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ATTN: Docket No. 06-10

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C., 20551
ATTN: Docket No. R-1266

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
RIN 3064-AD10

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
Attention: No. 2006-34

January 23, 2007

Ladies and gentlemen:

The Institute of International Finance, the International Swaps and Derivatives Association, the London Investment Bankers Association, and the Risk Management Association (IIF, ISDA, LIBA, and RMA, jointly the "Associations") appreciate the opportunity to comment on the Notice of Proposed Rulemaking on Risk-based Capital Standards: Market Risk ("NPR") issued by the United States Federal banking regulatory agencies ("Agencies"). In the Market Risk NPR, the Agencies have requested comment on a wide spectrum of issues associated with their proposed revisions to the market risk capital rule to enhance its risk sensitivity. IIF, ISDA, and LIBA have commented previously on the joint Basel-IOSCO consultative document on the application of Basel II to trading activities, and the Associations appreciate the opportunity to comment on the Agencies' application of Basel II to market risk and its implementation in the United States.

General Issues

The Associations have three general comments on the Market Risk NPR. Two concern the breakage between the Market Risk NPR and the international implementation of the Basel II Accord. The third concerns the proposed bifurcation of the trading book into "covered" and "non-covered" positions. Although the idea of bifurcating the trading book into covered and non-covered positions appeared in the Basel II Accord as a result of the July 2005 Basel/IOSCO Trading Book Review,[1] we have taken advantage of the solicitation of comment on it in the NPR. In contrast to the credit and operational risk features of the Basel II Accord, as reflected in the separate NPR[2] on which we will comment in due course, the market risk section of the Trading Book Review was adopted with only a short time for industry comment. Further, the Trading Book Review acknowledges ongoing methodological development. Since the adoption of the proposals in the Trading Book Review we have had more time to reflect on their justification and likely consequences.

- **Principles versus rules for calculation of VAR and incremental default risk**

  One of the best features of the original Market Risk Amendment to the Basel Accord was its focus on general principles and its specification of general parametric requirements for the calculation of VAR. In discussion with the industry, the drafters of the original Market Risk Amendment recognized that the method for modeling and calculating VAR was evolving. They recognized that even if, on any given date, there had been agreement on what constituted industry "best practice," the details of the best practice methodology should not be frozen into prescribed regulatory rules because of the evolving nature of the VAR methodology and the evolving characteristics of the instruments in trading portfolios.

  In contrast to the broad principles articulated in the original Market Risk Amendment, the Market Risk NPR is more prescriptive in several ways:

  - In contrast to the original Market Risk Amendment, it bifurcates the trading book into positions that are covered by the market risk rules and positions that are subject to banking book rules.
  - The rules for what is covered and what is non-covered are inconsistent with how a bank actually manages its trading portfolio and are unnecessary so long as a bank has a validated, complete process for calculating VAR and a robust calculation of incremental default risk.
  - In addition, the rules for bifurcating the trading book into covered and non-covered positions are vaguely formulated and open to subjective, inconsistent interpretation by firms and supervisors. As these rules for bifurcation are unnecessary, we seek their elimination rather than asking for added prescriptiveness in their formulation. If the

[1] "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects," Basel / IOSCO Working Group, July 2005. In particular, the changes in the market trading risk rules are contained in Strand 3 of the July 2005 document.

[2] 71 FR 55830 (September 25, 2006)

Market Risk NPR were more principles based it would not need to have an extensive set of requirements that needed clarification.

- Firms are required to generate an excessive amount of documentation about each trading portfolio that would serve no function other than regulatory compliance.
- The Associations believe it is essential to adopt an approach that would be consistent with paragraph 287 of the July 2005 Basel/IOSCO Trading Book Review which states that "… the proposed approach for capturing default risk [under the international Accord] will provide significant flexibility to banks in developing models, including how firms aggregate their specific risk and default related capital charge …." Naturally, it would be expected that this appropriately dynamic and flexible approach would also be subject to supervision pursuant to the ongoing supervisory dialogue on best practices also envisioned by paragraph 287.
- There is a new formal requirement that a bank must receive written approval from its primary Federal supervisor before using or before extending the use of a model to calculate RWA for trading risk. We propose that the standards for implementing this new rule should be commensurate with the nature and risk characteristics of a bank's trading business. The criteria for setting the standards for review and approval should be publicly available and applied uniformly to all firms.
- The Market Risk NPR asks some enumerated questions regarding: a) proposed additional requirements for securities with prepayment risk and b) a proposal to include specific risk for commodities and foreign exchange positions. Adopting either proposal would add prescriptiveness, and we do not think either proposal makes economic sense.

The Market Risk NPR correctly emphasizes the importance of a) the completeness and comprehensive of the VAR calculation, b) its validation, and c) the importance of developing and implementing a robust calculation of incremental default risk that appropriately takes liquidity risk into account.

The fundamental point is that, so long as a firm accurately captures and appropriately simulates the market risk of all of its trading portfolios, the added prescriptiveness described above adds no value but adds substantial incremental cost.

- **Trading book/banking book boundary**

The Market Risk NPR proposes prescriptive rules that bifurcate the trading book into positions that are covered by the proposed market risk rules and positions that would have their risk-weighted assets (RWA) calculated by banking book rules (e.g., rules for equity investments or securitization). This bifurcation could create a material breakage between the accounting and regulatory classification and treatment of positions. The magnitude of the breakage will depend on each bank's particular trading strategy. In contrast, the original Market Risk Amendment required all positions in the trading book to be captured by and included in the measurement of VAR.

