Morgan Stanley

February 3, 2012

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1401
RIN 7100-AD61

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219
Docket No. OCC-2010-0003
RIN 1557-AC99

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Comments/Legal ESS
RIN 3064-AD70

Re: **Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions**

Dear Sir or Madam:

This letter contains Morgan Stanley's comments on certain aspects of the amendment to the market risk NPR originally published January 11, 2011 that proposes alternatives to Credit Ratings for Debt and Securitization positions. Specifically, Morgan Stanley is commenting on the proposed regulations for securitization and correlation trading positions. Morgan Stanley has participated in the process of producing the letter of the joint industry associations. We support the issues and recommendations contained in industry comments and our comments in this letter supplement the ones found therein.

Morgan Stanley agrees with the objective of reducing overreliance on credit ratings and supports efforts to ensure that credit ratings are not relied upon to the detriment of independent analysis of the risk characteristics of securitization positions purchased by investors. Morgan Stanley also agrees that the principles that guide the selection of any alternative measurement of creditworthiness for securitization exposures should be to appropriately distinguish credit risk of particular exposures within an asset class, should provide for timely and accurate measurement of changes in creditworthiness, minimize opportunities for regulatory arbitrage and foster the objectives of prudent risk management. In addition, any alternative should:

- Promote understanding by banking organizations of the risks associated with their securitization exposures
- Focus on the actual performance of underlying assets and the credit support available to a given risk position within an ABS
- Facilitate the dynamic and timely adjustment of capital proportionate to changes in asset performance and the resulting risk profile of a given exposure
- Be based on data broadly available to all market participants

We believe that capital charges inconsistent with the actual risk of a given exposure could inappropriately motivate banking organizations to make investment decisions based solely on capital which doesn't reflect the risk involved. Furthermore, it is critical that the alternative creditworthiness standard not put U.S. banking organizations at a competitive disadvantage relative to non-U.S. institutions that operate under the Basel II regime.

We are concerned that the approach for calculating capital in the Proposed Regulation is less risk sensitive, for correlation trading, than that set forth in Basel II. The Simplified Supervisory Approach ("SSFA") set forth in its current form will overstate the amount of capital required for certain securitization exposures for all U.S. banks. The capital charge on correlation trading positions would be twice as much under the proposed regulations compared to the international Basel 2.5 guidelines. As such, U.S. banks will be less likely to invest in these instruments, given the increased cost of capital associated. The result will be an increase in the cost of credit for American consumers and businesses, which will dampen the recovery of the U.S. economy.

Correlation Trading Positions (CTP)

CTP mainly comprises standardized tranches and bespoke tranches hedged with single name CDS and CDS indices. Morgan Stanley believes that the current proposed standardized charges for correlation products do not properly reflect the relationship of the products contained in correlation books and their relative impact on the overall risk of the trading portfolio and therefore will produce unintended consequences if implemented. With the current proposal, a significant portion of the floor is generated by non-securitization hedges. The proposed rules therefore penalize a bank for hedging its correlation book with vanilla products. Prudent risk management should not be disincentivized by the structure of the CRM surcharge calculation and the capital rules should be aligned with the hedging of the market risk.

We therefore propose the following changes with respect to the proposed regulatory capital charges for CTP (in order of priority):

1. **Remove the temporary 15% surcharge and replace with the 8% floor as per Basel 2.5**

The proposed surcharge appears unduly punitive relative to Basel 2.5 and places US dealers at a competitive disadvantage relative to their European counterparts. This surcharge dominates the risk based CRM and Morgan Stanley estimates that the surcharge will be multiple times bigger than the CRM capital if the proposed rules are implemented.

In addition, the surcharge does not appear consistent with the usual practice of phasing in more punitive charges gradually over time. Rather than impeding the ability of banks to do business now, when capital is scarce and new credit structurings are rare, the more important objective should be to set appropriate rules before new structuring activity takes place. Therefore, Morgan Stanley does not see any advantage in the interim surcharge and instead believes the agencies should immediately adopt an internationally consistent floor approach.

