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Board of Governors of the Federal Reserve System
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Washington, DC 20551
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Office of the Comptroller of the Currency
250 E Street SW., Mail Stop 2-3
Washington, DC 20219
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Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW.
Washington, DC 20429
FDIC RIN 3064-AD95, 3064-AD96, 3064-AD97

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"Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action"
"Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements"
"Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule"

Ladies and Gentlemen:

The Goldman Sachs Group, Inc. ("Goldman Sachs") is pleased to comment on the above Notices of Proposed Rulemaking (collectively "the Proposals").[1] We thank the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (collectively, "the Agencies") for their efforts to implement the Basel Committee on Banking

[1] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52792 (Aug. 30, 2012) (the "Capital NPR"); Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, 77 Fed. Reg. 52888 (Aug. 30, 2012) (the "Standardized Approach NPR"); and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule, 77 Fed. Reg. 52978 (Aug. 30, 2012) (the "Advanced Approaches NPR").

Supervision's ("Basel Committee") Basel III Framework[2] ("Basel III"), and for endeavoring to integrate this Framework with the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which include the introduction of a regulatory capital "floor" (the "Collins floor")[3] and the removal of references to credit ratings from U.S. regulatory capital regulations.

We continue to support more rigorous capital standards that strengthen the overall resiliency of the U.S. banking system. These include capital levels that are commensurate with the nature and degree of risk to which U.S. banking organizations[4] are exposed, as well as improved capital quality. We therefore support many aspects of the Proposals and endorse the objective of creating a sounder and better capitalized U.S. banking sector.

However, we have a number of significant concerns with the Proposals, which we describe below. We have contributed to industry discussions on the Proposals, and we support the points made in the two comment letters submitted by the major U.S. banking industry groups (collectively the "Joint Letters").[5] Given that the Joint Letters address many of our concerns, we focus our own comments on the following elements of the Proposals:

A. Certain aspects of the proposed deduction from regulatory capital of a banking organization's investments in unconsolidated financial institutions[6]
B. The use of the Current Exposure Method ("CEM") to calculate over-the-counter ("OTC") derivatives exposures within the Standardized Approach,[7] the Supplemental Leverage Ratio and the calculation of capital requirements for certain exposures to central counterparties ("CCPs")
C. The treatment of funding transactions under the Standardized Approach
D. The proposed risk weights for broker-dealers contained in the Standardized Approach
E. The treatment of collateral pools that contain illiquid assets
F. The capital requirements for exposures to CCPs

While technical in nature, these issues could have significant negative consequences for U.S. financial markets, systemic safety and the international competitiveness of U.S. banking organizations. The Proposals could, for example, disconnect regulatory capital requirements from the efficient risk-based allocation of capital and robust internal risk management practices. They could also reduce market liquidity for certain economically vital financial instruments, raising costs for financial market end-users and for the issuers of these financial instruments. They could also impose a significant operational burden on U.S. banking organizations without substantially aiding the Agencies in achieving their stated objectives, while also disadvantaging U.S. banking organizations relative to their non-U.S. peers.

[2] Basel Committee on Banking Supervision, Basel II: A Global Regulatory Framework for More Resilient Banks and Banking Systems, (Dec. 2010, rev. June 2011).

[3] Sections 939A and 171 of Dodd-Frank, respectively.

[4] "Banking organizations" are defined as "national banks, state member banks, state nonmember banks, state and federal savings associations, top-tier bank holding companies domiciled in the United States that are not small bank holding companies, as well as top-tier savings and loan holding companies domiciled in the United States (collectively, banking organizations)." Capital NPR at 52795.

[5] The irs letter is from the American Bankers Association, the Financial Serv ces Roundtable and the Securities Industry and Financial Markets Association; the second is from The Clearing House and the American Securitization Forum.

[6] *See* Capital NPR at 52820, defining "financial institutions" as "bank holding companies, savings and loan holding companies, non-bank financial institutions supervised by the Board under Title I of the Dodd-Frank Act, depository institutions, foreign banks, credit unions, insurance companies, securities firms, commodity pools (as defined in the Commodity Exchange Act ("CEA")), covered funds under section 619 of the Dodd-Frank Act (and regulations issued thereunder), benefit plans, and other companies predominantly engaged in certain financial activities."

[7] The "Standardized Approach" amends the "generally applicable risk-based capital requirements" that are in effect for banking organizations that have not adopted the "Advanced Approaches" of the Basel III framework. The Standardized Approach will also serve as the "Collins floor" benchmark for the Advanced Approach banks, once the Standardized rules come into effect in 2015.

Section A: The Deduction of Investments in the Capital of Unconsolidated "Financial institutions" Is Inappropriate for Market Making Activities and Create Unnecessary Complexity

The Proposals would require U.S. banking organizations to deduct investments in the capital of unconsolidated "financial institutions" if these investments exceed specific Tier 1 common equity thresholds.[8] The stated objectives of this approach are to "reduce the double counting of regulatory capital"[9] and to "address systemic risk arising out of interconnectedness between banking organizations."[10] However, the proposed deduction has a number of significant shortcomings, most importantly:

I. The restrictions on hedge recognition may be sensible for long-term investments held in the "banking book" but are inappropriate and unsound when applied to market making activity held in the "trading book"[11]

II. The overly broad proposed definition of "financial institutions" is operationally impractical and, by overlapping with other proposed rules, also creates unnecessary complexity

The deficiencies in the proposed approach would overstate the level of exposure that a U.S. banking organization has to other financial institutions, potentially resulting in several negative outcomes, including:

- Penalizing prudent risk management practices by disconnecting hedges from true underlying risk
- Significantly increasing costs to financial market end-users, such as pension funds and asset managers, which enter into positions to express investment views or to hedge risks
- Unnecessarily penalizing and discouraging bona fide market-making activity in financial institutions' stock, which would reduce liquidity in that market. This reduced liquidity could make investments in these institutions less attractive to equity investors at a time when the Agencies would like banking organizations to raise more equity capital
- Unnecessarily duplicating other regulatory reforms designed to address the interconnectedness of financial institutions, such as single counterparty credit limits[12] and Global Systemically Important Bank ("G-SIB") capital buffers[13]

[8] The Proposals would require two separate threshold deductions. Banking organizations would first aggregate all non-significant investments in the capital of unconsolidated financial institutions (where "non-significant" is defined as owning 10% or less of the financial institution's common equity). The aggregate of these "non-significant" investments in excess of 10% of the banking organization's own Tier 1 common equity must be deducted following a corresponding deduction approach (i.e., capital instruments must be deducted from the corresponding level of capital, Tier 1 Common Equity, Additional Tier 1 or Tier 2). Second, banking organizations would then aggregate all "significant" investments in the capital of unconsolidated financial institutions (where "significant" is defined as owning more than 10% of the financial institution's common equity). All "significant" investments in non-common shares of unconsolidated financial institutions must be deducted following a corresponding deduction approach. The aggregate of "significant investments" in the common shares of unconsolidated financial institutions in excess of 10% of the banking organization's own Tier 1 common equity must be deducted from Tier 1 common equity. Subsequently, the sum of any remaining "significant" investments in the capital of unconsolidated financial institutions in the form of common shares, certain deferred tax assets and mortgage servicing rights in excess of 15% of Tier 1 common equity would also be deducted from Tier 1 common equity. Capital NPR at 52821–52823.

[9] Capital NPR at 52800.

[10] Capital NPR at 52820.

[11] By "trading book," we refer to "covered positions" as defined under the Agencies' final Risk-Based Capital Guidelines: Market Risk (the "Market Risk Capital Rules"). The Market Risk Capital Rules define covered positions to comprise "assets hat are in the trading book and held with the intent to trade," including "trading assets and trading liabilities that trading positions, i.e., held for the purpose of short-term resale, to lock-in arbitrage profits, to benefit from actual or expected short-term price movements, or to hedge covered positions." Risk-Based Capital Guidelines: Market Risk, 77 Fed. Reg. 53060, 53093, 53094 (Aug. 30, 2012). Covered positions under the final rule include certain debt positions, equity positions and securitization positions, and all commodities and foreign exchange positions. *See* Section 2 of the Market Risk Capital Rules. Any positions not in the "trading book" are classified as held in the "banking book."

I. The restrictions on hedge recognition are inappropriate for trading book market making activity

We are particularly concerned by the restrictions on hedge recognition in calculating exposures to financial institutions that arise from equity positions held as part of bona fide market making activities in a banking organization's trading book. The Proposals effectively penalize banking organizations for prudently managing their risks and, by "disconnecting" capital treatment from economic reality, may actually increase rather than reduce systemic risk.

Under the Proposals, an exposure to a financial institution is equal to the gross long position in the financial institution net of any short position in the same financial institution; netting is possible only when the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year.[14] This one-year restriction may be appropriate for the long-term strategic "investments" held in banking organizations' "banking books." However, it is inappropriate for the short-term market making positions that comprise banking organizations' "trading books," which are fundamentally different in their nature and risk profile.

Market making activities "provide intermediation and liquidity services to customers,"[15] meaning that market makers stand ready as counterparties to take positions to facilitate customer demand, rather than to make directional investments. This means that banking organizations' market making portfolios typically consist of a large number of client-driven positions and associated hedges, with little aggregate net risk because these positions offset each other, as measured by a variety of risk metrics. Market making positions are held in the trading book and are marked to market daily, which reduces the impact to capital of a sudden downward move in equity prices. They are also actively risk managed on an ongoing basis and are subject to multiple risk limits and distinct capital requirements. These aspects of market making positions in financial institutions make them inappropriate for the hedge recognition restrictions.

Moreover, because the Agencies' own Market Risk Capital Rules dictate that positions and/or associated hedges may only be eligible for the trading book if they are held with short-term trading intent (which is typically less than one year), it seems contradictory to require a one-year minimum hedge maturity for these positions under the financial institution deduction. A long-dated hedge for a short-dated position would actually increase the banking organization's risk, even as it would lower the capital requirements. The Basel Committee has acknowledged that a different treatment for trading book positions in financial institutions is appropriate, subject to the banking organization having in place adequate systems and controls as an active market maker.[16] We believe that this "dealer exception" remains both necessary and appropriate for these reasons.

[12] *See* Dodd-Frank Section 165; Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (the "Enhanced Prudential Standards NPR"), 77 Fed. Reg. 594 (Jan. 5, 2012).

[13] Basel Committee on Banking Supervision, Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement (Nov. 2011).

[14] It is not explicitly clear from the Proposals whether equity securities are subject to a test on the maturity date of the hedge. We do not believe that this would be appropriate given that equities typically do not have a maturity date, but rather, can be sold at any date. As such, we recommend that the Agencies explicitly exclude equity securities from the hedge maturity requirements.

[15] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846, 68869 (Nov. 7, 2011).