We believe the proposed bifurcation is unnecessary so long as a bank a) accurately and completely captures its market risk, b) appropriately simulates the potential loss of market value and c) builds and implements a robust calculation of incremental default risk which appropriately takes into account the liquidity horizon of each position. If these conditions are met, a bank will have a prudent measure of market risk. Once it has that measurement there is no need to split the trading book into "covered' and "non-covered" positions.

There are other material problems with the proposed bifurcation, in addition to its not being necessary:

- The proposed rules may create a material breakage between a) how a bank would categorize, measure, manage, and report its market risk by its own business standards; and b) how it would be required to categorize, measure, and report its market risk to meet regulatory rules. All else held constant, the larger and more complex the trading portfolio, the more likely would be the breakage in classification.
- Thus the proposed bifurcation of the trading book will also increase the breakage between how a bank would calculate economic capital and how it would be required to calculate RWA for trading risk. An explicit goal of Basel II was to increase the convergence between economic capital and RWA. The proposed bifurcation of the trading book into "covered" and "non-covered" positions achieves the opposite end.
- The proposed bifurcation of the trading book would impose on banks the additional cost of building and maintaining two parallel processes for classifying transactions and thus for calculating and reporting risk.
- While the Market Risk NPR mandates a far more extensive set of requirements for classification and documentation than the current Market Risk Amendment, it is actually quite vague in a number of areas as to the meaning of many of these new requirements. In some cases, the NPR is devoid of practical guidance. The proposed rules for bifurcating the trading book into covered and non-covered positions are unnecessary if a bank has a validated, complete VAR process and a robust measurement of incremental default risk. As a consequence, we seek the elimination of the new requirements for the classification and documentation of trading portfolios into covered and non-covered categories rather than asking for additional prescriptiveness in their formulation. If the Market Risk NPR were more principles based it would not have an extensive set of requirements that needed clarification.[3]
- The proposed rules create a conflict with other U.S. regulations governing the classification of trading book assets. For example:
  - U.S. regulations prohibit bank legal vehicles from purchasing non-investment grade or distressed debt. Any such purchases by a financial service holding company, whether for trading or investment, must be held in a broker/dealer legal vehicle.
  - SEC rules, however, require all such positions in the broker/dealer legal vehicle of a bank to be marked to market.

[3] We also note that the proposed bifurcation of the trading book will also create a breakage between GAAP and regulatory classification for firms subject to that accounting regime.

        - In contrast, the NPR would exclude a subset of the marked-to-market trading positions in the broker/dealer from the calculation of RWA for market risk. Those newly defined non-covered positions would be subjected instead to banking book rules, for example, equity investments or securitization.
    - Analysts and investors want to know the VAR of the positions in the trading book as a useful measure of the potential earnings volatility of the trading book. To provide such information, a bank would need to calculate and disclose VAR for all positions in its trading book. In addition, internal risk monitoring would likely be based on a VAR for all positions in the trading book.
    - The VAR that firms currently calculate and use for internal monitoring and reporting may of course differ from the VAR they use for regulatory reporting; this is a consequence of differences in confidence level or the event horizon over which market rates are shocked. The Market Risk NPR would introduce a deeper split in terms of covered vs. non-covered transactions, however. It is to that deeper split in categorization and to the effect of that split on risk measurement and reporting that we object.
    - Pillar 3 will require banks to publicly report the VAR used to calculate RWA. Bifurcating the trading book into covered and non-covered positions will result in incompatible measurements of VAR for internal versus regulatory use; this will in turn reduce transparency to investors and analysts.

As we state above, there is no need to split the trading book into covered and non-covered positions so long as a bank has a developed and implemented a complete, validated VAR process, including a robust measurement of increment default risk. RWA should be based on the application of the validated VAR process and the robust measurement of incremental default risk to all positions in the trading book, including loans in a warehouse pipeline for securitization that are managed as trading risk.

The only exceptions to the above are the derivative hedges of banking book risk that are marked to market as a consequence of FAS 133. Such derivatives are only in the trading book as an artifact of FAS 133; to include the derivative hedge in VAR but not the underlying positions that are being hedged would distort the measurement of economic risk. There are two equally viable solutions to this problem:

a) A bank should be allowed to include both the derivative hedge and the underlying banking book risk that is being hedged in its calculation of VAR for market risk.
b) A bank should be allowed to exclude both the derivative hedge and the underlying banking book risk that is being hedged from its calculation of VAR for market risk so long as there is no material residual risk. Any material residual risk, due to the risk of the derivative exceeding the risk of the banking book position it is hedging, should be included in VAR.

Option b) is consistent with the NPR proposal to exclude certain interest rate derivative and credit derivative hedges of banking book positions.

- **Effective date of 2008 and definition of benchmark**

  Background

  The NPR states: "The effective date of any final rule associated with the proposed revisions to the market risk capital rule would be January 1, 2008, with certain exceptions described below" (71 FR 55960). In contrast, the NPR for Credit and Operational Risks states: "The agencies are proposing to make 2008 the first possible year for a bank to conduct its parallel run and 2009-2011 the first possible years for the three transitional floor periods" (71 FR 55844).

  In addition, although it is not explicitly stated in the NPR, we have been told that the benchmark calculation of RWA that will be used during the parallel testing of 2008 and the transition period from 2009-2011 will consist of:

  - RWA for credit risk calculated under the current (that is, as of 2006) Basel I rules in the United States.
  - RWA for market risk calculated under the proposed Market Risk NPR rules.

