CONFERENCE OF STATE BANK SUPERVISORS

April 30, 2012

Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Ms. Johnson,

The Conference of State Bank Supervisors (CSBS) is pleased to respond to the Federal Reserve Board's (FRB's) request for comment on its proposed rule implementing aspects of sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) entitled *Enhanced Prudential Standard and Early Remediation Requirements for Covered Companies.* The majority of the proposed rule applies to bank holding companies (BHCs) with assets above $50 billion and other nonbank financial companies deemed systemically significant by the Financial Stability Oversight Council (FSOC) (collectively, covered companies). Aspects of the proposed rule, namely the annual stress testing and risk committee requirements, apply to banking institutions with assets above $10 billion. State bank regulators supervise a range of institutions above $10 billion in assets. We believe we can offer valuable insight concerning the operations and tendencies of the applicable institutions that can inform the FRB's perspective as it implements these provisions.

CSBS commends the FRB for its work in drafting proposed regulations on this complex topic. The enhanced prudential standards and early remediation requirements are some of the most critical aspects of Dodd-Frank. These requirements outline a range of tools prudential regulators can utilize in combatting systemic risk and preventing institutions from becoming "Too Big to Fail." We generally support the FRB's proposed rule, but offer suggestions on various aspects of the proposal that we believe will enhance the effectiveness of the framework.

It is critically important the FRB work with bank chartering authorities to ensure these rules do not interfere with laws and regulations the chartering authorities have established. Many provisions of the proposed rule overlap with standards for which the chartering authorities have authority, such as capital requirements and lending limits. While we understand these rules are meant to capture risks which could become systemic, we must ensure they do not create confusion by interfering with the chartering authorities' framework. The new rules should certainly not preempt any standards established by the chartering authorities. We urge the FRB to work with the states in implementing the enhanced prudential standards. Consistency among regulators on this matter is vital.

Below we provide a section-by-section outline of our comments.

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Scope of Application

As mandated by law, most of the provisions of the proposed rule apply to bank holding companies with assets above $50 billion and other nonbank financial companies deemed to be systemically significant by the FSOC. The annual stress testing requirements and some risk committee provisions apply to banking institutions with assets above $10 billion. CSBS generally agrees with the scope of the law and proposed rule. In applying the standards, the FRB should make appropriate risk adjustments for certain classes of institutions. For instance, a $1 trillion covered company should have more stringent and in depth enhanced prudential standards expectations than less complex institutions on the smaller end of the scope.

Risk-Based Capital Requirements and Leverage Limits

Dodd-Frank directs the FRB to establish risk-based capital and leverage standards for covered companies that are more stringent than the risk-based capital and leverage standards applicable to bank holding companies and applicable nonbank financial companies that do not present similar risks to the financial stability of the United States and increase stringency based on the systemic footprint of the institution.

The FRB has proposed to implement enhanced risk-based capital requirements and leverage limits in two phases: (1) in this proposal, the FRB will apply the FRB's already finalized capital plan rule to covered companies and (2) in a separate future proposal, the FRB will introduce a quantitative capital surcharge for covered companies or a subset of covered companies based on the Basel Committee on Banking Supervision's (Basel's) capital surcharge framework.

Under the FRB's capital plan rule, a covered company would have to submit a board approved capital plan to the FRB in which it demonstrates its ability to maintain capital above the Board's minimum risk-based capital ratios (total capital ratio of 8 percent, tier 1 capital ratio of 4 percent) and tier 1 leverage ratio (4 percent) under both baseline and stressed conditions over a minimum nine-quarter, forward looking planning horizon. Covered companies must also demonstrate the ability to maintain a minimum tier 1 common equity risk-based capital ratio of 5 percent over the same planning horizon. The capital plan must also include various other descriptions of an institution's process for assessing its own capital adequacy. A covered company that is unable to satisfy these requirements generally may not make any capital distributions until it provides a satisfactory capital plan to the FRB. In addition, a large bank holding company must obtain prior approval from the FRB before making a capital distribution in certain circumstances where the FRB had provided a non-objection to the large bank holding company's capital plan. Under the proposed rules' reservation of authority, the Board may require any covered company to hold additional capital or be subject to other requirements or restrictions if it determines that compliance with the requirements of the proposal does not sufficiently mitigate risks to U.S. financial stability posed by the failure or material financial distress of the covered company.

