July 24, 2023

Via Electronic Mail

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

Re: Petition for Rulemaking and FOIA Request Concerning Models and Stress Scenarios Used to Determine Stress Capital Buffer Requirements

Ladies and Gentlemen:

The Bank Policy Institute and the American Bankers Association are writing to petition the Board of Governors of the Federal Reserve System under section 553(e) of the Administrative Procedure Act to engage in rulemaking to seek public comment on, and codify by rule, any and all models, formulas, or other decisional methodologies that the Board uses to calculate the "stress capital buffer requirement" imposed pursuant to 12 C.F.R. § 217.11, including any component, subcomponent or other aspect of the "stress capital buffer requirement calculation" performed pursuant to 12 C.F.R. § 225.8(f). We further request, immediately and notwithstanding whatever action the Board takes on that petition for rulemaking, that the Board also make available to us and to the public all such models, formulas, and other decisional methodologies pursuant to the affirmative disclosure requirements of the Freedom of Information Act (5 U.S.C. § 552(a)). Finally, we also further petition the Board pursuant to section 553(e) of the APA to engage in rulemaking to seek public comment, and codify by rule, any and all scenarios used in any stress test exercise on which stress capital buffer requirements will be based, which rulemaking should be completed no less than thirty days prior to such stress test exercise.

We believe that, by granting these requests, the Board can remedy the serious existing legal defects that currently undermine the credibility and effectiveness of the Board's framework for setting stress-based capital requirements. In addition, granting these requests would acknowledge that the development of stress test models and scenarios is a complex and challenging task that could benefit from public review and a range of external perspectives, rather than relying solely on the views of the Board, its staff, and its private advisors.

Background

Large bank holding companies subject to the Board's stress capital buffer framework are legally obligated to maintain a stress capital buffer as calculated annually or biennially under the Board's Regulation Y. Any BHC that fails to maintain its required stress capital buffer is subject to automatic restrictions under Regulation Q on capital distributions, which include limitations on dividends to shareholders, share repurchases, and executive compensation.[1] By rule, calculation of each BHC's stress capital buffer requirement is a mechanical and mathematical function of the results of the supervisory stress tests conducted periodically by the Board.[2] The rule's incorporation of the stress test by reference is intentional and explicit – as the Board has repeatedly acknowledged, "[t]he stress capital buffer requirement … is determined from the stress test results."[3]

As the Board has also acknowledged, "[i]n the supervisory stress test, the Federal Reserve uses supervisory models that are developed internally and independently" by the Board.[4] These supervisory models and related assumptions include (i) models used to project the components of pre-tax net income and accumulated other comprehensive income, including pre-provision net revenue, operational risk losses, loan losses and provisions on loans measured at amortized cost, losses on loans measured on a fair-value basis, losses on securities in the available-for-sale and held-to-maturity portfolios, unrealized gains or losses on the fair value of available-for-sale debt securities, losses on trading and private equity exposures and credit valuation adjustment, and counterparty losses, and (ii) assumptions driving the evolution of balance sheet items, taxes, risk-weighted assets, as well as the calculation of regulatory capital ratios. These supervisory models and assumptions are applied in a uniform manner to each BHC subject to the relevant stress test; the Board "uses the same set of models and assumptions to produce loss projections for all covered companies participating in the supervisory stress test."[5] Thus, "[d]ifferences in covered companies' results reflect differences in firm-specific risks and input data instead of differences in modeling assumptions."[6] In cases where "it is not possible or

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1 *See* 12 C.F.R. § 217.11.

2 Specifically, 12 C.F.R. § 225.8(f)(2) states that a "[a] bank holding company's stress capital buffer requirement is equal to the greater of: (i) The following calculation: (A) The ratio of a bank holding company's common equity tier 1 capital to risk-weighted assets, as calculated under 12 CFR part 217, subpart D, as of the final quarter of the previous capital plan cycle, unless otherwise determined by the Board; minus (B) The lowest projected ratio of the bank holding company's common equity tier 1 capital to risk-weighted assets, as calculated under 12 CFR part 217, subpart D, in any quarter of the planning horizon under a supervisory stress test; plus (C) The ratio of: (1) The sum of the bank holding company's planned common stock dividends (expressed as a dollar amount) for each of the fourth through seventh quarters of the planning horizon; to (2) The risk-weighted assets of the bank holding company in the quarter in which the bank holding company had its lowest projected ratio of common equity tier 1 capital to risk-weighted assets, as calculated under 12 CFR part 217, subpart D, in any quarter of the planning horizon under a supervisory stress test; and (ii) 2.5 percent."

3 *See, e.g.*, Board of Governors of the Federal Reserve System, *Federal Reserve Board announces the individual capital requirements for all large banks*, effective on October 1 (Aug. 4, 2022) (press release).

4 12 C.F.R. pt. 252, Appendix B at § 1.1(a).

5 *Id.*

6 *Id.*

appropriate to create a supervisory model for use in the stress test," the Federal Reserve may also use "third-party models or data" to determine losses and revenues under stress.[7]

In the simplest terms, each of these supervisory and third-party models used by the Board in its stress tests is a mathematical formula derived from statistical models. These mathematical formulas are applied to the portfolios of the individual BHCs subject to each stress test to calculate the lowest projected common equity tier 1 capital ratio over the planning horizon. The difference between this ratio and the BHC's starting ratio serves as the primary determinant of the stress capital buffer to which the BHC is legally obligated to adhere under the Board's regulations.

Notwithstanding the fact that the stress tests clearly result in binding capital requirements, the Board to date has failed to publicly disclose, let alone issue for public comment by rulemaking, the models, mathematical formulas and other decisional methodologies that it uses to calculate BHCs' legally binding stress capital buffer requirements; instead, it keeps the mathematical formulas of the stress capital buffer calculation secret. As described further below, these secret rules violate both the rulemaking and publication requirements of the Administrative Procedure Act – fundamental defects which we request that the Board remedy as soon as possible.

Similar problems exist with respect to the stress test *scenarios* that the Board develops and applies in each year's annual stress testing exercise. As Board rules and policy statements describe, "[t]he stress tests evaluate the financial resilience of large banks by estimating bank losses, revenues, expenses, and resulting capital … under hypothetical recession scenarios into the future," and the Board "uses the results of the stress test to set large bank capital requirements."[8] Like the Board's stress testing models, these annual scenarios are essential elements of the methodology by which it determines stress capital buffer requirements for BHCs, and even small variations in those scenarios may result in large changes in the resulting stress capital buffer requirement to which a BHC is legally bound. Unlike the Board's stress test models, the Board *does* publicly disclose its stress testing scenarios each year, but it does so by fiat, not by notice-and-comment rulemaking. Because its failure to seek public comment on these scenarios also violates the APA's rulemaking requirement, as described further below, we also request that it remedy that profound defect here.

