The Clearing House
At the Center of Banking Since 1853

January 10, 2014

Bank of England
Threadneedle Street
London, EC2R 8AH
Attention: Mr. Vasileios Maduros

Re: A Framework for Stress Testing the UK Banking System

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("**The Clearing House**")[1] appreciates the opportunity to present its views on the Bank of England's (the "**BOE**") October 2013 Discussion Paper, *A framework for stress testing the UK banking system* (the "**White Paper**" and the proposed framework set forth therein, the "**Proposed UK Framework**").

The Clearing House has several years of experience with the Board of Governors of the Federal Reserve System's (the "**Federal Reserve**") comprehensive capital analysis and review program ("**CCAR**") as well as the related company-run stress testing requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") and the regulations promulgated thereunder in the United States (collectively, the "**U.S. stress testing framework**").[2]

The Clearing House supports the BOE's efforts to enhance the stability and resilience of both individual financial institutions and the broader financial system through the development and implementation of a regular stress testing regime for the UK banking system. More broadly, we recognize the value and importance of capital adequacy stress testing – as part of the suite of prudential regulatory tools – in supporting and preserving a safe and effective global banking system and are pleased to provide our views and observations in furtherance of

[1] Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over two million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. *See* The Clearing House's web page at www.theclearinghouse.org.

[2] *See* 12 C.F.R. § 225.8; 12 C.F.R., subparts F, G, and H to part 252.

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that effort. Moreover, in light of the application of the Proposed UK Framework to banking institutions with global operations, we strongly endorse the BOE's stated commitment to coordinate with other national regulators, including the Federal Reserve, both in finalizing the Proposed UK Framework and administering the UK stress testing framework as ultimately adopted (the "**Final UK Framework**").

We believe that our collective experience with the U.S. stress testing framework can provide constructive insight into the Proposed UK Framework and its potential application to banking institutions with global operations, including both in the United Kingdom and the United States. More specifically, in the United States, the first supervisory stress tests of banking institutions were conducted in 2009 by the Federal Reserve as part of its Supervisory Capital Assessment Program ("**SCAP**"). The results of SCAP were used by the Federal Reserve to cause certain of the subject U.S. banking institutions to bolster their regulatory capital levels, including through the issuance of additional common equity capital. Many market participants and other observers have subsequently recognized SCAP and the related capital raises as a critical supervisory response to the worsening of the financial crisis that occurred in the fall and winter of 2008 and which served to begin to stabilize the market perception of banking institutions' capital adequacy.[3] In light of this experience, The Clearing House strongly supports a robust and credible stress testing framework for banking institutions that includes real consequences for not meeting required regulatory capital minimums under projected stressed conditions.

Following the completion of SCAP in the beginning of 2010, the Federal Reserve initiated its annual CCAR exercise in late 2010. CCAR, which utilizes both supervisory- and company-run stress tests, is the process through which the Federal Reserve assesses U.S. bank holding companies' annual capital plans. Under CCAR, subject banking institutions must submit a capital plan to the Federal Reserve on an annual basis detailing their planned capital actions, including both planned capital issuances and capital distributions such as dividend payments and share repurchases, under baseline, adverse and severely adverse scenarios.[4] In order for the Federal Reserve to issue a non-objection to an institution's capital plan and planned capital actions, the banking institution must meet certain uniform quantitative and qualitative criteria. In November 2012, the U.S. banking agencies implemented the stress-testing requirements of the Dodd-Frank Act, which require, for the largest banking institutions, annual supervisory- and company-run stress tests as well as mid-year company-run stress tests. Unlike the annual supervisory-run and company-run stress tests, the mid-year stress tests are based solely on scenarios created by banking institutions themselves.

Under CCAR, the receipt of an objection to a banking institution's capital plan does not necessarily translate into an institution's being required to raise additional capital through

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[3] *See, e.g.*, Eric Talley and Johan Walden, *The Supervisory Capital Assessment Program: An Appraisal* (June 2009).

[4] 12 C.F.R. § 225.8 *et seq*.

securities offerings as was the case with SCAP.[5] We believe the U.S. experience has amply demonstrated that the consequence of not being able to pay desired dividends or pursue other planned capital actions as a result of inadequate stress test results provides strong incentives for banking institutions to maintain robust regulatory capital levels through a combination of mutually reinforcing actions, including conservative earnings retention policies and related moderate capital distribution levels, raising new capital and balance sheet management.

The Clearing House believes that, from a public policy perspective, the fundamental lesson to be drawn from the U.S. stress testing experience is that in order for a stress testing regime to have the desired effect of bolstering capital levels and strengthening risk management, board and senior management oversight of capital planning and encouraging the development of robust internal controls governing the capital adequacy process, as well as instilling market confidence in the banking system, it should satisfy three basic pillars: (i) it should have generally uniform requirements, while recognizing clearly definable differences, across banking institutions, (ii) its results should be credible and meaningful to both subject institutions and market participants (which, among other things, requires appropriate transparency, stress scenarios that are appropriately demanding and estimates of losses and revenues in those scenarios consistent with historical experience in stress), and (iii) it should include real and certain consequences for failing to meet such uniform requirements under stressed conditions. There is not one single "correct" mechanism by which to implement a robust stress testing regime and we are by no means advocating that all the detailed mechanics the U.S. has chosen for its stress testing framework should also be adopted by the BOE in the Final UK Framework. Nevertheless, we do believe, based on our experience with the U.S. stress testing framework, that, in crafting its own stress test framework, the BOE should focus on adopting practices and mechanisms that further these three fundamental pillars.

