Morgan Stanley

October 22, 2012

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 2-3
Washington, D.C. 20219

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Attention: Jennifer J. Johnson, Secretary

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20459
Attention: Robert E. Feldman, Executive Secretary

Re: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action. Docket ID OCC-2012-0008; Docket No. R-1442; FDIC RIN 3064-AD95.

Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements. Docket ID OCC-2012-0009; Docket No. R-1442; FDIC RIN 3064-AD 96.

Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule. Docket ID OCC-2012-0010; Docket No. R-1442; FDIC RIN 3064-D97.

Ladies and Gentlemen:

We appreciate the opportunity to comment on the joint notices of proposed rulemaking published by the Office of the Comptroller of the Currency (the "**OCC**"), the Board of Governors of the Federal Reserve System (the "**Board**") and the Federal Deposit Insurance Corporation (the "**FDIC**") (collectively, the "**Agencies**") with respect to implementation in the United States of the Basel III Accord of the Basel Committee on Banking Supervision ("**BCBS**") through modifications to banking organizations' regulatory capital requirements (the "**Basel III NPR**"),[1] the Standardized Approach for Risk-Weighted Assets (the "**Standardized Approach**

[1] 77 Fed. Reg. 52,792 (Aug. 30, 2012).

NPR"),[2] and the Advanced Approaches for Risk-Weighted Assets (the "**Advanced Approaches NPR**")[3] (collectively, the "**NPRs**").

Morgan Stanley, a financial holding company supervised by the Board, controls two FDIC-insured national banks supervised by the OCC. Morgan Stanley provides its products and services to a large and diversified group of clients and customers around the world, including corporations, governments, financial institutions and individuals.

I. Executive Summary

We strongly support the comments on the NPRs submitted by the American Bankers Association, the Securities Industry and Financial Markets Association and the Financial Services Roundtable (collectively, the "**Associations**") as well as the comments on the NPRs submitted by The Clearing House and the American Securitization Forum.[4] The Associations' comments provide reasonable, practical suggestions for improving the regulatory capital regime in the United States without harming banking organizations' ability to provide credit and liquidity to the broader economy.

Although we fully support the Associations' comment letter, we write separately to emphasize the following points:

A. **The definition of "financial institution" in the Basel III NPR should be limited to banking, securities and insurance entities, consistent with the Basel III Accord.** Morgan Stanley strongly supports the Associations' proposed definition of "financial institution," which more appropriately captures the range of entities intended by the Basel III Accord than the Basel III NPR's proposed definition.

   - ***Capital deductions for investments in Volcker covered funds***. In particular, the definition of "financial institution" should exclude Volcker covered funds (as defined below). At a minimum, if Volcker covered funds are included in the definition, no regulatory capital deductions should apply until after the end of all applicable conformance periods.

B. **Capital deductions should not be required for effectively hedged positions in the Trading Book.** Regulatory capital deductions should not be required for a banking organization's Trading Book exposures to other financial institutions' capital instruments, since the Market Risk Capital final rule (the "**Market Risk Rule**")

[2] 77 Fed. Reg. 52,888 (Aug. 30, 2012).
[3] 77 Fed. Reg. 52,978 (Aug. 30, 2012).
[4] The Associations submitted their comment letter on October 22, 2012, and it is available at http://www.sifma.org/issues/item.aspx?id=8589940758.

imposes a separate and comprehensive capital regime for these exposures.[5] The Agencies should revise the regulatory capital deduction provisions to clarify that deductions are only required for Banking Book exposures to other financial institutions' capital instruments.

- **Alternatively, if the Agencies require capital deductions to apply to Trading Book exposures, these deductions should be calculated with reference to the actual economic exposure of the banking organization's Trading Book, taking into account effective hedging and netting arrangements.** By relying on matching maturity criteria and residual maturity criteria, the netting criteria recognized in the Basel III NPR are appropriate for the longer holding periods associated with Banking Book exposures. The Agencies should recognize Trading Book-specific criteria to measure the actual economic exposure of these positions, consistent with the shorter holding period framework applicable to Trading Book exposures.