Petition for Rulemaking concerning the Board's Stress Test Models

For the foregoing reasons, we petition the Board to take action to propose, through notice-and-comment rulemaking, any and all models, assumptions, formulas or other decisional methodologies it uses to calculate or determine any component, subcomponent or other aspect of the "stress capital buffer requirement calculation" performed pursuant to 12 C.F.R. § 225.8(f), including but not limited to all models identified or described in the *2023 Supervisory Stress Test*

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7 *Id.*

8 Board of Governors of the Federal Reserve System, *2023 Stress Test Scenarios* (Feb. 2023), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230209a1.pdf.

Methodology published by the Board in June 2023 (such information collectively, the "Stress Test Models").[9]

The reason the Board should do so is simple and singular: the law requires it. The Stress Test Models determine the stress capital buffer requirement with which BHCs legally must comply pursuant to 12 C.F.R. § 217.11; therefore, the Stress Test Models are an "agency statement of general…applicability and future effect designed to … prescribe law" and are a rule under the APA.[10] As the Board is well aware, the APA requires that (i) the public have an opportunity, through notice-and-comment rulemaking, to meaningfully participate in the development of all relevant aspects of the stress testing rules, and (ii) the Board provide BHCs with adequate notice of what the law requires before they are subjected to Board-imposed restrictions.[11] The various models and processes that the Board applies each year to calculate stress capital buffers are never publicly disclosed, let alone subjected to notice-and-comment rulemaking.

Significant case law authority under the APA makes clear that this approach is legally unacceptable; that case law directly addresses the status of models under the APA and concludes that agencies must subject any model that establishes binding regulatory requirements to the notice-and-comment rulemaking process in order to protect the integrity of the process and to prevent agencies from basing rules on unsupportable analysis.[12] For example, in *Owner-Operator Indep. Drivers Ass'n, Inc. v. Fed. Motor Carrier Safety Admin.*, the court held that the Federal Motor Carrier Safety Administration violated the APA when it failed to subject to the public notice-and-comment process certain elements of a model that it had used to assess the merits of the rule it ultimately promulgated, concluding, that "[i]n light of … undisclosed elements, we cannot say that the agency's … model was made public in the proceeding and exposed to refutation as required by the APA."[13] In the case of the Stress Test Models, the models do not merely serve as the basis of justification for the rule, but as a part of the rule itself,

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[9] See Board of Governors of the Federal Reserve System, *2023 Stress Test Methodology* (Jun. 2023), *available at* www.federalreserve.gov/publications/files/2023-june-supervisory-stress-test-methodology.pdf. For purposes of this letter's requests, the term "model" has the same meaning given to that term in the Board's *Supervisory Letter SR 11-7: Guidance on Model Risk Management*, but does not include (i) any portfolio or other data provided by an individual firm that is used an *input* to any model nor (ii) the *output* of any model as calculated on the basis of any such inputs.

[10] 5 U.S.C. § 551(4).

[11] *See* 12 U.S.C. § 553.

[12] *See, e.g.*, *Sierra Club v. Costle*, 657 F.2d 298, 334 (D.C. Cir. 1981); *American Radio Relay League, Inc. v. F.C.C.*, 524 F.3d 227, 236 (D.C. Cir. 2008) ("Public notice and comment regarding relied-upon technical analysis, then, are [t]he safety valves in the use of . . . sophisticated methodology . . . Enforcing the APA's notice and comment requirements ensures that an agency does not . . . play hunt the peanut with technical information, hiding or disguising the information that it employs."); *McLouth Steel Products Corp. v. Thomas*, 838 F.2d 1317, 1320-22 (D.C. Cir. 1988); *U.S. Air Tour Ass'n v. F.A.A.*, 298 F.3d 997, 1008 (D.C. Cir. 2002) (noting that "[w]hen an agency uses a computer model, it must explain the assumptions and methodology used in preparing the model and, if the methodology is challenged, must provide a complete analytic defense" of the model) (internal quotation marks omitted); *Owner-Operator Indep. Drivers Ass'n, Inc. v. Fed. Motor Carrier Safety Admin.*, 494 F.3d 188, 202 (D.C. Cir. 2007).

[13] *Fed. Motor Carrier Safety Admin.*, 494 F.3d at 202 (internal quotation marks omitted).

thereby making the APA notice-and-comment process all the more necessary to follow in this context.

The Board's current approach is plainly inconsistent with this authority. These legal matters are addressed in greater detail in the attached prior comment letter of The Clearing House Association L.L.C., a predecessor to the Bank Policy Institute, which is attached as *Appendix A* to this letter and incorporated herein. Furthermore, as part of the notice-and-comment process legally required in this context, the APA states that an agency "shall give interested persons an opportunity to participate in the rulemaking through submission of written data, views or arguments,"[14] an opportunity that the current Fed process denies them but which is sorely needed in order to produce a credible stress test.

This petition is made pursuant to section 553(e) of the APA, and we respectfully request a response as is required by law. Section 553(e) provides that "[e]ach agency shall give an interested person the right to petition for the issuance, amendment, or repeal of a rule," a denial of which must be justified by a statement of reasons pursuant to section 555(e) of the APA and can be appealed to the courts under sections 702 and 706 of the APA.[15] We note that the APA requires that "[p]rompt notice … be given of the denial in whole or in part" of any petition under 5 U.S.C. § 553, and that any denial shall include a "brief statement of the grounds for denial."[16]

FOIA Request for the Board's Stress Test Models

For the same reasons, immediately and notwithstanding whatever action the Board takes on the above petition for rulemaking, we also request that the Board make available to us and the public all pertinent details of the Stress Test Models pursuant to the affirmative disclosure requirements of the Freedom of Information Act.[17]

We note that such public disclosure by the Board is legally mandated under the APA's publication requirement, which is part of FOIA. That requirement obligates federal agencies to publish substantive rules of general applicability, statements of general policy, and interpretations of general applicability in the Federal Register and to "make available for inspection in an electronic format" statements of policy and interpretations not published in the Federal Register, as well as administrative staff manuals and instructions to staff that affect the public.[18] The Stress Test Models determine the stress capital buffer requirement with which BHCs legally must comply pursuant to 12 C.F.R. § 217.11; therefore, the Stress Test Models constitute the standard by which that requirement is determined and are a "substantive rule of

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[14] 5 U.S.C. §§ 553(c).

[15] *See* 5 U.S.C. §§ 553(e), 555(e), 702, and 706; *see also Auer v. Robbins*, 519 U.S.C 452 at 459 (1997).

[16] The D.C. Circuit has opined that while there is "no per se rule as to how long is too long" to wait for an agency action, a reasonable time for agency action is "typically counted in weeks or months, not years." *In re Am. Rivers & Idaho Rivers United*, 372 F.3d 413, 419 (D.C. Cir. 2004) (quoting *Midwest Gas Users Ass'n v. FERC*, 833 F.2d 341, 359 (D.C. Cir.1987)).

[17] *See* 5 U.S.C. §§ 552(a).

[18] 5 U.S.C. §§ 552(a)(1), (a)(2)(B), (a)(2)(C).

general applicability" subject to public disclosure and must be published in the Federal Register.[19]

As the Board is aware, 5 U.S.C. § 552(a)(1) also provides that "[e]xcept to the extent that a person has actual and timely notice of the terms thereof, a person may not in any manner be required to resort to, or be adversely affected by, a matter required to be published in the Federal Register and not so published." Thus, public disclosure and publication of the Stress Test Models will also address the substantial defects under this provision associated with the imposition of legally binding capital requirements on the basis of rules kept secret in violation of the APA's publications requirements.

