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Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, SW., Suite 3E-218, Mail Stop 9W-11,
Washington, DC 20219
regs.comments@occ.treas.gov Docket ID OCC-2013-13

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW,
Washington, DC 20551
regs.comments@federalreserve.gov Docket No. OP-1461

RE: Proposed Supervisory Guidance on Implementing Dodd-Frank Act Company-Run Stress Tests for Banking Organizations with Total Consolidated Assets of more than \$10 Billion but less than \$50 Billion

Thank you for the opportunity to comment on the Proposed Supervisory Guidance.

The comments on the five questions share a common theme. Three points frame this theme:

- **First, the Guidance is founded on solid principles (p 16).**
 - Strong points in the Guidance include:
 - Openness to using any appropriate practices (§I p16)
 - Recognition of range of company-specific factors (§I p16)
 - Scope limitation that the document is not comprehensive (§I p16)
 - Recognition of broader risk to a company § IV E, pp44-45
 - Cautions on assumptions (§ III C, p22), especially proxy data and need to challenge past experience (§ III C 2, p24). This is emphasized with multiple cautions on use of historical data.
 - Concern with cost effectiveness in credit loss modeling (§ IV C 4, p31)
 - Explicit permission to link to the budgeting process (§ IV C, p29)
 - Some of the most forward-looking points are references to “company's core businesses and earnings capacity” (§ III C 6, p36) that provides focus on business model; and to overall strategy and business plans (§ IV E, p44).
- **Second, as with the past decade of struggles in financial institutions, achieving the aspirations of the Principles is likely beyond reach because implementation details are often at odds with the Principles.**
 - Basel Accords have also struggled with similar challenges.
 - The Accord's principles and some implementation were written with a forward-looking industrial systems approach to reducing risk to the quality of *future* products

and operations. Yet, later drafts introduced a backward-looking view of risk to reporting *previous* transactions.

- The difference is dramatic -- managing risk to the circus trapeze performers flying over hungry lions versus counting the cash box.
- Structural barriers to successful implementation of the Principles include:
 - Using compliance-oriented risk management methods. These tend to be more proximate cause, backward-looking, associative and/or loss event-oriented.
 - Such measures are often disconnected from forward-looking risk to business objectives such as making good loans and generating cash flow.
 - Capital model error ranges expand when proxy and synthetic data is used. This is simply because of the assumption that such data reflect real-life, specific environments faced by, and capabilities of each company. Such an error would not be made by a face-painted football fan in a sports bar comparing two teams. Why should it be acceptable in banks?
 - Such approaches usually misapply tools designed for credit risk or audit of internal controls to strategic or operational risk (including operational risk from strategic overreach).
 - For example:
 - Struggles to determine “risk appetite.” “Appetite” has little meaning outside business performance *objectives*. Objectives only have risk in the context of some environment and capabilities as described in scenarios. It is easy for a football player to run a football into the end zone on an empty field on a nice day.
 - IT-related risk. Company operations, especially information technology capabilities and digital geographic footprint (i.e., customer and data center locations), are critical dependencies. Without adequate or robust operations, there is no financial company. Technology is all about systems – motion pictures such as *Apollo 13* or the *Ocean’s* series use this point for dramatic effect. Tools designed for managing risk in systems (not credit or reporting audits) are required.
 - These approach/method/tool problems then pass inadequate data into capital adequacy models.
 - Emphasizing the capital adequacy model over the *business* model. Excessive focus on capital adequacy risk model has distracted from managing risks to business model strategy and execution. As a small retailer knows, an inventory credit line, while important, is no substitute for selling the right products at the right location. The wrong focus not only wastes cost, but also can be dangerous when model-mickeying distracts management from looming risk.

- Embed risk oversight and management into daily business decisions and activities (as emphasized in Principle 4, p16) as is done in other industries. Such an approach brings a more root cause, forward-looking and situation-in-time perspective. This not only makes a strong linkage to actually managing risk to business objectives, but also has potential for significant cost savings for smaller companies simply because it dovetails risk management with business performance management. This also minimizes governance and compensation misalignment.
- Center that embedded risk oversight and management on the design and daily execution of the banking business model – especially as it is changing and more complex.

Question Responses

- Question 1. These challenges and complications in tailoring are significant problems IF the more backward-looking, loss event-oriented approach is taken. However, IF the Principles (p16) are supported with the more forward-looking, systems-based approach, then these challenges will diminish because the needed tailoring will: a) be more clear through more life-like scenarios and b) managing risk to business performance (as defined in business plans and expectations communicated to investors) will naturally be more integrated with the risk model. Suggested improvements:
 - Revise throughout to emphasize performance-driven management of risk -- the more forward-looking, embedded, systems-based and business model-oriented approach.
 - Simplify the regional tailoring by providing: 1) starting assumptions that are more applicable to these companies and 2) a timely method to review/approve company tailoring *prior to* a company spending the cost to finalize.
- Question 2. Yes, simply make the primary approach forward-looking as in Principle 3 (p16), rather than the backward -looking emphasis (despite the document’s several cautions). Suggested improvements:
 - Focus on risk evaluation based on *realistically asking “what if?”* to understand risks lurking in the environment and business capabilities (including capabilities of parties who would maliciously or unintentionally engage a company).
 - *Strengthen existing cautions* on use of historical data and state the need to justify reasonableness of extrapolating from past data into the future.
 - Likewise, state the need to *justify proxy data* based on the expected future state of the environment and business capabilities.
- Question 3. Suggested improvements:
 - Companies to describe how risks common to *any* vendor managing any business activity are being managed for the third-party DFA stress test vendor.
 - Companies to describe, in the context of the unique role of stress test modeling, the ability of a third-party to *sufficiently understand the company’s specific environment and capabilities*; dependency risk on the company’s specific software, configuration, equations,

- people and locations; and why using a third-party to manage the model does not cause a disconnect from the company's daily activities to manage risks to performance objectives.
- Question 4. This situation would be helped by the improvement in reply to Question 1 -- to shift to an approach that is more deeply *embedded in daily business*, including the financial and operational performance management tools. This is simply because the risk model would then be more integrated with tools already used for company modeling and reporting.
 - Additional suggested improvement: Graphically present the table in a way that is similar the primary supervisor tables found on some agency websites.
 - Question 5. Summarizing the above comments, suggest communicating to boards and management that:
 - A system-based approach is embedded into daily decisions and activities that design or execute the business model; and that this information flows to the risk model.
 - It is acceptable (if not encouraged) to integrate risk modeling into normal business modeling and reporting of financial and operational performance. Better outcomes for all, lower costs for banks.

Suggest Resources:

- Operational Risk: A Simpler Starting Point for Capital Modeling and Estimation, Gabriel David and Brian Barrier, GARP, March 2013. <http://www.garp.org/risk-news-and-resources/2013/march/a-simpler-starting-point-for-capital-modeling-and-estimation.aspx>
- The Operational Risk Handbook, Brian Barnier, Harriman House, Great Britain, 2011
- ICGN Dialogue in Corporate Governance: Risk Oversight, a six page guidance document for investors to use in evaluating company risk oversight. https://www.boardmember.com/Article_Details.aspx?id=9994

Respectfully submitted,

Brian Barnier
Principal Analyst/Member, ValueBridge Advisors, LLC