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Goldman Sachs

Ms. 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

Office of the Comptroller of the Currency,
250 E Street SW., Mail Stop 2-3,
Washington, DC 20219
OCC Docket ID OCC-2010-0003

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

February 3, 2012

Ladies and Gentlemen:

"Risk-Based Capital Guidelines: Market Risk"

The Goldman Sachs Group, Inc. ("Goldman Sachs") is pleased to provide comments on the Notice of Proposed Rulemaking ("NPR") entitled "Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions" ("the Proposals"). We commend the Board of Governors of the Federal Reserve System ("the Board"), the Office of the Comptroller of the Currency ("the OCC") and the Federal Deposit Insurance Corporation ("the FDIC") (collectively "the Agencies") for their efforts to address Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Act"), which requires them to remove references to credit ratings from their regulations.

The Proposals raise numerous issues that we consider to be important. We are participating in the industry discussions on the Proposals that are being conducted by the ASF, TCH, ABA, FSR, IIF, ISDA, and SIFMA[1]. Their letter will address many of these issues, and we focus this letter on those that will have the most significant impact on the availability of credit to consumers, and that will unnecessarily render banking organizations in the United States less competitive than their non-U.S. counterparts.

Our overriding concern is that the Proposals call for excessive levels of capital that will result in adverse consequences for the broader economy. In particular, by requiring very high levels of capital for credit that is extended in the form of a security, the Proposals would render most securitization activities uneconomic and would create a strong incentive for banks to retain all loans directly on their own balance sheets. Because the aggregate capacity of the combined balance sheets of all U.S. banks is insufficient to support the current level of consumer loans that have been extended, this would severely limit the future supply of credit to the broader economy. In addition, we believe that the appetite of the non-bank sector to purchase securitized loans will be greatly curtailed if the regulated banks that normally make markets in such securities are discouraged from doing so by excessively onerous capital requirements.

Finally, although a stated goal of the Proposals is to achieve a result that is broadly comparable to the Basel guidelines, we do not believe they achieve this objective. While we recognize the difficulty of identifying alternatives to the use of credit ratings, we believe that such alternatives do in fact exist and we would be happy to work with the Agencies to help develop them.

Our primary recommendations are set out below:

1) **We recommend that the Agencies issue a further NPR that would combine the Proposals with the January 2011 NPR[2] and give greater clarity to aspects that are currently open to alternative interpretations; in addition, we recommend that the combined NPR be the subject of a comprehensive impact study to determine its overall effect on both individual banks and the broader economy.**

   Our assessment of the impact of the Proposals has been rendered considerably more difficult by the fact that there is no single rule-set to review: rather, the Proposals must be read in conjunction with both the January 2011 NPR and the current risk-based capital rules. In addition, the Proposals contain a number of references that have been the subject of a wide divergence of interpretation during industry meetings[3]. Several examples are discussed in more detail in Appendices A to C, including the following:

   - the definition of "cumulative loss" in the calculation of the 'floor' in the Simplified Supervisory Formula Approach ("SSFA");
   - for derivatives that reference securitization assets, whether capital requirements should be based on the market value of the underlying assets rather than the notional value of the derivative;
   - whether the principle that capital requirements should not exceed the "maximum loss" of a position can be applied to both long and short positions; and

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[1] *The American Securitization Forum (ASF), The Clearing House Association LLC (TCH), American Bankers Association (ABA), the Financial Services Roundtable (FSR), Institute of International Finance (IIF), International Swaps and Derivatives Association, Inc. (ISDA), and the Securities Industry and Financial Markets Association (SIFMA).*

[2] *"Risk-Based Capital Guidelines: Market Risk" published in the Federal Register on January 11, 2011*

[3] *See the American Securitization Forum letter to the Agencies dated January 17, 2012 seeking clarification on various issues*

- the appropriate treatment of derivatives that reference indices.

Although technical in nature, the interpretation of these references can significantly change the results. A further NPR that would combine the Proposals with the January 2011 NPR would give greater clarity to those aspects that are currently open to different interpretations and ensure that all banks have a common understanding of the Proposals and are properly able to assess their impact.