We are willing to pay fees for this request up to a maximum of $100,000.00. If you estimate that the fees will exceed this limit, please contact us before processing our request. However, we would expect that the Board's own governance practices would require it to maintain an accurate inventory and documentation of all models that it uses to calculate certain firms' legal capital requirements, such that no exhaustive search should be required to identify the Stress Test Models the disclosure of which is requested here.

Petition for Rulemaking concerning the Board's Stress Test Scenarios

For the foregoing reasons, we also petition the Board to take action to propose, through notice and comment rulemaking, any and all scenarios used in any stress test exercise on which stress capital buffer requirements will be based, which rulemaking should be completed no less than thirty days prior to such stress test exercise being conducted (such scenarios collectively, the "Stress Testing Scenarios").[20]

The reason the Board should do so is again simple and singular: the law requires it. The Board's development of the annual stress test scenarios clearly constitutes rulemaking that requires use of notice-and-comment procedures under the APA. Without the stress test scenarios, the Board would lack any basis to conduct the stress tests and calculate stress capital buffer requirements in accordance with the results of the tests. And the scenarios do not interpret existing regulations or policy; they establish, anew each year, specific and critical elements of the stress test exercise that serve as the basis for calculating BHCs' legally binding capital

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[19] Although documents related to bank examinations are broadly excluded from FOIA, *see* 5 U.S.C. § 552(b)(8), the exemption cannot be applied here to allow the Board to shield rules of general applicability from disclosure to the public and from regulated entities. The exemption covers "examination, operating, or condition reports," 5 U.S.C. § 552(b)(8), and is designed to avoid public disclosure of sensitive bank information and to promote cooperation between banks and regulators. *See Public Investors Arbitration Bar Ass'n v. U.S. S.E.C.*, 930 F. Supp. 2d 55, 64 (D.D.C. 2013). These are clearly important interests, but they are not at issue here because the Stress Test Models are applied in a uniform manner to *all* BHCs subject to the stress capital buffer requirement and do not themselves contain confidential information.

[20] *See* Board of Governors of the Federal Reserve System, *2023 Stress Test Methodology* (Jun. 2023), *available at* www.federalreserve.gov/publications/files/2023-june-supervisory-stress-test-methodology.pdf.

requirements. Thus, the Board's current approach – unilateral establishment without rulemaking – is plainly inconsistent with the APA's rulemaking requirement.[21]

This petition concerning the stress test scenarios is made pursuant to Section 553(e) of the APA, and we respectfully request a response as is required by law.

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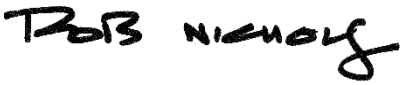
If you have any questions, please contact the undersigned by email at *greg.baer@bpi.com* and *nichols@aba.com*.

Sincerely,

Greg Baer
President and Chief Executive Officer Bank Policy Institute



Rob Nichols
Chief Executive Officer American Bankers Association

cc: Mark Van Der Weide
(General Counsel)

[21] These legal matters are again addressed in greater detail in the attached prior comment letter of The Clearing House Association L.L.C., a predecessor entity of the Bank Policy Institute, which is attached as *Appendix A* to this letter and incorporated herein.

Appendix A:

January 2018 Letter Concerning Stress Test Transparency & Administrative Law Matters

The Clearing House
At the Center of Banking Since 1853®

January 22, 2018

Via Electronic Mail

Mr. Mark Van Der Weide
General Counsel
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Stress Testing Framework: Increased Transparency Proposal Package (Docket Nos. OP-1586, OP-1587, OP-1588)

Mr. Van Der Weide:

The Clearing House Association L.L.C.[1] appreciates the opportunity to comment on the Board of Governors of the Federal Reserve System's proposed policy statements and disclosure enhancements related to scenario and model design for stress testing.[2] As we set forth in a companion comment letter focused on policy issues, we believe that the stress testing program will be greatly improved and strengthened by full transparency with respect to both the scenarios and models the Board employs in each CCAR exercise. We also believe, however, that such transparency is required as a matter of law. Accordingly, we focus in this letter on matters of administrative law and procedure related to the proposal, and in particular our concern that the Comprehensive Capital Adequacy Review ("CCAR") exercise—even as modified by the proposal—would continue to fall short of the public transparency standards required under the Administrative Procedure Act ("APA").

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[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 payment 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, Stress Testing Policy Statement, 82 Fed. Reg. 59,528 (Dec. 15, 2017); Federal Reserve System, Policy Statement on the Scenario Design Framework for Stress Testing, 82 Fed. Reg. 59,533 (Dec. 15, 2017); Federal Reserve System, Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test, 82 Fed. Reg. 59,547 (Dec. 15, 2017).

To be clear at the outset, we strongly support the Board's use of stress testing as a core component of the prudential framework for large banks. Given this importance, we strongly support the steps the Board has taken to publicly engage with and seek comment on, for the very first time, the appropriate level of public transparency into the scenarios and models the Board employs in CCAR.[3] Historically, the CCAR program has been what many have referred to as a "black box," with very little information shared with the public or regulated institutions about key and highly consequential elements of the exercise. Although the proposed disclosures would certainly represent an improvement over the current process, we believe that nothing short of full transparency and the opportunity for public comment concerning all aspects of the stress test scenarios and models the Board uses under CCAR are necessary, both as a matter of law and as a matter of sound administrative policy.

Simply put, the APA requires that (i) the public have an opportunity, through notice-and-comment rulemaking, to meaningfully participate in the development of all relevant aspects of the stress testing rules and (ii) the Federal Reserve provide banking institutions with adequate notice of what the law requires before they are subjected to Board-imposed restrictions. The CCAR framework continues to suffer from two fundamental deficiencies with respect to those requirements, neither of which the proposal would remedy. First, although the annual stress test scenarios employed in each CCAR exercise are publicly disclosed, they are established by the Board without public review and participation through notice-and-comment rulemaking. Second, the various models that the Board applies each year to estimate a bank's performance and resulting regulatory capital levels under the scenarios are never publicly disclosed, let alone subjected to notice-and-comment rulemaking. Yet there is significant case law authority under the APA that directly addresses the status of models under the APA, and which concludes that agencies must disclose the substance of any model that establishes binding regulatory requirements. The Board's current approach, under which the substance of the models is *never* disclosed, is inconsistent with this authority.

