

THE ADMINISTRATIVE PROCEDURE ACT AND FEDERAL RESERVE STRESS TESTS ENHANCING TRANSPARENCY




SEPTEMBER 2016

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ACT AND FEDERAL RESERVE STRESS
TESTS**

Enhancing Transparency

September 2016



Founded in 2006, the Committee on Capital Markets Regulation is dedicated to enhancing the competitiveness of the U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-four leaders drawn from the finance, business, law, accounting, and academic communities. The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations

The Committee Co-Chairs are R. Glenn Hubbard, Dean of Columbia Business School and John L. Thornton, Chairman of the Brookings Institution. The Committee's Director is Hal S. Scott, Nomura Professor and Director of the Program on International Financial Systems at Harvard Law School. The Committee's research on the regulation of U.S. capital markets provides policymakers with an empirical foundation for public policy.

Introduction¹

The Administrative Procedure Act of 1946 (the “**APA**”) imposes a set of uniform procedural requirements on federal agencies, requiring that: (a) agencies provide the public notice of proposed rules and an opportunity to comment on them (“**notice-and-comment procedures**”)²; (b) agencies publish their final rules³; and (c) agency actions be subject to judicial review and reversal if they fail to comply with the APA’s procedural requirements or are otherwise arbitrary and capricious.⁴ The objective of the APA is to “achieve relative uniformity in the administrative machinery of the federal government,”⁵ and to “ensure[] that the massive federal bureaucracy remain[s] tethered to those it governs.”⁶

However, the Federal Reserve (“**Fed**”) has likely not complied with the APA’s procedural requirements in adopting key aspects of its Comprehensive Capital Analysis and Review (“**CCAR**”) stress tests that quantify whether under future adverse economic conditions a bank can maintain sufficient capital to meet regulatory minimums.⁷ Importantly, if a bank fails to maintain adequate capital then the Fed can prevent the bank from returning cash to shareholders through dividends or stock buybacks.⁸ Therefore, the Fed’s stress tests act as a *de facto* binding capital constraint on banks.

¹ Deutsche Bank and the ICBA dissent from this report.

² 5 U.S.C. § 553.

³ *Id.* § 552(a)(1)(D).

⁴ *Id.* § 706(2).

⁵ U.S. Dep’t of Justice, Attorney General’s Manual on the Administrative Procedure Act 5 (1947) [*hereinafter* Attorney General’s Manual].

⁶ *Riverbed Farms, Inc. v Madigan*, 958 F.2d 1479, 1484 (9th Cir. 1992).

⁷ Non-banks supervised by the Fed, such as institutions designated as systemically important financial institutions by the Financial Stability Oversight Council can also be made subject to the stress tests by the Fed. *See* 12 CFR §252.43(a).

⁸ Indeed, since the Fed formally adopted the program in late 2011, each time an institution has failed the stress tests the Fed has objected to the institution’s planned capital distributions. *See, e.g.*, Stephen Gandel, *Citi and four other banks stumble in Fed stress tests*, *Fortune*, Mar. 26, 2014, <http://fortune.com/2014/03/26/citi-and-four-other-banks-stumble-in-fed-stress-tests/> (noting that Zion’s failed the stress tests and the Fed rejected its capital plan); *Fed*

The Committee on Capital Markets Regulation (the “**Committee**”) recommends that the Fed follow the APA’s procedural requirements in developing key aspects of its stress tests because doing so would result in better public policy outcomes and reduce the threat of legal challenge to the Fed’s actions. Part I of this report describes the Fed’s stress test process. Part II analyzes how the Fed’s stress test process has likely failed to comply with the APA’s procedural requirements. Part III sets forth policy recommendations that would improve the transparency of the stress test process and promote compliance with the APA’s procedural requirements.

Rejects Ally, BB&T capital plans in stress tests, Reuters, Mar. 14, 2013, <http://www.reuters.com/article/usa-banks-stresstests-idUSW1N0BP03B20130314> (noting that Ally Financial was the only bank to fail the quantitative stress test and its capital plan was rejected); Peter Eavis and B. Silver-Greenberg, *15 of 19 Big Banks Pass Fed’s Latest Stress Test*, N.Y. Times, Mar. 13, 2012, <http://www.nytimes.com/2012/03/14/business/jpmorgan-passes-stress-test-raises-dividend.html> (noting that Citi failed the stress tests and that Citi’s capital plan was rejected); *SunTrust says no dividend raise till 2013*, Reuters, July 20, 2012, (noting that SunTrust failed the stress test and its capital plan was rejected); Robin Sidel et al., *Citi Rejection Stings Pandit*, Wall Street Journal, Mar. 15, 2012, <https://www.gsb.stanford.edu/sites/default/files/research/documents/Print%20-%20Citi%20Rejection%20Stings%20Pandit%20-%20WSJ.pdf> (noting that Ally Financial failed the stress test and its capital plan was rejected); Press Release, MetLife, MetLife Comments on Federal Reserve’s Comprehensive Capital Analysis and Review (noting the Fed rejected MetLife’s capital plan after it failed the stress test).