While we believe the capital planning requirements are generally appropriate for covered companies, we urge the FRB to consult with applicable state banking regulators when determining capital needs or restrictions. Particularly regarding the FRB's proposed controls over capital distributions and authority to require covered companies to hold additional capital in certain circumstances, it is essential that the FRB cooperate with applicable chartering authorities in developing acceptable and reasonable requirements for these significant issues.

LIQUIDITY REQUIREMENTS

Enhanced liquidity requirements are a central piece of the Dodd-Frank mandate to establish heightened prudential standards. The FRB is proposing to implement enhanced liquidity risk management standards for covered companies through this proposal and minimum quantitative liquidity standards in a future proposal. The enhanced liquidity risk management standards would build on the 2010 *Interagency Policy Statement on Funding and Liquidity Risk Management,* requiring covered companies to take a number of prudential steps to manage liquidity risk. The proposed rules would introduce liquidity stress testing requirements for covered companies and require covered companies to continuously maintain a liquidity buffer of unencumbered highly liquid assets sufficient to meet projected net cash outflows and the projected loss or impairment of existing funding sources for 30 days over a range of liquidity stress scenarios. The proposed rules would also require a covered company to generate comprehensive cash flow projections, to establish and monitor its liquidity risk tolerance, and maintain contingency plans for funding. The future proposal on quantitative limits would be based on Basel's work surrounding the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR).

We support many of the proposed measures related to enhanced liquidity risk management and concur with the FRB that many of the proposed requirements, such as cash flow projections, contingency funding planning, and establishment of liquidity risk management strategies, policies and procedures, do not represent wholly new concepts. Supervisors have experience enforcing such liquidity standards. Further, we believe the proposal offers some new concepts that will help enhance liquidity monitoring. Specifically, requirements to periodically test components of contingency funding plans to assess their reliability during liquidity stress events are practical.

CSBS urges the FRB to enforce these requirements in a fashion consistent with the size, complexity and sophistication of the covered company. Institutions on the smaller end of the covered scope may struggle with the stress testing frequency expectation, which seems to allow for a supervisory expectation of constant stressing of liquidity positions. In a similar concept, such institutions may struggle with monitoring requirements related to shifts between intraday liquidity positions. Conversely, institutions heavily involved in lines of business, such as payment processing, which require constant liquidity monitoring, should be held to high standards in this area. CSBS also requests clarity on the FRB's requirements surrounding an independent review of a company's liquidity risk management, specifically to what extent the FRB expects this reviewing entity to be independent of the liquidity risk management function.

Regarding some of the limits discussed in the proposal, such as the requirement for companies to set limits on concentrations in funding, maturity time horizons, and off balance sheet exposures, CSBS requests clarity from the FRB on the nature of these limits—whether they will be treated as hard limits or guidelines, and when companies may make exceptions to the limits, if ever. Additionally, it seems the proposed requirement to continuously maintain a liquidity buffer results in another limit. CSBS requests more information on the circumstances in which FRB believes a company would make use of or dip into the buffer. Also related to the buffer, it may be difficult for some institutions to comply with the requirement to discount the fair market value of an asset included in the buffer for purposes of reflecting credit risk and market volatility of the asset.

Single-Counterparty Credit Limits

In effort to address single-counterparty concentration risk among large financial companies, Dodd-Frank directs the FRB to establish single-counterparty credit concentration limits for covered companies in order to limit the risks that the failure of any individual firm could pose to a covered company. Dodd-Frank requires the FRB to issue regulations that prohibit covered companies from having credit exposure to any unaffiliated company that exceeds 25 percent of the capital stock and surplus of the covered company and authorizes the FRB to lower the 25 percent threshold if necessary to mitigate the risks to the financial system.