The legal shortcomings of the historical CCAR framework are especially concerning given the extraordinary importance of the CCAR exercise, both to regulated firms and to the broader U.S. economy. The CCAR framework can result, and often has resulted, in significant limitations on a bank's ability to distribute capital; it therefore acts as a key constraint on one of the most fundamental aspects of a bank's management and operation, functioning as a *de facto* capital requirement. There is no doubt that compliance with the CCAR framework is mandatory for regulated banks. And as we explain below, both the annual stress test scenarios and the underlying models that the Board employs in CCAR have a profound and dispositive impact on

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[3] *See, e.g.*, 92 Fed. Reg. 59,549 ("The Board requests comment on the proposed enhanced disclosure of the models used in the Federal Reserve's supervisory stress test . . . Specifically, feedback is requested on the following questions: Does the enhanced disclosure appropriately balance the benefits and costs of additional disclosure as outlined above? Would the enhanced disclosure allow the public, including academics, to comment on the soundness of the models and their alignment with best modeling practices? Are there specific ways the enhanced disclosures could be tailored to limit the potential for increased correlation of risks in the system? Are there additional disclosures that would be more helpful to the public without increasing the potential for increased correlation of risks in the system?").

the exercise's results, and thus are a key driver of whether and to what extent banks may engage in capital distributions. Moreover, the consequences of CCAR are substantial not just for banks, but also for the broader U.S. economy, which relies on banks to provide credit and other key financial intermediation services. As our prior research and other academic papers have clearly demonstrated,[4] because the Board's stress scenarios and models play such an important role in placing binding limits on banks' ability to manage and allocate capital, they ultimately have a large and meaningful impact on American consumers' and businesses' access to credit. Therefore, many members of the public beyond banks have a strong interest in public comment and could provide meaningful input on the Board's testing program.

For these reasons, ensuring that all aspects of the Board's CCAR scenarios and models are disclosed and subject to notice-and-comment rulemaking is essential both to legal compliance with the APA and sound regulatory policy.

I. Executive Summary

- All aspects of the Board's stress test scenarios and models are legislative rules requiring notice-and-comment rulemaking under the APA.
- The current stress test process, which does not seek comment on the scenarios and never discloses the models to regulated parties, violates the APA. The Board's proposals should be modified to provide that all aspects of the scenarios and models will be fully disclosed and adopted using notice-and-comment rulemaking.
- The use of notice-and-comment rulemaking under the APA will improve the accuracy and strengthen the credibility of the stress testing program.

II. All aspects of the Board's stress test scenarios and models are legislative rules requiring notice-and-comment rulemaking under the APA.

The law does not countenance secret or opaque administrative procedures: as the Supreme Court has made clear, "[a] fundamental principle in our legal system is that laws which regulate persons or entities must give fair notice of conduct that is forbidden or required."[5] In

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[4] *See* The Clearing House, *The Capital Allocation Inherent in the Federal Reserve's Capital Stress Tests* (Jan. 2017), *available at* https://www.theclearinghouse.org/~/media/TCH/Documents/TCH%20WEEKLY/2017/20170130_WP_Implicit_Risk_Weights_in_CCAR.pdf; The Clearing House, *Are the Supervisory Bank Stress Tests Constraining the Supply of Credit to Small Businesses?* (May 2017), *available at* https://www.theclearinghouse.org/-/media/tch/documents/research/articles/2017/05/2017_05_12_small_business_lending.pdf; Viral V. Acharya et al., *Lending Implications of U.S. Bank Stress Tests: Costs or Benefits?*, Journal of Financial Intermediation (Aug. 18, 2017) (forthcoming), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2972919; Kristle Cortés et al., *Where are the Large Banks? Stress Tests and Small Business Lending*, (Oct. 2017) (manuscript), *available at* http://sydney.edu.au/business/__data/assets/pdf_file/0008/337463/Cortes_Stress_tests_SMB_Lending_Oct_30_2017.pdf.

[5] *F.C.C. v. Fox Television Stations, Inc.*, 567 U.S. 239, 253 (2012) (recognizing "two connected but discrete due process concerns: first, that regulated parties should know what is required of them so they may act

the agency decision-making context, this principle is primarily protected by the APA,[6] which establishes standards for agency action, including publication requirements, the use of mandated procedures and the proscription of arbitrary decision-making. While we strongly support the Board's efforts to reassess and seek public input on greater CCAR transparency, neither the current CCAR process nor the Board's proposed changes meet those standards.

The Board's stress testing process constitutes a set of substantive legal requirements that are binding on regulated institutions. An institution that fails to satisfy the demands of the Board's models and scenarios faces significant and immediate consequences. Among other things, the Board can restrict institutions from paying dividends and require modification of capital plans to align with Board expectations. And because the Board publicizes the results of the stress testing, institutions and their shareholders may suffer harm if an institution's submission is rejected by the Board. Given these substantial consequences, the Board's stress-test standards function as additional *de facto* capital standards on regulated institutions.

Despite the enormous potential impact of the stress testing standards on covered institutions—and on consumers, businesses, and the broader U.S. economy—the Board's proposal continues to keep crucial aspects of the CCAR framework nonpublic. The annual stress test scenarios, while made public shortly before each CCAR exercise, are not subject to notice and comment. The underlying models that drive CCAR results are never made public; indeed, even after testing is complete, they are not disclosed to institutions or the public for consideration and analysis. And further, the Board provides no detailed information about how the results of the various models are used to reach an overall conclusion about an institution, and whether this conclusion is based on a prescribed formula or on a more discretionary standard.

The Clearing House strongly urges the Board to adopt notice-and-comment procedures for the development of both the scenarios and models. Not only would this approach improve the quality of the stress testing process and render the Board's policy judgments more accountable and more credible, it is also required by the APA. Although the Board has undertaken several public rulemakings of relevance to CCAR, such as the capital plan and stress test rules and related policy statements, these rules and public pronouncements provide little more than a rough outline that leaves the substantive elements of the stress tests to be developed by the Board outside of any notice-and-comment process.[7] The requirements of the APA do not

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accordingly; second, precision and guidance are necessary so that those enforcing the law do not act in an arbitrary or discriminatory way").

[6] 5 U.S.C. § 551 *et seq*.

[7] *See, e.g.*, 12 C.F.R. § 252.44.

contemplate this type of process, under which an agency only publishes general standards and then later decides, behind closed doors, the actual binding rules that will apply.[8]

A. The annual stress test scenarios are legislative rules that must be established through notice-and-comment rulemaking under the APA

The Board's proposals contemplate a continuation of the current process for specifying stress test scenarios. Every year, the Board develops three scenarios for use in stress testing. The scenarios are used for the company-run stress tests required by 12 U.S.C. § 5365(i)(2), as well as the stress tests run by the Board, and every covered entity is evaluated according to the same set of scenarios.[9] The scenarios are announced by February 15 and stress testing must be completed by June 30.[10] Under the Board's proposals, the Board would continue to adhere to this process and would not subject the scenario assumptions to notice-and-comment rulemaking.

This approach cannot be squared with the requirements of the APA, under which each annual scenario is a legislative rule that must be promulgated via notice-and-comment procedures. The APA divides agency action into two primary categories: rulemaking and adjudication.[11] Rules are generally applicable requirements designed to have prospective legal effect. By contrast, adjudications involve individual determinations that "immediately bind parties by retroactively applying law to their past actions."[12] Not all types of rules require adherence to APA notice-and-comment rulemaking procedures. "Interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice" are exempted.[13] There is also an exception allowing an agency to issue rules without notice and comment "when the agency for good cause finds … that [these procedures] are impracticable, unnecessary, or contrary to the public interest."[14] But most rules—that is, rules of a "legislative" character designed to have binding prospective effect—require notice-and-comment procedures.

