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By electronic delivery

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Mail Stop 1–5
Washington, DC 20219
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Regulation Comments
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1700 G Street, NW
Washington, DC 20552
Attention: No. 2006–34
regs.comments@ots.treas.gov

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street & Constitution Ave., NW
Washington, DC 20551
regs.comments@frb.gov

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 Seventeenth Street, NW
Washington, DC 20429
comments@fdic.gov

Re: **OCC** Docket No. 06-10; **FRB** Docket No. R-1266; **FDIC** (No Docket Number); **OTS** Docket No. 2006-34; Risk-Based Capital Standards: Market Risk; 71 Federal Register 55958; September 25, 2006

Ladies and Gentlemen:

The Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (the Agencies) have proposed revisions to the market risk capital rule that was put in place in 1997 (the proposed revisions). The avowed purpose of these proposed revisions is to enhance the sensitivity to market fluctuations of the capital requirements, as well as to introduce public disclosure requirements for certain quantitative and qualitative information of a bank or bank holding company.

The American Bankers Association (ABA) appreciates the opportunity to comment on behalf of the more than two million men and women who work in the nation's banks. ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, savings banks, and bankers banks – makes ABA the largest banking trade association in the country.

Summary of Comments

As a general matter, ABA supports revision of the market risk capital rule, as well as the intent to align market risk capital charges with actual risks associated with banks' trading book positions. However, some of the proposed revisions may underestimate the burden and costs associated with implementation. We recommend the following changes to the proposed revisions:

- Institutions should not be required to "clearly articulate" which positions are hedges or hedging strategies.
- Exclusion of fees, commissions, reserves and net income from the daily trading profit and loss amounts is appropriate for purposes of back-testing.
- The market risk rule should recognize partial-modeling of specific risks to encourage progress in managing market risk.
- The market risk rule should not impose a capital charge for prepayment risk, which is already covered in the capital treatment for interest rate risk management.
- The market risk rule should not include a deterministic default risk calculation.
- The proposed required disclosures of quantitative and qualitative aspects of internal modeling should be reconsidered to remove excessive reporting burdens that serve no useful purpose.
- The board of directors should not be required to verify that the institution has made all necessary disclosures and maintains effective internal controls under the market risk rule. Nor should the chief financial officer be required to provide any additional certification beyond what is required by existing laws.

Discussion

ABA supports the Agencies' intent to align market risk capital charges with actual risks associated with banks' trading book positions. However, the Agencies' proposed revisions do not adequately take into consideration the burden and costs associated with implementation. Nevertheless, ABA believes that this goal can be accomplished if the Agencies take the following comments under advisement.

1. <u>Institutions should not be required to "clearly articulate" which positions are hedges or hedging strategies.</u>

ABA supports having the range of coverage of the proposed rule include only trading assets and liabilities classified as trading positions. Exclusion of interest rate swaps from the definition of "covered positions" would eliminate the distortion in the value-at-risk (VaR) model that could arise from modeling of only one side of a hedged transaction. However, ABA believes that requiring institutions to "clearly articulate" which positions are being hedged or serve as hedging instruments within the trading book would be unrealistic given industry practice. Instead, the overall effect of hedging must be viewed within a holistic netting of trading book positions through refinement of the VaR model.

Hedging strategies are often used in the management of banking book assets but are typically not employed in the trading book. An institution trades to balance profits against potential losses, and it is conceivable that a position could serve as either an investment or a hedge at any given time. Therefore, it would not be reasonable, and would be contrary to business practices, for positions to be separated into hedges (for inclusion in the trading book) and non-hedges (for exclusion).

2. <u>Fees, commissions, reserves and net income from the daily trading profit and loss amounts should be excluded for purposes of back-testing.</u>

The current market risk rule requires that a VaR model be validated via back-testing. This back-testing framework includes comparing the VaR-based measure to actual profit and loss (P&L) results, which generally include fees and commissions associated with trading. The proposed revisions would exclude all fees, commissions, reserves and net interest income from the daily trading P&L for purposes of back-testing.

ABA is in favor of excluding these items from the hypothetical P&L portfolio. We believe this is likely to yield more meaningful results. To avoid any confusion about whether a given item should be backed out, the Agencies may wish to consider simply requiring a comparison of the VaR-based measure to a hypothetical P&L that is based solely on market changes without reference to extraneous charges. We believe this would make it easier for institutions to apply the rule.

3. <u>The market risk rule should recognize partial modeling of specific risks to encourage progress in managing market risk.</u>

The proposed revisions to the market risk rule would eliminate recognition of partial modeling of specific risk, starting in 2010. Institutions that cannot fully model specific market risk at that time would be subject to the standard specific risk charge for all portfolios.

ABA opposes this change. Modeling of specific risk represents a more sensitive way to manage market risk for the position(s) it applies to than does wholesale imposition of a standard risk charge. Any standard specific risk charge is likely to be a less reliable reflection of the risks that are being addressed than is a bank's own modeling. Accordingly, institutions should be encouraged to continue their efforts to develop models of specific risk, even if they cannot meet a deadline of 2010 for full modeling.