Part I of this letter provides an executive summary of our comments regarding the Proposed UK Framework. Part II details our key observations and recommendations based on our experience with the U.S. stress testing framework and the fundamental principles described above. Part III discusses areas in which we would urge coordination and cooperation between the BOE and the U.S. Federal banking agencies. Part IV includes other issues and points of clarification.

I. <u>Executive Summary</u>

Based on our experience with the U.S. stress testing framework, we respectfully submit the following observations and recommendations regarding the Proposed UK Framework:

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[5] One reason for this has been that banking institutions' capital has increased substantially since the onset of the financial crisis, thereby permitting many banking institutions to manage regulatory capital primarily through earnings retention and conservative capital distributions. For example, between the fourth quarter of 2007 and the fourth quarter of 2010 U.S. banking institutions increased Basel III Common Equity Tier 1 capital ("**CET1**") by approximately $200 to $250 billion. *See* The Clearing House, *"How much capital is enough?" Capital Levels and G-SIB Capital Surcharges* (Sept. 26, 2011), at 9.

- A generally uniform and consistent set of quantitative post-stress minimum capital ratios should be established for purposes of assessing stress test results. We believe that our experience with CCAR shows that a quantitative minimum requirement that is variable and idiosyncratic on an institution-by-institution basis (such as the proposed "hurdle rate") may undermine the meaningfulness of stress test results, inject additional uncertainty into the capital planning process and have a potentially damaging competitive effect on banking institutions facing such disparate treatment.

    - We therefore urge the BOE to adopt in the Final UK Framework a consistent set of post-stress quantitative minimum capital ratios based on the Basel III[6] minimums, including CET1, that will apply uniformly across all subject banking institutions and rely on the supervisory process to identify and deal with institution-specific concerns.

- The Final UK Framework explicitly should include, absent extraordinary circumstances, at least one or more clear consequences in the event a banking institution fails to meet the uniform and consistent quantitative regulatory minimums for which we advocate above. Certain and explicit consequences for failing to meet required minimums under stressed conditions encourage banking institutions to hold robust capital, enhance market discipline and introduce a level playing field among different banking institutions.

- The Proposed UK Framework's expectation that bespoke scenarios will generate higher losses than the common scenarios should be reconsidered because it undermines the benefits of having banking institutions design bespoke scenarios. We believe that banking institutions should design bespoke scenarios to reflect their own realistic expectations and perceived vulnerabilities, rather than to satisfy an artificial requirement for higher losses under the bespoke scenario.

- To help ensure the accuracy of data provided by banking institutions and enhance the efficiency and effectiveness of the stress testing program, we suggest that the applicable process be managed by the BOE so that only necessary changes are made to data templates, meaningful instructions regarding completion of the templates are provided, a formal process for resolving questions about the templates is established and communications between banking institutions and the BOE are managed in a centralized and coordinated manner.

In view of the application of the Proposed UK Framework to banking institutions with global operations, we strongly endorse the BOE's stated commitment to coordinate with other national regulators. Our recommendations for areas of cooperation and coordination with

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[6] "**Basel III**" as used in this letter refers to the Basel Committee on Banking Supervision's publication titled, *Basel III: A global regulatory framework for more resilient banks and banking systems*.

respect to banking institutions that operate in the United States and the United Kingdom (and more generally) are as follows:

- The BOE and the U.S. banking agencies should cooperate and coordinate in order to achieve a mutual alignment, to the greatest extent practicable, of the key components of their stress testing frameworks, including with respect to common stress scenarios, data requirements and supporting documentation, and the timing of the stress testing cycle. We strongly believe that such cooperation and coordination will, among other benefits, increase certainty in the capital planning process, increase the quality of results and enhance transparency and credibility of stress testing results.

- The relative general severity of the stress scenario being used will likely be one of the most important drivers of capital levels. In the event that the common stress scenarios of the Final UK Framework and the U.S. stress testing framework are not generally aligned, there should at least be a broad degree of consistency during each annual stress testing cycle in the general relative severities of the stress scenarios in both frameworks. If the severities of the common scenarios are not generally consistent, banking institutions subject to both regimes will find it quite challenging to engage in prudent capital planning across their UK and U.S. operations.

- Absent close alignment with respect to data collection requirements, documentation and the like, the annual stress testing cycle of the Final UK Framework should begin one quarter following that of the U.S. stress testing framework. Staggering the two frameworks in this manner would greatly assist banking institutions with U.S. and UK operations to distribute more evenly the time and resources spent on stress testing and therefore enhance the quality of the results from both a banking institution and supervisory perspective.

- The BOE should take into consideration CCAR's disclosure templates when finalizing the Proposed UK Framework's disclosure requirements. If the BOE determines to align the two disclosure frameworks, we believe that such an alignment will facilitate the comparison of U.S. and UK stress test results, reduce the possibility of inconsistent market signals and increase the credibility and meaningfulness of stress test results. Regardless of whether the BOE determines to align disclosure requirements, banking institutions should under no circumstances be required to disclose – or should the BOE, the Prudential Regulatory Authority (the "**PRA**") or the Financial Policy Committee (the "**FPC**") disclose – base case stress test results or other information that effectively could be used as earnings guidance.