In implementing this mandate, the FRB has proposed to establish a general limit that prohibits a covered company and its subsidiaries from having aggregate net credit exposure to any single unaffiliated counterparty in excess of 25 percent of the company's capital stock and surplus. In addition, the proposed rule would establish a more stringent net credit exposure limit between a major covered company ($500 billion or more in total consolidated assets) and a single counterparty of 10 percent of the major covered company's capital stock and surplus.

General Comments

Our primary concern with both the mandate and the proposed rule revolves around these limits' interaction with state legal lending limits. The FRB acknowledges this potential issue in the proposal. State lending limits address many of the components captured in these single-counterparty limits. We understand the proposed single-counterparty credit limits are intended to act as a net for systemic events. We nevertheless urge the FRB to work with the states to ensure the single-counterparty credit limits do not interfere with or undermine state legal lending limits. It will be difficult for institutions to keep up with two separate standards addressing many of the same lines of activity. We hope to work with the FRB in creating a clear and consistent framework in which these two standards can co-exist and not serve overlapping purposes.

We also strongly believe the FRB's proposal should include gross limits on credit exposure and not simply rely on aggregate net credit exposure. As depicted in the proposed calculations of aggregate net credit exposure, institutions will be afforded the opportunity to lower their counterparty exposure levels through certain exemptions. Since these limits are intended to capture systemic, worst case scenarios, we believe gross calculations are more prudent and practical. Using net credit exposure depends on many structures functioning properly. In our estimation, it is not clear these structures which qualify for exemptions will properly function in all downturns. In fact, it seems some of the netting allowances outlined in this proposal would not have held up in the most recent crisis.

We do support the notion of single-counterparty credit limits as a means for capturing systemic exposures, but we urge the FRB to be mindful of these limits' interactions with lending limits and the need to consider gross credit exposure. We endorse the FRB's proposal to apply more strict limits on major covered companies. CSBS also supports the FRB's proposal to value debt securities purchased from a counterparty at the greater of purchase price or market value, so that when the value of the debt falls, it would not lower the exposure to the counterparty and allow further exposures. Conversely, other proposal provisions for collateral valuation use the lower of cost or market. In this case, the net exposure to a secured counterparty would go up when the values of the securities used as netting collateral go down. This supervisory framework will help prevent many institutions from lending into a downturn. Additionally, we endorse the FRB's definition of control for purposes of this proposal, which sets control at 25 percent or more of total equity or voting securities in an institution, instead of aiming for complete consistency with all aspects of the Bank Holding Company Act (BHC Act).

Comments Specifically Related to Net Credit Exposure Calculations

While CSBS generally supports abandoning a strict reliance on aggregate net credit exposure, we offer some observations related to the FRB's proposed calculation methods for net credit exposure. The FRB poses a recurring question in its proposed calculation methods related to adopting a more conservative approach to eligible netting exemptions, including requiring the company to potentially recognize gross credit exposure. We strongly endorse a more conservative approach that would include a gross credit exposure overlay.

Related to eligible collateral for netting purposes, we believe the FRB has proposed a reasonable framework. It is important to be as specific as possible as far as what types of collateral is eligible for netting. Allowing any flexibility for netting out questionable forms of collateral could be harmful.

Regarding eligible guarantees, CSBS believes the FRB should alter the definition of eligible protection provider so it does not automatically qualify a sovereign entity as an eligible protection provider. We are not recommending the FRB specifically endorse or not endorse certain sovereign entities as qualified for eligible protection providers. However, it should outline some circumstances to consider in evaluating a sovereign entity as an eligible protection provider in lieu of the blanket qualification given obvious issues with sovereign debt internationally. Further, and in response to a question posed by the FRB, we support additional requirements placed on eligible protection providers, such as risk weightings, to ensure their capacity to perform on their guarantee obligations. Nevertheless, it seems that being able to lower counterparty exposure based on guarantees is not far afield from the framework that induced much of the systemic risk build up leading up to the crisis. The FRB should strongly consider this notion as it finalizes these rules.