Lastly, since price risk on correlation trading positions is measured through CRM, VaR and also Stressed VaR, Morgan Stanley believes that this potential double counting should reduce, if not eliminate altogether the need to impose a 15% surcharge on modeled measures of price risk, even for a temporary period.

2. **Remove the non-securitization index and single name CDS hedges from the standardized charges within the surcharge**

As mentioned above, the proposed standardized charges for CTP penalize banks for hedging CTP with vanilla products. A significant portion of the surcharge would arise from non-securitization index and single name CDS hedges under the current proposal. The impact of the Specific Risk Add-On ("SRAO") under the current proposal is much more punitive than the Basel 2.5 floor calculation, which also incorporates non-securitization hedges. In order to align capital rules with effective risk management practices, we are proposing to remove the non-securitization index and single name CDS hedges from the standard charges within the surcharge.

3. **Non-Securitization CTP hedges should be effective offsets for the SRAO calculation**

Morgan Stanley believes that effective economic hedges of risk exposures should be reflected in offsetting capital charges. CTP positions are often most effectively hedged by a combination of securitization and non-securitization hedges. Therefore, we are proposing that offsetting should be allowed across tranche and index positions and across bespoke and CDS positions for purposes of determining the floor. We therefore request that section 10 be modified accordingly such that the offset described in 10 (a)(5) applies to index tranches versus index and bespoke tranches versus single name CDS and the offset described in 10 (a)(4) applies to derivative positions with matching cash flows.

4. **Banking organizations should be permitted to use the SFA when computing the surcharge**

Due to the fundamental differences between traditional securitizations and CTP, organizations should be allowed to use the more advanced SFA approach, allowed under Basel 2.5, as opposed to the less risk-sensitive SSFA under the proposed regulations. These differences were recognized in the creation of the CRM, which generally permits banking organizations to measure material price risks using a comprehensive risk model.

The rationale for the SSFA approach is strongest for securitization exposures in which the underlying data for the SFA is difficult to source. However, for correlation trading, applying the SFA would be feasible and more prudent due to the following:

a. The underlying pool information is available and the tranche attachment and detachment points are known at all times.
b. Underlying exposures are traded CDS exposures that reference corporate credit risk and are priced by both dealer and pricing services.
c. Underlying exposures are known and valued by the counterparties / risk takers on a daily basis.
d. Any changes to underlying portfolio are generally known as they occur (merger/acquisition events).
e. Realized losses based on credit events are known as they occur.

Additionally, as the SFA approach does not rely on external ratings, it would be in line with an important objective of the Dodd-Frank Act. Finally, the application of the SFA approach for CTP would address the risk insensitivity of the SSFA and better align with Basel 2.5, reducing the risk of regulatory arbitrage across regulatory capital regimes.

In the absence of internal ratings, Morgan Stanley is proposing that banking organizations would be able to use one of the following alternatives:

- Use K_G as the Kirb input into the SFA formula
- Make K_G proportional based on maturity, i.e., reduced for shorter dated exposures
- Use the Alternative Credit Spread Approach outlined in the proposed rules, which applies a specific risk-weighting factor based on a credit-spread-approach scoring model driven by three variables: (1) the spread of the securitization position over U.S. Treasuries of comparable maturity; (2) the spread of a high-yield index of corporate exposures (e.g., CDX.HY.B37), which captures business cycle conditions; and (3) the maturity of the securitization

5. **Cumulative loss floor should be removed for correlation trading**

Unlike traditional securitizations, CTP primarily consist of OTC derivatives, which are often assigned from one counterparty to another and can be amended to remove historic losses from the underlying portfolio once cash flows have been realized. Therefore, the concept of cumulative losses is not relevant and should be removed from the standardized charges in the CTP calculation.