In addition, there appears to be a considerable discrepancy between the industry's estimate of the impact of the Proposals and the Agencies' observation that the outcome is expected to be "comparable" to the Basel standards. Estimates both by banks and independent market analysts point to capital requirements for securitizations and corporate positions that are so high that firms will be forced either to scale back their activities or to exit certain markets. We consider the potential impact of the Proposals to be sufficiently serious that a comprehensive impact study should be conducted to assess the impact on individual banks' capital ratios and on the broader economy.

2) **We recommend that the Proposals be revised in order to achieve greater risk-sensitivity.** As currently written, the Proposals fail to meet one of the Agencies' stated objectives, which is to assign "relatively higher capital requirements to the more risky junior tranches of a securitization that are the first to absorb losses and relatively lower requirements to the most senior positions". This is primarily because of certain flaws in both the 'core formula' and the 'floor' in the SSFA methodology. As a result, certain investment grade and mezzanine tranches will attract the same capital requirement as more junior, riskier tranches of a securitization. Because there is no capital disincentive to doing so, an undesirable consequence is that banks may tend to seek higher returns by holding the riskier positions. Further, the "cliff effects" that are inherent in the calculation of the 'floor' will result in significant increases in capital requirements from very small changes in the level of cumulative losses. This will not only introduce volatility in capital requirements that will be difficult for banks to manage, but it will create procyclical capital requirements that increase as the economy deteriorates. We expand on these concerns in Appendices B and C, and recommend that the Proposals be amended in such a manner as to differentiate among levels of risk in securitization structures.

3) **We recommend that the Proposals be re-calibrated to ensure greater consistency with international standards.** Although the Agencies have noted that "the capital requirements under the proposed methodologies generally would be comparable to those produced by Basel's standardized measurement method", our estimates indicate that capital requirements would be significantly higher than those contemplated in the "Basel 2.5" guidelines[4]. We are already concerned that existing inconsistencies in the calculation of Risk Weighted Assets give non-U.S. banks a competitive advantage, and note that the Proposals will exacerbate these inconsistencies yet further.

As we discuss in more detail in Appendices A to C, there are numerous ways in which the Proposals are inconsistent with, and in many respects, more conservative than the Basel guidelines. The following are among the most significant examples of this:

[4] *Primarily set out in "Revisions to the Basel II market risk framework" of July 2009*

- by applying the SSFA framework to Credit Correlation Trading Portfolios, the Proposals unnecessarily diverge from the Basel 2.5 guidelines, resulting in capital requirements that are risk-insensitive and not well calibrated to the risks of such portfolios;
- the proposed 'floor' within the SSFA framework, which has no parallel in the Basel guidelines, is flawed in certain respects and increases capital requirements without economic justification;
- the "securitization surcharge" results in a capital requirement for a transaction-wide securitization holding that is 1.5 times higher than under the Basel guidelines; and
- the vast majority of exposures to investment grade companies would take higher capital requirements than under the Basel guidelines.

While we recognize that the prohibition on the use of credit ratings makes it impossible to harmonize every aspect of the Agencies' capital rules with international standards, we believe that it is possible to find an overall outcome that produces broadly consistent capital requirements for each class of asset, and therefore does not distort the competitive playing-field. We recommend that the Proposals be re-calibrated to produce an outcome that is more consistent with the Basel 2.5 guidelines.

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In closing, we would like to reiterate our support of the efforts of the Agencies to address Section 939A of the Act. We recognize that this is an extremely challenging exercise, and would be pleased to assist in any way that would be helpful.