C. **Trust-preferred securities ("TruPS") should qualify as regulatory capital if they meet the substantive requirements of Tier 2 Capital.** Consistent with market practice and the substantive goals of the regulatory capital regime, the Agencies should expand the Tier 2 Capital criteria to permit (1) limited guarantees pursuant to which a banking organization merely guarantees that funds (if any) paid by the banking organization to the trust will in turn be paid by the trust to outside investors and (2) accelerations resulting from failure to pay deferred interest after 20 quarters.

D. **Banking organizations should be permitted to calculate exposures from derivatives and securities financing transactions ("SFT") in the Standardized Approach by using regulator-approved internal models.** Consistent with the Basel III Accord, banking organizations should be permitted to use the internal models methodology ("**IMM**") to calculate derivatives and SFT exposures, rather than relying on the risk-insensitive and outdated Current Exposure Method ("**CEM**").

E. **Exposures to securities firms should be risk-weighted at 20 percent.** Consistent with existing U.S. regulatory capital rules and the Basel III Accord, banking organizations should be permitted to assign a 20 percent risk-weight to exposures to securities firms that are approved to calculate regulatory capital under the Securities and Exchange Commission's ("**SEC**") Alternative Net Capital ("**ANC**") Rule, that have registered as swap dealers or security-based swap dealers or that are registered broker-dealer consolidated subsidiaries of bank holding companies.[6]

[5] Risk-Based Capital Guidelines: Market Risk, 77 Fed. Reg. 53,060 (Aug. 30, 2012).
[6] *See* 17 C.F.R. § 240.15c3-1.

F. **The risk-weights applicable to cleared transactions should better reflect the economic reality and risks of these transactions**. A banking organization should be permitted to use IMM to calculate its exposure to the default fund of a qualifying central counterparty ("**QCCP**"). In addition, the Agencies should fully incorporate the revisions to the capital framework applicable to clearing agreed to by the BCBS in July 2012,[7] including an 85 percent net-to-gross ("**NGR**") ratio and a new "Method 2" for calculating default fund exposures, and incorporate other revisions to the final rules necessary to improve the viability of a mandatory clearing regime.

II. Discussion

A. The term "financial institution" should be limited to banking, securities and insurance entities, consistent with the Basel III Accord.

The Basel III NPR, following the Basel III Accord, requires banking organizations to take regulatory capital deductions for certain investments in unconsolidated "financial institutions."[8] The BCBS has issued FAQs explaining that "examples of the types of activities that financial entities might be involved in include financial leasing, issuing credit cards, portfolio management, investment advisory, custodial and safekeeping services and other similar activities that are ancillary to the business of banking."[9] Significantly, the BCBS's clarifications do not indicate that a "financial institution" is any entity that participates in, or has exposures to, the financial markets.

Morgan Stanley shares the Associations' concern that the Agencies' proposed definition of "financial institution" is overly broad, capturing not only regulated banking organizations, securities firms and insurance companies, but also investment funds, commodity pools, ERISA plans, and other entities "predominantly engaged" in financial activities. We support the proposed definition of "financial institution" included in the Associations' letter, which we believe better captures the range of entities that engage in the illustrative activities identified by the BCBS.[10] In addition to our specific concerns about inclusion of Volcker covered funds in the Agencies' proposed definition, discussed at greater length below, we have three general concerns about the Agencies' proposed definition of "financial institution."

---

[7] BCBS, *Capital requirements for bank exposures to central counterparties*, July 2012, ¶ 125.
[8] Basel III NPR § __.22(c)(3)-(5); Basel III Accord ¶¶ 80-85.
[9] BCBS, *Basel III definition of capital – frequently asked questions*, December 2011, p. 10.
[10] The Associations have proposed the following definition of "financial institution": (i) insured depository institutions (including banks, thrifts and credit unions); (ii) depository institution holding companies (including bank holding companies and savings and loan holding companies); (iii) nonbank financial companies designated by the FSOC under Section 113 of the Dodd-Frank Act; (iv) insurance companies; (v) securities holding companies (as defined in section 618 of the Dodd-Frank Act; (vi) foreign banks; (vii) securities firms (including U.S. broker-dealers); (viii) futures commission merchants; and (ix) swap dealers and security-based swap dealers.