[16] *See* Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standard: A Revised Framework—Comprehensive Version (June 2006) (the "June Framework") at ¶ 689(ii). "Positions in the bank's own eligible regulatory

We would also note that although the Proposals provide for hedge recognition when the hedge has the same maturity as the associated long position, exact matching is rarely possible in market-making portfolios. For example, a banking organization's client might seek exposure to a particular financial institution for 60 days, but it may be impossible or prohibitively expensive for the banking organization to hedge that position for exactly 60 days. This is because hedges are often done in liquid, listed futures and options markets, where products typically have standard quarterly expiration dates that are unlikely to perfectly match any given client facilitation position. As a result, across the market making portfolio, there will often be small differences in the maturity date of the client position and an associated hedge, making it necessary to roll these hedges to continue to risk manage the client position. Nevertheless, given the liquidity of these markets,[17] banking organizations are able to execute such hedges or to exit the original positions in advance of the maturity date, making a capital deduction due to these small maturity mismatches seem unjustified.[18]

In the example above, extending the hedge maturity to achieve a lower capital requirement would significantly increase the banking organization's basis risk. This "disconnect" may actually increase rather than reduce systemic risk. Moreover, the long-dated hedge would be more expensive than a short-dated hedge because it would be obtained in less liquid markets, and this higher cost would likely be passed on to end-users.[19] Banking organizations might also be unwilling to assume the additional basis risk involved in entering into such long-dated hedges of short-dated positions, making them likely to facilitate fewer client trades, resulting in reduced market liquidity.

The hedge recognition restrictions also appear to be premised on the idea that market makers only enter into long positions in financial institutions, and then hedge them with short positions. While this assumption might be appropriate in the case of banking book investments, it is often not the case for market making positions. For example, in order to benefit from expected market appreciation, a pension fund might take a long position in the S&P 500 via a three-month swap.[20] The market maker that facilitates this transaction must be willing to take an offsetting short position in the S&P 500. From the market maker's perspective, it has three-month short risk to the S&P 500[21] that it must hedge with an offsetting long position. Such hedges are typically short-term in nature, but the standard dates in the listed futures and options markets may not (and in fact are unlikely to) perfectly match the bespoke maturity date of the short position.

capital instruments are deducted from capital. Positions in other banks', securities firms', and other financial entities' eligible regulatory capital instruments, as well as intangible assets, will receive the same treatment as that set down by the national supervisor for such assets held in the banking book, which in many cases is deduction from capital. Where a bank demonstrates that it is an active market maker then a national supervisor may establish a dealer exception for holdings of other banks', securities firms', and other financial entities' capital instruments in the trading book. In order to qualify for the dealer exception, the bank must have adequate systems and controls surrounding the trading of financial institutions' eligible regulatory capital instruments."

[17] The extent of market liquidity is also part of the Agencies' assessment of the eligibility of a position for classification in the trading book, as defined in the final Market Risk Capital Rules; i.e., only liquid positions are eligible for trading book treatment.

[18] We also note that the Market Risk Capital rules already explicitly address the extent of maturity mismatch.

[19] For example, over the last three years, funding on total return swaps that reference the S&P 500 index has ranged from approximately 3-month Libor - 15 basis poin s to 3-month Libor + 5 basis points, while the bid/ask spread has typically been about 5 basis points. We estimate the funding cost would need to rise by approximately 130 basis points in order to allow a banking organization to maintain its Return on Average Equity.

[20] An equity swap is a derivative that enables an investor to gain exposure to a security or other financial instrument without having to physically hold the security, and without having to fund the entire position initially. Swaps provide an efficient way for end users to gain access to a market or other broad-based set of securities.

[21] Financial institutions comprise approximately 15% of the S&P 500 index. Thus this transaction would include unconsolidated investments in financial institutions.

Because reduced liquidity would make it more difficult and expensive for investors to enter and exit positions in financial institutions, including banking organizations, the Proposals could diminish investors' appetite for financial institutions' stock. This would undermine regulators' goal of increasing equity capital in the U.S. banking sector as Basel III becomes effective.

- ***We recommend that the Proposals be amended to better address market making activities in the equity of financial institutions***

Given these negative potential consequences and the different risk profile of market making positions, we recommend that the Agencies confirm that the existing dealer exception for market making activities[22] set out in paragraph 689(ii) of the Basel Committee's July 2006 Framework would apply to the unconsolidated financial institution deduction, thereby avoiding the negative consequences we have outlined above.

If this approach is not feasible, we recommend that the final rules distinguish between banking book investments and trading book positions[23] and impose different capital treatments on the two. We believe that the most effective way to do this would be to base the calculation of any deduction for trading book positions on a delta-based exposure, which would be consistent with the Agencies' Market Risk Capital Rules and standard risk management practices.

Delta is based on the relationship between movements in the prices of a derivative and of its underlier, and is widely used as a measure of trading book exposures and hedge effectiveness. Each instrument's delta is a function of a variety of risk factors at a point in time, including maturity. As such, deltas yield a more risk-sensitive measure of exposure than the Agencies' proposed definition of a "net long position."[24] Delta provides a common metric across a myriad of financial products that can be used to aggregate and manage exposures at a portfolio level. To risk manage their trading books, banking organizations net their short and long positions on a delta-adjusted basis in aggregate, and usually seek to hedge any residual risk at a portfolio level. Thus, the use of a delta-based exposure measure would take into account residual maturity, but would do so among other relevant risk factors and without applying arbitrary restrictions on residual maturity that are inappropriate for a trading book. This would correspond with the way that banking organizations risk manage and assess regulatory capital (as required by the Agencies) for their market making activities.[25]

[22] Goldman Sachs and industry responses to the Basel Committee on Banking Supervision's Consultative Document: Strengthening the Resilience of the Banking Sector (Dec. 2009) requested that market-making positions should not be subject to this deduction.