Sincerely,

Sarah Smith
Chief Accounting Officer

cc: Michael F. Silva, Federal Reserve Bank of New York

Appendix A: Risk Weights for Positions in Corporates and Non-Bank Financials

Although the three indicators chosen to determine the specific risk weighting factors for corporate positions (EBITDA[5]-to-assets, stock return volatility, and debt-to-assets) are reasonable indicators of creditworthiness, we have some reservations about them which we outline below:

1. It is too simplistic to focus only on these indicators, since standard thresholds do not take account of differences across industries (such as debt-to-asset ratios), and they ignore other valid measures (e.g. the term structure of a company's debt will also have a significant impact on its creditworthiness.)
2. We estimate that the proposed thresholds would result in positions in the vast majority of investment grade companies taking the higher capital requirements previously associated with non-investment grade exposures (either 8% or the new rate of 12%), with very few companies rated non-investment grade moving to the lower 1.6% capital requirement. As a result, we do not believe that the Proposals would lead to a result that is "comparable" to that achieved under the Basel international frameworks. Instead, it would lead to a situation where a foreign bank holding a security issued by a U.S. corporation would need to set aside only one-fifth[6] of the capital required by a U.S. bank holding the same security.
3. We would also note that, based on our initial analysis, the amount of capital required would be procyclical, with capital requirements in the depths of a recession being higher than during other phases of the business cycle.

It would be possible to address the second of these concerns by widening the volatility and debt-to-assets thresholds so that, for a representative portfolio, the resulting risk weights become comparable to those required by international standards.

This change, however, would not address our concern that the indicators are procyclical and are over-simplistic measures of the creditworthiness of a company. We believe therefore that an approach based on relative spreads should be considered, and have performed some initial analysis on a widely traded universe of names. Our analysis examined the relative difference between each name's CDS spread and the CDS spread of the CDX.NA.IG Index (in each case this was based on an average of the month-end spreads over the prior twelve months). Risk weights were then assigned to each name based on the size of this ratio. The use of a twelve-month average mitigates much of the concern that the use of spreads would lead to undesirable procyclicality and volatility in capital requirements. Additionally, our initial analysis indicates that, over the 2008-2011 period, this approach would have resulted in more positions moving to higher (non-investment grade) capital requirements than under a ratings-based approach. We would very much like to discuss this analysis with you further.

The use of relative spreads is also important for positions in financials: we believe that the blanket application of an 8% specific risk charge for all non-bank financials is too risk-insensitive. Ignoring other considerations, this would incentivize banks to hold the riskiest corporate exposures in order to maximize

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[5] *Earnings Before Interest expense, Taxes, Depreciation and Amortization (EBITDA)*

[6] *Depending on the scope of model approval, a foreign bank may be subject to a 1.6% capital requirement on an investment grade position, whereas the US bank would likely be subject to an 8% requirement on the same position.*

returns, since all positions are capitalized at 8%. We recommend that further analysis be carried out to assess whether risk weights for financials should be based on average relative spreads.

Finally, the Agencies should provide clarity as to how the methodology is intended to work for positions in indices. We believe that the intention is for banks to "look-through" to the individual constituents of an index (effectively creating a position in each constituent name), since it would not be possible to calculate each of EBITDA-to-assets, stock return volatility, and debt-to-assets at the index level. However, it would be helpful if the Agencies could explicitly confirm this assumption.

Appendix B: Simplified Supervisory Formula and Securitizations

As we have noted in the body of our letter, we are concerned that the proposed SSFA approach is insufficiently risk-sensitive. The combination of assumptions within both the 'core formula' and the additional 'floor' result in capital requirements that we believe to be excessive, particularly when compared to the Basel 2.5 international requirements. We have set out below a number of concerns regarding the proposed SSFA, as well as some points of clarification that are required. In addition, although the comment period has not allowed the industry adequate time to fully develop revised approaches, we broadly support the alternatives that have been discussed and have also set out some initial thoughts below as to alternatives. We would be happy to discuss these further with the Agencies.

1. Credit Correlation Trading Portfolios[7] ("CCTPs"): we believe that these portfolios should not be subject to the SSFA, but should instead be eligible for a model-based approach ('Comprehensive Risk Measure') with a 'floor' based on the full Supervisory Formula Approach[8] ("SFA"), in line with the Basel 2.5 guidelines (see Appendix C).