II. Key Observations and Recommendations

A. A generally uniform and consistent set of quantitative post-stress minimum capital ratios should be established for purposes of assessing stress test results.

The Clearing House acknowledges the value of the PRA and the FPC having some degree of flexibility in responding to stress test results, at both banking institution and system-wide levels. However, we strongly believe that there is a need to set consistent quantitative post-stress minimums for assessing the stress test results of individual banking institutions that are aligned with internationally agreed capital standards. The White Paper provides that banking institutions need to maintain sufficient capital resources to be able to absorb losses in the stress scenario and remain above the internationally agreed minimums. In addition, it states that the applicable regulators will take a view on the level of capital that they want banking institutions to maintain in the stress scenario – which it refers to as the "hurdle rate". The hurdle rate would take into account bank-specific factors such as credit concentration risk, interest rate risk in the banking book and the degree of confidence regulators have in the regulators' and banking institutions' ability to model the impact of stress scenarios, and, importantly, could vary from banking institution to banking institution. We believe that establishing a *bank-specific* and therefore variable "hurdle rate" is neither desirable nor appropriate.

Indeed, imposing potentially different minimum capital requirements across banking institutions may have several adverse consequences from a policy perspective. First, unless the "hurdle rate" is published for a particular banking institution, it will significantly limit the meaningfulness of the stress test results. Because the "hurdle rate" as proposed in the White Paper could be idiosyncratic to each participating banking institution and is the actual level of capital that banking institutions are required to maintain, a banking institution's *pro forma* stressed capital ratios, by themselves, will likely convey little meaningful information to the banking institution, its counterparties, market participants or members of the public who are attempting to make sense of the stress test results and undermine their ability to make "apples-to-apples" comparisons of the UK stress test results across institutions. Second, having minimum capital requirements vary across banking institutions, and potentially across stress testing cycles, will inject additional uncertainty into the capital planning process, making it more difficult for institutions to engage in prudent consolidated capital planning, especially for those subject to stress testing regimes in multiple jurisdictions. Third, if varying supervisory minimum capital requirements become apparent to market participants (and we believe they almost certainly would), they could have a damaging competitive effect on the banking institutions that are being held to higher minimum capital standards than other banking institutions, subjecting these banking institutions to increased funding costs and decreased returns on equity relative to their competitors. Markets can and should take into account regulatory assessments of capital adequacy. However, without universally applicable quantitative minimums, there is a significant degree of risk that market participants will have difficulties making informed judgments as to why banking institution X was held to a higher standard than banking institution Y, for example, thus leading to potentially distorted reactions to stress testing results. Finally, having different minimum requirements across different institutions poses the danger of discriminatory treatment among institutions due to what could be perceived, rightly or wrongly, by market participants as mere regulatory fiat, thus further undermining the credibility of the process.

Simply put, variable post-stress minimums undermine the meaningfulness and credibility of stress test results, which we believe are essential aspects of a robust and effective stress testing regime. They also threaten to cause damage to institutions' reputations in the market.

Under CCAR as currently in effect for the 2014 supervisory stress test cycle, all subject U.S. banking institutions, among other requirements, are required to maintain a ratio of (i) Tier 1 common equity to risk weighted assets of 5% under the U.S.'s previously applicable Basel I-based capital rules and (ii) CET1 to risk weighted assets of 4.5% under the U.S.'s new Basel III-based capital regulations (after giving effect to certain phase-in provisions), including under three supervisory scenarios and a banking institution-designed stress scenario, in order for their respective capital plan and planned capital actions to receive a non-objection from the Federal Reserve.[7] These quantitative requirements are readily understood by the market and provide a generally uniform standard against which all banking institutions subject to CCAR are evaluated.

Although we understand the need for flexibility in determining the response to stress test results, we do not believe that this flexibility should extend to setting what the minimum required capital ratios should be on a banking institution-by-banking institution basis. Even without the ability to set a "hurdle rate", the FPC and PRA can retain the ability to give different supervisory and policy responses to stress test results by restricting capital distributions and other planned capital actions and making a qualitative assessment of the stress test process, as well as any other factors deemed relevant, such as their confidence in the models and analyses used to determine the stress test results. The CCAR supervisory process consists of *both* a quantitative element and a qualitative assessment of stress test results and a banking institution's capital planning efforts. Under the qualitative prong of the CCAR evaluation, even if a banking institution exceeds the relevant quantitative minimum capital levels, the Federal Reserve may object to its capital plan for a variety of reasons, such as if there are unresolved supervisory issues, if the capital plan relies on inadequate assumptions and analyses or a banking institution's capital adequacy process or governance and controls are not sufficiently robust. We believe that our experience with CCAR shows that a quantitative minimum requirement that is variable and idiosyncratic on an institution-by-institution basis is neither necessary nor desirable for the reasons outlined above. We would instead urge the BOE to

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[7] 12 C.F.R. § 225.8(e)(1)(i); Federal Reserve, *Application of the Revised Capital Framework to the Capital Plan and Stress Test Rules*, 78 Fed. Reg. 59779 (Sept. 30, 2013); Federal Reserve, *Annual Company-Run Stress Tests at Banking Organizations with Total Consolidated Assets of more than $10 Billion but less than $50 Billion; One-Year Transition Prior to Revised Regulatory Capital Framework for 2013-2014 Stress Test Cycle*, 78 Fed. Reg. 59791 (Sept. 30, 2013).

adopt in the Final UK Framework a consistent set of post-stress quantitative minimum capital ratios based on the Basel III minimums, including CET1, that it will apply across all subject banking institutions and rely on the supervisory process to identify and deal with institution-specific concerns.