  There are two divergences from Basel II and its implementation in other international financial centers, namely, the different implementation dates for the market risk and credit/operational risk rules and the proposed definition of the benchmark.

  Comments

  We do not understand the motivation or justification for splitting the implementation date of the proposed market risk rules from the implementation date of the proposed credit and operational risk rules. We consequently oppose the split in the implementation dates. We also oppose the proposed definition of the benchmark. As these are related issues we shall discuss them together.

  Logical issues. Some trading positions that are covered by the current market risk rules would not be covered under the proposed market risk rules, as a consequence of the proposed bifurcation of the trading book into "covered" and "non-covered" positions. . Under the Market Risk NPR, the RWA generated by these non-covered positions would be calculated instead according to the proposed banking book rules, for example, the equity investment rules or securitization rules. But since these proposed banking book rules will not go live until 2009, banks will initially have to fit these non-covered positions into the current banking book rules as best as they can.

  Implementation issues. Given that the comments to the Market Risk NPR must be received by January 23, 2007, we do not expect the final version of the U.S. rules to be issued until mid-year 2007 at the earliest. That would leave banks six months or less to implement the final version of the market risk rules before going live on January 1, 2008.

Prudence demands that before new regulatory capital rules go into effect, banks should have sufficient time to implement and test systems, and supervisors should have sufficient time to ensure changes in rules do not have unintended consequences.

It must be noted that the bifurcation of the implementation date of the market risk rules versus the credit and operational risk rules, when joined with the bifurcation of the trading book into covered and non-covered positions, creates a new, additional implementation burden for banks in the U.S. Banks would need to build two separate processes:

a) A process to calculate RWA for the newly defined non-covered positions under the current banking book rules, which would be needed for the "live" RWA used in 2008 and the proposed "benchmark" RWA to be used during the transition period (2009-2012 at a minimum).
b) A process to calculate RWA for the newly defined non-covered positions under the proposed banking book rules, which would be needed for the "parallel" calculation of 2008 and the live calculation after 2009.

Burden a) is created by the combination of the bifurcation of the trading book into covered and non-covered positions and the bifurcated implementation date. It is a new implementation burden, unique to U.S. implementation, which is not in the Basel II Accord. When one takes into account the vagueness of the standards for splitting the trading book into covered and non-covered positions, the implementation of this process in time for 2008 is problematical.

Burden b) is created by bifurcation of the trading book into covered and non-covered positions. It is an exaggerated form of the burden that exists in the Basel II Accord because of the added prescriptiveness of the Market Risk NPR with regard to documentation of the classification of trading portfolios.

Untying the Basel/IOSCO package. In addition to the logical inconsistencies and additional implementation burden of two implementation dates, we have another fundamental objection. One of our primary objections to both the bifurcated implementation dates and the definition of the benchmark is that the changes to the market risk rules are only one component of the Basel/IOSCO Working Group's Trading Book Review, referred to above. This document was formulated as an integrated "package," and we think it is a mistake to tear that package apart and implement its components at different times. We also think it is a mistake to include one component of the package in the benchmark against which the entire set of Basel II changes will be compared.

The changes in the market risk rules essentially reflect Strand 3 of the Basel/IOSCO Trading Book Review. The Trading Book Review was composed of three "Strands," reflecting the three sub-groups of the Basel/IOSCO Working Group:

- Strand 1 focused on counterparty credit risk including the treatment of cross-product netting.
- Strand 2 focused on the treatment of double default effects and the treatment of the short-term maturity adjustment.
- Strand 3 focused primarily on market risk in the trading book but also included the capital treatment of unsettled and failed transactions.

We in the industry have repeatedly been told that the three strands of the Basel/IOSCO Trading Book Review need to be looked at as an integrated package. Indeed, we have been told that regulators expect that Strands 1 and 2 will on average cause a decrease in RWA, while Strand 3 will on average cause in an increase in RWA. The increase in RWA is expected because a) those trading book positions that are "not-covered" will be treated by the generally more onerous banking book rules, and b) the implementation of the measurement of incremental default risk will tend to increase RWA. (Incremental default risk must be implemented no later than January 1, 2010.)

It is therefore puzzling that the U.S. regulators want to incorporate one component (Strand 3) of the Basel/IOSCO Trading Book Review into the denominator (benchmark) of the measurement of the relative effect of Basel II while all three components (Strands 1, 2, and 3), will be incorporated into the numerator. If all else were held constant, the proposed definition of the benchmark would introduce a downward bias to the measurement of the ratio of RWA under Basel II relative to the benchmark. This is because the denominator of the ratio would include the one component of the Trading Book Review that is expected to increase while the numerator would include all three components of the Trading Book Review, whose net effect is expected to be approximately neutral.

We have raised this issue only because the Credit and Operational Risk NPR makes clear the high level of attention and scrutiny the U.S. regulators will place on the ratio – i.e., on the comparison of RWA under Basel II relative to the benchmark. Although we see many fundamental problems in using Basel I as a benchmark to evaluate Basel II—because the risk weights assigned by Basel I are arbitrary and risk-insensitive—the proposed definition of the benchmark would only exacerbate an already difficult problem.

We therefore propose that:

- There should be no bifurcation of implementation dates for the Market Risk NPR versus the Credit and Operational Risk NPR. They should be implemented at the same time.
- The benchmark for evaluating the effect of Basel II should only include the RWA calculated under the current market and credit risk rules.