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[8] It is black-letter law that the APA does not allow an agency to promulgate an open-ended rule through notice-and-comment and then impose substantive requirements through interpretive statements. *See Elec. Privacy Info. Ctr. (EPIC) v. U.S. Dep't of Homeland Sec.*, 653 F.3d 1, 7 (D.C. Cir. 2011) ("[T]he purpose of the APA would be disserved if an agency with a broad statutory command . . . could avoid notice-and-comment rulemaking simply by promulgating a comparably broad regulation . . . and then invoking its power to interpret that statute and regulation in binding the public to a strict and specific set of obligations.").

[9] 82 Fed. Reg. 59,534; 82 Fed. Reg. 59,531. Banks also develop their own scenarios to account for idiosyncratic or unique risks.

[10] 12 C.F.R. § 252.44(b); 12 C.F.R. § 252.46(b)(1).

[11] *See Global Crossing Telecommunications, Inc. v. FCC*, 605 Fed. Appx. 4, 4 (D.C. Cir. May 15, 2015) ("[T]he Administrative Procedure Act's rulemaking-adjudication dichotomy is not open to mixing and matching.").

[12] *See Safari Club Int'l v. Zinke*, --- F.3d ----, 2017 WL 654114, at *11 (D.C. Cir. Dec. 22, 2017).

[13] 5 U.S.C. § 553(b)(A).

[14] 5 U.S.C. § 553(b)(B).

The principal test for whether a rule is "legislative" is whether the rule imposes legal obligations. The D.C. Circuit has identified four considerations in determining whether a rule is "legislative": "(1) whether in the absence of the rule there would not be an adequate legislative basis for enforcement action or other agency action to confer benefits or ensure the performance of duties, (2) whether the agency has published the rule in the Code of Federal Regulations, (3) whether the agency has explicitly invoked its general legislative authority, or (4) whether the rule effectively amends a prior legislative rule."[15]

The Board's development of the annual stress test scenarios clearly constitutes "legislative" rulemaking under this standard and thus requires use of notice-and-comment procedures under the APA.[16] *First*, without the stress test scenarios, the Board would lack any basis to conduct the stress tests and impose restrictions based on the results of the tests. Neither 12 U.S.C. § 5365(i)(2) nor its implementing regulations provide meaningful or enforceable standards, but instead direct the Board to create stress test scenarios. The scenarios do not interpret existing regulations or policy; they establish, anew each year, specific and critical elements of the CCAR process with which covered entities must comply. And failure to maintain adequate capital levels through each scenario has serious and substantive implications for regulated banks. *Second*, the Board's development and implementation of the stress test scenarios implements a statutory requirement that Congress has not exempted from ordinary rule-making procedures.[17] In implementing the scenarios and conducting the CCAR exercise, the Board thus "invokes its general legislative authority," much like any other federal agency does when it relies on a congressional authorization to impose binding legal obligations on private entities. The scenarios are therefore properly considered legislative rules, and unless a "good cause" exception applies, the scenarios should be promulgated by the Board through notice-and-comment rulemaking.[18]

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[15] *Am. Min. Cong. v. Mine Safety & Health Admin.*, 995 F.2d 1106, 1112 (D.C. Cir. 1993); *see also Nio v. United States Dep't of Homeland Sec.*, --- F. Supp. 3d ----, 2017 WL 3917006, at *11 (D.D.C. Sept. 6, 2017) ("[A] legislative rule can broadly be characterized as an agency action that purports to impose legally binding obligations or prohibitions on regulated parties or sets forth legally binding requirements for a private party to obtain a benefit.") (internal quotation marks omitted).

[16] We note also that the Board's use of binding scenarios and models clearly constitute "final agency action" under the APA. 5 U.S.C. § 704.

[17] *See* 12 U.S.C. § 5365(i)(1)(B)(i) ("The Board of Governors … shall provide for at least 3 sets of conditions under which the evaluation required by this subsection shall be conducted."); 12 U.S.C. § 5368 (Board "shall issue final regulations" to implement Dodd-Frank requirements).

[18] *See Indep. U. S. Tanker Owners Comm. v. Lewis*, 690 F.2d 908, 926 (D.C. Cir. 1982) ("[W]here an agency's analytic task begins rather than ends with a set of forecasts, sound practice would seem to dictate disclosure of those forecasts so that interested parties can comment upon the conclusions properly to be drawn from them."); *see also Batterton v. Marshall*, 648 F.2d 694, 701–02 (D.C. Cir. 1980) (stating legislative rules are those that "grant rights, impose obligations, or produce other significant effects on private interests."); *La Casa Del Convaleciente v. Sullivan*, 965 F.2d 1175, 1178 (1st Cir. 1992) ("If a rule creates rights, assigns duties, or imposes obligations, the basic tenor of which is not already outlined in the law itself, then it is substantive.").

The "good cause" exceptions are "narrowly construed and only reluctantly countenanced," and clearly no exception applies to the scenarios.[19] As an initial matter, the Board has not cited any "good cause" exception, which itself is dispositive, as one of the prerequisites of such an exception is that it must be expressly invoked by the agency.[20] But even if it were, none of the recognized "good cause" exceptions could relieve the Board of its obligation to use notice-and-comment rulemaking here. The "impracticability" exception applies where exigency requires immediate action, but there is no such exigency.[21] The Board develops the stress test scenarios over a period of several months, during which time it "collect[s] and consider[s] information from academics, professional forecasters, international organizations, domestic and foreign supervisors, and other private-sector analysts."[22] These consultations occur in October and November each year.[23] The Board collects additional information about macroeconomic conditions through January and publicly releases the stress test scenarios by February 15.[24] The statute requires the Board to conduct its analysis and release a summary of stress test results by June 30.[25] This existing timeline and process could easily accommodate proper notice-and-comment rulemaking. Indeed, the Board is in effect already engaging in a process of seeking outside comment, but only with those select academics, analysts and fellow regulators with whom it consults.

The Board also cannot rely on the "unnecessary" exception, which applies where a rule is "insignificant in nature and impact, and inconsequential to the industry and to the public."[26] The significance of the stress test scenarios is self-evident: they establish the conditions under which regulated entities' capital plans will be evaluated and, practically speaking, drive capital planning at each institution. Nor could the Board claim that using notice-and-comment procedures for the scenarios is "contrary to the public interest." Providing advance notice of the scenarios and soliciting public comment would hardly defeat the purpose of the rule—indeed, the benefits from public participation would advance the rule's purpose by enhancing the quality and credibility of the scenarios employed.

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19 *Am. Fed'n of Gov't Emp., AFL-CIO v. Block*, 655 F.2d 1153, 1156 (D.C. Cir. 1981).