[23] To address any concerns with the boundary between banking and trading books, we note that the narrower definition of trading book in the Agencies' Market Risk Capital Rules requires banking organizations to demonstrate the eligibility of positions for trading book classification (i.e., that they are held with short-term trading intent and are marked to market by reference to liquid markets).

[24] Delta for non-tranched products will be between zero and one. An out-of-the-money stock option with a longer maturity would typically have a higher delta (closer to one than to zero) than would a shorter-dated option. This is because the likelihood that the stock price and strike price will align increases with time (among other factors). It a market maker were long $100 in a financial institution's stock, which has a delta of one, then the market maker would be more effectively hedged by buying a $100 notional position in a short option with a delta of one rather than by buying a short option with a delta o zero, such that the value of the short position would be as tied to the stock price as the long position in the stock itself. Yet, the Proposal would treat both short positions as either equally effective or ineffective offsets to the long position, depending only on the maturity date of the short positions.

[25] In practice, a delta-based "net long position" in an unconsolidated financial institution in the trading book would be based on the net of the gross long and short positions in that financial institution, multiplied by the net delta of all of the positions in that financial institution. For example, a portfolio might consist of 1) a $950 long equity swap on a financial institution with a maturity of two months and a delta of one, and 2) a $1,000 in-the-money short call option on the same financial institution with a maturity of six months and a delta of 0.95. The delta-

If the Agencies are not prepared to make either of these modifications, we strongly encourage them to adjust the Proposals in other ways – for instance, by changing the one-year maturity to a shorter time horizon more appropriate to the trading book (such as one month), taking a more expansive view of a maturity match,[26] exempting long positions in broad-based indices,[27] or exempting physically-settled equity derivatives. Additionally, because the Agencies' objectives are focused on losses to a banking organization's capital that arise from unhedged long positions in other financial institutions, we see no rationale for requiring a deduction when the tenor of the short hedge exceeds that of the long position, irrespective of the length of any maturity mismatch. We would welcome the opportunity to work with the Agencies to develop reasonable alternatives.

II. The definition of "financial institution" is overbroad

The proposed definition of a "financial institution" is exceedingly broad, extending well beyond the universe of regulated banking organizations, broker-dealers and insurance companies that the Agencies would need to include to address the double-counting of regulatory capital in the system.[28] We believe that the proposed approach is imprecise and impossible to accurately implement, that it creates unnecessary complexity by overlapping with other rules and that it could discourage banking organizations from investing in financial market infrastructure.

While we recognize the Agencies' goal of reducing the systemic risk that could arise from excessive interconnectedness, we believe this goal is already being addressed more directly through other regulatory initiatives. These include the stringent single counterparty credit limits proposed for large financial institutions in the United States, the G-SIB capital buffers (interconnectedness is one of the five categories within the G-SIB buffer) and the 1.25 capital charge multiplier for exposures to unregulated financial institutions and regulated institutions above a certain size.

i) The proposed financial institutions deduction is operationally impractical

The proposed financial institution deduction is highly burdensome from an operational perspective. Banking organizations will not be able to apply the Agencies' required tests with any reasonable degree of accuracy, and the cost and effort for the industry of complying would be disproportionate to any potential prudential benefit.

For each company in which a banking organization holds a position, the banking organization would be required to assess whether that company is "predominantly engaged" in financial activities.[29] Applying

adjusted exposure, reflective of the banking organization's true economic risk, would be zero [(950 * 1) + (-1,000 * 0.95)]. However, under the Proposals, the net long position in the financial institution would be $950, because the short position would not be eligible for netting.

[26] This could allow up to a certain number of days of maturity mismatch, or could be based on various maturity buckets (0-1 month, 1-3 months, 3-6 months, 6-12 months) allowing progressively higher maturity mismatches within the buckets (reflecting the time available to re-hedge positions).

[27] This approach would exempt positions in the S&P 500 and other indices where financial stocks do not dominate, but would include positions within financial sector indices

[28] The Agencies requested comment on this topic in Question 32 of the Capital NPR.

[29] *See* Section 2 of the rules proposed in the Capital NPR. As proposed, the "predominantly engaged" test is defined as 85% or more of the total consolidated annual gross revenues or consolidated total assets (both as determined in accordance with applicable accounting standards) of the company were derived, directly or indirectly, by the company on a consolidated basis from financial activities. "Financial activities" include lending money, securities or other financial instruments, including servicing loans; insuring, guaranteeing, indemnifying against loss, harm, damage, illness, disability, or death, or issuing annuities; underwriting, dealing in, making a market in, or investing as

such a test across all potential financial institutions (including all of their subsidiaries, whether held directly, indirectly or synthetically) is impractical, as the granularity of information required is not publicly available for many companies. We estimate that we alone would need to apply this test to over 15,000 separate corporate entities; the impact is magnified by the fact that each U.S. banking organization would be required to make similar assessments.[30] As such, we recommend that the definition of financial institution be more narrowly defined and that the "predominantly engaged" test be removed. We do not believe that making these adjustments will have any material impact on the Agencies' objectives.

If the Agencies do conclude that a more expansive definition of financial institution is necessary, we recommend that they consider more practical approaches. They could use industry classification codes,[31] or identify financial institutions through Legal Entity Identifiers, or limit the test to positions in the largest corporates. Each of these alternatives would be more feasible for banking organizations of all sizes to implement, and would also promote consistency across the industry.