Enumerated questions

Question 1: The agencies seek comment on the thresholds for the application of the market risk capital rule and, if they should be changed, on what appropriate thresholds might be.

Reference in NPR:

> "Thus, the proposed rule would continue to apply to any bank with aggregate trading assets and liabilities equal to 10 percent or more of total assets, or $1 billion or more. The proposed revisions would apply to a bank meeting the market risk capital rule applicability threshold regardless of whether the bank would adopt the proposed advanced capital adequacy framework or remain under the general risk-based capital rule" (71 FR 55962).

Response:

> These criteria were originally set circa 1995. Since then, inflation and industry consolidation have caused additional financial institutions to become subject to these criteria. Such institutions may not have active trading businesses, but merely seek to service their customer requirements. We therefore suggest that the criteria be updated to reflect the current state of the industry. For example, 10% or $3 billion would be more appropriate today to capture institutions that in fact have active trading businesses.

Question 2: The agencies request comment on all aspects of the proposed definition of covered position. The agencies are particularly interested in comment on additional safeguards that the agencies might implement to prevent abuse of the hedge component of the definition of covered position and increase transparency for supervisors.

Reference in NPR:

> "The NPR modifies the definition of a covered position to include only trading assets and trading liabilities (as reported on schedule RC-D of the Call Report, Schedule HC-D of the Consolidated Financial Statements for Bank Holding Companies, or as defined in the instructions to the Thrift Financial Report) that are trading positions. The definition also includes trading assets and liabilities that hedge covered positions. In addition, the trading asset or liability must be free of any restrictive covenants on its tradability or the bank must be able to hedge its material risk elements in a two-way market. A trading position would be defined as a position that is held by the bank for the purpose of short-term resale or with the intent of benefiting from actual or expected price movements or to lock in arbitrage profits. The proposed definition of a trading position recognizes that the accounting definition of trading assets and liabilities includes positions that are not held with the intent or ability to trade.
>
> "A trading asset or liability that hedges a trading position is a covered position only if the hedge is within the scope of the bank's hedging strategy (discussed below). The agencies

encourage the sound risk management of trading positions and therefore include hedges that offset their risk in the definition of covered position and thus in the measure for market risk. The agencies are concerned, however, that a bank could craft its hedging strategies in order to bring non-trading positions that are more appropriately treated under the credit risk capital rules into the bank's covered positions. The agencies will scrutinize a bank's hedging strategies to ensure that they are not being manipulated in this manner. For example, mortgage-backed securities that are not held with the intent to trade, but that are hedged with interest rate swaps to mitigate interest rate risk, would be subject to the credit risk capital rules" (71 FR 55963).

Response:

Please see our response above in the "General Issues - Trading Book/Banking Book Boundary" section of our letter.

Question 3: The agencies request comment on whether there is a better approach that matches more effectively the true economic impact of these transactions.

The above refers to excluding credit derivatives, which are entered into to hedge the credit risk of non-covered (i.e., non-trading book) positions.

Response:

This is a good proposal. As we stated above, there are two viable solutions to treating derivative hedges of banking book risk:

a) A bank should be allowed to include both the derivative hedge and the underlying banking book risk that is being hedged in its calculation of VAR for market risk.

b) A bank should be allowed to exclude both the derivative hedge and the underlying banking book risk that is being hedged from its calculation of VAR for market risk so long as there is no material residual risk. Any material residual risk, due to the risk of the derivative exceeding the risk of the banking book position it is hedging, should be included in VAR.

Although we agree with the proposal, a problem may arise from a new form of credit risk mitigation, contingent credit default swaps (CCDS), which have started to be used to hedge counterparty credit risk. A CCDS is similar to a credit default swap (CDS) in that upon default of the referenced obligor, the seller of the CCDS will pay the buyer the contract notional, which in the case of the CCDS is the market value of a referenced derivative transaction.

From a more general perspective, just as a CDS enables the buyer to hedge against an increase in the credit risk premium of a bond or loan, a CCDS enables the buyer to hedge against an increase in the credit risk premium of a derivative contract. The credit risk

premium of a derivative contract is its Credit Value Adjustment (CVA). The CVA is an adjustment made to the market value of a derivative contract to take into account the credit risk of the counterparty.

The only problem in the Market Risk NPR regarding CCDSs is the potentially ambiguous meaning of "covered" transaction. Most CCDSs will be entered into in order to hedge the counterparty credit risk of covered positions in the trading portfolio. However although the hedged instruments are "covered" positions, the risk that is being hedged is counterparty credit risk, not market risk. A literal interpretation of the NPR would require the inclusion of the CCDSs which are hedging counterparty credit risk in the VAR for market risk.

If the CCDS were to be included in VAR for market risk then the potential change in the CVA of the underlying derivative should also be included in VAR.

An alternative solution would treat a CCDS that is hedging counterparty credit risk in parallel to the treatment of a CDS that is hedging loan credit risk: The CCDS would be excluded from VAR. The underlying derivative combined with the CCDS would be decomposed into hedged and non-hedged residual exposure. The RWA for the combination of hedged exposure and CCDS would be calculated in accordance to the substitution approach (or potentially the double default approach). We recognize that regulators may need some time to become comfortable with CCDSs before allowing the double default approach to be used.

More generally, a principles-based approach should be flexible enough to accommodate further risk management improvements and innovations such as CCDS.