I. The Fed's Stress Tests

In 2011, the Fed implemented rules establishing an intensive, annual assessment of the capital adequacy of bank holding companies with total consolidated assets equal to or greater than \$50 billion and non-financial companies supervised by the Fed, often referred to as the CCAR stress tests.⁹ As Fed officials have stated, the stress tests “complement standard capital ratios by adding a more forward-looking perspective and by being more oriented toward protection against so-called tail risks”¹⁰ and therefore serve as “a means for assuring that large, complex financial institutions have sufficient capital to allow them to remain viable intermediaries even under highly stressful conditions.”¹¹

The Fed collects the historical bank-specific data used in the stress tests throughout the calendar year prior to the test, as well as additional, more current data during the stress test period.¹² The Fed typically discloses the potentially adverse economic conditions it will apply in the tests by mid-February¹³ and the banks must provide their capital plans to the Fed by April 5.¹⁴ The capital plans must include a description of a bank's planned issuances or repurchases of stock or debt and payment of dividends.¹⁵ The Fed then runs stress tests that quantify, based on

⁹ Capital Plans, 76 Fed. Reg. 74,631 (Dec. 1, 2011); 12 CFR § 225.8., Board of Governors of the Federal Reserve System, Comprehensive Capital Analysis and Review 2016 Summary Instructions 1 (Jan. 2016), *available at* <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160128a1.pdf>. 12 CFR § 225.8(b).

¹⁰ Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System, Stress Testing Banks – What Have We Learned? (Apr. 8, 2013). The large financial institutions subject to the Fed's supervisory stress tests are subject to minimum capital requirements, including a common equity tier 1 capital ratio of 4.5 percent, a tier 1 capital ratio of 6 percent, a total capital ratio of 8 percent and a leverage ratio of 4 percent. *See* 12 CFR § 217.10(a).

¹¹ Governor Daniel K. Tarullo, Member of the Board of Governors of the Federal Reserve System, Stress Testing After Five Years (June 25, 2014).

¹² Board of Governors of the Federal Reserve System, Instructions for the Capital Assessments and Stress Testing Information Collection (Reporting Form FR Y-14Q), *available at* https://www.federalreserve.gov/reportforms/forms/FR_Y-14Q20151231_i.pdf; Board of Governors of the Federal Reserve System, Instructions for the Capital Assessments and Stress Testing Information Collection (Reporting Form FR Y-14M), *available at* https://www.federalreserve.gov/reportforms/forms/FR_Y-14M20151231_f.pdf.

¹³ 12 CFR § 252.44(b)

¹⁴ *Id.* § 225.8(e)(1)(ii).

¹⁵ 12 CFR § 225.8(e).

detailed bank-specific data – including data on loans, investments, revenues, operational risks, trading activities, net interest income and assets¹⁶ – a bank’s projected future capital ratios under adverse economic conditions¹⁷ and releases the results by June 30.¹⁸ If the projected capital ratios for the four quarters immediately following the release of the results do not meet or exceed the required regulatory minimum capital ratios then the Fed will object to a bank’s planned dividends and stock buybacks for that period.¹⁹ Although Dodd-Frank requires the Fed to conduct stress tests, it does not require the implementation of stress tests that provide the Fed with the authority to veto a bank’s capital distributions.²⁰

A. Stress Test Assumptions

To run the stress tests, it is necessary for the Fed to decide what stressful economic and financial market conditions banks may encounter on a going-forward basis, and so the Fed adopts *assumptions* about these conditions. These assumptions include estimates of future GDP growth, interest rates and the unemployment rates, along with dozens of other macroeconomic

¹⁶ See generally Board of Governors of the Federal Reserve System, Instructions for the Capital Assessments and Stress Testing Information Collection (Reporting Form FR Y-14Q), *available at* https://www.federalreserve.gov/reportforms/forms/FR_Y-14Q20151231_i.pdf; Board of Governors of the Federal Reserve System, Instructions for the Capital Assessments and Stress Testing Information Collection (Reporting Form FR Y-14M), *available at* https://www.federalreserve.gov/reportforms/forms/FR_Y-14M20151231_f.pdf

¹⁷ The CCAR review also contains what the Fed refers to as a “qualitative” review. As part of that review, the Fed focuses on the bank’s capital planning processes. In particular, the supervisors focus on the bank’s internal practices used to determine the amount and composition of capital that it needs to continue to function in a period of stress. For example, the Fed considers the extent to which the bank’s internal analysis captures and addresses potential risks stemming from the bank’s activities. Board of Governors of the Federal Reserve System, Comprehensive Capital Analysis and Review 2015: Assessment Framework and Results 16 (March 2015), *available at* <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20150311a1.pdf>. This qualitative review is distinct from the quantitative stress tests, which are the focus of this report.

¹⁸ *Id.* §225.8(f)(2)(v).

¹⁹ Board of Governors of the Federal Reserve System, Comprehensive Capital Analysis and Review 2016: Assessment Framework and Results 23 (June 2016), <https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160629a1.pdf> [hereinafter 2016 CCAR Results].

²⁰ 12 U.S.C. § 5365(i).

and financial market variables.²¹ These assumptions are applied consistently among banks subject to the stress tests.²²

More specifically, the Fed develops three sets of assumptions to test how banks would fare under those varying conditions. Its CCAR rule refers to those assumptions as “baseline,” “adverse,” and “severely adverse” assumptions. “Baseline” assumptions is defined as “a set of conditions that affect the U.S. economy or the financial condition of a covered company and that reflect the consensus views of the economic and financial outlook”²³; adverse assumptions as “a set of conditions that affect the U.S. economy or the financial condition of a covered company that are more adverse than those associated with the baseline scenario”²⁴; and severely adverse assumptions as “a set of conditions that are overall more severe than those associated with the adverse scenario.”²⁵ The “severely adverse” set of assumptions are of the greatest importance because banks must maintain their capital ratios under all of the assumptions and the “severely adverse” assumptions are the harshest.

Despite the importance of the assumptions to the stress tests, the specifics of these assumptions are not set forth in any of the Fed’s rules that were subject to public notice-and-comment procedures. Although the Fed has published a high-level scenario design paper

²¹ Beverly Hirtle & Andreas Lehnert, Supervisory Stress Tests, Federal Reserve Bank of New York Staff Reports, No. 696 at 18 (2014).