B. The failure to meet post-stress test requirements should have clear consequences in order to provide the proper incentives to maintain robust capital levels.

The White Paper sets forth the proposition that the results of the stress-testing exercise should not be automatically linked to particular remedial or policy actions.[8] Under the Proposed UK Framework, the PRA could require banking institutions to take a range of capital related actions including limitations on dividends, limitations on staff compensation, issuing new capital instruments, and engaging in liability management exercises – or, in some circumstances, possibly no additional action at all.[9] While we appreciate the inherent appeal of such a flexible approach, we also believe that the Final UK Framework should explicitly include, absent extraordinary circumstances, a pre-commitment for at least one or more clear consequences in the event a banking institution fails to meet the uniform and consistent quantitative regulatory minimums we advocate above.

Certain and explicit consequences for failing to meet required minimums under stressed conditions serve three interrelated purposes. First, they provide the proper incentives for banking institutions to hold robust capital levels. Second, they enhance market discipline as investors and analysts understand and anticipate the consequences of a banking institution failing a stress test and will therefore be more likely to demand more robust capital levels. Third, they provide an important level playing field among different banking institutions from a competitive equality perspective. We are not necessarily advocating which particular consequence or consequences from the menu set forth in the White Paper should be more or less automatic, but we do note that limitations on dividends and other similar capital distributions have been an effective tool in the United States as described above.

C. The expectation that bespoke scenarios will generate higher losses than the common scenarios should be eliminated because it undermines the benefits of having banking institutions design bespoke scenarios.

The White Paper provides that a key principle underlying the approach to designing bank-specific scenarios is the expectation that these scenarios would result in higher losses than the common scenarios designed by the FPC.[10] The rationale for this expectation is, according to the White Paper, that the bespoke scenarios are intended to explore risks to which

[8] White Paper, at 29.

[9] White Paper, at 30.

[10] White Paper, at 21.

each banking institution is most vulnerable and it is natural to expect that such a scenario would generate higher losses than the common stress scenario. We urge the BOE to eliminate this expectation for higher losses in the Final UK Framework because it may have the unintended consequence of causing firms to design bespoke scenarios to meet this artificial expectation rather than the banking institution's own evaluation of the specific risks faced by the institution.

Under the U.S. stress testing framework, banking institutions with more than $50 billion in total consolidated assets are required to perform and publicly release the results of mid-year stress tests based on their own company-generated scenarios in addition to annual stress tests based on common supervisory-generated stress scenarios.[11] These mid-cycle stress tests using company-generated scenarios "should reflect an individual company's unique vulnerabilities to factors that affect its firm-wide activities and risk exposures, including macro-economic, market-wide, and firm-specific events,"[12] and banking institutions should "consider their own risk profiles and operations in designing specific elements of the . . . scenarios."[13] There is no automatic supervisory expectation that such bespoke scenarios will necessarily be more severe than the scenarios created by the U.S. banking regulators. Indeed, for the 2013 mid-year stress test cycle, subject U.S. banking institutions reported stress test results and losses that were sometimes more severe than for the previous supervisory scenario tests and sometimes less.[14]

We submit that this should be a more optimal approach from a policy perspective. Banking institutions should design bespoke scenarios to reflect their own realistic expectations and perceived vulnerabilities, rather than simply design scenarios in a results-oriented manner in order to satisfy an artificial requirement that the resultant losses be more severe than those losses estimated under the common regulatory scenario. The Proposed UK Framework's expectation may also potentially divert banking institutions' focus away from actually identifying key vulnerabilities and risks that are not well-captured in the common scenarios. For example, banking institutions with a large custody business will inherently face different

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[11] *See* 12 C.F.R., subpart G to Part 252.

[12] Federal Reserve, *Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice* (Aug. 2013), at 23.

[13] Federal Reserve, *Dodd-Frank Act Mid-Cycle Stress Tests 2013: Summary Instructions*, *available at* www.federalreserve.gov/bankinforeg/stress-tests/dfa-mid-cycle-2013/May-2013-Requirements-for-Mid-Cycle-Stress-Tests.htm.

[14] For example, for CCAR 2013, the Federal Reserve projected a minimum Tier 1 common ratio of 7.5% in the supervisory severely adverse scenario for the two-year period starting in the fourth quarter of 2012 for one banking institution. Under its own severely adverse scenario as part of its 2013 mid-year stress test, this institution projected a higher minimum Tier 1 common ratio of 8.1% for the two-year period commencing in the second quarter of 2013. In contrast, another financial institution projected a *lower* minimum Tier 1 common capital ratio in its 2013 mid-year stress test than the Federal Reserve did in CCAR 2013, with that institution and the Federal Reserve projecting minimum Tier 1 common ratios of 11.2% and 13.2%, respectively.

risks from institutions that would be more significantly affected by a real-estate downturn. In our view, the supervisory focus of the review of the scenarios should be on the banking institution's governance processes surrounding the development and implementation of the stress scenarios and identification of the relevant risks, rather than whether the modeled risks necessarily result in higher loss figures than under the common supervisory scenarios. This is consistent with the U.S. stress testing framework's focus not just on quantitative results, but also on qualitative factors concerning the comprehensiveness of the capital planning and stress testing processes, including the extent to which the U.S. institution's plan adequately addresses all material risks and vulnerabilities of the banking institution, whether its governance processes provide sufficient oversight of the stress testing and capital planning processes, and the reasonableness of the banking institution's assumptions underlying the stress testing and capital planning processes.[15]

D. The practical implementation of the Final UK Framework should incorporate practices that enhance transparency between supervisors and banking institutions with respect to the mechanics and conduct of the stress testing process.