In addition, and consistent with Basel III, the Proposals require banking organizations to look through holdings of index securities to deduct any holdings in their own equity from regulatory capital. This approach appears designed to address a "problem" that does not really exist, and in doing so presents several practical challenges. The Proposals would require a banking organization to look through to the underlying positions of all index securities (such as Exchange Traded Funds) to determine whether it is indirectly holding its own stock. The burden of this "purist" approach greatly outweighs the benefits, as it is difficult to understand why a banking organization would deliberately attempt to re-purchase its own stock by such indirect means.[32] In addition, the overly restrictive limitations on the recognition of hedges for this purpose are similar to the restrictions that apply to holdings in unconsolidated financial institutions. We recommend that the Agencies not require a look-through test for index securities, on the grounds that they are not "covert buybacks," but rather are incidental positions held within the trading book, are often entered into on behalf of clients, customers or counterparties, and are economically hedged.

ii) We propose a more limited definition of "financial institutions" to avoid overlapping with other regulation and to encourage needed investment in financial infrastructure

Given the impracticality of the tests, we recommend that the Agencies define "financial institution" more narrowly. Beyond reducing operational complexity, this would offer several other benefits, including avoiding unnecessary overlap with other regulations and encouraging investment in financial market infrastructure (which contributes to systemic safety and soundness).

principal in securities or other financial instruments; asset management activities (not including investment or financial advisory activities); or acting as a futures commission merchant. Capital NPR at 52851.

[30] Other examples of the impracticability of the Proposal include the requirement to look through an investment in an unconsolidated entity to *its* investments in financial institutions. This would require insight into the underlying positions of every corporate for which a banking organization has a trading book or banking book position. In addition, the Proposals do note that positions that have been deducted from capital do not also need to be risk weighted. But for trading book positions, which are subject to model-based requirements across the portfolio, this is impractical to apply, and could result in trading book positions being subject to both capital deduction and risk weighting.

[31] Standard Industrial Classification is a U.S. government system for classifying industries by a four-digit code. It is being supplanted by the six-digit North American Industry Classification System, which was released in 1997.

[32] Although a banking organization may use a conservative estimate of its "investments in the capital instruments of other financial institutions through the index security", including any indirect positions in its own stock, even under this approach, it would be excessively burdensome to estimate these exposures with any reasonable degree of accuracy. Capital NPR, Fed. Reg. at 52820, 52821.

We propose that the financial institution definition be limited to entities that are subject to regulatory capital requirements broadly equivalent to those imposed on banking organizations. This definition would encompass some broker-dealers, as well as those entities that will become subject to equivalent regulatory capital requirements in the future (including swaps and securities-based swaps dealers, major swaps and securities-based swaps participants, and non-bank SIFIs[33] identified by the Financial Stability Oversight Council). Regulated insurance entities should also be included as they are subject to solvency-based requirements that, in many respects, are similar to regulations imposed on banking organizations. This alternative definition would fully address the Agencies' goal of eliminating double counting of regulatory capital and would be considerably more straightforward and less burdensome to administer.

We think the Agencies should clarify that the revised definition excludes a number of other areas, because the Agencies' definition of "financial institution" could scope in commodity pools,[34] certain special purpose vehicles and joint ventures, which are not subject to Volcker Rule capital deductions.[35]

- Covered Funds. We believe that the inclusion of all "covered funds" as defined by the proposed Volcker Rule is broader than the scope of "financial entities" contemplated by the Basel Committee. We think the treatment under the proposed Volcker Rule already considers and seeks to address the risks that these funds could pose to the financial system, obviating the need for the Agencies to impose additional restrictions in the Proposals.[36] In addition, many of the funds captured in the Agencies' definition of "financial institution" are already subject to other regulatory capital treatments, such as the treatment of "investment funds" within the capital requirements for "equity exposures to investment funds."[37] We are concerned that multiple layers of capital regulation for the same type of exposure will create unnecessary complexity. Finally, as to the specific issue of deductions from Tier 1 Capital of investments in hedge funds and private equity funds, while the Agencies indicate that they intend to address the overlap for funds that are within the scope of both the financial institution deduction and the Volcker Rule capital deduction, we are concerned by the potential of having to apply the financial institution deduction (a Tier 1 Common deduction) to Volcker Rule "organized and offered" funds (and potentially all covered funds), prior to the end of the Volcker Rule conformance period.[38]
- Certain special purpose vehicles. The Securitization Framework[39] already imposes specific capital treatments on certain special purpose vehicles, which could also be scoped into the

[33] Or equivalent designations by overseas regulators, provided that the entity in question is subject to broadly equivalent capital adequacy regulations.

[34] Section 2 of the rules proposed in the Capital NPR refers to section 1a(10) of the CEA to define a "commodity pool." Capital NPR at 52851. According to the CEA and CFTC interpretation, a "commodity pool" can encompass registered mutual funds, exchange traded funds, banks and bank holding companies, investment companies that qualify for exemptions other than Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act") (i.e., not "covered funds" under the proposed Volcker Rule), and even non-financial companies that fall outside the definition of "investment company," if they trade in "commodity interests."

[35] Moreover, the Volcker Rule exempts a number of covered funds from the Volcker restrictions, whereas the financial institution deduction proposed by the Agencies offers a more limited range of exemptions.

[36] The Agencies also do not recognize an exemption contained in the Volcker Rule proposals for certain investments in covered funds that are designed to reduce the specific risks to the banking entity and the banking system in connection with certain customer-driven transactions. Imposing additional capital requirements on these entities would run counter to the purpose of Basel III by discouraging appropriate risk-mitigating hedging activities and potentially increasing financial system risk rather than reducing it.

[37] *See* section 53 of the rules proposed by the Standardized NPR at 52967-52968; section 154 of the rules proposed by the Advanced Approaches NPR at 53034-53035.