²² Supervisory and Company-Run Stress Test Requirements for Covered Companies, 77 Fed. Reg. 62,378, 62,384 (Oct. 12, 2012); Tarullo, *supra* note 10; Bernanke, *supra* note 9.

²³ 12 CFR § 252.42(e).

²⁴ *Id.* § 252.42(b).

²⁵ 12 CFR § 252.42(o). The commentary in the Fed’s adopting release stated that severely adverse assumptions will, at a minimum, include economic and financial market condition variables “generally consistent with the paths observed during severe post-war U.S. recessions.” Supervisory and Company-Run Stress Test Requirements for Covered Companies, 77 Fed. Reg. at 62,384. The Fed has also stated that in the severely adverse assumptions the unemployment rate would generally increase three to five percentage points from the existing level of unemployment over a six to eight calendar quarter period, though the unemployment rate in under severely adverse assumptions will rise to at least 10 percent. The values of the other variables are derived from the assumed unemployment rate, either based on historical relationships or case-by-case judgments. *See* Policy Statement on the Scenario Design Framework for Stress Testing, 78 Fed. Reg. 71,435, 71,444-48 (Nov. 29, 2013).

outlining its general approach, it does not provide details about each year's assumptions as they are being developed or specific details about how those assumptions were determined.²⁶ Instead, the Fed develops the assumptions internally and discloses them to the public as a fait accompli in mid-February.²⁷ According to the Fed, this process allows the Fed's assumptions to "incorporate economic or financial market data that are as current as possible."²⁸

However, because the Fed's assumptions are ultimately disclosed, we can learn a great deal from them. For example, we know that the assumptions used by the Fed have varied significantly from year-to-year. For example, in 2015, the Fed's severely adverse assumptions were more severe than those used in 2014 insofar as the Fed's 2015 assumptions assumed that in a severe recession corporate credit quality would worsen even more than in 2014 and therefore included a greater decline in equity prices, a greater increase in market volatility, and a greater widening of corporate bond spreads than the 2014 assumptions.²⁹

The Fed assumptions have also vastly differed from reality. For example, for the stress test results released in 2014, the Fed's severely adverse scenario assumed that GDP would decline 4.75% from the end of the third quarter in 2013 until the end of 2014 and that the unemployment rate would hit 11.25% in 2015.³⁰ In reality, the unemployment rate in 2015 peaked at 5.7%³¹ and GDP growth in 2014 ranged from a low of (0.9)% in the first quarter to a

²⁶ See generally Policy Statement on the Scenario Design Framework for Stress Testing, 78 Fed. Reg. 71,435, (Nov. 29, 2013).

²⁷ 12 CFR § 252.44(b).

²⁸ Supervisory and Company-Run Stress Test Requirements for Covered Companies, 77 Fed. Reg. at 62,382.

²⁹ Board of Governors of the Federal Reserve System, Dodd-Frank Act Stress Test 2015: Supervisory Stress Test Methodology and Results 7 (2015) [*hereinafter* 2015 Dodd-Frank Report].

³⁰ Board of Governors of the Federal Reserve System, 2014 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule 3 (Nov. 1, 2013), *available at* <http://www.federalreserve.gov/bankinfo/bcreg20131101a1.pdf>.

³¹ *Tables & Calculators by Subject*, United States Department of Labor Bureau of Labor Statistics, Databases, <http://data.bls.gov/timeseries/LNS14000000> (last visited June 27, 2016).

high of 4.6% in the second quarter.³² One could therefore question whether the severely adverse assumptions are within reason.

More recently, the 2016 assumptions failed to consider the most salient economic and financial market risks facing institutions. For example, although the Fed's worst case assumptions for the stress tests released in June 2016 assumed a severe downturn in the United Kingdom and the Euro area, they did not explicitly assume a decision by the United Kingdom to leave the European Union and the specific risks that "Brexit" entailed.

B. Stress Test Models

To quantify how a bank's capital regulatory ratios would fare under the assumptions, the Fed applies its own internally developed projection *models* as well as third-party models.³³ The models fall into five broad categories: (1) models to project losses on loans held in the accrual loan portfolio; (2) models to project other types of losses, including from changes in the fair value of loans held for sale, losses on securities, trading and counterparty exposure, and losses related to operational risk events; (3) models to project the components of pre-provision net revenue; (4) models to project balance sheet items and risk-weighted assets; and (5) calculations to project capital ratios given projections of pre-tax net income and provisions for the allowance for loan and lease losses.³⁴

However, the Fed's models are never released to the public. And although the Fed makes certain efforts to provide transparency, such efforts are limited. For example, each year the Fed includes a high-level summary of its modeling approach in the annual release of its stress tests

³² *United States GDP Growth Rate*, Trading Economics, <http://www.tradingeconomics.com/united-states/gdp-growth> (last visited June 27, 2016).

³³ 2015 Dodd-Frank Report, *supra* note 28, at 11.

³⁴ Board of Governors of the Federal Reserve System, Dodd-Frank Act Stress Test 2016: Supervisory Stress Test Methodology and Results 53 (2016), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160623a1.pdf> [hereinafter 2016 Dodd-Frank Report].

results and holds an annual symposium on stress tests where the models are discussed, but those disclosures generally do not provide specific details about its models.³⁵ Additionally, each year the Fed's models are evaluated by a Model Validation Council comprised of five outside academics selected by the Fed.³⁶ But the Fed does not publicly disclose the feedback that it receives from the Model Validation Council.

