BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

October 8, 2009

BEN S. BERNANKE
CHAIRMAN

The Honorable Elizabeth Warren
Chair
Congressional Oversight Panel
732 North Capitol Street, N.W.
Room C-320 and C-617
Washington, D.C. 20401

Dear Ms. Warren:

With respect to the report issued by the Government Accountability Office (GAO) entitled *Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and across System* (July 2009), the Federal Reserve Board agrees with the GAO's recommendation that, in light of lessons learned from the current financial crisis, it assess the extent to which proposed reforms to the Basel Capital Accord (Basel II) address risk evaluation and regulatory oversight concerns associated with advanced risk modeling approaches. This recommendation is consistent with the Federal Reserve's ongoing efforts to address the potential shortcomings of the Basel II framework and determine whether, and to what degree, fundamental changes to the framework are warranted.

Among the lessons learned from the financial crisis is the degree to which banking organizations' internal risk measurement models may fail to work as intended or may be used inappropriately for purposes not considered in their initial design. To help mitigate these potential issues, the U.S. rule implementing the Basel II advanced approaches (Basel II rule) imposes specific model validation, stress testing, internal control, and supervisory approval requirements that a banking organization must meet in order to use advanced models to calculate its regulatory capital requirements and determine the risk parameters that factor into those calculations.[17] Nonetheless, use of internal models to determine capital requirements for credit and operational risk remains largely untested in practice. The Federal Reserve will continue to assess the risk evaluation and regulatory oversight aspects of the advanced approaches as banking organizations implement the risk assessment and other systems required by the Basel II rule. It will also maintain the leverage capital requirement as a complement to the risk-based capital requirements. In addition, as described in the Basel II rule, before any banking organization may rely on the rule to determine its risk-based capital requirement, the federal banking agencies will publish the conclusions from a study that evaluates the advanced approaches of the Basel II rule to determine if there are any material deficiencies in its function as a regulatory capital framework.

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[17] See 72 Fed. Reg. 69288, 69396 (Dec. 7, 2007).

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Another lesson learned from the crisis is that firms that adopted a comprehensive view of their risk exposures tended to deal more successfully with market turmoil by using information developed across the firm to adjust their business strategy, risk management practices, and exposures proactively in response to changing market conditions. In institutions that experienced greater difficulty in responding to the crisis, business line and senior management often did not adequately coordinate the firms' risks in light of evolving conditions in the marketplace, leaving the business lines to make decisions in isolation. In some cases, this further increased the institutions exposures to risk. Supervisors must therefore emphasize the importance of a firm's assessment of its overall capital adequacy--incorporating among other things the uncertainty around model outputs, correlations across risk types, and risks not easily subject to quantification--in addition to focusing on its micro-level risk measurement models. Moreover, minimum regulatory capital requirements alone cannot achieve safety and soundness. In particular, more attention must be given to liquidity requirements and the overall effectiveness of the risk management systems of financial institutions. In this vein, the Board and the other federal banking agencies recently issued for public comment proposed guidance on funding and liquidity risk management.[18]

The Board will continue to incorporate the lessons of the recent crisis into its domestic supervisory agenda as well as the work of the Basel Committee. Federal Reserve staff participate in, and in several cases lead, Basel Committee working groups tasked with evaluating and addressing weaknesses in Basel II. As a result of this work, in July 2009, the Basel Committee published revisions to the Basel II treatment of market risk and of certain securitization exposures. Ongoing work includes a broader review of the treatment of securitization, counterparty credit risk, the definition of capital, a leverage capital requirement to supplement the risk-based capital requirements, and assessment of the procyclical effects of Basel II.

Thank you for the opportunity to comment on this important matter. The Board appreciates the professionalism of, and the careful analysis performed by, the GAO review team.

Sincerely,

cc: The Honorable Jeb Hensarling
Mr. Richard H. Neiman
The Honorable Paul Atkins
Mr. Damon A. Silvers

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[18] 74 Fed. Reg. 32035 (July 6, 2009)