20 *See* 5 U.S.C. § 553(b)(B) (exception applies "when the agency for good cause finds *(and incorporates the finding and a brief statement of reasons therefor in the rules issued)* that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest") (emphasis added).

21 *Utility Solid Waste Activities Group v. EPA*, 236 F.3d 749, 754 (D.C. Cir. 2001).

22 82 Fed. Reg. 59,546. And, as noted *supra*, the failure to fully disclose the information and materials relied upon by the Board is problematic under the APA.

23 *Id.*

24 *Id.*

25 12 C.F.R. § 252.46(b)(1).

26 *Utility Solid Waste*, 236 F.3d at 755.

The failure to meaningfully disclose the information and opinions relied upon by the Board in setting the standards runs counter to the APA's policy of regulatory accountability.[27] The stress test scenarios should not be developed behind closed doors based on input from a group of analysts and academics handpicked by the Board and without affording proper notice and an opportunity to comment to regulated institutions and the public. The APA embodies a very different approach: "[T]he notice requirement improves the quality of agency rulemaking by exposing regulations to diverse public comment, ensures fairness to affected parties, and provides a well-developed record that enhances the quality of judicial review."[28] Indeed, the Board itself has publicly acknowledged the value of seeking input from outside sources.[29] Opening the scenario development process to public comment will expose the Board to a broader range of views as to what reasonably foreseeable risks the economy might face and will ensure that the Board carefully considers a variety of perspectives.

B. All material aspects of the stress test models are also legislative rules requiring notice-and-comment rulemaking

Like the stress test scenarios, all material aspects of the models used by the Board in CCAR to estimate covered entities performance under stress and resulting capital levels are legislative rules that must be promulgated via notice-and-comment rulemaking. Critical models that must be disclosed include (but are not limited to):

- The models used to project the components of pre-tax net income, including those used to estimate provision expense for loan and lease losses for each loan category, each subcomponent of pre-provision net revenue, including trading and operational risk losses;
- The models used to forecast balance-sheet items and risk-weighted assets, as well as assumptions on taxes and how it impacts regulatory capital; and

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[27] For example, courts have found that agencies violated the APA where the agency relied upon "critical factual information" that was not disclosed during the rulemaking process. *See, e.g., Owner-Operator Ind. Drivers Ass'n v. Fed. Motor Carrier Safety Adm.*, 494 F.3d 188, 203–06 (D.C. Cir. 2007) (finding error where agency failed to provide an opportunity to comment on the methodology used to justify an increase in maximum number of hours truck drivers may drive); *Chamber of Commerce of U.S. v. SEC*, 443 F.3d 890, 903 (D.C. Cir. 2006) (holding that SEC violated APA by using data that had not been included in rulemaking and that "supply the basic assumptions used . . . ."); *Idaho Farm Bureau Fed. v. Babbitt*, 58 F.3d 1392, 1403 (9th Cir. 1995) (agency committed error by failing to include data that was central to decision in rulemaking); *Penobscot Indian Nation v. U.S. Dep't of Hous. & Urban Dev*., 539 F. Supp. 2d 40, 49 (D.D.C. 2008) (holding that internal analysis of HUD loan portfolio "constitutes critical factual information"); *cf. Lee Memorial Health System v. Burwell*, 206 F. Supp. 3d 307, 332 (D.D.C. 2016) ("Plaintiffs had the 'critical factual material' necessary to review the agency's method, as evidenced by the ability of commenters to replicate [the agency's] calculations").

[28] *Sprint Corp. v. F.C.C.*, 315 F.3d 369, 373 (D.C. Cir. 2003).

[29] *See, e.g.*, 82 Fed. Reg. 59,547 ("The Federal Reserve recognizes that disclosing additional information about supervisory models and methodologies has significant public benefits … [and] could further enhance the credibility of the stress test by providing the public with information on the fundamental soundness of the models and their alignment with best modeling practices.").

- The models used to project gains or losses on investment securities held in the firm's available-for-sale and held-to-maturity portfolios and the mapping between loan losses and provisions.

All relevant details of these models should be subject to notice-and-comment rulemaking, including the specification of the models, regression model estimates, a description of how the specification search of the model was conducted, and the manner in which the models are back-tested to prior experience.

As a general matter, any model treated by an agency as binding is required to go through notice-and-comment rulemaking.[30] This procedure acts as a safeguard to ensure that use of the model is consistent with reasoned decision-making. For example, in *Sierra Club v. Costle*, the D.C. Circuit emphasized the importance of ensuring that computer models adopted by agencies are reviewed by the public via notice-and-comment, noting that even the best models are "at best imperfect" and that the results of the models "can change drastically for a given range of input data if key assumptions are adjusted even slightly . . . [and that] [t]he accuracy of the model's predictions . . . hinges on whether the underlying assumptions reflect reality[.]"[31] Recognizing that the use of modeling injected the possibility for arbitrary action, the court reasoned that "[t]he safety valves in the use of such sophisticated methodology are the requirement of public exposure to the assumptions and data incorporated into the analysis and the acceptance and consideration of public comment, the admission of uncertainties where they exist, and the insistence that ultimate responsibility for the policy decision remains with the agency rather than the computer."[32] The principles expressed by the D.C. Circuit are particularly apt here, where the Board seeks to predict the performance of banks under the stress test scenarios using models that reflect assumptions about the overall performance of the economy and different asset classes (clearly, a highly complex and subjective exercise dependent on a myriad of factors and assumptions).

Once the uniform stress testing models are developed by the Board, they are applied to project the financial performance and post-stress regulatory capital levels of all covered institutions under the stress test scenarios.[33] The standards and assumptions built into the models are the very set of standards used to determine whether banks pass or fail the stress test. The models are thus essential elements of a legal obligation that is binding on regulated institutions

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30 *See Sierra Club v. Costle*, 657 F.2d 298, 334 (D.C. Cir. 1981); *see also American Radio Relay League, Inc. v. F.C.C.*, 524 F.3d 227, 236 (D.C. Cir. 2008) ("Public notice and comment regarding relied-upon technical analysis, then, are [t]he safety valves in the use of . . . sophisticated methodology . . . Enforcing the APA's notice and comment requirements ensures that an agency does not . . . play hunt the peanut with technical information, hiding or disguising the information that it employs."); *McLouth Steel Products Corp. v. Thomas*, 838 F.2d 1317, 1320-22 (D.C. Cir. 1988).

31 657 F.2d 298, 334 (D.C. Cir. 1981).