Of course, the models are shrouded in even more secrecy than the assumptions because even after the stress test results are released the Fed *never* discloses the models. Former Fed Chairman Bernanke and Fed Governor Tarullo, have justified this secrecy by contending that disclosure of the models would allow banks to “game” the tests.³⁷ Gaming the tests could include a bank accumulating assets after disclosure of the models and prior to the test that would perform well on the test and then changing the composition of its portfolio after the test.³⁸ If a bank did so, then it is possible that the stress test would have failed to make the bank more resilient to certain adverse events on a going-forward basis. However, the Fed has not provided a detailed analysis of why “gaming” of the stress tests is a realistic concern.

In recent years there has been concern within the Fed regarding the Fed's process for developing the models. For example, in 2015, the Fed's Office of the Inspector General conducted an internal evaluation of the Fed's model validation activities that resulted in a set of recommendations.³⁹ The Inspector General's report noted, among other concerns, that the Fed

³⁵ See, e.g., *id.* at 53-67.

³⁶ Board of Governors of the Federal Reserve System, *Model Validation Council*, <https://www.federalreserve.gov/aboutthefed/mvc.htm> (last updated Mar. 8, 2016) (the current members of the Model Validation Council are Nancy Wallace, Gregory Duffee, Majur Puri, Philip Strahan and M. Suresh Sundaresan).

³⁷ Bernanke, *supra* note 9; Tarullo, *supra* note 10.

³⁸ Then-Chairman Bernanke also noted in his speech that disclosure of the models could lead banks to rely on the Fed's model when conducting their own internal stress tests rather than relying on their own models.

³⁹ See generally Office of the Inspector General, Board of Governors of the Federal Reserve System, *The Board Identified Areas of Improvement for its Supervisory Stress Testing Model Validation Activities, and Opportunities*

staffers that reviewed the Fed's models did not receive feedback on the quality of their reviews, that a limited pool of Fed staffers existed to review certain types of models, and that changes made to the models late in the process were not always independently reviewed by Fed staffers outside of the model development team.⁴⁰ However, the Inspector General has not publicly disclosed whether the Fed has adequately implemented its recommendations for addressing these concerns.⁴¹

C. Capital Ratios

The final step of the stress test is for the Fed to compare a bank's projected capital ratios under the stress test with the required regulatory capital ratios to determine if the projected ratios meet or exceed them. The applicable regulatory capital ratios include the common equity tier 1 ratio, the tier 1 common ratio, the total capital ratio, and the tier 1 leverage ratio.⁴² In contrast to the assumptions and models, the specific capital ratios that the banks must meet are included in the Fed's stress test rules, which are subject to notice-and-comment procedures.⁴³ The Fed has signaled that for the eight largest banks it will soon increase the minimum applicable capital requirements and that it will do so through notice-and-comment procedures.⁴⁴

If a bank's projected capital ratios under the test do not meet or exceed the regulatory capital ratios, then the Fed's practice is to privately notify a bank in advance of the public release

Exist for Further Enhancement (2015), available at <https://oig.federalreserve.gov/reports/board-supervisory-stress-testing-model-validation-oct2015.pdf>.

⁴⁰ See generally Office of the Inspector General, Board of Governors of the Federal Reserve System, The Board Identified Areas of Improvement for its Supervisory Stress Testing Model Validation Activities, and Opportunities Exist for Further Enhancement (2015), available at <https://oig.federalreserve.gov/reports/board-supervisory-stress-testing-model-validation-oct2015.pdf>.

⁴¹ *Id.*

⁴² 2016 CCAR Results, *supra* note 18.

⁴³ See 12 CFR § 225.8(d)(8); *id.* § 225.8(f)(1)(i)(C).

⁴⁴ Jesse Hamilton, Jennifer Surane & Yalman Onaran, *Fed's Tarullo Says Stress Tests to Get Tougher for Big Banks*, Bloomberg (June 2, 2016), <http://www.bloomberg.com/news/articles/2016-06-02/tarullo-says-eight-biggest-banks-to-face-higher-capital-rules>.

of the results to provide the bank with an opportunity to revise its capital distribution plans.⁴⁵ However, it appears that in the past the Fed has not always disclosed the changes that a bank must make to their capital distribution plan in order to guarantee passing the stress tests. For example, in 2013 following private notification from the Fed, Ally Financial resubmitted its capital plan but then had its resubmitted plan also rejected by the Fed.⁴⁶ If a bank still fails the stress test after the bank has resubmitted its plan, then the Fed will formally and publicly object to its dividend and stock buyback plans.⁴⁷ The Fed has done so on six occasions for banks that failed this quantitative review.⁴⁸

⁴⁵ For example, in 2016, M&T Bank Corporation was allowed to resubmit a capital plan that, as revised, passed the Fed's stress tests.

⁴⁶ See Board of Governors of the Federal Reserve System, Comprehensive Capital Analysis and Review 2013: Assessment Framework and Results 4, 6, (2013), available at <http://www.federalreserve.gov/newsevents/press/bcreg/ccar-2013-results-20130314.pdf>.

⁴⁷ Though the Fed's rules allow, but do not require, that a bank can resubmit a capital plan after the Fed officially objects to the bank's plan. See 12 CFR §225.8(e)(4)(ii).

⁴⁸ The Fed objected to each of Ally Financial's, Citigroup's, MetLife's, and SunTrust's capital plans in 2012 for failing the quantitative stress tests, as well as Ally Financial's plan in 2013, and Zion Bancorporation's in 2014. This figure does not include the Fed's 2011 objection to Bank of America's capital plan because it was not disclosed whether the Fed objected on quantitative or qualitative grounds. The Fed has objected to numerous entities' capital plans on qualitative grounds. In 2013 it objected to each of Ally Financial's and BB&T's capital plans on qualitative grounds. In 2014 the Fed objected to Citigroup's, HSBC North America Holding's, RBS Citizens Financial Group's, and Santander Holdings USA's plans on qualitative grounds. In 2015 and 2016, the Fed objected to Deutsche Bank Trust Corporation's and Santander USA's plans on qualitative grounds.