First, while Morgan Stanley supports the Agencies' goal of reducing financial system interconnectedness and systemic risk, this goal is not advanced by requiring capital deductions for investments in entities that are not core institutions engaged in banking, securities or insurance activities. Investment funds, commodity pools and ERISA plans may engage in some financial activities, but these activities are not central to the global financial system and each set of entities is subject to an extensive regulatory regime. These institutions are fundamentally different than large, internationally active banking, securities and insurance companies, where interconnections may magnify systemic risk in a crisis. The over-inclusiveness of the Agencies' proposed definition is particularly striking in the case of entities "predominantly engaged" in financial activities, since this extremely broad, difficult-to-apply standard will capture a wide and diverse range of market participants, most of which do not perform critical operating functions in the U.S. financial system.

Second, by significantly expanding the scope of the definition, the Basel III NPR places U.S. banking organizations and the broader U.S. economy at a competitive disadvantage vis-à-vis global competitors. To the extent that a wider definition of "financial institution" results in capital deductions that exceed international norms, U.S. banking organizations will be restricted in their ability to provide normal-course lending and credit intermediation services to U.S. businesses and consumers.

Third, the expansive scope of the "financial institution" definition, especially the "predominantly engaged" prong, will be very burdensome for banking organizations to apply in practice. Large banking organizations have exposures to tens of thousands of counterparties, not all of whom make publicly available the financial information necessary to apply an 85 percent revenue and assets test, as proposed by the Agencies; small banking organizations may have fewer exposures to evaluate but also typically have fewer resources to deploy in such exercises. A simplified definition focused on the core institutions active in financial markets would significantly ease the operational burdens on large and small banking organizations and avoid mis-classification, while ensuring that the underlying concern of limiting cross-holdings among financial institutions is addressed.

1. Volcker covered funds should not be included in the definition of "financial institution" for purposes of regulatory capital deductions

Section 13 of the Bank Holding Company Act, commonly known as the Volcker Rule, imposes extensive restrictions on banking organizations' relationships with hedge funds and private equity funds ("**Volcker covered funds**"). Under the Volcker Rule, banking organizations are generally prohibited from investing in Volcker covered funds, subject to limited exceptions, such as making *de minimis* investments. To the extent banking organizations are permitted to engage in Volcker covered fund activities, they are subject to statutorily imposed conflict-of-interest prohibitions and limitations on *de minimis* investments.

The Volcker Rule provides a comprehensive scheme for regulating banking organizations' relationships with Volcker covered funds. By contrast, the Basel III Accord does not contemplate restrictions on, or capital deductions for, banking organizations' investments in Volcker covered funds. Moreover, Volcker covered funds' status is based on the particular exemption they rely on from registration under the Investment Company Act of 1940, rather than on such funds' activities or investments, which in many cases are not "financial" in the conventional sense. We are concerned that, by including Volcker covered funds in the definition of "financial institution," the Basel III NPR unnecessarily interferes with the regulatory scheme Congress established in the Volcker Rule, including the statutory requirement that, before any capital deductions apply, regulatory agencies first find that such deductions are necessary to protect "the safety and soundness" of the banking system. We respectfully submit that such a finding is unjustified, as the relatively high risk-weights applied to non-publicly traded equity investments is sufficient to manage risks associated with Volcker covered fund investments.

Finally, if the Agencies incorporate capital deductions for investments in Volcker covered funds into final rules implementing the Basel III Accord, we recommend delaying capital deductions until the end of all applicable conformance periods. Congress designed these statutorily-recognized conformance periods to permit banking organizations to restructure and/or divest their holdings in Volcker covered funds over time in an orderly manner. Applying capital deductions during the conformance periods would effectively negate the rationale of the conformance periods by requiring banking organizations to assume dollar-for-dollar losses on remaining investments that are being wound down. This punitive capital treatment is unnecessary, since banking organizations are already incentivized to divest their holdings and, during the conformance periods, any residual exposures will be appropriately managed as risk-weighted assets.

B. Capital deductions should not be required for effectively hedged positions in the Trading Book.

The Basel III NPR requires banking organizations to deduct from regulatory capital their "investments" in other financial institutions' capital instruments. Morgan Stanley supports the underlying policy goal of this deduction, which is to reduce interconnectedness and systemic risk by limiting banking organizations' economic exposures to other financial institutions.