Securitization Exposures

Morgan Stanley welcomes the changes proposed with respect to traditional securitization positions since the inclusion of attachment/detachment points as inputs into the supervisory formula will lead to a much more risk-based result as compared to the Basel 2.5 ratings-based approach. We fundamentally agree with the proposals for securitization exposures and do not think significant changes are required upon finalization of the rules. There are, however, instances where K_{ssfa} and K_g are not risk sensitive enough and should be modified accordingly.

Morgan Stanley's specific issues with the SSFA approach proposed for securitized exposures (non - correlation trading) are as follows:

1. **Kssfa is often not sufficiently risk sensitive as a result of the cumulative loss floor**

The cumulative loss floor included in the proposed SSFA in many instances will require the same capital to be held against senior securitization positions as compared to riskier junior securitization positions. For example, the super senior security in the SASC 2006-BC6 capital structure with over 95% enhancement will require 52 to 100% capital, the same as the considerably more risky junior positions.

We understand the need to increase capital requirements for transactions that underperform the expectations set forth in the initial Kg. We therefore propose to increase Kg to make Kssfa risk sensitive as follows:

$$\mathbf{K_G = Max(initial\ K_G,\ alpha * cumulative\ losses\ on\ transaction\ structure)}$$

The above modification would increase K_G for underperforming transactions. The formula would result in higher capital requirements while still properly incorporating attachment and detachment points and remaining risk sensitive. It would also eliminate the need for a floor ladder as the increased K_G would appropriately penalize underperforming transactions.

In addition, the inclusion of an alpha coefficient allows regulators to set capital levels as they deem appropriate. Instead of the cumulative loss floor, we recommend using the regulators' existing

formulaic methodology to allocate more capital to the junior tranches where needed. We believe that an alpha of 1 may be appropriate but include examples in the tables below with an alpha of 2 for comparison.

We considered metrics other than cumulative losses on the transaction structure but chose the calculation to remain consistent with the metrics provided by regulators in the proposed NPR.

Finally, to address concerns related to capital held against these positions, we propose a global floor of 1.6%.

2. The carrying value of a securitization position is not taken into account in determining its attachment point for purposes of the SSFA calculation

Under the current proposal, the inclusion of the attachment point as an input parameter to the SSFA without consideration of the carrying value will overstate the capital requirements for such positions. The difference between the par value and carrying value of a securitization position represents credit enhancement that is available for that position. This credit enhancement should be reflected in the attachment point input in order to properly calculate the capital requirement for these positions. We would modify the attachment point in the following way, and then include $A_{modified}$ in the NPR formula:

$$A_{modified} = A + (D - A) * (1 - C)$$

$$C = \frac{\text{Carrying value of security}}{\text{Par value of security}}$$

We believe that these two small modifications, alongside the proposed regulations, will help create a more risk-sensitive framework. The revised methodology requires no additional complications or calculations and offers flexibility for regulators to adjust capital requirements as they deem appropriate.

In addition to our two main proposed revisions above, below we note two other points to be considered with respect to the SRAO calculation for securitization positions:

- Consider more risk sensitivity in initial K_G. For example, prime auto and subprime auto both currently require 8% initial K_G. We believe that prime bank credit cards and prime auto should be considered as candidates for an initial K_G of 4%.
- Positions with corporate guarantees should attract the minimum capital of K_{SSFA} or the guarantor given that both the guarantor and the asset must jointly default for the banking organization to take a loss.

3. **<u>Morgan Stanley seeks confirmation for the following calculation assumptions</u>**

- Cumulative losses would be losses on the debt liabilities of the capital structure, expressed as a percentage of the total liabilities in the capital structure. We prefer this over losses on the collateral for two main reasons:
    I. Cumulative losses to the structures incorporate excess spread and other structural enhancements

II. The calculation is considerably simpler and more understandable for certain structures such as re-securitizations and revolving structures

- Other specific structural enhancements should be included in the attachment calculation such as fully funded reserve accounts
- Securities with a minimal inclusion of other securities, such as those with less than 10%, should not be considered re-securitizations for purposes of determining the supervisory calibration parameter
- Credit indices should be decomposed for netting and risk-weighting purposes.
- Positions subject to a 1250% risk-weighting (dollar-for-dollar capital charge) should be excluded from all other market risk capital calculations.