Question 4: The agencies request comment on the extent and materiality of any distortion of the VaR-based measure due to the inclusion of some, but not all, offsetting transactions, and on any appropriate approaches to address this distortion in the final rule, including, subject to certain restrictions, (1) permitting a bank to include in its VaR-based measure the interest rate risk associated with certain non-covered positions that are hedged by covered positions (while remaining subject to a credit risk capital requirement for the non-covered positions) or (2) permitting a bank to include in its VaR-based measure certain internal interest rate derivatives hedging non-covered positions. The agencies also request comment on any operational considerations such approaches would entail.

Response:

We agree with this proposal. The problem it seeks to address is an artifact of FAS 133. Many interest rate derivative transactions entered into for the purpose of hedging the interest rate risk of an accrual portfolio are required to be marked to market by FAS 133 because they do not meet FAS 133's exceedingly narrow definition of an economic hedge. Some banks put these derivative hedges into their trading account largely because they are marked to market. If the interest rate risk of the derivative (but not the interest rate risk it is hedging) is included in VAR, it will exaggerate the total VAR. The

solution to this distortion is to either a) exclude both the interest rate factor sensitivities of the underlying accrual positions and that of their derivative hedges, or b) include both in VAR. The proposal to exclude both would rectify that problem.

Question 5: The agencies seek comment on the proposed definition of residual securitization position, and on the market maker exception and the conditions to use that exception. With respect to positions that do not qualify for the market maker exception, the agencies request comment on the treatment of those positions under the credit risk capital rules and whether such treatment could give rise to any operational or other issues.

Reference in NPR:

> "Under the proposed rule, the definition of a covered position would exclude any securitization position that is a residual securitization position, subject to a limited market maker exception" (71 FR 55964).

Response:

> This is similar to the Basel/IOSCO Trading Book Review of July, 2005, which stipulated that securitization positions subject to deduction would generate risk-weighted assets for market risk at least equal to the RWA calculated under the securitization approach.
>
> Because a comment was requested, however, we want to go on record that the incremental RWA generated by residual securitization positions should not be subject to floors or minima so long as a bank has a complete, validated calculation of VAR and of incremental default risk. Thus our position is consistent with our argument, stated above, in which we oppose the proposed bifurcation of the trading book into covered and non-covered positions once a bank has a complete, validated calculation of VAR and of incremental default risk.

Question 6: The agencies seek comment on these requirements and on whether different or additional policies and procedures would be beneficial for ensuring appropriate identification of positions to which the market risk capital rule should be applied and appropriate risk management of covered positions.

Reference in NPR:

> "The proposal introduces new requirements for the identification of trading positions and the management of covered positions. The agencies believe that these new requirements are warranted based on the trend towards the inclusion of more credit risk-related, less liquid, and less actively traded products in banks' covered positions. The risks of these

positions may not be fully reflected in the requirements of the market risk capital rule and may be more appropriately captured under the credit risk capital rules.

"A bank would be required to have clearly defined policies and procedures for determining which of its trading assets and trading liabilities are trading positions. In determining the scope of trading positions, the bank would be required to consider (i) the extent to which a position (or a hedge of its material risks) could be marked-to-market daily by reference to a two-way market, and (ii) possible impairments to the liquidity of a position.

"In addition, the bank must have clearly defined trading and hedging strategies. The bank's trading and hedging strategies for its trading positions must be approved by senior management. The trading strategy must articulate the expected holding period of and the market risk associated with each portfolio of trading positions. The trading strategy must also articulate whether the purpose of each portfolio of trading positions is to accommodate customer flow, to engage in proprietary trading, or to make a market in the positions. The hedging strategy must articulate for each portfolio the level of market risk the bank is willing to accept and must detail the instruments, techniques, and strategies the bank will use to hedge the risk of the portfolio. The hedging strategy must clearly articulate which positions are being hedged and which positions serve as hedging instruments.

"A bank would be required to have clearly defined policies and procedures for actively managing all covered positions. In the context of nontraded commodities and foreign exchange positions, active management could focus on managing the risks of those positions within the bank's risk limits. For all covered positions, these policies and procedures would be required to address, at a minimum, marking positions to market or model on a daily basis; assessing on a daily basis the bank's ability to hedge position and portfolio risks and the extent of market liquidity; and the establishment and daily monitoring of position limits by a risk control unit independent of the trading business unit. Senior management would be required to monitor all of this information on a daily basis. The policies and procedures would be required to provide for reassessment by senior management of established position limits on at least an annual basis, as well as annual assessments by qualified personnel of the quality of market inputs to the valuation process, the soundness of key assumptions, the reliability of parameter estimation in pricing models, and the stability and accuracy of model calibration under alternative market scenarios" (71 FR 55964).

Response:

It is appropriate for a bank to have "product programs" or "trading strategies" for each of its trading desks, to define the purpose of trading, to specify the types of instruments that may be traded, and so forth. The documentation requirements of this section go far beyond what is appropriate, however. As we argued above, so long as a bank has a complete, validated VAR process and a robust calculation of incremental default risk, there is no need to bifurcate the trading book into covered and non-covered positions. If

there were no bifurcation requirement there would be no need for the imposition of the proposed costly documentation requirements for each desk.

Several components of the documentation requirement are at odds with actual practice and with the purposes of the NPR, namely:

- *Hedging vs. hedged*. The NPR states that:

  > "The hedging strategy must clearly articulate which positions are being hedged and which positions serve as hedging instruments" (71 FR 55964).