As proposed by the Agencies, the Basel III NPR recognizes that not all balance sheet exposures to financial institutions' capital instruments should require regulatory capital deductions. In many instances, a banking organization may have an exposure to a financial institution's capital instruments that is completely hedged by another balance sheet position. The Basel III NPR recognizes the principle that no regulatory capital deduction should be required when an effective hedge is in place, since the banking organization has no market risk exposure to the issuer of the capital instrument.

This principle is codified in the Basel III NPR through the definition of "investment in the capital of an unconsolidated financial institution," which permits a banking organization to calculate its "net long position" to a capital instrument as the "gross long position" net of short positions in the same exposure. As formulated in the Basel III NPR, the offsetting short positions must meet one of two sets of criteria: (1) the long and short positions must have matching maturities (the "**matching maturity criteria**") or (2) the short position must have a residual maturity of one year or greater (the "**residual maturity criteria**"). In addition, the "investment" definition recognizes separate netting principles for index exposures.

Morgan Stanley appreciates the relevance of the matching maturity criteria and the residual maturity criteria for Banking Book exposures, which are generally longer-term investments of the banking organization. Neither set of criteria, however, appropriately applies to Trading Book exposures, which have very different risk profiles and characteristics. Since they are necessarily actively-managed and dynamic, Trading Book exposures often do not have hedges with perfectly matched maturities or hedges with maturities of one year or greater; instead, the banking organization manages its risk on Trading Book exposures through ongoing risk management and hedge practices that are adjusted on a daily or intra-day basis. Since Trading Book risk management is always ongoing and responsive to market conditions, a banking organization may effectively hedge these short-term positions through arrangements that meet neither the matching maturity criteria nor the residual maturity criteria.

Significantly, banking organizations' effectively hedged Trading Book exposures are often taken to accommodate clients' trading or investment strategies. Asset managers, for instance, often gain access to the equity markets by entering into (long) equity-linked swaps with banking organizations, which may hedge their (short) client-facing risk by purchasing the (long) underlying equity instrument. In this situation, while the banking organization technically holds the equity instrument on its balance sheet, it is only as a hedge to the client-facing position. If the client-facing swap has a maturity of less than one year, the banking organization may be unable to net these positions under either the matching maturity criteria or the residual maturity criteria, even though contractual and market arrangements permit the banking organization to determine the close-out price of the client-facing swap as the same price as the close-out price of the equity position. Although not fully recognized by the Basel III NPR, in these circumstances the banking organization has effectively transformed market risk on the equity exposure into counterparty credit risk to its client.

The purpose of the regulatory capital deduction is to limit banking organizations' economic exposure to one another to reduce interconnectedness and systemic risk. In the situation described above, the banking organization has no economic exposure to the issuer of the equity instrument; rather, the banking organization's economic exposure is to its client. By relying on unnecessarily restrictive netting criteria, the Basel III NPR would result in banking organizations taking capital deductions for normal course, effectively hedged equity transactions taken to accommodate client positions.

We respectfully submit that the regulatory capital deduction rules, as formulated in the Basel III NPR, should not apply to Trading Book exposures, since these exposures are separately captured by the enhanced capital regime of the Market Risk Rule. Alternatively, if regulatory capital deductions are applied to the Trading Book, the Agencies should recognize Trading Book-specific netting principles to avoid banking organizations taking regulatory capital deductions for effectively hedged Trading Book positions that accommodate client trading and investment requests. These alternative approaches are discussed in greater detail below.

1. ***Regulatory capital deductions should not be required for Trading Book exposures to other financial institutions' capital instruments, since the Market Risk Rule imposes a separate and comprehensive capital regime for these exposures.***

The Agencies' new Market Risk Rule, which is effective on January 1, 2013, imposes enhanced capital requirements on banking organizations that engage in significant trading activities. The rule is designed to reduce pro-cyclicality in market risk capital requirements, enhance sensitivity to risks that are not adequately captured by previous regulatory methodologies, and increase transparency through enhanced disclosures. The Market Risk Rule recognizes, through Value at Risk (VaR) and other capital requirements, that Trading Book exposures are necessarily short term and will not have hedging maturities of one year or greater.

By focusing on the Trading Book exclusively, the Market Risk Rule imposes a capital regime specifically tailored for short-term positions. The Market Risk Rule does not apply to Banking Book positions precisely because the Agencies recognize that longer-term exposures in the Banking Book have qualitatively different risk profiles and characteristics.