32 *Id.*

33 *See* 82 Fed. Reg. 59,530 ("The Federal Reserve uses the same set of models and assumptions to produce loss projections for all covered companies participating in the supervisory stress test.").

and has significant economic consequences for institutions based on the models' results. Moreover, the good cause exceptions for impracticability and unnecessariness do not excuse a lack of notice-and-comment rulemaking with respect to the models for the same reasons as for the scenarios: the models are developed through a regular process that in no way reflects exigent circumstances and they have significant consequences for regulated institutions and the broader economy. The tests are far from hypothetical exercises: banks that fail the stress test suffer concrete consequences, including a statutory requirement that they reconsider their resolution plans and Board-imposed limitations on their ability to pay dividends or repurchase stock.[34]

The Board's proposal appears to recognize that the models are substantive legal standards, but justifies its refusal to disclose the actual models on two policy grounds. First, the Board claims that banks could attempt to "game" the stress tests by using the models as a blueprint for "mak[ing] modifications to their businesses that change the results of the stress test without changing the risks they face."[35] According to the Board, this could lead to inaccurate stress test results as well as a greater correlation between assets held by banks, which could inhibit the financial system's ability to weather a shock. Second, the Board has expressed concern that regulated entities would adopt internal models similar to those used by the Board, creating a "model monoculture" in which companies fail to assess idiosyncratic elements of their risk profiles.[36] Although we acknowledge these concerns, these issues are solvable through means other than the extraordinary step of keeping the models nonpublic.

First, as a general matter, the notion that the details of a regulatory regime cannot be made public because those subject to the regime might align their behavior with its rules and standards is an untenable premise. To adapt to regulatory imperatives is not "gaming" or "reverse engineering"; it is obedience and compliance. The proposal on enhanced disclosures itself recognizes that it is entirely appropriate for firms to make capital allocation and other business decisions based on how certain exposures or activities are treated in CCAR.[37] Indeed, the risk-weights assigned by the banking agencies to assets and investments under the regulatory capital rules also influence the business decisions of banking organizations. Yet no one would argue that this fact should allow the banking agencies to withhold those risk weights from the public.

Second, while some have suggested the remote possibility that, were the models public, a bank might temporarily alter its holdings to improve its performance, such suggestion certainly

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[34] *See* 12 U.S.C. § 5365(i)(B)(iv); 12 C.F.R. § 225.8; Press Release, Board of Governors of the Federal Reserve, Federal Reserve Releases Results of Comprehensive Capital Analysis and Review (CCAR) (June 28, 2017), (available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170628a.htm).

[35] 84 Fed. Reg. 59,548.

[36] *Id*.

[37] 82 Fed. Reg. 59,547 (stating that "more detailed disclosures of how the Federal Reserve's models assign losses to particular positions could help those financial institutions that are subject to the stress test understand the capital implications of changes to their business activities, such as acquiring or selling a portfolio of assets.").

does not justify making the regulatory regime secret. For one, it is difficult to fathom a set of practical circumstances under which a bank could divest and shortly thereafter re-acquire large portfolios of assets, which are highly likely to be relatively illiquid, to affect the test's outcomes. And even if that were a realistic possibility, the Board could easily identify and address any actions of this nature through its routine monitoring and supervisory activities.

Third, the proposal notes the possibility that covered companies could make longer-term and more permanent changes that would lead to better stress test performance, but not improved risk profiles. To the extent that were the case, however, it would suggest potential weaknesses in the models themselves, rather than a problem with disclosing them. If the models are properly designed to identify and estimate the relevant risks, then better model results should reflect lower risk – and thus any bank actions to improve their results after taking models into account would be salutary to the resilience of regulated institutions. In any event, the appropriate way to address this issue is not to keep the models nonpublic; rather, it is to ensure that the models are as accurate and effective as possible. In this respect, notice-and-comment rulemaking is the solution, not the problem, as it would improve the models by affording the Board and the public with the opportunity to identify potential weaknesses and ensure that the models incorporate appropriate variables.[38]

Finally, the proposal also notes, as a potential concern, the possibility that banks may adapt their behavior in a way that could lead to greater and undue concentration of holdings, or begin utilizing a uniform set of models, does not justify keeping the models outside the public view. But here again, to the extent the models are accurate and effective, any resulting concentration would reflect a shift across the industry towards assets that are less susceptible to loss under stress—a result exactly consistent with the policy purpose of CCAR, which is to ensure banks' resilience under stress. This concern also ignores the fact that institutions are required to develop their own proprietary models that must account for their own particular risk profile and exposure; they cannot use the same one-size-fits-all supervisory models as the Board. And ultimately, as noted elsewhere, the best way to account for potential shortcomings in the models is not to shield them from view, but rather to implement the models through notice-and-comment rulemaking.

Finally, the "contrary to public interest" good cause exception does not and cannot exempt the models from notice-and-comment procedures. That exception is reserved for "the rare circumstance when ordinary procedures—generally presumed to serve the public interest—would in fact harm that interest."[39] The paradigmatic example is the imposition of price controls, where notifying the public could lead to the price increases the rule was intended to

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[38] Consideration of irrelevant factors or failure to consider an important factor are grounds for overturning a rule as arbitrary and capricious. *See, e.g. Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) ("Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.").

[39] *Mack Trucks, Inc. v. E.P.A.*, 682 F.3d 87, 95 (D.C. Cir. 2012).

prevent.[40] By contrast, here the purpose of the stress tests would not be defeated or undermined by proposing models and soliciting comments. Rather, the use of public notice and comment is likely to improve both the effectiveness and the credibility of the testing. And, as noted above, the fact that institutions may align their behavior with the models is not a tenable justification for not disclosing them. Rather, behavior that adapts to the models should result in lower risks to institutions and suggests that the stress testing program is operating effectively.

Beyond the Board's justifications for not complying with notice-and-comment, the fact that the Board does not even disclose the substance of the models after annual testing raises further concerns. Agencies must explain the decision-making process and the reasons for their actions. This is true not just as a matter of APA procedural requirements, but also for judicial review of agency action under the APA: an action that is not adequately explained may be overturned by courts as arbitrary and capricious.[41] Courts have expressly recognized this principle in the context of predictive modelling, as in other contexts. As the D.C. Circuit has explained: "When an agency uses a computer model, it must explain the assumptions and methodology used in preparing the model and, if the methodology is challenged, must provide a complete analytic defense" of the model.[42] In this case, the Board's failure to disclose the models—or even enough details to understand how the assumptions and variables are incorporated into the models—is the antithesis of the full explanation, or "complete analytic defense," required by courts.

Consistent with this requirement, agency actions have consistently been found arbitrary and capricious, and thus overturned, when the agency relied on models that were undisclosed or not subjected to notice-and-comment rulemaking. For example, in one case, the Federal Motor Carrier Safety Administration conducted a cost-benefit analysis of a rule change based in part on a model for calculating crash risks based on operator fatigue. The agency did not disclose key parts of its methodology for developing this model until the final rule was implemented. The D.C. Circuit held that "[i]n light of these undisclosed elements, we cannot say that the agency's operator-fatigue model was made public in the proceeding and exposed to refutation as required by the APA."[43] The Court also found that the agency had failed to justify the choices it made in

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[40] *See, e.g., DeRieux v. Five Smiths, Inc.*, 499 F.2d 1321, 1332 (Temp. Emer. Ct. App. 1974) ("Had advance notice issued, it is apparent that there would have ensued a massive rush to raise prices . . . before the freeze deadline.").

[41] *See, e.g., Sorenson Commc'ns Inc. v. F.C.C.*, 755 F.3d 702, 707 (D.C. Cir. 2014) ("Under the arbitrary-and-capricious standard, an agency must examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made.") (internal quotation mark omitted).