  In liquid markets there often is no clear distinction between which instruments on a trading desk are "being hedged" and which ones are the "hedging instrument". For example, a simple USD interest rate derivative desk might have factor sensitivity limits for USD Libor and USD Treasury yields to maturity of different tenors (or sensitivity limits for forward interest rates, for different forward time buckets), as well as limits on the Libor/Treasury spread. On such a desk, Libor FRAs, Libor interest rate swaps, Eurodollar futures, Treasury securities, and Treasury future contracts may all be traded. An essential purpose of the desk is to take and manage "base rate risk," that is, risk of changes in the level, shape, and spread between the Libor and Treasury yield curves. It would not be meaningful for such a desk to specify which are the hedged instruments and which are the hedging instruments.

  In contrast, the distinction between hedged and hedging contracts is easier to identify for a desk that trades relatively illiquid contracts, which it then hedges with more liquid contracts.

- *Customer flow vs. trading*. The NPR states that:

  > "The trading strategy must also articulate whether the purpose of each portfolio of trading positions is to accommodate customer flow, to engage in proprietary trading, or to make a market in the positions" (71 FR 55964).

  The clean segregation of trading portfolios into customer flow, proprietary trading, or market making is often not meaningful. All customer flow desks necessarily must engage in some degree of proprietary trading. Customer flow and trading go hand-in-hand; a bank cannot actively quote prices to customers unless it is in the market trading. Trading provides the bank with access to liquidity and with price discoveries it can use for its customer flow.

  Virtually all desks that engage in customer flow will consequently engage in some degree—potentially a large degree—of proprietary trading. The converse, however, is not true: a desk may engage in pure proprietary trading (e.g., based on analysis of arbitrage opportunities, or based on program trading) without engaging in customer flow.

Question 7: The agencies request comment on all aspects of prepayment risk, including the extent and materiality of prepayment risk, whether material prepayment risk may warrant a further explicit requirement that banks hold capital against prepayment risk over a one-year horizon under both the internal models and standard approaches to specific risk, and the interplay between prepayment risk and default risk for purposes of determining the bank's overall measure for market risk. The agencies also seek comment on how an explicit capital requirement for prepayment risk could be designed.

Response:

This is actually an issue concerning the degree of specificity of the market factor sensitivities used to simulate the potential change in value of mortgage-backed securities and any other securities with prepayment risk. A robust VAR calculation for mortgage-backed securities would include simulating such market factors as a) option-adjusted spreads (general and specific) and b) prepayment speeds. The option-adjusted spreads for mortgage-backed securities incorporate the market's uncertainty in the prepayment rate over the life of the transaction. The volatility of that spread reflects the potential change in the market's uncertainty of prepayment rates over the life of the transaction.

The proposal to hold capital for prepayment risk over a one-year horizon would in essence be double counting prepayment risk. The mortgage-backed security (or, more generally, the tranche of a mortgage-backed security) already incorporates uncertainty in prepayment rates over the life of the transaction in its option-adjusted spread; that is, its expected cash flows are discounted at a higher rate than the risk free rate. Daily changes in the uncertainty in prepayment rates <u>over the life of the transaction</u> are reflected in daily changes in the option-adjusted spread.

The need to model accurately the general and specific risk of mortgage-backed securities, including their prepayment risk, is not different from the need to model the general and specific risks of other types of securities. The degree of specificity and granularity required for the market factors used to calculate VAR will depend on the context of the portfolio and should be tested as part of the general VAR validation, for example, by means of hypothetical backtesting of test portfolios with different degrees of risk concentration.

Question 8: The agencies request comment on the exclusion of fees, commissions, reserves, and net interest income for the trading profit or loss used for regulatory backtesting, including the appropriateness and feasibility of these exclusions, and whether additional items should also be excluded. The agencies also request comment on the role of hypothetical backtesting—specifically, whether hypothetical backtesting is feasible as part of model validation; whether other forms of backtesting should also be used; and whether regulatory backtesting should be based on hypothetical backtesting.

Background:

There are two types of VAR backtesting required in the NPR:

a) Validating VAR by means of hypothetical backtesting (i.e., comparing ex-ante VAR with ex-post "hypothetical P&L") using test portfolios of different degrees of risk concentration (this is not something that was part of the original Market Risk Amendment to the Basel Accord). The definition of "hypothetical P&L" is given below.

b) The determination of the number of "exceptions" to daily VAR that has occurred over the prior 250 business days. If the number of exceptions exceeds a low threshold, the scaling factor used to transform the 99%, ten-day VAR into RWA is increased.
   - At the time the Market Risk Amendment to Basel was adopted in the U.S. (mid-1990's) an exception was defined as the condition in which ex-post actual P&L was negative and larger in magnitude than the prior end-of-day ex-ante VAR.
   - Under the NPR, an exception will be defined as the condition when the ex-post hypothetical P&L is negative and larger in magnitude than the prior end-of-day ex-ante VAR.

Response:

We think this question mixes two related but different issues: a) the validation of VAR as an estimate of potential loss of a constant portfolio, and b) appropriateness of the scaling factor used to transform VAR into a measure of economic risk for the purpose of assessing capital adequacy.

a) The validation of VAR

VAR is an order statistic that measures the potential loss of economic value of a fixed portfolio, at some specified confidence level, for an N-day instantaneous shock in market factors. The standard VAR calculation does not usually entail measuring the consequence of the passage of time.

As is well known, the actual daily P&L of a trading desk has many contributing components:

i) The change in value of a constant or "frozen" portfolio, due to the changes in market factors over a specified time interval, under the assumption that the changes in market factors occurred instantaneously (i.e., without the effects of the passage of time). This component of the actual daily revenue is usually referred to as "hypothetical P&L".
ii) The change in the value of a fixed portfolio, due purely to the passage of time.
iii) Intraday trading.
iv) Intraday customer flow.
v) Net interest income (NII) that is not already included in (ii), above.
vi) Fees and other income not included above.