RISK MANAGEMENT AND RISK COMMITTEE REQUIREMENTS

To address risk management weaknesses exposed during the financial crisis, Dodd-Frank directed the FRB to establish overall risk management requirements as part of the enhanced prudential standards framework and issue regulations requiring all covered companies and publicly traded bank holding companies with assets over $10 billion to establish risk committees responsible for oversight of the enterprise-wide risk management practices of the company.

In addressing the mandate, the FRB has proposed that all covered companies and bank holding companies with total consolidated assets of $10 billion or more will establish a stand-alone risk committee responsible for overseeing the enterprise-wide risk management standards of the institution. These companies' risk management standards would need to reinforce the independence of the firm's risk management function. Covered companies would have to adhere to additional requirements, including establishing a Chief Risk Officer (CRO) to oversee the risk management functions of the company.

We endorse the enhanced risk management standards proposed by the FRB. Regarding the make-up of the risk committee, and in response to questions posed by the FRB, we support the notion of requiring more than one independent director and believe there should be requirements for ongoing director training and education specifically related to risk management. Additionally, we believe it is critical the risk committee be given explicit authority to access all aspects of a company's business activities.

Regarding the additional requirements for covered companies, we do not believe the CRO should report both to the CEO and the Risk Committee. Such dual reporting could limit the CRO's ability to function appropriately. We believe the CRO should report to solely the Risk Committee. However, we also believe it should be made clear the CEO will have a role on the risk committee that allows him or her to be engaged in the risk management function of the firm, while also affording the Risk Committee appropriate independence.

STRESS TESTING REQUIREMENTS

Dodd-Frank requires the FRB to establish rules for stress testing for both covered companies and banking institutions above $10 billion. Covered companies will have to undergo an annual supervisory stress test administered by the FRB, perform a company-run annual stress test based on scenarios published by the FRB, and also perform an additional company run stress test based on scenarios developed by the company. The annual company-run stress test based on FRB scenarios is required for all banking organizations above $10 billion. Indeed, Dodd-Frank requires all the federal bank regulatory agencies to establish rules requiring annual company-run capital adequacy stress tests for banks above $10 billion.

We support the concept of stress testing as a risk management tool, and we endorse the Dodd-Frank requirement. Additionally, we commend the FRB for developing a workable framework to implement the law's requirement. While we generally endorse the provisions of the stress testing proposal, below we discuss some specific suggestions we believe can enhance the effectiveness of the rule and the comparability of stress testing requirements across the industry. The FRB-administered stress test for covered companies and the proposed annual stress test for institutions above $10 billion are substantially similar in content and process. For these tests, the FRB will publish a set of baseline, adverse, and severely adverse scenarios against which institutions will be stressed and will need to stress. The additional company run stress test for covered companies based on company established scenarios is similar to the others in process, but allows more flexibility with regard to scenario analysis. Therefore, we largely address all three stress tests together in our discussion below, with some specific references to the different tests.

Above all, we request the FRB work with the state chartering authorities in developing and implementing stress testing expectations for specific institutions. State banking regulators oversee many institutions above $10 billion, and will undoubtedly have insights about critical aspects of these institutions' business models on which the FRB should focus stress testing efforts. Generally, such consultation is worked out in the field by examiners under the direction of the Nationwide State-Federal Supervisory Agreement[1]. To enhance supervisory transparency for the industry, we believe it is important the FDIC clarify in the rule that it will work with the state chartering authority in implementing these requirements. We also request the FRB coordinate with the states on any examiner training initiatives it intends to develop related to stress testing.

CSBS believes it is appropriate, as the FRB has conveyed, to expect covered institutions to consider the annual capital adequacy stress tests in concert with broader enterprise-wide stress testing work that will be expected by supervisors as illustrated in the Interagency Proposed Large Bank Stress Testing Guidance[2]. However, it is critical when this guidance is finalized that supervisors do not mandate prescriptive enterprise-wide risk management standards. CSBS believes enterprise-wide stress testing should be an industry driven solution; that is, banks should be given a chance to set expectations in this area. Stress testing should develop as a valuable risk management tool and not simply as a regulatory exercise.