4. <u>The market risk rule should not impose a capital charge for prepayment risk, which is already covered in the capital treatment for interest rate risk management.</u>

Prepayment risk is most directly an issue for asset-liability management. There is a specific element of the capital requirements for this risk, mandated in the FDIC Improvement Act, as part of interest rate risk management. Therefore, inclusion of prepayment risk also in a market risk capital charge would be overkill.

Prepayment risk belongs with treatment of net interest margin and rate risk management, not market risk, for at least two reasons. First, there is no direct loss or impairment of capital associated with prepayment risk; the risk is that funds will be returned to the lender at a disadvantageous time. Second, prepayment risk is best evaluated over a long time horizon (as the proposed revisions observes), whereas the trading book involves short-term positions.

5. The market risk rule should not include a deterministic default risk calculation.

The proposal would require incremental default risk measurements to be made at a one-year, 99.9 percent confidence level. ABA questions the value of an incremental default risk capital charge. A one-year measurement period far exceeds the term of short-term trading positions, and is better suited for scenario-based stress-testing. The proposed 99.9 percent confidence level would create an unrealistic demand on data and model assumptions. Thus, market risk modeling here is not appropriate.

Therefore, ABA believes that incorporating a deterministic incremental default risk calculation into market risk analysis is not appropriate at this time. If the Agencies have safety and soundness concerns about a particular institution, the proposed rule still allows them to be addressed via increasing capital requirements based upon a review of specific stress-testing results.

6. The proposed required disclosures of quantitative and qualitative aspects of internal modeling should be reconsidered to remove excessive reporting burdens that serve no useful purpose.

The proposed market risk rule revisions would require detailed disclosure of the qualitative and quantitative aspects of a bank's internal models. We appreciate the need for regulated institutions to disclose their policies and to describe applicable processes and models used in market risk calculations. However, ABA believes that the extent of disclosures under the proposed revisions is excessive and should be simplified to avoid unnecessary regulatory burdens.

An example of a disclosure that may yield little benefit is the required disclosure of valuation "procedures." If by "procedures" the Agencies intend for an institution to disclose items such as which files to open or how to launch batch process jobs, then they are asking for information that is proprietary and that would not facilitate market discipline. If, on the other hand, the Agencies have something else in mind, then clarification of their intent would be helpful.

7. The board of directors should not be required to verify that the institution has made all necessary disclosures and maintains effective internal controls under the market risk rule. Nor should the chief financial officer be required to provide any additional certification beyond what is required by existing laws.

While recognizing that a comprehensive risk management program endorsed by the bank's board and senior management is essential to proper implementation of market risk controls, ABA believes the proposed revisions go too far in requiring bank board verification. The proposal blurs the boundaries between boards and senior management, stating in the preamble, for instance, that "The board of directors and senior management must verify that the bank has made all required disclosures and maintains effective internal controls and disclosure controls and procedures." These tasks are more appropriately handled by bank management. Imposing responsibilities at the board level for these activities would increase the directors' exposure for actions that they should not be asked to take. As such, it is likely to make it more difficult for banks to attract and retain qualified individuals to serve as directors.

ABA also believes that it is inappropriate to require chief financial officer (CFO) certification of the appropriateness of all disclosures. To the extent that this certification overlaps what is required by other laws (such as the FDIC Improvements Act and Sarbanes-Oxley Act), it is unnecessary. To the extent that it imposes a new certification requirement, we believe it will add considerable burden, leading to another attestation by the bank's independent auditor, without commensurate benefit.

Conclusion

ABA supports the Agencies' efforts to align the market risk rules with industry practice through these proposed revisions. However, while ABA generally supports adoption of the proposed market risk rule revisions, we believe that further refinement of the proposal would be prudent.

Specifically, ABA believes that requiring banks to articulate what positions are hedges or hedging strategies is unnecessary and would unreasonably interfere with trading activities. ABA further believes that eliminating the option for banks to conduct partial modeling of specific risk would discourage banks from attempting to manage market risk better. Inclusion of prepayment risk as a factor in determining market risk is inappropriate and as such should be dropped from the proposed revisions. Also, given that assets are not commonly held on the trading book for a one-year period of time, assigning a capital charge to incremental default risk assets does not make sense.

In addition, detailed disclosure of quantitative and qualitative aspects of a banks' internal modeling is excessive, unnecessarily reveals proprietary information, and offers no practical benefit to anyone outside of the bank. Concomitantly, ABA urges the Agencies not to revise the market risk rules so as to require a bank's board of directors to verify the disclosures and that effective internal control structures are in place. We also urge the Agencies not to require an additional CFO certification about the appropriateness of disclosures.

If the Agencies have any questions regarding these comments, please do not hesitate to contact the undersigned.

Sincerely,

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Senior Counsel

Robert W. Strand
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