A one-day VAR typically measures the potential loss in economic value of a constant portfolio, at a specified confidence level, due to an instantaneous change in market factors. It therefore corresponds only to the first component (i) of the daily trading revenue.

It should therefore be noted that if a VAR process does incorporate the change in portfolio value due to the change in time, the hypothetical P&L that such a VAR is compared to should also include the change in portfolio due to the passage of time. In other words, if VAR includes the effect of the passage of time, the appropriate component of NII should be included in the hypothetical P&L against which VAR is compared.

In this context, if VAR is to be validated by backtesting, then the validation should consist in comparing ex-ante VAR against the ex-post hypothetical P&L (i.e., component (i) above) of an actual or test portfolio. While it is feasible to validate a 99% confidence level (CL) one-day VAR by hypothetical backtesting, it is not practically feasible to validate a one-day VAR at a 99.9% CL (a requirement that is implied by the 99.9% confidence interval mentioned in Section 8 of the NPR covering incremental default risk); there would be only a few exceptions every ten years. It is correspondingly even more infeasible to validate a 99.9% CL VAR for a ten-day shock in rates by hypothetical backtesting of test portfolios against hypothetical P&L. For the latter, only a few exceptions would be expected for every hundred years of daily data.

A one-day 99% CL VAR should be validated periodically for each asset class by means of a) analysis of the VAR process, and b) hypothetical backtesting test portfolios of different degrees of risk concentration (or whatever other standard validation has been agreed to by the supervisor and the bank). A VAR that is defined at a confidence level greater than 99% and for instantaneous shocks greater than one day needs to be validated more indirectly then by hypothetical backtesting.

b) Capital Adequacy

Once VAR has been validated, and once a process has been established to validate VAR periodically, there should not be a need to also compare the ex-ante daily VAR to the ex-post daily actual P&L to ascertain the validity of the VAR process. Such daily testing would be redundant to a robust validation process.

On the other hand, there is a virtue in continuing to require banks to compare ex-ante VAR to the ex-post actual P&L of the trading desk. This is a useful test of capital adequacy of the trading business. For example, if the trading desk tends to lose money on intraday trading and has little customer flow, this would increase the likelihood of an exception when ex-ante VAR is compared to ex-post actual P&L. Conversely, a trading business with a strong customer franchise will tend to generate

strong customer revenues which, when included in actual P&L, acts as a cushion to absorb losses. In fact, a bank with a strong customer franchise will tend to benefit from increased customer flow precisely when markets become more volatile and choppy, and will thereby reduce their actual trading risk.

We strongly support the validation of VAR. We strongly recommend that for the purpose of ascertaining the scaling factor that transforms the 99%CL ten-day VAR into economic risk, banks should have the option of defining an exception in terms of a comparison of either:

- Ex-ante VAR to ex-post actual P&L (as per the current rules)
- Ex-ante VAR to ex-post hypothetical P&L

The choice should be made in consultation with the bank's principal regulator and should be based on a consideration of what is the most appropriate measurement given the nature of the firm's business.

Question 9: The agencies request comment on the proposed timeframe for phasing out partial modeling of specific risk and on whether it would allow banks enough time to implement the proposed changes.

Reference in NPR:

"The proposed phase-out of partial modeling of specific risk would not preclude a bank from using an internal model to calculate the specific risk of some, but not all, portfolios of covered debt and equity positions and using the standard approach to calculate the specific risk of other portfolios. Rather, effective January 1, 2010, a bank would not be permitted to use an internal model to calculate the specific risk add-on of a portfolio if the model did not capture all material aspects of specific risk for that portfolio. The bank would be required to use the standard approach to calculate the specific risk add-on for the portfolio until it receives written approval from its primary Federal supervisor to measure the specific risk for the portfolio using its internal model" (71 FR 55967).

Response:

January 1, 2010, seems sufficient time to design and build a model of incremental default risk as well as meet the other VAR requirements.

Question 10: The agencies seek comment on the extent and materiality of specific risk for commodities and foreign exchange positions and on whether and how a specific risk capital requirement for those positions could be developed under both the internal models and standard approaches.

Response:

Commodities and foreign exchange do not have issuer risk in the sense of debt and equity securities. There is a valid issue regarding whether the number of market factors used in the VAR calculation is large enough and sufficiently granular to capture the market risk of the portfolio, desk or firm being analyzed. These are questions that should be addressed in the validation of VAR, and not by muddying the waters by using the term specific risk in connection with commodity and foreign exchange contracts.

Question 11: The agencies request comment on how a bank should adjust the incremental default risk capital requirement to adjust for the impact of liquidity, concentrations, hedging, and optionality.

Response:

This is still under discussion by the ISDA/IIF/LIBA working group with the appropriate regulators. We defer our comments to that ongoing dialogue.

Question 12: The agencies request comment on all aspects of the proposal to reflect in the market risk capital requirement a measure of incremental default risk. Specifically, the agencies seek comment on the feasibility of measuring incremental default risk at a one-year, 99.9% confidence level and the appropriateness of the assumption of a constant level of risk.

Proposed Response:

As with question 11, this is still under discussion.

Question 13: The agencies request comment on the extent to which banks, at present, measure incremental default risk and the prospects for development of methodologies to capture this risk.

Response:

As with question 11, this is still under discussion.

