IIF
Institute of International Finance
1333 H Street, N.W., Suite 800E
Washington, DC 20005-4770
Tel: (202) 857-3312
Fax: (202) 463-0993

ISDA
International Swaps and Derivatives Association, Inc
360 Madison Avenue, 16th Floor
New York, NY 10017
Tel: 1 (212) 901-6000
Fax: 1 (212) 901-6001

LIBA
London Investment Banking Association
6 Frederick's Place
London, EC2R 8BT
Tel: 44 (0) 20 7796 3606
Fax: 44 (0) 20 7796 4345

RMA
The Risk Management Association
1801 Market Street
Suite 300
Philadelphia, PA 19103
Phone: (215) 446-4000
Fax: (215) 446-4101

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, D.C. 20219
ATTN: Docket No. 06-10

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C., 20551
ATTN: Docket No. R-1266

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
RIN 3064-AD10

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
Attention: No. 2006-34

January 23, 2007

Ladies and gentlemen:

The Institute of International Finance, the International Swaps and Derivatives Association, the London Investment Bankers Association, and the Risk Management Association (IIF, ISDA, LIBA, and RMA, jointly the "Associations") appreciate the opportunity to comment on the Notice of Proposed Rulemaking on Risk-based Capital Standards: Market Risk ("NPR") issued by the United States Federal banking regulatory agencies ("Agencies"). In the Market Risk NPR, the Agencies have requested comment on a wide spectrum of issues associated with their proposed revisions to the market risk capital rule to enhance its risk sensitivity. IIF, ISDA, and LIBA have commented previously on the joint Basel-IOSCO consultative document on the application of Basel II to trading activities, and the Associations appreciate the opportunity to comment on the Agencies' application of Basel II to market risk and its implementation in the United States.

General Issues

The Associations have three general comments on the Market Risk NPR. Two concern the breakage between the Market Risk NPR and the international implementation of the Basel II Accord. The third concerns the proposed bifurcation of the trading book into "covered" and "non-covered" positions. Although the idea of bifurcating the trading book into covered and non-covered positions appeared in the Basel II Accord as a result of the July 2005 Basel/IOSCO Trading Book Review,[1] we have taken advantage of the solicitation of comment on it in the NPR. In contrast to the credit and operational risk features of the Basel II Accord, as reflected in the separate NPR[2] on which we will comment in due course, the market risk section of the Trading Book Review was adopted with only a short time for industry comment. Further, the Trading Book Review acknowledges ongoing methodological development. Since the adoption of the proposals in the Trading Book Review we have had more time to reflect on their justification and likely consequences.

- **Principles versus rules for calculation of VAR and incremental default risk**

  One of the best features of the original Market Risk Amendment to the Basel Accord was its focus on general principles and its specification of general parametric requirements for the calculation of VAR. In discussion with the industry, the drafters of the original Market Risk Amendment recognized that the method for modeling and calculating VAR was evolving. They recognized that even if, on any given date, there had been agreement on what constituted industry "best practice," the details of the best practice methodology should not be frozen into prescribed regulatory rules because of the evolving nature of the VAR methodology and the evolving characteristics of the instruments in trading portfolios.

  In contrast to the broad principles articulated in the original Market Risk Amendment, the Market Risk NPR is more prescriptive in several ways:

  - In contrast to the original Market Risk Amendment, it bifurcates the trading book into positions that are covered by the market risk rules and positions that are subject to banking book rules.
  - The rules for what is covered and what is non-covered are inconsistent with how a bank actually manages its trading portfolio and are unnecessary so long as a bank has a validated, complete process for calculating VAR and a robust calculation of incremental default risk.
  - In addition, the rules for bifurcating the trading book into covered and non-covered positions are vaguely formulated and open to subjective, inconsistent interpretation by firms and supervisors. As these rules for bifurcation are unnecessary, we seek their elimination rather than asking for added prescriptiveness in their formulation. If the

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[1] "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects," Basel / IOSCO Working Group, July 2005. In particular, the changes in the market trading risk rules are contained in Strand 3 of the July 2005 document.

[2] 71 FR 55830 (September 25, 2006)

Market Risk NPR were more principles based it would not need to have an extensive set of requirements that needed clarification.

- Firms are required to generate an excessive amount of documentation about each trading portfolio that would serve no function other than regulatory compliance.
- The Associations believe it is essential to adopt an approach that would be consistent with paragraph 287 of the July 2005 Basel/IOSCO Trading Book Review which states that "… the proposed approach for capturing default risk [under the international Accord] will provide significant flexibility to banks in developing models, including how firms aggregate their specific risk and default related capital charge …." Naturally, it would be expected that this appropriately dynamic and flexible approach would also be subject to supervision pursuant to the ongoing supervisory dialogue on best practices also envisioned by paragraph 287.
- There is a new formal requirement that a bank must receive written approval from its primary Federal supervisor before using or before extending the use of a model to calculate RWA for trading risk. We propose that the standards for implementing this new rule should be commensurate with the nature and risk characteristics of a bank's trading business. The criteria for setting the standards for review and approval should be publicly available and applied uniformly to all firms.
- The Market Risk NPR asks some enumerated questions regarding: a) proposed additional requirements for securities with prepayment risk and b) a proposal to include specific risk for commodities and foreign exchange positions. Adopting either proposal would add prescriptiveness, and we do not think either proposal makes economic sense.

The Market Risk NPR correctly emphasizes the importance of a) the completeness and comprehensive of the VAR calculation, b) its validation, and c) the importance of developing and implementing a robust calculation of incremental default risk that appropriately takes liquidity risk into account.

The fundamental point is that, so long as a firm accurately captures and appropriately simulates the market risk of all of its trading portfolios, the added prescriptiveness described above adds no value but adds substantial incremental cost.

- **Trading book/banking book boundary**

The Market Risk NPR proposes prescriptive rules that bifurcate the trading book into positions that are covered by the proposed market risk rules and positions that would have their risk-weighted assets (RWA) calculated by banking book rules (e.g., rules for equity investments or securitization). This bifurcation could create a material breakage between the accounting and regulatory <u>classification</u> and treatment of positions. The magnitude of the breakage will depend on each bank's particular trading strategy. In contrast, the original Market Risk Amendment required all positions in the trading book to be captured by and included in the measurement of VAR.