II. The Fed's Stress Test Process and the APA's Procedural Requirements

The APA divides agency actions into two categories – rulemakings and adjudications, and while rules are generally subject to the APA's notice-and-comment procedures, adjudications are not.⁴⁹ Therefore, an assessment of whether the Fed's assumptions and models are subject to the APA's notice and comment procedures must first begin with an examination of whether these actions constitute rulemakings or adjudications under the APA.⁵⁰

A. *The Fed's Assumptions and Models Are Rulemakings*

According to the 1947 Attorney General's Manual on the APA,⁵¹ and federal case law, the key distinction between rules and adjudications is that rules relate to policy considerations and have future effect, whereas adjudications determine past and present rights and liabilities, often resolving disputed facts on a case-by-case basis. Specifically, the Attorney General's Manual states that rulemaking "is agency action which regulates the future conduct of either groups or persons or a single person" and is "primarily concerned with policy considerations" and that adjudication "is concerned with the determination of past and present rights and

⁴⁹ See 5 U.S.C. §§ 553-554. The APA does impose trial-type procedural requirements under §§ 556-557 for formal adjudications, which agencies rarely use unless required to by statute. To the extent the Fed's actions are adjudications, they would be informal adjudications, for which the APA imposes negligible procedural requirements. See *id.* § 555.

⁵⁰ As an initial matter, for the Fed's assumptions and models to be subject to challenge under the APA they must be governed by the APA. They undoubtedly are. By default, the APA applies to the actions of federal agencies. However, Congress can override the APA's requirements in specific legislation. The Dodd-Frank Act serves as the statutory basis for the stress tests, see Dodd-Frank Act, Pub. L. No. 111-203, §165(i), 124 Stat. 1376, 1430 (2010), and it exempts certain agency actions from notice-and-comment requirements through very explicit provisions that carve out enumerated agency actions from the APA's notice-and-comment procedures. For example, Dodd-Frank provided that the Securities and Exchange Commission could adjust the fees it charges national securities associations without following the APA's notice-and-comment procedures. See, e.g., Dodd-Frank Act, Pub. L. No. 111-203, §1023(c)(7), 124 Stat. 1376, 1986 (2010). The Dodd-Frank Act does not contain any such language overriding the APA's procedural requirements with respect to any aspect of the stress tests.

⁵¹ The Supreme Court has turned to the Attorney General's Manual to assist it in interpreting the APA. See *Bowen v. Georgetown Univ. Hosp.* 488 U.S. 204, 218 (1988) (Scalia, J., concurring) (describing the 1947 Attorney General's Manual as "the Government's own most authoritative interpretation of the APA," which the Supreme Court has given "great weight").

liabilities,” in which “issues of fact are often sharply controverted.”⁵² The Supreme Court has similarly stated that the basic distinction between the two is that rulemakings are “proceedings for the purpose of promulgating-policy type rules or standards,” and adjudications are “proceedings designed to adjudicate disputed facts in particular cases.”⁵³

In our view, both the assumptions and models should be categorized as rules because: (a) the assumptions represent uniform macroeconomic conditions and the models represent predicted responses to those conditions and they are both applied to all the banks; (b) the assumptions and models have future effect through their significant influence over whether the bank will be allowed to make capital distributions or buyback stock; and (c) the assumptions and models establish *de facto* capital requirements for banks.

The Fed could contend, however, that their assumptions and models are part of an adjudication – that is, they are part of the bank-by-bank assessment of whether a bank is well capitalized enough to make planned capital distributions and therefore the assumptions and models should qualify as adjudications, not rulemakings. Specifically, the Fed could cite to the Supreme Court’s 1974 decision in *NLRB v. Bell Aerospace*.⁵⁴ In that case, the Supreme Court addressed the question of whether the NLRB could, in an adjudicatory proceeding, make a determination about who was a “managerial employee,” which was central to the ultimate question before the NLRB of whether it could certify a union. The determination of who was a “managerial employee” would then be applied more broadly by the NLRB to other employers

⁵² Attorney General’s Manual, *supra* note 4, at 14-15.

⁵³ *United States v. Fla. E. Coast Rwy. Co.*, 410 U.S. 224, 245 (1973). In a concurrence in *Bowen v. Georgetown University Hospital*, Justice Scalia stated that rules under the APA cannot have retroactive effect, but only future effect. *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 221 (1988) (Scalia, J., concurring) (noting that rulemaking “deals with what the law will be”).

⁵⁴ 416 U.S. 267 (1974).

who were not parties to the case. The Supreme Court held that the NLRB could do so through an adjudicatory proceeding.⁵⁵

However, we believe that the Fed’s development of the stress tests’ assumptions and models is distinguishable from *Bell Aerospace* and that the case does not provide grounds for the Fed to argue that the assumptions or models are not rulemakings. In *Bell Aerospace*, the NLRB’s determination of who was a “managerial employee” was the very question to be decided in the adjudication. It was not a term that the NLRB had pre-defined and the NLRB needed to apply a definition of the term to reach a judgment in that particular case. On the contrary, in the Fed’s review of a bank’s capital adequacy, the assumptions and models are developed *in advance of* and *separately from* the Fed’s determination of whether the banks have adequate capital. In other words, the assumptions and models are criteria that function as rules that the Fed has already developed and that it consistently applies to all banks to reach a decision about the appropriateness of a particular bank’s capital distribution plans. Indeed, the assumptions and models function no less as rules than the capital ratio requirements used in the tests, which the Fed treats as rules.