In addition to the fundamental importance of having meaningful and credible stress test results as set forth above, we believe that transparency between supervisors and banking institutions with respect to the mechanics and conduct of the stress testing process itself is also a core element of an effective and credible stress testing framework. Our experience with the evolution of the U.S. stress testing framework from SCAP to its current state has amply demonstrated the benefits of (i) regular communication and coordination throughout the stress testing process between banking institutions and regulators, (ii) clear, specific and consistent instructions regarding informational requirements, data elements, and related calculations, (iii) a well-defined, centralized and uniform process for clarifying uncertainties, and (iv) communicating changes in the stress testing process as early and promptly as possible to give banking institutions sufficient time to implement any necessary control or governance changes.

More specifically, in order to help ensure the accuracy of data provided by banking institutions and enhance the efficiency and effectiveness of the stress testing program, we suggest the following:

- *Make only necessary changes to data templates*: Changes to data reporting templates often necessitate changes to internal systems and controls. These changes increase the likelihood that inaccurate or unresponsive information will be provided. We would encourage the BOE to make changes to the data templates only when necessary. Further, in the event changes are made, we suggest that requirements are issued for comment and finalized with a sufficiently long lead time (generally at least three months in advance and possibly longer depending on the scope of the changes) before implementation is required.

[15] *See* 12 C.F.R. § 225.8(e)(1)(i).

- *Provide clear instructions*: Incomplete and unclear instructions create uncertainty and can lead to the provision of inaccurate or incomplete data. In our experience with the U.S. stress testing framework, clear, specific and consistent instructions increase the probability that accurate and complete data will be provided by banking institutions and reduce the burden on both regulators, who must respond to questions from banking institutions and review the data provided, and banking institutions.

- *Establish a formal process for clarifying uncertainties*: It is critical in our view to establish a formal process for asking and responding to questions about data collection efforts. A clear process for promptly resolving uncertainties helps to avoid misunderstandings and mistakes.[16]

- *Centralized regulatory management of communication with banking institutions*: Extensive interaction between a banking institution and its regulator is vital to the stress testing process. It can assist the regulator in understanding key assumptions and judgments in a banking institution's models and help to ensure that complete and accurate data were used, which in turn will increase the comparability of stress test results across banking institutions and the usefulness of stress test results for regulatory and internal planning purposes. We believe it is important, however, that the BOE manage these interactions in a centralized and coordinated manner to avoid the potential for inconsistent instructions or other information being provided to one or more subject banking institutions.

Over the past several years, the U.S. banking agencies have made notable improvements to the U.S. stress testing framework, including enhancing the clarity of the data templates and their related instructions, implementing a formal uniform, centrally managed "Frequently Asked Questions" process, and improving communications regarding changes to the stress testing framework and the quantitative and qualitative aspects of the agencies' criteria for reviewing capital plans and stress test results. For example, the Federal Reserve provided notice early in the stress testing cycle to institutions that would be subject to the counterparty default component of CCAR 2014, giving these institutions additional lead time to integrate this component into their stress scenarios. In addition, the Federal Reserve recently published additional guidance concerning the qualitative aspects of CCAR. This guidance outlined the Federal Reserve's expectations and views on "best practices" for internal capital planning at subject banking institutions, including with respect to institution-specific risk sensitivity, capital planning governance processes, and analytical support for capital planning, risk management, scenario design and other practices.[17] Furthermore, significant progress has

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[16] We would also encourage the BOE to establish a broadly similar process for answering questions about the Final UK Framework.

[17] *See* Federal Reserve, *Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice* (August 19, 2013).

been made in the U.S. to, over time, reduce the number of changes to data templates from year to year.

III. Recommendations for Areas of Coordination and Cooperation

A. The BOE and the U.S. banking agencies should cooperate and coordinate in order to achieve a mutual alignment, to the greatest extent practicable, of the key components of their stress testing frameworks, including with respect to common stress scenarios, data requirements and supporting documentation, and the timing of the stress testing cycle.