[42] *U.S. Air Tour Ass'n v. F.A.A.*, 298 F.3d 997, 1008 (D.C. Cir. 2002) (internal quotation mark omitted); *Small Refiner Lead Phase-Down Task Force v. U.S.E.P.A.*, 705 F.2d 506, 535 (D.C. Cir. 1983). *See also Natural Resources Defense Council v. Herrington*, 768 F.2d 1355 (D.C. Cir. 1985); *Eagle-Picher Industries v. E.P.A.*, 759 F.2d 905 (D.C. Cir. 1985); *Sierra Club v. Costle*, 657 F.2d 298 (D.C. Cir. 1981).

[43] *Owner-Operator Indep. Drivers Ass'n, Inc. v. Fed. Motor Carrier Safety Admin.*, 494 F.3d 188, 202 (D.C. Cir. 2007) (internal quotation marks omitted).

developing the model and that "[t]his complete lack of explanation for an important step in the agency's analysis was arbitrary and capricious."[44]

The Board's CCAR process is legally indistinguishable from this authority. The Board evaluates regulated institutions and imposes significant limitations on their capital position using models that have not been subjected to notice-and-comment rulemaking and that are never disclosed to the public. Because its models are not disclosed, the Board cannot explain how it determines what capital levels covered entities must maintain to remain adequately capitalized through each of the stress test scenarios, let alone why it has made those determinations. The information provided in the existing disclosures, and the additional information contemplated by the proposed enhanced disclosures, falls far short of the "complete analytic defense" required under the APA.[45] For example, the description of the model used to project losses on corporate loans says that the probability of default is "projected over the planning horizon using a series of equations fitted to the historical relationship between changes in the [probability of default] and macroeconomic variables."[46] No additional information is provided about this "series of equations," making it impossible to evaluate whether they are based on sound methodology and take into account appropriate factors. Other models used by the Board in its stress testing program are also described in general terms.[47]

The proposed enhanced disclosures would provide more information than has been provided in the past, but the proposals cannot substitute for notice-and-comment rulemaking that would provide banking institutions and the broader public with adequate notice of what the models require. Additional information about the methodology underlying the models is undeniably a step in the right direction. But the enhanced disclosures do not include key factors that the Board relies on in performing the stress tests, and as a practical matter, the models remain a "black box". And, just as problematically, the Board does not provide detailed information about how the results of the models are then combined into a final result.

Ultimately, even with the additional proposed disclosures, the stress testing framework is a broad reservation of authority to set substantive standards in the future without using notice-and-comment rulemaking. The stress test rules and policy statements do not themselves contain any meaningful standards for analyzing capital. Instead, they merely direct the Board to conduct

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[44] *Id.* at 204. *See also Prometheus Radio Project v. F.C.C.*, 373 F.3d 372, 411 (3d Cir. 2004), as amended (June 3, 2016) (questioning whether sufficient notice provided where "underlying methodology" not revealed).

[45] *U.S. Air Tour Ass'n*, 298 F.3d at 1008.

[46] Board of Governors of the Federal Reserve, *Dodd-Frank Act Stress Test 2017: Supervisory Stress Test Methodology and Results* at 62 (June 2017).

[47] For example, the model for estimating loss given default on commercial real estate mortgages "first estimates the probability that a defaulted loan will have losses as a function of loan characteristics and macroeconomic variables . . . [then] estimates the loss on the CRE mortgage as a function of the expected probability of loss, characteristics of the loan, and residential house prices and the unemployment rate." Board of Governors of the Federal Reserve, *Dodd-Frank Act Stress Test 2017: Supervisory Stress Test Methodology and Results* at 55 (June 2017). The Board is silent on how these estimates are performed.

an analysis and provide generalized statements about how the testing will proceed. The actual rules and standards are left for the Board to decide later on in private during the annual testing. That approach is simply not permissible under the APA, and courts have consistently rejected attempts by agencies to avoid notice-and-comment by promulgating rules that grant discretion to the agency to impose substantive regulatory requirements at a later date.[48] The legal requirements on the Board are no different, and financial regulation enjoys no special exemption from APA safeguards.[49]

C. The models are substantive rules that must be published in the Federal Register or otherwise made publicly available.

Finally, apart from the rulemaking requirements of the APA, the Board's lack of public disclosure raises additional serious concerns of regulatory transparency and fair process. Under the APA's publication requirement, which is part of the Freedom of Information Act ("FOIA"),[50] agencies are required to publish substantive rules of general applicability, statements of general policy, and interpretations of general applicability in the Federal Register and to "make available for inspection in an electronic format" statements of policy and interpretations not published in the Federal Register, as well as administrative staff manuals and instructions to staff that affect the public.[51] Because the models are applied generally to regulated entities and functionally establish a set of mandatory standards with which institutions must comply, the models are "substantive rules of general applicability" subject to public disclosure and must be published in the Federal Register.[52]

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[48] In *United States v. Picciotto*, for example, the Park Service sought to reserve the right to impose substantive requirements without using formal rulemaking. The court rejected the Park Service's reliance on an "open-ended" regulation, stating an agency cannot "grant itself a valid exemption to the APA for all future regulations, and be free of APA's troublesome rulemaking procedures forever after, simply by announcing its independence in a general rule." *Picciotto*, 875 F.2d at 347. *See also EPIC*, 653 F.3d at 7.

[49] Indeed, the Board has itself committed to comply with notice-and-comment rulemaking prior to adjusting the Basel III Countercyclical Capital Buffer based on similar industry concerns about the use of a general policy statement to avoid notice-and-comment rulemaking. 81 Fed. Reg. 63,684 (Sept. 16, 2016).

[50] 5 U.S.C. § 552.

[51] 5 U.S.C. §§ 552(a)(1), (a)(2)(B), (a)(2)(C).

[52] Although documents related to bank examinations are broadly excluded from FOIA, *see* 5 U.S.C. § 552(b)(8), the exemption cannot be applied here to allow regulators to shield rules of general applicability from disclosure to the public and from regulated entities. The exemption covers "examination, operating, or condition reports," 5 U.S.C. § 552(b)(8), and is designed to avoid public disclosure of sensitive bank information and to promote cooperation between banks and regulators, *see Public Investors Arbitration Bar Ass'n v. U.S. S.E.C.*, 930 F. Supp. 2d 55, 64 (D.D.C. 2013). These are clearly important interests, but they are not at issue here because the uniform stress test models are applied to *all* covered entities and do not themselves contain confidential information.

As currently implemented, the Board's stress tests impose serious consequences on regulated institutions based on a set of standards, including stress test scenarios and models, that have never been subjected to public comment, and in some cases are not ever made public. The Clearing House urges the Board to adopt a fully transparent process in keeping with the requirements of the APA, which will both improve the testing assumptions and models used by the Board and that will ensure that the program conforms to basic administrative law principles of notice and fair process.

The Clearing House appreciates the opportunity to comment on the proposal. If you have any questions, please contact the undersigned by phone at (202) 649-4622 or by email at *jeremy.newell@theclearinghouse.org*.

Respectfully submitted,

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