B. Exceptions to the APA’s Notice and Comment Procedures

The APA requires compliance with notice-and-comment procedures for rulemakings unless one of three exceptions apply: (1) the policy is merely guidance; (2) the rule is only an interpretative rule of prior policy; or (3) the agency demonstrates that notice-and-comment procedures are unnecessary, impractical or contrary to the public interest (“**good cause**

⁵⁵ *Id.* at 294.

exceptions”).⁵⁶ We first analyze the applicability of these exceptions to the assumptions and then to the models.

1. The Exceptions Do Not Apply to the Assumptions

The federal courts have stated that guidance “does not seek to impose or elaborate or interpret a legal norm,” but rather “merely represents an agency position with respect to how it will treat – typically enforce – the governing legal norms.”⁵⁷ According to the D.C. Circuit, this standard means that guidance cannot be treated as binding on either the agency or private parties.⁵⁸ The D.C. Circuit has further explained that as a practical matter, an agency pronouncement is binding “if it either appears on its face to be binding or is applied by the agency in a way that indicates that it is binding.”⁵⁹

The Fed treats its assumptions as binding by uniformly applying the assumptions to all of the banks. Indeed, there is no process whereby a bank can discuss with the Fed why particular assumptions should not be applied to it or why different assumptions would be more relevant in the review of its capital plan. Additionally, the Fed’s projected capital ratios are largely dependent on the assumptions and the Fed treats the projected ratios as binding. As noted earlier, whenever a bank’s projected capital ratios have fallen below the capital requirements in the publicly released test results, the Fed has objected to that bank’s capital distribution plan.⁶⁰ The assumptions are therefore not guidance.

Second, the D.C. Circuit has stated that an interpretative rule is “an agency action that merely interprets a prior statute or regulation, and does not itself purport to impose new

⁵⁶ 5 U.S.C. § 553(b). While the APA requires that an agency invoke the good cause exemption, the Fed has not done so with respect to the assumptions or models. However, courts have been willing to accept such invocation at the time of a legal challenge. *See, e.g., Nader v. Sawhill*, 514 F.2d 1064, 1068 (Temp. Emer. Ct. App. 1975).

⁵⁷ *Sec. Indus. Fin. Mkts. Ass’n v. Commodities Futures Trading Comm’n*, 67 F. Supp. 3d 373, 417 (D.D.C. 2014).

⁵⁸ *See Gen. Elec. Co. v. EPA*, 290 F.3d 377, 382 (D.C. Cir. 2002).

⁵⁹ *Id.* at 383.

⁶⁰ *See sources supra* note 7.

obligations or prohibitions or requirements on regulated parties.”⁶¹ The D.C. Circuit has stated that “the practical question . . . is whether the new rule effects ‘a substantive regulatory change’ to the statutory or regulatory regime.”⁶² If it does, then the rule is not interpretative.

The Fed could assert that the assumptions are simply interpretations of the definitions of “baseline,” “adverse,” and “severely adverse” assumptions. However, the content of the Fed’s assumptions change every year and the changes in the assumptions significantly impact the amount of capital a bank needs to hold in a given year.⁶³ For example, The Clearing House stated that the more sudden increase in the unemployment rate in the assumptions for the stress tests conducted in 2016, as compared to prior stress tests, likely caused simulated losses to be greater than in prior tests.⁶⁴ The assumptions are therefore not interpretative.

Finally, the APA’s good cause exception is narrowly construed by the courts and will succeed in only special and limited circumstances.⁶⁵ The D.C. Circuit has explained the three conditions for the good cause exception as follows: It is *impracticable* for an agency to follow the procedures where an agency finds that due and timely execution of its functions would be impeded; *unnecessary* for an agency to follow the procedures if the rule is routine in determination, insignificant in nature and impact, and inconsequential to the industry and the public; and *contrary to the public interest* to follow the procedures where there is a situation in

⁶¹ *Nat’l Mining Ass’n v. McCarthy*, 759 F.3d 243, 252 (D.C. Cir. 2014).

⁶² *Elec. Privacy Info. Cir. v. Dep’t of Homeland Sec.*, 653 F.3d 1, 6-7 (D.C. Cir. 2011).

⁶³ See The Clearing House, TCH Research Note: 2016 Federal Reserve’s Stress Testing Scenarios 2 (2016), available at <https://www.theclearinghouse.org/~media/action%20line/documents/volume%20vii/20160316%20tch%20research%20note%20ccar.pdf>.

⁶⁴ *Id.*

⁶⁵ See *Sorenson Commc’ns v. FCC*, 755 F.3d 702, 706 (D.C. Cir. 2014).

which the interest of the public would be defeated by a requirement of advanced notice.⁶⁶ If any of these three conditions is met then the good cause exception would apply.

There is no apparent reason why public participation in the development of the assumptions would be impractical, unnecessary or contrary to the public interest. First, the Fed should be capable of developing proposed assumptions with enough time for the Fed to incorporate public comments prior to issuing its final assumptions in mid-February. Second, the assumptions are certainly not insignificant or inconsequential for reasons already discussed. Finally, public participation is actually in the public interest because it would allow the public to provide the Fed valuable information and feedback on proposed assumptions and therefore enhance the quality of the assumptions.

With regards to impracticality, one argument that the Fed could potentially assert is that it might be impractical to proceed with notice-and-comment procedures because the assumptions should reflect the most salient risks based on the most recent economic and financial market developments.⁶⁷ Therefore, if the Fed were to provide the public with proposed assumptions months in advance of the final assumptions, then the Fed could be limited in its ability to include salient risks that arise late in the process.