The Clearing House strongly endorses the BOE's commitment to "engage with relevant authorities internationally to consider how the various initiatives around stress testing can be coordinated to minimize unnecessary costs of compliance."[18] We believe that coordination with other national supervisors, including the Federal Reserve and the other U.S. Federal banking regulators, is integral to the successful implementation of the Proposed UK Framework in light of the multi-jurisdictional scope of the businesses of many of the banking institutions that will be covered by it.[19] At a fundamental level, both the U.S. stress testing framework and the Proposed UK Framework are aimed at the same supervisory objective – to assess capital adequacy from both a micro-prudential institution-specific and a macro-prudential systemic perspective, in each case, on a forward-looking basis. For a U.S.-based institution subject to the U.S. stress testing framework on a consolidated level and the Proposed UK Framework with respect to its UK operations, the consolidated U.S. stress testing results will inherently include effects on its UK operations. Conversely, for a UK-based financial institution subject to the Proposed UK Framework at a consolidated level and the U.S. stress testing framework for its U.S. operations, the UK stress tests will also necessarily reflect its effects on such institution's U.S. subsidiaries and affiliates. If the two stress testing regimes are not coordinated to a substantial degree, both the U.S.-based and the UK-based financial institutions will be faced with the difficult task of meeting possibly contradictory capital adequacy assessments. Further, a lack of coordination resulting in a divergence between the two regimes could undermine the credibility of both frameworks to market participants. Finally, from a policy and supervisory perspective, the UK and the U.S. banking regulators may find it difficult to adequately assess international systemic capital adequacy without a coordinated and comparable approach to stress testing. We would expect that such coordination would serve to strengthen both the Proposed UK Framework and the U.S. stress testing framework, and allow the U.S. banking agencies and the BOE to benefit from each other's observations and experiences. Certainly the

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[18] White Paper, at 12.

[19] In addition, The Clearing House believes that national regulators, including the BoE, should further consider the manner in which consolidated, cross-jurisdictional stress testing should be applied to banking institutions that are organized with largely stand-alone operations in various individual jurisdictions.

events of the 2007-2009 financial crisis have amply demonstrated the necessity of international regulatory cooperation in the face of cross-border risks and spill-over effects.

We urge the BOE and the U.S. banking regulators to coordinate when developing stress scenarios, data requirements and supporting documentation and to make such components, to the greatest extent practicable, consistent for institutions that will be subject to dual stress testing under both regimes. To the extent that there is a closer alignment of key aspects of the Final UK Framework and those of the U.S. stress testing framework, we believe that the timing of the annual stress testing cycle for the two frameworks should similarly be aligned.

More particularly, we submit that there are several substantial benefits to such coordination and consistency:

- *Increased certainty*: Greater consistency between the U.S. stress testing framework and the Final UK Framework will lessen the uncertainty of the capital planning process for banking institutions subject to both frameworks. This increased certainty will enhance the ability of such institutions to engage in medium-to-longer-term capital planning on a holistic, enterprise-wide basis by minimizing the risk of contradictory or inconsistent capital adequacy assessments by the BOE, on the one hand, and the Federal Reserve, on the other.

- *Increased quality of results* The stress testing process at large, internationally active banking institutions is a time- and resource-intensive exercise. As the BOE notes in the White Paper, stress testing at a high frequency would entail "material resource costs, both for banks and regulators" and "it would risk the stress-testing exercise becoming an overly mechanical process, squeezing out innovative thinking around new, emerging risks or sufficient engagement by key-decision makers to interpret – and act upon – the results."[20] Absent international coordination, this same type of risk is present with international banking institutions having significant operations in both the UK and the U.S. We believe that stress testing is a fundamental part of sound risk management and capital planning practices. However, a failure to align the U.S. stress testing framework and the Final UK Framework for institutions subject to multiple stress testing regimes risks degrading the quality of the stress testing exercise, because, instead of focusing their attention and resources on the analytical rigor of their stress testing process and the quality of results therefrom, institutions will have to focus on and dedicate material resources to meeting different stress testing requirements on each side of the Atlantic. This risk can be mitigated by aligning key aspects (including the stress scenarios, data requirements, supporting documentation and stress testing cycle timing) of the Proposed UK Framework and the corresponding elements of the U.S. stress testing

[20] White Paper, at 14.

framework. Such an alignment will increase the ability of key banking institution personnel to devote attention to stress testing and how best to address risks identified during the stress testing process, thereby enhancing the quality and value of the stress testing process from the perspective of supervisors and banking institutions themselves.

- *Enhanced transparency*: Aligning key components of the Final UK Framework and the U.S. stress testing framework would allow both the U.S. banking regulators and the BOE to leverage their respective experience and insights and thereby enhance transparency and global confidence in the results of these stress testing frameworks. As discussed above, market participants, analysts and the broader public have had several years of experience with the U.S. stress testing framework, which has produced stress test results broadly perceived as credible. Substantial coordination and congruity between the two stress testing regimes would likely produce synergies that increase the transparency of capital adequacy by eliminating the potential for confusion stemming from competing and overlapping supervisory assessments based on divergent stress testing processes, different models and incompatible assumptions. It would also reduce the likelihood of inconsistent market signaling, whereby significantly different stress test results in the UK and the U.S. for the same institution, or for various institutions with not-too dissimilar businesses, lead capital markets to generally penalize banking institutions because of inherent uncertainty concerning cross-border capital adequacy.

- *Mutual improvement in stress testing practices*: Our experience with the U.S. stress testing framework has impressed on us the value and necessity of making iterative improvements to the stress testing process over time based on feedback on the stress testing process from banking institutions, regulators and market participants. Accordingly, we believe that greater coordination would afford the BOE and U.S. banking agencies an opportunity to benefit from each other's experiences with stress testing and to improve and strengthen both frameworks.