Similarly, the regulatory capital deductions in the Basel III NPR for exposures to financial institutions' capital instruments should apply only to exposures in the Banking Book, not the Trading Book. The underlying policy goal of this deduction is to reduce banking organizations' economic exposures to unaffiliated financial institutions, and the matching maturity criteria and residual maturity criteria appropriately recognize hedging activities applicable to Banking Book exposures. By contrast, Trading Book exposures are typically short term, are often taken in response to client requests, and are always captured by the enhanced capital requirements of the Market Risk Rule. Capital deductions for Trading Book exposures are therefore unnecessary to accomplish the Agencies' policy goal, and may compromise banking organizations' ability to accommodate client trading and investment strategies or otherwise dynamically manage the banking organization's own short-term risks.

2. ***Alternatively, if the Agencies require capital deductions to apply to Trading Book exposures, these deductions should be calculated with reference to the actual economic exposure of the banking organization's Trading Book, taking into account effective hedging and netting arrangements.***

The overarching policy goal of the regulatory capital deduction for exposures to other financial institutions' capital instruments is to limit a banking organization's economic exposures to financial entities and thereby reduce interconnectedness and systemic risk. Critically, the Agencies observe in the Basel III NPR that these economic exposures are "equivalent to the banking organization's potential loss should the underlying capital instrument have a value of zero."[11] If the Agencies decline to exclude Trading Book exposures from the regulatory capital deduction regime, the netting rules should be expanded to better capture the economic exposure of Trading Book positions since, when a position is effectively hedged, the banking organization's potential loss is only the amount of the exposure that is unhedged, which will be significantly less than 100 percent of the gross exposure.

Consistent with the Market Risk Rule, we believe that the economic exposure of Trading Book positions would be more accurately reflected by Trading Book-specific criteria that take into account effective hedging and netting arrangements. The Trading Book exposure amount could be based on (a) a delta-based measure of exposure, consistent with the risk-based capital requirements in the Market Risk Rule, (b) the netting criteria applicable to index positions in the Basel III NPR, or (c) the ability of the banking organization to determine the close-out prices of offsetting positions.

a. Applying a delta-based measure of exposure

The Market Risk Rule requires banking organizations to calculate risk-weighted assets for certain Trading Book exposures by using the "delta" of the financial instrument.[12] Delta, which is sensitive to corresponding changes in the values of financial instruments and underlying factors, will change over time in response to dynamic market conditions; for instance, options with otherwise identical economic terms will receive different delta values depending on their remaining maturities, reflecting the fact that long-dated options have a greater potential range of

[11] Basel III NPR, p. 52,821.
[12] *See* Market Risk Rule, p. 53,073.

economic outcomes. Delta calculations are particularly useful for managing risks at a portfolio level, permitting a banking organization to net its long and short positions vis-à-vis a specific counterparty on a risk-adjusted basis, taking into account a variety of relevant risk factors and market considerations.

Morgan Stanley believes that such delta calculations, determined in accordance with the Market Risk Rule, provide the most accurate, risk-sensitive approach for calculating Trading Book exposures. Accordingly, if the Agencies require regulatory capital deductions for Trading Book exposures to other financial institutions' capital instruments, the exposure amount should be calculated with reference to the delta of the position, calculated by a banking organization in accordance with the already-established Market Risk Rule framework.

b. Applying the index netting criteria to Trading Book exposures

Alternatively, the Basel III NPR provides specific netting criteria for index positions that include the capital instruments of other financial institutions. Specifically, a banking organization can recognize short positions in indices that hedge long cash or synthetic positions as long as (i) both the exposure being hedged and the short position in the index are positions subject to the Market Risk Rule, (ii) the positions are fair valued on the banking organization's balance sheet, and (iii) the hedge is deemed effective by the banking organization's internal control processes assessed by the primary supervisor of the banking organization.[13]