In its proposal, the FRB recognizes that certain parent company structures of covered banks may include one or more financial companies, each with total consolidated assets greater than $10 billion. The Dodd-Frank stress testing requirements apply to the parent company and to each subsidiary financial company regulated by a primary federal banking regulator that has more than $10 billion in total consolidated assets. To avoid unnecessary complexity or duplication of efforts, the FRB proposes to coordinate with the other primary federal financial regulatory agencies, to the extent needed. We appreciate the FRB's efforts to reduce complexity and burden. The desired outcome of this coordination should not be, however, that an institution escapes the requirement all together.

To address another procedural matter, we would like to highlight the potentially tight timeframe institutions will have to conduct these stress tests. The FRB has proposed to release scenarios by mid-November. Stress tests should be completed and reported to the FRB by January 5. This could present timing issues for institutions preparing additional year-end information, especially institutions on the smaller end of the $10 billion scope, which do not have the same resources as truly large institutions. It is worth noting the OCC has proposed to

[1] http://www.csbs.org/regulatory/Cooperative-Agreements/Documents/nationwide_state_fed_supervisory_agrmnt.pdf

[2] http://www.gpo.gov/fdsys/pkg/FR-2011-06-15/pdf/2011-14777.pdf

release scenarios by mid-October. Unless there is specific information the FRB needs to collect between the OCC's proposed timeline and mid-November, we strongly encourage the FRB to consider publishing scenarios in concert with the OCC. Further, the FRB has proposed that covered institutions should publish a summary of results publicly by April. We want to ensure this period builds in sufficient time for potential revisions to stress testing results in the event that the FRB believes the institution's initial report is flawed.

We support the proposed stress testing report institutions must provide to the FRB, including the qualitative and quantitative categories the institutions must include. It is important these expectations are clear and simple enough so that many institutions, particularly those on the smaller end of the $10 billion scope, do not have to turn to vendors or third-party professionals to produce and interpret the report. We believe this would result in a less useful exercise. Also, we believe the public disclosure of the summary of results is an important requirement but certainly a challenging aspect of the exercise. Institutions would benefit from clarity surrounding the FRB's expectations in this area. There will be many different analytical interpretations of these results by the public. To the extent these results will be used for comparison across institutions, regulators may run the risk of creating an environment where many institutions demonstrate irrationally conservative bias in the aspects of the tests where there is flexibility in choosing inputs. We understand the FRB's publication of scenarios will help standardize the process to a degree. The FRB should work with the institutions to ensure the public disclosure requirement does not result in unusable results because institutions fear an unfavorable outcome. Specifically with regard to the annual stress test administered by the FRB, it goes without saying the FRB must be clear and structured about how the public information is released and what conclusions are being drawn.

With regard to the additional company run stress test for covered institutions, in which the institution will develop its own scenarios, we caution the FRB against significantly critiquing a company's choices in developing certain scenarios. Management should be allowed appropriate discretion in developing these tests on their own. The additional tests may not be useful if they become another regulatory exercise. It is also important these tests avoid too much overlap with the two other tests a covered company is required to undergo.

A critically important point is the federal banking regulators must, to the greatest extent possible, maintain comparability across stress testing requirements for covered institutions. Dodd-Frank requires each federal banking agency to "issue consistent and comparable regulations" to implement the stress testing requirements[3]. While the OCC's proposal on the topic is similar to the FDIC's and the FRB's, it nevertheless contains some key distinctions which could result in different reporting requirements among covered banks. We outline these distinctions in our comment letter[4] to the OCC on its stress testing proposal. We urge the agencies to seek comparability on these requirements.