However, this impracticability argument is unconvincing. The Fed would not be prohibited from revising the final assumptions after the proposed assumptions are released if risks to the economy changed in the interim. And in the unlikely event that the salient risks changed so dramatically between the time the proposed assumptions were released and the final

⁶⁶ *Util. Solid Waste Activities Grp. v. EPA*, 236 F.3d 749, 754-55 (D.C. Cir. 2001); *see also Riverbend Farms, Inc. v. Madigan*, 958 F.2d 1479, 1485 (9th Cir. 1992) (noting that departure from the APA is appropriate “only where compliance would interfere” with an agency’s ability to carry out its mission).

⁶⁷ *See, e.g.*, Policy Statement on the Scenario Design Framework for Stress Testing 78 Fed. Reg. at 71,439; Tarullo, *supra* note 10.

assumptions were released, such that the final assumptions differed so materially from the proposed assumptions that the public would have, in effect, not had an opportunity to comment on the assumptions used in the stress tests, then the Fed could assert the good cause exception in that special circumstance.⁶⁸ We do not believe that this possibility is a basis for avoiding notice-and-comment procedures as a standard practice.

We therefore find that the exceptions to the APA's notice and comment procedures do not apply to the assumptions and that the assumptions are therefore rules required to be adopted through the APA's notice-and-comment procedures.

2. The Exceptions Likely Do Not Apply to the Models

With regards to the models, we believe that the exceptions for guidance and interpretative rules would not apply, for the same reasons that they would not apply to the assumptions; the models are treated as binding and impose substantive obligations to hold capital based on the design of the models themselves. However, unlike the assumptions, we believe that the Fed has *some* basis for contending that the good cause exception may apply to the models.

In general, the good cause exception would apply to the models if notice-and-comment procedures would defeat the purpose of the models. Although there is limited applicable case law, a 1975 appeals court case on the good cause exception, *DeRieux v. Five Smiths, Inc.*,⁶⁹ is relevant. In that case an appeals court held that it would have been contrary to the public interest to follow notice-and-comment procedures in adopting a rule that instituted a price freeze on gasoline because advance disclosure of the rule would have resulted in a rush to raise prices.⁷⁰

⁶⁸ The argument would also be applicable to the Fed's modeling of revenues, losses, balance sheets, capital, risk-weighted assets, and so forth, which could be slightly adjusted, if necessary, and validated in advance of apply the models in the stress tests.

⁶⁹ 499 F.2d 1321 (Temp. Emerg. Ct. App. 1975).

⁷⁰ *Id.* at 1332.

That, of course, would have defeated the very purpose of the price freeze – stopping prices from increasing.

Similarly, in 1975 that same appeals court in *Nader v. Sawhill* held that the government validly invoked the good cause exception in not subjecting a rule to notice-and-comment procedures that was going to allow for an increase in oil prices. The rule was intended to alleviate an oil shortage and the court noted that if the increase in prices was broadcast before the final rule was announced, then the oil shortage would actually have been exacerbated in the short term because sellers would hold off on selling oil until the price increase went into effect.⁷¹

While those forty-year old cases are both from an appeals court that no longer exists, it is possible that, like those cases, disclosure of the models prior to the running of the annual stress test could undermine the Fed's ability to accurately predict how banks would be impacted by the stress tests. That is because disclosure of the models could allow the banks to “game” the tests by, for example, building a portfolio of assets that would fare well under the models with an intention of altering the construction of the portfolio as soon as the test is completed.

The Fed could also seek to use this exception to avoid the separate APA requirement that final rules be published once adopted (an APA requirement that it presently does not comply with). The Fed could do so by arguing that the release of the models at any time, even after the stress tests results are released, could allow banks to game tests in future years. However, we know of no instances where the good cause exception has been successfully invoked for the purpose of keeping a rule permanently secret and doing so would likely be an even heavier lift than using the good cause exception to avoid notice-and-comment procedures.

⁷¹ *Nader v. Sawhill*, 514 F.2d 1064, 1068 (Temp. Emerg. Ct. App. 1975).

The validity of the good cause exception to justify either avoidance of notice-and-comment procedures or publication of the final models faces serious doubts, however. First, it is unclear whether such gaming is realistic to all or parts of the models. Additionally, gaming concerns may be resolvable by the Fed. Most obviously, the Fed could object to a bank's capital distribution plan if the Fed suspected a bank of gaming the tests. Indeed, the Fed has broad authority to object to a bank's capital plan even if it passes the quantitative stress test and such authority could be used to enforce a good faith or anti-circumvention principle.⁷² Moreover, given that the Fed collects data throughout the year from the banks, it is well positioned to determine whether a bank is attempting to game the test.

To avoid publishing the final models the Fed could also seek to rely on a separate APA exception that provides that an agency that supervises financial institutions does not need to disclose to the public *a matter* that is contained in or related to an examination report. Specifically, the APA provides that matters “contained in or related to examination, operating or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions,” are exempt from publication requirements.⁷³ The Fed could assert that the models are *a matter related to* the stress test examinations because they form the analytical basis for the Fed's decision about whether to object to a bank's capital plan or not.

Once again, however, we are unaware of any case law that provides that a *rule* related to an examination report is a “matter” covered by the exception. Indeed, if such an assertion were to

⁷² See 12 CFR § 225.8(f)(2)(ii). The same anti-circumvention principle could apply if the Fed was concerned that the banks would not develop their own internal models to conduct their own, independent internal stress tests. In that scenario, the Fed could object to a bank's capital plan on qualitative grounds. This would relate to Chairman Bernanke's concern set forth in note 37.