[38] We would like to stress that the financia institution deduction should not undermine the Volcker Rule's statutory conformance period, which was designed to provide banking organizations and markets sufficient time to adjust to the new requirements. Dodd-Frank, § 619.

[39] *See* sections 41-44 of the rules proposed in the Standardized NPR at 52961-52966; sections 141-150 of the rules proposed in the Advanced Approaches NPR at 53026-53032.

"financial institutions" deduction as covered funds and/or as commodity pools. In many cases this treatment would result in the equivalent of a full capital deduction (1,250% risk weight), and their inclusion here unnecessarily complicates the capital treatment of securitization vehicles.

- Investments in financial market utilities. Global regulatory changes have significantly increased demand for additional financial market infrastructure, including clearing houses, swap execution facilities and data repositories. We believe that financial markets are best served, and systemic risk most effectively reduced, when key users of market infrastructure have significant ownership stakes and governance roles in that infrastructure. This involvement has contributed to the success of systems for trade execution,[40] trade affirmation[41] and clearing and settlement,[42] all of which have contributed to greater efficiency, higher transparency and lower cost execution. However, much of this infrastructure is costly and may provide a low financial return. The users of this infrastructure can currently tolerate a lower return on their investment because they benefit from a more efficient market, but by imposing a further financial penalty on banking organizations that invest in it, the Agencies may reduce the quality and scale of what infrastructure will be built in the future.

III. Deduction of Minimum Regulatory Capital Requirements in Regulated Insurance Subsidiaries

Finally with respect to capital deductions, we note that the proposed rules require banking organizations that have consolidated insurance subsidiaries both to risk weight the insurance company's assets and to deduct from capital the minimum regulatory capital requirements in regulated insurance subsidiaries. The latter amount already reflects the relative riskiness of the insurance subsidiaries' assets through solvency-based requirements, so risk weighting the same assets in the banking organization's consolidated capital ratio effectively double-counts the risk. The proposed approach is inconsistent with the Basel frameworks, which generally require insurance entities to be de-consolidated (deduction of an investment in a subsidiary). We encourage the Agencies to be consistent with Basel and to require deconsolidation, in addition to the deduction of any deficit in the insurance subsidiaries.[43]

Section B: The Use of the Current Exposure Method in the Standardized Approach, Supplementary Leverage Ratio and for Aspects of the Calculation of Capital Requirements for Certain Exposures to Central Counterparties Is Inconsistent with the Agencies' Stated Aims

The Agencies' stated intention is to improve the resiliency of the U.S. banking system by implementing capital requirements that better reflect banking organizations' risk profiles and that enhance their ability to operate as financial intermediaries, even during periods of financial stress.[44] However, the use of the CEM for OTC derivatives capital calculations within the Standardized Approach[45] and the Supplemental

[40] For example, DirectEdge, BATS, TradeWeb, MarketAxxess.
[41] For example, MarkitWire, TradeXpress, MarketAxxess, MarkitSERV.
[42] For example, DTCC, LCH, CLS.
[43] The Agencies requested comment on this topic in Question 21 of the Standardized Approach NPR.
[44] Capital NPR at 52795.
[45] The Standardized Approach requires that exposure calculations for OTC derivatives be based upon the CEM. Furthermore, within the context of the Proposals, the CEM is also prescribed to calculate derivatives exposures within the Supplementary Leverage Ratio applicable to Advanced Approach banking organizations. Regulators have also proposed use of the CEM in the context of the recent single counterparty credit limits included in the Enhanced Prudential Standards NPR, and in the proposed approach for default fund contributions to central counterparties.

Leverage Ratio, as well as in the calculation of capital requirements for certain exposures to CCPs, is inconsistent with this aim.[46]

Concerns with the CEM approach are well known among market participants and regulators alike.[47] As we have highlighted in our response to the proposed U.S. single counterparty credit limits, the CEM approach dramatically overstates risk by failing to fully account for key risk mitigating factors such as legally enforceable netting, portfolio diversification and variation margin. For an explanation of our concerns with the CEM and specific examples, please see our previously submitted letter commenting on the Enhanced Prudential Standards NPR.[48]

By requiring use of the CEM, the Proposals deviate from the international Basel standards, which allow banking organizations to use internal models for credit risk capital calculations under the Basel Standardized Approach. We strongly advocate the use of regulator-approved internal models ("IMM") in lieu of the CEM approach,[49] which would be consistent with the Basel III Advanced Approach ratio. IMM offers a more risk-sensitive and more sophisticated alternative, and in fact was developed, in the words of the Basel Committee, "in response to the limited risk sensitivity of CEM."[50]

Banking organizations in the United States that are required to implement the Advanced Approaches should be given the choice, just as their international peers maintain, to utilize supervisor-approved models for the purposes of computing derivatives exposure under the Standardized Approach. Holding U.S. banking organizations to a less risk-sensitive standard could force them to hold more capital per unit of risk than their international peers. This could compromise the international competitiveness of U.S. banking organizations without advancing the Agencies' stated goals.

Section C: Funding Transactions Are Subject to Inappropriate Haircuts under the Standardized Approach

Like the use of the CEM for OTC derivative transactions, the Standardized Approach includes a similarly risk-insensitive treatment for secured funding transactions (including repurchase agreements or "repos," reverse repurchase agreements or "reverse repos," securities borrowed and lent, and agency stock lending). Under the Standardized Approach, the measure of funding exposure can be reduced by eligible financial collateral. The Proposals mandate that banking organizations decrease the value of collateral received, and increase the value of securities posted, by pre-determined percentages ("haircuts"). Haircuts must also be applied for any foreign exchange differences, on both sides of the same transaction.