Question 14: The agencies seek comment on all aspects of the proposed public disclosure requirements.

Response:

Section 8 of the Market Risk NPR (71 FR 55078) lists the requirements for public disclosure of market risk information.

Section 8(c)2 of the NPR proposes that banks disclose "Separate VaR-based measures for interest rate risk, credit spread risk, equity price risk, foreign exchange risk, and commodity price risk."

Statistical risk measures such as VAR by necessity include volatility and correlation assumptions. If a bank's internal VAR model assumes each of the above classes of risk factors (i.e., interest rates, credit spreads, equity prices, etc.) are independent of each other, then the proposed decomposition of VAR into each component would be straightforward. However, the value and ease of decomposing VAR into these components very much depends on the assumptions made and methods employed by the VAR model. We believe banks should have the flexibility to disclose risk measures, including VAR, that are most meaningful to them.

For banks that use historical simulation, the time series currently used to calculate VAR for many debt instruments incorporates both interest rate and credit spread movements. It may not be practical at this time for some banks to separate these two components. We believe that banks should be given the discretion to report interest rate and credit spread risk separately or combined depending what they consider to be appropriate and what their systems permit. Alternatively, banks could be permitted to report interest and credit spread risk based on the predominant risk characteristic of a given line of business, e.g., an interest rates business would be reported under interest rate risk and a credit markets business would be reported under credit spread risk. We are not aware of any request from the investment community for such disclosures.

Currently major banks subject to the Market Risk Amendment do not bifurcate fixed income risk into its subcomponents of interest rate and credit spread risks in their disclosures. Moreover, the international Accord has no such requirement.

Section 8(c)3 of the NPR proposes that banks disclose "a comparison of VaR-based estimates with actual gains or losses experienced by the bank, with analysis of important outliers."

As described above, one-day 99%CL VAR is a measure of the potential loss over one day and it may be validated by hypothetical backtesting, or some other process. For a thoroughly valid process, a one-day 99% VAR would have an average of 2.5 exceptions per year. Even for a thoroughly valid process, however, the actual number of exceptions in any year will fluctuate above or below that expected number because of statistical noise. In a thoroughly validated VAR the number of exceptions would have a binomial distribution. If one uses hypothetical backtesting to validate VAR then it will be necessary to perform backtesting on a huge number of independent portfolios over a one-year horizon and to compare the observed distribution of exceptions with the theoretical binomial distribution.

Here are the issues we have with the above statement from the NPR:

i) VAR measures potential loss. Why would we compare VAR with potential gains? Doing so assumes the P&L outcome is perfectly symmetric, which will not necessarily be the case.
ii) Are we supposed to compare VAR to actual P&L or to hypothetical P&L?
iii) Are we supposed to summarize the result of backtesting many independent hypothetical test portfolios or are we suppose to disclose the number of exceptions for the actual portfolio over the last year? If the number of exceptions corresponds to the number of expected exceptions within the precision of statistical noise, what is the point of the disclosure?

Section 8(d) of the NPR proposes a number of requirements for "qualitative disclosures for internal models." Depending on the level of detail expected, these requirements may impose an excessive reporting burden. For example, the NPR proposes disclosure of "the composition of material portfolios of covered positions." Banks with large trading businesses may have hundreds of portfolios comprising hundreds of different types of positions. A detailed description of even the most material subset of these positions may produce a large reporting burden while at best providing uncertain information value to potential users of the information.

Another proposal is for disclosure of "the results of a comparison of the bank's internal estimates for purposes of this rule with actual outcomes during a sample period not used in model development." It is unclear as to what this provision is referring. It appears it may be referring to the results of hypothetical backtests used for model validation. If so, it would be excessively burdensome for a bank to have to repeat and document all these tests on even an annual basis.

We therefore request additional explanation pertaining to both the definitions of the proposed qualitative disclosures, and the level of detail that is expected.

In short, we believe strongly in the principles-based approach in this area, especially given the rapid methodological advances that continue to be made and the fact that each bank's business may give rise to different methodological and disclosure needs. We do not believe details should be locked in to formal regulation. It is essential, therefore, to underscore the above difficulties with the current proposal. The final rule should be revised to remain on a principles basis, but to eliminate as many as possible of the implementational uncertainties discussed above.

Conclusion

Like the related Basel II NPR, the Market Risk NPR focuses appropriately on the completeness and comprehensiveness of a firm's VAR calculation and its validation. The NPR further focuses on the inclusion of a robust calculation of incremental default risk, taking liquidity risk appropriately into account. The final rules should require a firm to have robust means of accurately capturing and appropriately simulating the material market risk of its trading

portfolios. The Associations and their members are already working hard on achieving these goals for their internal systems, and firms should of course expect to have to demonstrate to their supervisors that they have accomplished the above objectives.

As mentioned at the beginning of this letter, we believe that one of the best features of the Market Risk Amendment is its focus on general principles instead of enshrining industry "best practices" as rules. We continue to believe that the attempt to prescribe methodological details in a field where advances are being made regularly and where the business and risk profiles of firms vary greatly is at best premature. Some of the proposed requirements in the Market Risk NPR, however, will impose substantial additional costs—not to mention complexities that may lead to unnecessary errors, confusion, or compliance problems—while adding no real risk management value to the methodologies firms are developing.

The foregoing comments are intended to respond at an appropriate level of detail to the questions posed in the NPR. The Associations and their member institutions look forward to discussing the above comments, and stand ready to respond to any questions or provide any necessary clarifications.

Very truly yours,

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