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act: 165(i)(2)(C)
[4] http://www.csbs.org/regulatory/policy/Documents/CSBSCommentLetterOCCStressTesting.pdf

DEBT-TO-EQUITY LIMITS FOR CERTAIN COVERED COMPANIES

Dodd-Frank provides that the FRB must require a covered company to maintain a debt-to-equity ratio of no more than 15-to-1, upon a determination by the FSOC that such a company poses a grave threat to the financial stability of the United States. The FRB proposes that once a company has been deemed to be a grave threat, they would receive a written notice from the FRB indicating the company has 180 days to comply with the debt-to-equity ratio requirement.

According to the law, in making its grave threat determination, the FSOC is to consider, among other things, the extent of the leverage of the company, the nature, scope, size, scale, concentration, interconnectedness, mix of activities of the company, and importance of the company as a source of credit for U.S. households, businesses, state and local governments, and as a source of liquidity for the U.S. financial system.

While there is some direction about what might constitute a "grave threat," we believe more clarification is needed in this area. We understand there may be circumstances unique to certain determinations, but we encourage the FRB to work with the FSOC to more narrowly identify what it means to pose a grave threat to the U.S. financial system. In our estimation, "threat" implies that a company has already crossed a certain threshold in which it may be extremely difficult to lower its debt-to-equity ratio. We believe more clarity in this area, particularly surrounding when and how the FSOC establishes that a threat exists, will help the FRB establish a more workable process for meeting the Dodd-Frank debt-to-equity mandate. Further, if more clarity is established in this area, it may be the case that the 180 day compliance period will need to be revised. It seems an institution that poses a grave threat will realistically need to improve its immediate condition, including its debt-to-equity ratio, more expeditiously than over a period of 180 days.

EARLY REMEDIATION REQUIREMENTS

Section 166 of Dodd-Frank requires the FRB to promulgate regulations providing for the early remediation of financial weaknesses at covered companies. The FRB is required to define measures of a covered company's financial condition, including, but not limited to, regulatory capital, liquidity measures and other forward-looking indicators that would trigger remedial action.

The FRB has proposed a regime for the early remediation of financial distress at covered companies that includes four levels of remediation requirements and several forward-looking triggers designed to identify emerging or potential issues before they develop into larger problems. The four levels of remediation are: (1) heightened supervisory review; (2) initial remediation, in which a covered company would be subject to restrictions on growth and capital distributions; (3) recovery, in which a firm would be subject to a prohibition on growth and capital distributions, limits on executive compensation, and requirements to raise additional capital, and additional requirements on a case-by-case basis; and (4) recommended resolution, in which the FRB would consider recommendation to Treasury and FDIC the use of Title II authority to resolve an institution. These levels of remediation would be based on a company's standing within a range of risk-based capital/leverage limits, stress testing requirements, enhanced risk management and risk committee standards, enhanced liquidity risk management standards, and market indicators.

CSBS believes the proposed early remediation framework represents a reasonable implementation of the mandate. In response to the FRB's question regarding the use of a quantitative liquidity trigger in the early remediation framework, we endorse the FRB's initial inclination not to include such triggers in the framework, as they are covered in the liquidity requirements aspect of the proposed rule. Additionally, in response to the inquiry related to including certain balance sheet measures, we believe the FRB should explore including some measures related to loan concentrations. Further, while market indicators are excellent information for supervisors to consider, it would be risky to include such indicators as crucial factors in a remediation framework. We are pleased the FRB has included market indicators as a soft aspect of the remediation framework, as this is an evolving area.

In our estimation, while capital is a lagging indicator of performance, and the other triggers included in the remediation framework will be a good indicator of a company's potential for early remediation, we believe the capital triggers included in the framework are low. For instance, we would be particularly concerned about a systemically important firm's solvency if its Tier 1 risk-based capital is below 4%, which is the standard only in level 2 of the proposed framework. Additionally, in regard to the remediation levels, the potential divestiture a company might face in level 3 of the framework may be troubling if the divestiture resulted in an uncontrolled fire sale of assets. We encourage the FRB to work with institutions in stage 3 to dispose of assets in an orderly manner, consistent with safe and sound practices.

Thank you for the opportunity to engage on this highly important issue.

John W. Ryan

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President and CEO