The Agencies' proposed criteria for netting index positions provide a practical, risk-sensitive approach for determining regulatory capital deductions based on actual economic exposures. Significantly, the index netting criteria include a requirement that the index positions be subject to the Market Risk Rule, recognizing the interplay of the Trading Book capital regime with the more flexible approach taken to netting short-term trading positions. We believe that there is no meaningful conceptual distinction for regulatory capital purposes between index and non-index positions in the Trading Book, and that non-index positions should be subject to the same netting requirements as index positions. In particular, the requirement for a banking organization's internal control process to confirm the effectiveness of the hedge would result in exposure calculations based on actual economic exposures. Accordingly, if the Agencies require regulatory capital deductions for Trading Book exposures, if would be appropriate for all such exposures to be calculated under the criteria applicable to index positions.

c. Banking organizations' ability to determine the close-out prices of offsetting positions

A banking organization could also calculate the net delta of its Trading Book exposures by excluding those exposures in which the organization can determine the final price of the

[13] Basel III NPR, § __.2 (definition of "investment in the capital of an unconsolidated financial institution").

instrument and its offsetting position. In this situation, the banking organization would net positions where it could determine the final price of both positions, such that the final price of the short position can be the same as the sale price of the long position, thus eliminating market risk associated with termination or unwind of the short position.

For instance, when a banking organization faces a client in a short position on an equity-linked swap, the organization may acquire the underlying equity instrument to offset its exposure. Contractual arrangements permit the banking organization to close out the equity-linked swap and equity instrument positions simultaneously, thus ensuring that the prices match and the banking organization's market risk is eliminated. In this situation, if the value of the equity instrument drops to zero, the banking organization is fully hedged through its short position facing the client. While the banking organization has counterparty credit risk to the client, this risk is managed through initial and variation margin requirements and, in some cases, credit support arrangements.

We believe that there is no reason to require a regulatory capital deduction in this situation. While the banking organization has economic exposure related to the transaction, the exposure is not to the issuer of the equity instrument but instead to the client. Further, even in periods of market stress, including in September 2008, the equity markets demonstrated sufficient depth and liquidity to allow banking organizations to close out equity and equity-linked swap positions easily. Accordingly, we believe that if Trading Book exposures are subject to the capital deduction requirements, the economic exposure calculation for these positions should exclude positions where the banking organization can determine the final price, such that the final price of the short position can be the same as the sale price of the long position.

C. TruPS should qualify as regulatory capital if they meet the substantive requirements of Tier 2 Capital.

In the preamble to the Basel III NPR, the Agencies state that while, after full implementation of the Basel III Accord, TruPS will no longer qualify as Tier 1 Capital, these instruments "could qualify for inclusion in Tier 2 Capital under the proposed eligibility criteria for Tier 2 Capital instruments."[14] Morgan Stanley supports the Agencies' position, and believes that TruPS should qualify as Tier 2 Capital under appropriate circumstances.

We are concerned, however, that the Basel III NPR may, contrary to the Agencies' statement of intent, inappropriately exclude many existing TruPS from Tier 2 Capital unless modifications are made to the proposed Tier 2 Capital eligibility criteria to address: (1) limited guarantees pursuant to which a banking organization merely guarantees that funds (if any) paid

[14] Basel III NPR, p. 52,814.

by the banking organization to the trust will in turn be paid by the trust to outside investors; and (2) acceleration rights triggered by the failure to pay interest for 20 or more consecutive quarters.

1. Limited guarantees

In a TruPS transaction, a banking organization issues a junior subordinated note to a trust, the note being the sole asset of the trust. The trust, in turn, issues TruPS to outside investors (TruPS holders) and uses payments received from the banking organization on the junior subordinated note to pay the TruPS holders.

TruPS commonly contain a limited guarantee under which the banking organization guarantees that any principal and accrued interest paid to the trust on the junior subordinated note will be used exclusively to pay the TruPS holders. Under such a limited guarantee, the banking organization does not guarantee the trust's obligations to pay TruPS holders the full face value of the TruPS instruments. The banking organization only guarantees that funds (if any) paid by the banking organization to the trust as principal or accrued interest will in turn be paid by the trust to the TruPS holders. The guarantee does not enhance the seniority of the instrument and thus does not compromise the integrity of these instruments as regulatory capital or reduce their loss absorbency. Rather, the limited guarantee is akin to a corporate governance guarantee for the trust, ensuring that payments received by the trust are paid to TruPS holders.