⁷³ 5 U.S.C. § 552(b)(8).

be successful, it could open up the possibility that other bank regulations could be deemed “matters,” and therefore could be adopted without public input and kept secret. In our view, it is more likely that this APA exception is to be more narrowly construed to only cover *matters* such as information obtained from the banks as part of the examination. That is because, as the D.C. Circuit has explained, there are two clear rationales for the existence of the exception: (1) to permit regulators to make frank evaluations without undermining public confidence in and causing a run on a bank; and (2) to protect a bank’s information to safeguard free exchange of information between banks and the supervising agency.⁷⁴ Disclosing the models would neither cause a run on a bank nor hinder the flow of information to the Fed.

⁷⁴ *Consumer Union of U.S., Inc. v. Heimann*, 589 F.2d 531, 534 (D.C. Cir. 1978). Therefore, the exception would be more appropriately invoked to justify keeping feedback the Fed gives to banks on their capital plans and processes confidential.

III. Policy Recommendations for Enhancing the Fed’s Stress Test Process

We believe that the APA’s notice-and-comment procedures are legally required for the stress test assumptions and that the Fed should engage in notice-and-comment procedures for its assumptions in its next round of stress tests. In our view, utilizing those procedures would confer at least two benefits. First, public participation would result in better policy outcomes, because the public is likely to provide valuable information and insights to the agencies, which will help promote quality decisionmaking when it comes to determining the appropriate assumptions.⁷⁵ The public can also help “ensure that agencies and their staffs act fairly, approaching regulatory problems with an open mind and listening respectfully to a broad spectrum of public perspectives.”⁷⁶ Additionally, we believe that following notice-and comment procedures would reduce the threat of legal challenge to actions taken in reliance on the stress tests, including the rejection of a bank’s capital plan.

We also believe that the Fed should promptly and publicly analyze whether the stress tests could in fact be gamed if all or parts of the models were subject to notice and comment procedures. The Fed has not publicly produced a detailed analysis of the likelihood of that risk, or of the consequences if the models were indeed gamed. The Fed should consider each of its five categories of models separately and the burden should be on the Fed to determine how such gaming could occur with respect to each model and the parts of each model. A public analysis should also explain why the Fed could not use tools to prevent “gaming” by banks. For example, the Fed should explain why it would not be able to impose a good faith or anti-circumvention

⁷⁵ Connor Raso, *Agency Avoidance of Rulemaking Procedures*, 67 Admin. L. Rev. 101, 103 (2015); Cary Coglianese et al., Presidential Transition Task Force, *Transparency and Public Participation in the Rulemaking Process* v (2008).

⁷⁶ Coglianese et al., *supra* note 73, at v.

rule that would allow it to object to a bank's capital plan if the bank engaged in certain actions that would constitute "gaming". Indeed, it would seem that the Fed has the authority to impose such additional requirements because the Fed has broad powers to object to a bank's capital plan even if it passes the quantitative stress tests.⁷⁷

In principle, we believe that there should be as much public participation in the creation of the models as possible. Greater participation would likely increase the validity and robustness of the models, as well as increase confidence in the results of the stress tests. It is particularly important that the development of the assumptions and models *both* involve public participation because if there is only public notice and comment for the assumptions then any changes made to the assumptions could be offset by changes to the models that would not have had the benefit of public input.

If after a public analysis the Fed concludes that its existing position regarding disclosure of the models is warranted, then we believe that at the very least there needs to be more transparency around the process by which the models are evaluated. This should be accomplished by publishing periodic reports that explain how the Model Validation Council evaluates the models and summarize the concerns or issues raised by the Model Validation Council. The report should also discuss the extent to which the Fed made changes to the models to reflect any such comments. Additionally, the Fed should disclose whether the Inspector

⁷⁷ See 12 CFR §225.8(f)(2)(ii). A detailed review and analysis of the "qualitative" reasons for why the Fed can object to a bank's capital distribution plans is beyond the scope of this statement. However, it is worth noting that the Fed has published statements about the governance, risk management, and internal controls processes banks should use to pass the "qualitative" review, among other requirements. See Board of Governors of the Federal Reserve System, SR 15-18, Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISC Firms and Large and Complex Firms (Dec. 18, 2015); Board of Governors of the Federal Reserve System, SR 15-19, Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms (Dec. 18, 2015). These requirements were not adopted through notice-and-comment procedures and raise concerns about compliance with the APA that are similar to the concerns raised by the assumptions and models used in the stress tests.

General has determined that the Fed has sufficiently undertaken the recommendations made in the Inspector General's report on the Fed's model validation processes. This additional transparency will inspire more confidence that the Fed's models are robust and provide a means to ensure that the Fed is receptive and responsive to criticisms of the models made by the Model Validation Council.

As a final matter, we note that in our view there are several other instances where regulatory agencies may have failed to comply with the requirements of the APA. This includes the "living wills" process,⁷⁸ the designation of certain non-banks as systemically important⁷⁹ and banking regulators' deference to foreign regulatory bodies, including the Basel Committee on Banking Supervision and the Financial Stability Board. We intend to further explore whether these regulatory actions or processes are consistent with the APA.

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Should you have any questions or concerns, please do not hesitate to contact the Committee's Director Prof. Hal S. Scott (hscott@law.harvard.edu), its Executive Director of Research, John Gulliver (jgulliver@capmksreg.org), or its Senior Research Fellow, Brent Speed (bspeed@capmksreg.org), at your convenience.

⁷⁸ Hal Scott, Op-Ed., *Publish the Secret Rules for Bank's Living Wills*, Wall St. J., June 10, 2016, <http://www.wsj.com/articles/publish-the-secret-rules-for-banks-living-wills-1465511622>.

⁷⁹ Hal Scott, Op-Ed., *When Treasury Intrudes*, The Washington Times, May 1, 2016, <http://www.washingtontimes.com/news/2016/may/1/hal-scott-when-treasury-intrudes-in-court-decision/>.

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