2. If a bank held every tranche of a securitization, the overall capital requirement under the SSFA would be significantly higher than if it held the underlying assets directly on its balance sheet. We believe that there is no economic justification for this approach; it is also inconsistent with the Basel international standards, which adhere to the principle that capital requirements for securitizations should not exceed the capital requirements for the underlying assets. We believe that this distortion will likely create regulatory arbitrage (i.e. it creates a strong incentive for banks to hold risk in the form of underlying loans, rather than in the form of a security referencing those loans.) Without an active, liquid market in these securities, banks will be restricted in their ability to extend credit to consumers. In addition, today's non-bank credit providers will have less appetite to participate if there are not liquid markets allowing them to manage their risks on an ongoing basis.

3. We are concerned about the use of risk weights derived from the general risk-based capital rules to determine K_G, both in the context of the 'core formula' and the 'floor'. Such a K_G parameter is both risk-insensitive and static. The Basel 1 framework, upon which the current risk-based capital rules are based, does not appropriately differentiate between the varying risk profiles of different asset classes; for example, K_G would be an unvarying 8% for several asset classes, including commercial mortgage-backed securities, prime and subprime auto loans, and corporate loans. Additionally the Basel 1 risk weight is static and does not adjust to market conditions. We believe that an "experience-adjusted" K_G would provide a more risk-sensitive parameter (see section on alternatives below).

4. There is an arbitrary "securitization surcharge" (the "p" factor) of 0.5 for securitizations and 1.5 for re-securitizations, which results in a capital requirement that is 1.5 times higher for a transaction-

[7] *For the purposes of this letter, we define Credit Correlation Trading Portfolios consistently with the definition used by the Agencies in the January 2011 NPR*
[8] *The Supervisory Formula Approach established in the Basel 2 framework, and modified by the Basel 2.5 revisions*

wide securitization holding than if the underlying exposures were directly held on the balance sheet (and 2.5 times higher for re-securitizations).

5. It is important that the purchase price of an asset be taken into account in the framework. The purchase of assets at a discount effectively results in additional credit enhancement for the purchasing bank, and must be adjusted for in the framework (e.g. the definition of cumulative losses could be adjusted to exclude losses that have taken place prior to purchase date) so that banks are not required to set aside more capital than they are at risk of losing.

6. With respect to the treatment of derivatives that reference securitization assets, the following points need to be clarified:
    i. that the capital requirements for derivatives should, consistent with the Basel 2.5 guidelines, be calculated based on the market value of the underlying asset(s), rather than on the notional value of the derivative; and
    ii. also consistent with the Basel 2.5 guidelines, the capital requirements (inclusive of the 'floor') should be capped at the maximum economic loss to the bank, both when buying *and* selling protection.

7. Additional clarity should be provided on the appropriate treatment of indices such as the CMBX and ABX indices (see also the related point in Appendix C on the treatment of indices in Credit Correlation Trading Portfolios). We believe it is critical that the final rules allow for "look-through" treatment, permitting offsetting of risks across indices and single name credit derivatives. In other words, banks should be permitted to break such indices into their underlying constituents, both to determine the appropriate risk weight, and to match or offset[9] those underlying constituents against offsetting single name positions. This treatment would appropriately reflect the combined economic risk of the positions, as the aggregate cash flows of the constituent parts will be exactly the same as those of the initial security, regardless of which credit events may occur. We believe that this treatment of indices is implicit in the Proposals (since, for example, it is not possible to apply the SSFA to a credit index because the inputs required for the SSFA are not available for the index, but only for the underlying constituents); however, this should be clarified in the final rule.