Illustrative Example of Morgan Stanley's Proposed Changes for Securitized Products

Capital structure of SASC 2006-BC6

Tranche	Original Rating	Current Rating	Orig Balance ($MM)	Current Balance ($MM)	Attach	Detach	Carrying Value
A1	Aaa	Caa3	481	208	26	100	53
A2	Aaa	Aaa	306	17	95	100	98
A3	Aaa	Baa2	52	52	76	95	91
A4	Aaa	Ca	104	104	36	76	33
A5	Aaa	C	28	28	26	36	15
M1	Aa1	C	98	98	8	26	2
M2	Aa2	C	54	45	0	8	1
M3-B			136	0			

Potential Capital under three regimes : Basel 2.5, NPR, and MS proposal

Tranche	Current NPR	Current NPR 6 months Forward	Without carrying cost		With carrying cost		Basel 2.5
			MS with Alpha 1	MS with Alpha 2	MS with Alpha 1	MS with Alpha 2	
A1	52%	100%	1.60%	11.92%	1.60%	1.60%	100%
A2	52%	100%	1.60%	1.60%	1.60%	1.60%	1%
A3	52%	100%	1.60%	1.60%	1.60%	1.60%	6%
A4	52%	100%	1.60%	8.81%	1.60%	1.90%	100%
A5	52%	100%	3.68%	50.50%	1.50%	33.25%	100%
M1	52%	100%	48.07%	97.93%	8.23%	77.96%	100%
M2	100%	100%	100.00%	100.00%	100.00%	100.00%	100%
M3-B							

Note: Moody's ratings. Basel 2.5 calculation ignores other ratings for simplicity in the example

- Under the proposed regulations, today's cumulative losses of 11.5% on the structure leads to a risk-insensitive floor of 52% across most of the capital structure
- Capital will surge to a risk-insensitive 100% for all tranches in a few months when cumulative losses reach 12%
- The Morgan Stanley methodology, which incorporates losses into K_G, shows more appropriate risk sensitivity across the capital structure, with the junior tranches remaining at 100%
- In determining alpha, regulators have a methodology to increase or decrease capital requirements, while maintaining appropriate risk sensitivity across the capital structure. Again, we believe that an alpha of 1 may be appropriate, but have illustrated an alpha of 2 as well. K_G would increase to 23 in our example, increasing capital requirements in the mezzanine and subordinate parts of the structure

- Incorporating carrying cost into the attachment point reflects the true attachment point of the tranche. For example, the A1 tranche has a 26% hard enhancement but we believe that the true attachment point is closer to 61, given the carrying value of 53. So if the transaction structure were to recover 40% of the principal, the bank holding the A1 at 53 would likely receive its entire investment whereas a bank with a higher carrying value would not receive its entire investment. Correspondingly, in our example with an alpha of 2, an institution carrying the bond at 53 would require 1.6% of capital but an institution holding the bond at par would require 11.92% capital.
- Comparing the three regimes, the proposed regulations, Basel 2.5 and the Morgan Stanley proposal: In this example, only the Morgan Stanley proposal captures the true risk sensitivity in the tranches. The risk sensitivity of the proposal suffers from the floor, and Basel 2.5 suffers due to its dependence on ratings, which focus on first dollar of loss, not overall risk

Thank you for considering the data and information provided in this supplemental letter. We appreciate the opportunity to share our views with the Agencies and would be pleased to provide any further clarification or granularity regarding the data reported herein. If you have any questions, please contact Candice Koederitz, Managing Director of Morgan Stanley, at (212) 761-4219 (e-mail: Candice.Koederitz@morganstanley.com).

Respectfully submitted,

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