.gov/supervisionreg/srletters/sr1107.htm.