8. With respect to the proposal to require a 'floor' based on comparing 'cumulative losses' to 'K_G', we have a number of concerns:
    - It is unclear from the NPR whether 'cumulative losses' and 'K_G' are <u>both</u> calculated at the level of the tranche/security or on all of the underlying exposures of the securitizations (deal level). We believe that 'cumulative losses' should be defined at the security level, since the alternative would result in all senior tranches taking a 100% capital requirement (for instance once losses on a portfolio reach 12% compared to a K_G of 8%), irrespective of credit enhancements and the overall securitization structure. In order to be consistent, this would also require K_G to be calculated at the security level.
    - Realized losses on a portfolio are not necessarily a good indicator of future losses in that portfolio. For example, a senior tranche with an underlying portfolio of 12% low quality names and 88% very high quality names would require a 100% capital requirement as

[9] *Determining whether to 'match' or' offset' would be based on the usual criteria for trading book positions*

soon as the 12% low quality names default (no account would be taken of the high quality of the remaining loan pool);

- This approach does not adequately consider credit enhancement within securitization structures, and capital requirements automatically jump to 100% when losses rise to 12%[10], irrespective of the level of credit enhancement. This creates an incentive for banks to minimize the credit enhancement in the senior tranches since no recognition is given for capital purposes.
- The 'floor' also suffers from the drawbacks raised in the point above: K_G is set at an arbitrary, risk-insensitive value, taking minimal account of the securitization structure. Comparing cumulative losses relative to K_G (as defined) could result in a high quality portfolio getting a higher 'floor' requirement than a low quality portfolio with the same percentage of defaults. For example, a portfolio with a K_G of 4% and losses of 4.01% is subject to a 'floor' of 52%, whereas the same percentage of losses in a riskier portfolio with a K_G of 8% would only be subject to a 'floor' of 8%.
- The proposed 'floor' has major cliff effects: in other words, very small increases in cumulative losses can result in enormous changes to capital requirements on the more senior pieces of a securitization. For example, a $1 increase in cumulative losses can result in capital requirements increasing from 8% to 52%[11]. Such cliff effects create unwelcome volatility, both for individual banks, and for the system as a whole.
- The proposal to have an absolute risk weight 'floor' at 20% means that foreign banks will have a major competitive advantage when they invest in the most senior tranches of a securitization, since their capital requirements will be approximately one-third of the amount that banks in the United States would be required to hold.
- It should be clarified that 'cumulative losses' would include only losses that remain within the securitization structure, and do not include losses that have already been settled.

For the reasons set out above, we consider the 'floor' to be arbitrary and unnecessarily punitive, creating new areas of international inconsistency without meaningful regulatory benefits for the system as a whole. We recommend that the 'floor' be removed and that the SSFA formula be amended to make K_G more risk-sensitive.

Alternatives

We broadly support the alternatives that have been discussed in the industry working groups, although some further analysis is required to ensure that these are appropriately calibrated. We believe that the K_G parameter should be experience-adjusted, i.e. it should be linked to the underlying performance of the securitization exposures, so that it is updated as risks increase in the underlying portfolio, thereby resulting in higher capital requirements. One option to make K_G more risk-sensitive in this way would be to link it to the level of delinquencies and charge-off rates used for accounting purposes (i.e. for loan loss reserve estimates). We would be happy to discuss this approach further with the Agencies.

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[10] Assuming K_G of 8%

[11] Depending on whether 'cumulative losses' are defined at the security level or deal level, this 550% increase in the amount of capital requirement would be either for the residual amount on that security, or on all senior tranches of that securitization.

Another alternative that may merit further consideration is the approach used by the National Association of Insurance Commissioners ("NAIC"), under which third party assessors estimate the 'Intrinsic Price' of every tranche, reflecting future expected losses as well as actual losses. This intrinsic value is compared to the insurance company's book value to determine the level of capital required. This approach could be developed further to address unexpected loss as well as expected loss.