We see several flaws with this approach. Most importantly, it is risk-insensitive because the haircut buckets are insufficiently granular (i.e., all securities in the same haircut bucket are assigned the same

[46] The Agencies requested comment on this topic in Question 3 of the Capital NPR, Questions 11, 12 and 13 of the Standardized Approach and Questions 5-6 of the Advanced Approach.

[47] *See* Basel Committee on Banking Supervision, The Application of Basel II to Trading Activities and the Treatment of Double Default Effects (April 2005); Risk-Based Capital Standards: Advanced Capital Adequacy Framework - Basel II, 72 Fed. Reg. 69288 (Dec. 7, 2007); Financial Services Authority, Prudential Sourcebook for Banks, Building Societies and Investment Firms, Article 13; Basel III Framework; Lending Limits Interim Final Rule, 77 Fed. Reg. 37265 (June 21, 2012).

[48] Available a http://www.'ederalreserve.gov/SECRS/2012/May/20120524/R-1438/R-1438_043012_107262_476742371698_1.pdf.

[49] The Agencies requested comment on this topic in Question 15 of the Standardized Approach NPR.

[50] Basel Committee on Banking Supervision, The Application of Basel II to Trading Activities and the Treatment of Double Default Effects (April 2005) at ¶ 9.

haircut, regardless of the fact that these securities will have different risk profiles). This approach does not appropriately differentiate between credit quality and maturity, which is a particular problem for corporate bonds.[51] The haircut percentages are also generally higher than those actually applied in the funding of inventory today,[52] and would result in greatly increased capital requirements for this type of transaction, particularly for equity funding trades. Because the haircuts are applied without any netting, this approach is even less risk-sensitive than the CEM, which does allow limited netting.

Risk insensitivity is particularly acute under the proposed collateral haircut approach for portfolios of trades. The approach implicitly assumes that, at the same time, for every counterparty, and for every trade, each security posted as collateral increases in value, while each security received as collateral decreases in value, and that the impact of foreign exchange movements is always negative. The Proposals do not recognize the very real possibility that posted collateral and borrowed instruments might move in the same direction, rather than in opposite ones.[53] This problem is compounded by the fact that this haircut approach would be applied on a trade-by-trade basis, without netting, meaning that the larger the portfolio of trades with a single counterparty, the greater the overstatement of exposure.

We recognize that the Proposals allow banking organizations to compute their own haircuts, subject to supervisory guidance and approval, which does give them more flexibility in determining volatility. However, this method again ignores portfolio diversification effects. We recommend that the Agencies also allow banking organizations to use the IMM approach, which provides a more risk-sensitive measure. If the Agencies decide not to allow IMM, we recommend that the standardized percentages be made more consistent with the haircuts that are applied in financial markets today, which more accurately reflect economic risk.

Section D: The Proposed 100% Risk Weight for Broker Dealers and Insurance Companies Should Be Brought in Line with the Treatment of Banks

The Proposals' application of a 100% risk weight for broker-dealer and regulated insurance company[54] exposures within the Standardized Approach is disproportionate relative to risk weights for other prudentially regulated financial institutions. On a global basis, many regulators mandate stand-alone capital requirements for broker-dealers that are broadly equivalent to Basel standards; they also often impose other regulatory constraints, such as liquidity requirements and the segregation of client assets.

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[51] For example, the same 25% haircut would be applied to both the investment grade and non-investment grade corporate debt, despite the fact that the investment grade corporate debt is a more effective credit risk mitigant and qualifies as 'eligible collateral' while the non-investment grade corporate debt does not. Furthermore, the 25% haircut is significantly super-equivalent to Basel II, under which the highest haircut is 12%, less than half the NPR's level. Furthermore, there is no gradation by maturity: the same 25% haircut is applied to all corporate bonds, regardless of whether they have a 1-day maturity or a 10-year maturity, even though the risk profiles of these bonds are very different. This is also super-equivalent to Basel III, under which the haircut for a corporate bond can be as low as 2%, compared to 25% in the NPR.

[52] Market participants actively manage these haircuts, taking into consideration a broad range o factors including volatility, liquidity and type of collateral to ensure that they are adequately protected in case the counterparty fails to perform.

[53] Consider a banking organization that enters into two simultaneous transactions with another financial institution. The first is a repurchase agreement in which the banking organization provides $105mn of 2-year Gilts to the financial institution and receives $100mn of cash in USD in return. The second is a reverse repurchase agreement in which the banking organization provides $100mn of cash in USD to the same financial institution and receives $105mn of 5-year Gilts in return. The IMM approach would acknowledge that the two Gilts are likely to move in the same direction, despite their different maturities. As such, IMM would result in an exposure for the banking organization of $300,000 for these two transactions and a capital requirement of $4,480. The Standardized Approach, in contrast, would result in a significantly over-estimated exposure of $4.5mn and a capital requirement of $71,232.

[54] Insurance companies are typically subject to different regulations than banking organizations and broker-dealers, but the Solvency regulations applicable to insurance companies would also suggest that a lower risk weight than a flat 100% would be appropriate.

Many broker-dealers are also subsidiaries of prudentially regulated bank holding companies. Given that the regulatory regimes for broker-dealers are similar to those for banking organizations, and because banking organizations' exposures to these broker-dealers will be subject to the financial institution deduction, these exposures should in fact be less risky than exposures to an unregulated corporate.