Under the Basel III NPR, one of the eligibility criteria for Tier 2 Capital requires that "[t]he instrument is not . . . covered by a guarantee of the [BANK] or of an affiliate of the [BANK], and not subject to any other arrangement that legally or economically enhances the seniority of the instrument in relation to more senior claims."[15] Morgan Stanley requests that the Agencies clarify in the final rules that this criterion does not prohibit limited guarantees commonly used in TruPS transactions because such guarantees protect the integrity of the trust's payment obligations without weakening the regulatory capital characteristics of TruPS.

2. Acceleration rights triggered by failure to pay interest for 20 or more consecutive quarters

Under the Basel III NPR, the proposed eligibility criteria for Tier 2 Capital include a requirement that "[t]he holder of the instrument must have no contractual right to accelerate payment of principal or interest on the instrument, except in the event of a receivership, insolvency, liquidation, or similar proceeding" of the banking organization.[16] Unlike the Federal Reserve's existing capital regulations governing TruPS,[17] the proposed eligibility criteria would

[15] Basel III NPR § ___.20(d)(1)(iii).

[16] Basel III NPR § ___.20(d)(1)(vi).

[17] 12 C.F.R. Part 225 App. A § II.A.1(c)(iv)(2).

appear to preclude instruments that provide for acceleration of principal and accrued interest upon nonpayment of interest for 20 or more consecutive quarters.

We believe this aspect of the Basel III NPR should be clarified to expressly provide that Tier 2 Capital instruments may include acceleration rights that are triggered by failure to pay interest for 20 or more consecutive quarters. First, as a practical matter, acceleration based on 20 consecutive quarters of interest nonpayment mirrors the other Tier 2 Capital requirement that an instrument have an original maturity of at least five years.[18] If a banking organization issues Tier 2 Capital instruments and fails to pay interest beginning on the first quarterly payment due date, there will still be no permitted acceleration for another five years (i.e., 20 quarters). If there are 20 consecutive quarters of nonpayment of interest with respect to an instrument, the Agencies can treat the final month as the maturity date, which would allow the instrument to comply with the five-year maturity requirement.

Second, many banking organizations, relying on the Federal Reserve's existing capital regulations, have issued TruPS with acceleration rights that are triggered by nonpayment of interest for 20 or more consecutive quarters.[19] If the Agencies' Basel III final rules do not permit such acceleration rights, these previously issued instruments will likely not qualify as Tier 2 Capital, which is inconsistent with the Agencies' stated intention to recognize TruPS as Tier 2 Capital going forward.

D. Banking organizations should be permitted to calculate exposures from derivatives and SFTs in the Standardized Approach by using regulator-approved internal models.

As noted by the Agencies, the Basel III Accord permits banking organizations to use IMM for calculating derivatives and SFT exposures under the Standardized Approach.[20] Although the Standardized Approach NPR does not contemplate the use of IMM, the Agencies have requested comment on whether final rules implementing the Standardized Approach in the United States should permit the use of IMM for measuring these exposures.[21]

Morgan Stanley believes that the option to use IMM to measure exposure amounts for derivatives and SFTs should be included in final rules implementing the Standardized Approach in the United States, for two reasons: (i) IMM provides the most accurate, risk-sensitive methodology for measuring these exposures and (ii) the alternative methodology, CEM, lacks the

---

[18] Basel III NPR § ___.20(d)(1)(iv).

[19] *See* U.S. Government Accountability Office, Hybrid Capital Instruments and Small Institution Access to Capital (Jan. 2012), available at http://www.gao.gov/assets/590/587759.pdf (Observing that "the terms of the trust preferred securities allow dividends to be deferred for at least 5 years without creating an event of default or acceleration of the principal and accrued interest.").

[20] Standardized Approach NPR, p. 52,913.

[21] Standardized Approach NPR, Question 15.

risk sensitivity necessary to accurately calculate exposures for these product categories. In addition, permitting the use of IMM to measure these exposures under the Standardized Approach would be consistent with the Basel III Accord, thereby promoting global harmonization and avoiding any potential competitive disparities.[22]

1. IMM provides the most accurate, risk-sensitive and reliable methodology for measuring a banking organization's derivatives and SFT exposures.