Appendix C: Credit Correlation Trading Portfolios

As we noted in Appendix B, we are concerned that the Agencies consider it necessary to apply the SSFA to CCTPs. These portfolios are fundamentally different to other securitization exposures in that they primarily consist of publicly traded index tranches and credit default swaps for which daily pricing information is available to all market participants; consequently, the data required for the full Supervisory Formula Approach ("SFA") on underlying assets is generally available. The Basel Committee has recognized this and has carried out extensive work to create an appropriate capital framework for CCTPs: banks may apply a model-based approach (the Comprehensive Risk Measure ("CRM")), but the resulting capital requirements are subject to a 'floor' based on the Securitization Framework of Basel 2. Because the vast majority of positions in CCTPs are unrated, and because data is available on underlying assets so that all banks can calculate the full SFA, the removal of the "Ratings Based Approach" (as required under Section 939A of the Act) should not impact the capital framework for CCTPs.

The full SFA can be applied without reliance on external ratings, as estimates of Probability of Default and Loss Given Default can be derived from parameters used in models that are approved by the regulators for other purposes. Indeed, several banks have already invested significant resources in developing systems and processes that are compliant with the full SFA for correlation portfolios, and we believe that this approach should continue to be made available for CCTPs.

Given the above, and the importance of international consistency, we encourage the Agencies to adhere as much as possible to the Basel 2.5 guidelines in this area. We note that the Agencies have commented that they are concerned about regulatory arbitrage if both the SFA and SSFA are available to banks. We believe that these concerns can be mitigated by requiring banks to choose which approach they are using for each portfolio, with the assumption that changes in approach should be rare and require approval.

With respect to CCTPs, we have a number of other concerns regarding the Proposals and the January 2011 NPR, which result in certain risks within these portfolios being double-counted (and, in some cases, triple-counted) across the capital requirement calculations. In particular:

- The 15% surcharge proposed in the January 2011 NPR as an additive requirement to the model-based requirements is inappropriate, would create significant inconsistencies in capital requirements between US and foreign banks, and should be removed. Banks will have to undergo a process of intensive regulatory scrutiny in order to qualify for CRM approval. To protect against model risk, the Basel 2.5 guidelines require a 'floor' of 8% of the higher of capital requirements on the net long or net short positions, as calculated under the SFA. We believe that the Agencies should remove the proposed surcharge, and should impose a 'floor' in a consistent manner with the international guidelines in this area.
- A surcharge, rather than a 'floor', would cause capital requirements to diverge greatly from economic risk. In fact, it would create a situation where banks would have an incentive to remove hedges in order to lower their capital requirements (so they would have a higher risk profile, but lower overall capital requirements.)

- Whichever framework is used for the purposes of a 'floor' (i.e. whether it is based on the specific risk haircuts in the general risk-based framework as amended in the January 2011 NPR, on the SSFA as proposed in this NPR, or on the SFA), it is vital that hedges receive adequate recognition in the capital requirements – otherwise, capital requirements for hedged portfolios will actually be greater than for unhedged ones, thereby creating a strong disincentive for banks to engage in sound risk-management practices.
- A key issue with respect to the appropriate recognition of hedges for CCTPs is the treatment of indices such as the CDX or Itraxx. Positions in indices should be broken down into their underlying constituents, both for the purposes of determining the appropriate risk weight and for the purposes of matching and offsetting against constituents of other indices and against single name positions. Such an approach would reflect the economic nature of the hedge on a name-by-name basis (the aggregate cash flows of each constituent name will be exactly the same as those of the underlying securities). In order to apply the framework proposed by the Agencies for corporate credit risk weights, we believe that it will be necessary for indices to be treated in this way; we encourage the Agencies to clarify the treatment of indices in the final rule.
- In addition, the proposals contained in the January 2011 NPR would only allow positions to match if they are long and short positions on the same reference obligation (subject, of course, to other criteria). For the majority of credit default swaps ("CDS"), a specific instrument is quoted as the reference obligation to serve as the "hook" in the capital structure. The reference entity and seniority of the obligation (but not the reference obligation itself) are used to determine the occurrence of a credit event and the ensuing recovery level, and the instruments are fungible, so different reference obligations of the same entity can be used to fulfil the CDS contract. The matching criteria should likewise be based on the reference entity and on seniority. This is particularly important as it would align the rules with evolving market conventions that are moving away from referencing specific bonds and toward referencing issuing entities.