Broker-dealers that are part of a bank holding company group, or that are subject to capital requirements that are broadly equivalent to Basel standards, should therefore be subject to risk weights that are consistent with the treatment of banking organizations and should not be penalized by a five-fold increase in required capital, as the Proposals would require.[55] We see no discernible reasonable justification for this inconsistency, which could create competitive distortions in global financial markets. We therefore urge the Agencies to align the risk weights for registered broker-dealers to those that apply to banking organizations (i.e., based on country of incorporation and OECD Country Risk Classification scores).

Section E: Treatment of Illiquid Assets Is Counterintuitive and Could Create Volatility

In a number of instances, the Proposals create cliff effects, whereby a small change can trigger a disproportionate increase in capital requirements. One particularly concerning example is the treatment of illiquid assets. Under the Proposals, an entire portfolio of collateral will be deemed "illiquid" if a single piece of collateral within the portfolio is "illiquid," and banking organizations will be required to double the margin period of risk for all the trades within this portfolio.[56]

We do not believe a single piece of "illiquid" collateral should taint an entire netting set. The additional collateral, though illiquid, does have some economic value, meaning that it should either lower capital requirements or at least leave them unchanged. Instead the Proposals would distort risk management incentives by raising capital requirements. In addition, the absence of guidance in the Proposals (such as product categories) could generate inconsistent application across banking organizations, and this asymmetric application could unintentionally destabilize liquidity for some products. Banking organizations should therefore be given the choice to exclude the illiquid collateral from the rest of the collateral in the netting set when determining the margin period of risk.

We are also concerned by the proposed requirement that banking organizations determine whether each piece of collateral is "liquid" or "illiquid" on a daily basis,[57] which may increase volatility. It is unclear whether banking organizations must apply a "live" dynamic test that could make such a determination on a daily basis. Any methodology implemented as part of a "live" test, if not applied consistently across banking organizations, could lead to tremendous confusion among market participants and could destabilize the funding markets. We recommend that the Agencies clarify the final rules to indicate that

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[55] Under the Proposals, the capital required for exposures to broker-dealers under the Standardized Approach (100% risk weight) would increase by a factor of five compared to Basel I (typically a 20% risk weight). Exposures to a banking organization and broker-dealer in the same group would also attract a capital requirement that differs by a actor of five. As a result, an exposure to a U.S.-domiciled banking organization would attract a risk weight of 20%, while an exposure to a U.S. broker-dealer in the same bank holding company group would be risk wei:hted at 100%.

[56] *See* sections 37 c)(3)(iv) and 37(c)(4)(i)(c) of the rules proposed by the Standardized Approach NPR at 52888, 52959-52960.

[57] Advanced Approaches NPR at 52982 states: "For purposes of determining whether collateral is illiquid or an OTC der vative cannot be easily replaced for these purposes, a banking organization could, for example, assess whether, during a period of stressed market conditions, it could obtain multiple price quotes within two days or less for the collateral or OTC derivative that would not move the market or represent a market discount (in the case of collateral) or a premium (in the case of an OTC derivative)."

the test of liquidity should be done on a product category basis and based on the long-term liquidity data observed by banking organizations.

Section F: Capital Requirements on CCPs Should Reflect the Basel Committee's Latest Guidance as well as Other Enhancements

The Basel Committee issued interim rules[58] regarding exposures to CCPs in July 2012, after the Agencies had issued the Proposals, providing several critical clarifications and improvements upon guidance it had previously issued. These enhancements include a cap on default fund and trade exposure capital requirements of 20% of the trade exposures to each CCP, clarification regarding the exposures for which a clearing member must hold capital,[59] and the introduction of a five-day margin period of risk for cleared trades between a clearing member and its clients. We view these enhancements as helpful to the efficient functioning of markets and CCPs and recommend that they be incorporated into the Agencies' Final Rules. Beyond these improvements, further clarifications and modifications will be needed to avoid market disruptions. In particular, rather than require each banking organization to demonstrate that a particular central counterparty is "qualified," the Agencies should coordinate with other regulators to develop a list of qualifying CCPs, on which banking organizations can rely for regulatory capital purposes.

Section G: Timing Should be Extended to Allow for Thoughtful Implementation and International Coordination

The complexity involved in implementing the Proposals merits an adequate notice period between issuance of the final rules and their comprehensive implementation. Although banking organizations that will be subject to these rules are already working towards their implementation, they will nonetheless need sufficient time to review, interpret and communicate within their organizations any changes made to the final rules. Implementation work that is already underway will need to be modified, tested, run in parallel, reviewed and assessed, concurrent with any management actions undertaken to meet regulatory capital targets and to enact future capital plans.

We therefore strongly urge the Agencies to delay the implementation of the regulatory capital rules beyond January 1, 2013. This would both allow for sufficient time to examine the potential impacts to U.S. banking organizations and to be better aligned with what appears to be a delayed international implementation timeline. We further ask that the Agencies align the timing of Pillar 3 disclosure requirements across all U.S. banking organizations, and if possible, with the implementation of Basel III, to avoid market confusion.

[58] Basel Committee on Banking Supervision, Capital Requirements for Bank Exposures to Central Counterparties (July 2012).

[59] Notably, clarification that when a banking organization provides clearing services, its resulting trade exposures to a CCP should be subject to risk weights only if the banking organization is obligated to reimburse the client for losses in the event of a CCP default.

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Ir closing, we reiterate our support of the Agencies' efforts to implement a more robust regulatory capital framework for the U.S banking system. We recognize that this is an extremely challenging exercise, and we would be pleased to assist in any way that would be helpful.

Sincerely,

Sarah Smith
Principal Accounting Officer
The Goldman Sachs Group, Inc.

cc: Michael Silva (FRBNY)