We readily recognize that certain aspects of the Proposed UK Framework may need to be tailored to address UK-specific risks, for example, because macro-economic conditions may differ in each jurisdiction over time. Nevertheless, for all the reasons stated above, we urge the BOE and the U.S. banking agencies to align the key components of their respective stress testing frameworks, to the greatest extent practicable, for institutions subject to both regimes. We are convinced that both UK and U.S. regulators will be able to cooperatively ensure that country-specific risks are addressed on a coordinated basis such that, for example, in implementing the Final UK Framework, the BOE's stress testing scenario assumptions regarding the path of the U.S. economy for UK banking institutions with significant U.S. operations are consistent with those of the Federal Reserve for U.S.-based banking institutions and *vice versa*. Similarly, global market shocks and other similar components of stress scenarios, whether applicable to a subset of systemically important institutions such as under CCAR in the U.S. or more broadly, should be coordinated because they inherently measure the same types of global risks for banking institutions irrespective of their jurisdiction of incorporation.

B. To the extent the common stress scenarios of the Final UK Framework and the U.S. stress testing framework are not generally aligned, there should at least be a broad degree of consistency during each annual stress testing cycle in the general relative severities of the stress scenarios in both frameworks.

Pursuant to the White Paper, a banking institution is expected to maintain its capital levels at or above internationally-agreed minimums even under stress conditions.[21] Although the specific details of the variables of the macroeconomic scenario will certainly affect how particular portfolios and lines of business are impacted for each stress test cycle, the general degree of severity of each macroeconomic scenario – once every 20-year recession, Great Depression, etc. – can usually be determined using appropriate historical and econometric analysis tools. The relative general severity of the stress scenario being used will likely be one of the most – if not the most – important driver of capital levels under stressed conditions. If the relative severities of the UK and U.S. stress test frameworks are not generally aligned for each stress test cycle, banking institutions subject to both regimes will find it quite challenging to engage in prudent capital planning across their UK and U.S. operations as a practical matter because of the relative differences in the amount of capital they would be required to hold under each jurisdiction's stress test scenarios. Thus, even if the details of the macroeconomic variables of the stress scenarios themselves are not coordinated between the UK and U.S., we would nevertheless urge the BOE to at least align the relative severities of the Final UK Framework's stress scenarios with those of the U.S. stress testing framework. For example, the macroeconomic variables of the stress scenarios could be calibrated to a probability or occurrence ceiling of no more than once in five years (*i.e.*, a 20% probability of occurrence) in both jurisdictions even if the actual details of the scenarios are different. If a more severe scenario is also utilized, as it is in the United States, that scenario could be calibrated to, for example, a 5% probability of occurrence in both the U.S. and the UK for a particular stress test cycle. Therefore, although macroeconomic scenarios and variables could change from year to year and from jurisdiction to jurisdiction, their relative general severities in both the U.S. and the UK for each particular cycle would be calibrated to the common coordinated probability of occurrence. Absent greater degrees of coordination as discussed above, The Clearing House believes that such an approach would at least serve to ameliorate the challenges to capital planning to meet both the U.S. and the UK stress test-dictated requirements.

C. In the event stress scenarios, data collection requirements and documentation are not closely aligned with those components of the U.S. stress testing framework,

[21] If a bank's capital levels fall below internationally agreed minimum capital levels in any of the stress scenarios, the White Paper provides that the PRA would likely require the banking institution to make material adjustments to its capital plan to strengthen its ability to withstand shocks. White Paper, at 30.

the annual stress testing cycle of the Final UK Framework should begin one quarter following that of the U.S. stress testing framework.

As noted above, we strongly urge the BOE and the Federal Reserve to align key components of the Proposed UK Framework and the U.S. stress testing framework. However, if these components are not closely aligned, having the timing of the annual stress testing cycle of the Final UK Framework and the U.S. stress testing framework be the same, and therefore requiring institutions subject to both frameworks to run substantively different stress tests on a concurrent basis, is likely undesirable. The ability of key personnel to engage fully in both stress testing processes (in addition to managing important business lines) may be quite limited in light of the substantial time and resources necessary to ensure a robust stress testing process. Constraining the ability of key personnel to participate in the stress testing process may undermine the value and quality of the stress testing process itself to the detriment of both banking institutions subject to both regimes as well as U.S. and UK regulators. Absent solving this issue through substantive coordination, we would, at minimum, propose that the annual UK stress testing cycle generally begin one quarter after the commencement of the U.S. stress test cycle and be based on year-end financial results.[22] Although some overlap between the U.S. and UK stress test cycles is inevitable, commencing the Final UK Framework's annual stress testing cycle three months after the start of the U.S. annual stress testing cycle would help subject banking institutions to distribute more evenly the time and resources spent on stress testing over the course of the year. Delaying the commencement of the Final UK Framework's annual stress testing cycle more than three months may result in additional overlap and regulatory burden because of the mid-year stress testing process in the United States, which begins six months following the commencement of the annual stress testing cycle.

D. The BOE should take into consideration CCAR's disclosure templates when finalizing the Proposed UK Framework's disclosure requirements.

The Clearing House agrees that stress test results and an analysis of those results should be made public in order to enhance the meaningfulness and credibility of the UK stress test process. As with other aspects of the Final UK Framework, we would encourage the BOE to coordinate with the Federal Reserve regarding the substantive disclosure requirements under the Final UK Framework. In addition, we urge the BOE to take into consideration the CCAR disclosure requirements and templates when finalizing the Proposed UK Framework's own disclosure requirements. We have found that the CCAR disclosure framework, although not without some flaws, generally strikes a reasonable balance between providing useful information to investors, counterparties and other market participants and protecting proprietary information, which could cause competitive harm to a banking institution if disclosed. If the BOE determines to align the two disclosure frameworks, we believe that such an alignment will facilitate the comparison of U.S. and UK stress test results, reduce the

[22] The annual CCAR process is based on financial data as of the end of the third quarter of each year.

possibility of inconsistent market signals and increase the credibility and meaningfulness of stress test results.

Regardless of what the BOE determines regarding alignment, under no circumstances should banking institutions be required to disclose – or should the BOE, PRA or FPC disclose – base case stress test results or other information that effectively could be used by analysts and the market as earnings guidance.[23] To do otherwise would be the equivalent of requiring subject banking institutions to provide earnings guidance and detailed profit and loss forecasts for the relevant planning horizon. The virtually inevitable differences between actual results and the presumed expectations set forth in any baseline disclosures could create significant and unnecessary risks to banking institutions and the banking sector more broadly, and potentially lead to exposure to other liabilities under the securities laws of various jurisdictions.

IV. Other Issues and Clarifications

A. Clear rules should be established regarding the treatment of, over the relevant stress test planning horizon, capital requirements subject to phase-in or delayed implementation, as well as proposed amendments to capital requirements.

As in the United States, certain aspects of capital regulation in the United Kingdom remain subject to phase-in and potential amendment. Further, the Basel Committee on Banking Supervision continues to consider changes to its market risk capital rules as well as the treatment of securitization exposures, investment funds and derivatives and cleared transactions, among other aspects of capital regulation. These changes will likely prompt corresponding changes to CRD IV[24] and the UK implementation thereof. In our experience, it is critical that there be clear instructions as to how any proposed changes to the relevant capital framework or requirements subject to a phase-in or delayed implementation should be addressed for purposes of stress testing requirements.[25] Failing to provide clear instructions can cause unnecessary confusion on the part of both banking institutions and regulators. It can also lead to inconsistent implementation of capital requirements, which in turn undermines the comparability of stress test results as well as their usefulness to banking institutions, regulators and market participants.

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[23] Disclosure of base case stress results has not been required under any iteration of CCAR.

[24] "**CRD IV**" as used in this letter refers to Directive 2013/36/EU of the European Parliament and of the Council of the European Union of June 26, 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, together with its implementing regulations.

[25] For example, these rules could address whether projections of capital over the planning horizon should be based on existing capital rules or capital rules that will not go into effect until a certain number of quarters into the planning horizon.

B. Supervisory decisions regarding the appropriateness of *pro forma* management actions when modeling the impact of a given scenario should be made in a centralized and uniform manner.

Under the Proposed UK Framework, management would be expected to take a "conservative approach" to incorporating management actions when modeling the impact of a given scenario.[26] We believe that incorporating *pro forma* management actions makes the stress test results more accurate and realistic and commend the BOE for proposing to take them into account. We would urge, however, the BOE to clarify in the Final UK Framework that the decision regarding whether management took an appropriately "conservative approach" would be made in a centralized manner by the BOE and applied in the same manner across banking institutions. We believe it is crucial from the perspective of competitive equity among institutions and for the credibility of the stress testing process itself, that evaluations concerning such management actions be made in a horizontally consistent manner as opposed to on an *ad hoc* basis by individual examination teams.

C. The BOE should clarify that a banking institution is permitted to design bespoke scenarios that apply to all its subsidiaries.

In addition to the common scenarios applied across all banking institutions taking part in the exercise that would be designed by the FPC in consultation with the PRA, the Proposed UK Framework would require banking institutions to design bespoke scenarios in order to explore risks to which each banking institution would be most vulnerable, and to strengthen banking institutions' ability to identify and quantify risks to their businesses. We request that the BOE clarify in the Final UK Framework that a banking institution is permitted to design a single bespoke scenario for all its subsidiaries. We appreciate, of course, the need for the bespoke scenario to address any applicable business-line-specific, geographic or other sources of risk present in the subsidiaries. However, requiring separate stress tests for particular subsidiaries would create additional complexity for market participants attempting to understand the stress test results and create additional administrative burden for subject banking institutions and regulators.[27]

D. Banking institutions should be permitted to manage capital distributions in a flexible manner among legal entities of the same consolidated group.

The ability to manage intra-group capital distributions within the consolidated entity is of particular importance to banking institutions with global operations. Restricting this ability could impede these institutions' ability to manage capital and liquidity at the consolidated level in a prudent manner, including in particular their ability to manage double leverage. We would therefore encourage the BOE to clarify in the Final UK Framework that distributions to parent

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[26] White Paper, at 25.

[27] We note that the U.S. banking agencies generally have committed to using and indeed have used consistent supervisory scenarios at the bank holding company and depository institution levels.

companies would be permitted, absent extraordinary circumstances, in the event that the relevant banking institution satisfies all applicable capital planning buffers, individual capital guidance and internal buffer requirements and meets the minimum capital requirements under applicable stress conditions.

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We would be pleased to engage in additional dialogue with the BOE, as well as the U.S. banking regulators, regarding the recommendations and other matters addressed in this letter as the Proposed UK Framework is finalized and the Final UK Framework is implemented.

We thank you for considering the comments provided in this letter. If you have any questions or need further information, please contact me at 212.613.9883 (email: david.wagner@theclearinghouse.org) or Brett Waxman at 212.612.9211 (email: brett.waxman@theclearinghouse.org) if we can be of assistance to you in helping to arrange for those discussions or in any other way.

Respectfully submitted,

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