Most large U.S. banking organizations with significant exposures in financial markets have developed sophisticated, risk-sensitive internal models to calculate these exposures. These organizations' models permit firms to appropriately manage risk in the derivatives and SFT markets, as well as to calculate their regulatory capital requirements under the Basel II and Basel III frameworks. Although weaknesses in internal models appeared during the financial crisis, banking organizations have since significantly strengthened and refined their models as part of the Agencies' Basel II parallel run review process, including through rigorous back-testing.

The financial crisis did not reveal fundamental flaws with IMM, but rather mistaken assumptions in banking organizations' models concerning volatility and the range of possible market conditions for particular model inputs, especially mortgage securitizations and correlation trading positions. Banking organizations have since addressed these deficiencies, either independently or at the direction of banking supervisors during the parallel run process. In addition, the Agencies' revised Market Risk Rule, effective January 1, 2013, and the pending Basel III NPR will further strengthen IMM requirements, in general, and specifically address previous weaknesses related to mortgage securitizations and correlation trading positions.

IMM is a superior approach for measuring derivatives and SFT exposures because models synthesize a wide range of dynamic market inputs, including under historical and stressed scenarios. These risk-sensitive frameworks permit banking organizations to accurately forecast the volatility of specific exposures, taking into account the unique attributes of each position. Consistent with the Basel III Accord, the Agencies should revise the Standardized Approach to permit banking organizations to measure these exposures through IMM, thereby ensuring the most risk-sensitive and accurate exposure measurements possible.

---

[22] *See International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (June 2006), Annex 4 ¶ 20 (unmodified by the Basel III Accord) ("The internal modelling method [IMM] is available both for banks that adopt the internal ratings-based approach to credit risk and for banks for which the standardised approach to credit risk applies to all of their credit risk exposures.").

2. *CEM lacks the risk sensitivity to accurately calculate derivatives and SFT exposures.*

The Standardized Approach NPR proposes that banking organizations use CEM to measure their exposures from derivatives and SFT transactions. Under CEM, a banking organization calculates credit exposure as a combination of net current exposure plus potential future exposure ("**PFE**"). As formulated in the Standardized Approach NPR, CEM severely limits the ability of a banking organization to take into account legally enforceable netting arrangements; fails to take into account collateral that will be posted against future exposures; and significantly overstates PFE by relying on mechanical, risk-insensitive assumptions about the risk profiles of broad product categories.

CEM, originally formulated in the 1980s before derivatives and SFT markets emerged, is a rudimentary tool for measuring these exposures since it relies on generalized assumptions about risk rather than the product-specific risk sensitivity of IMM. While banking organizations must hold appropriate amounts of capital against their exposures, unrealistically high exposure calculations will result in excessively large capital requirements, which may negatively impact banking organizations' ability to engage in normal course banking activities, including lending and credit intermediation activities. The Agencies should modify the Standardized Approach to permit banking organizations to measure their derivatives and SFT exposures through IMM.

E. The risk-weight for exposures to securities firms should be 20 percent, consistent with the Basel III Accord, rather than 100 percent, as proposed in the Standardized Approach NPR.

As noted by the Agencies in the Standardized Approach NPR, the Basel III Accord assigns a risk-weight of 20 percent to exposures to securities firms.[23] This treatment is consistent with existing U.S. regulatory capital rules[24] and with the Agencies' proposed treatment of exposures to U.S. depository institutions.[25] Breaking with the Basel III Accord, however, the Agencies propose to assign a 100 percent risk weight to securities firm exposures, stating that they "do not believe that the risk profile of these firms is sufficiently similar to depository institutions to justify that treatment."[26]

Morgan Stanley respectfully submits that a 20 percent risk-weight for exposures to qualifying securities firms would be more appropriate than the proposed 100 percent risk-weight. The Agencies' proposed risk-weight is inconsistent with global norms, putting U.S. banking

[23] Standardized Approach NPR, p. 52,897.
[24] *See* 12 C.F.R. Part 225, App. A § III.C.2.d (Board); 12 C.F.R. Part 225, App. G § 54(d) (Table 10) (Board); 12 C.F.R. Part 3, App. A § 3(a)(2)(xiii) (OCC); 12 C.F.R. Part 325, App. A § II.C (Category II) (FDIC).
[25] Standardized Approach NPR § __.32(d)(1).
[26] Standardized Approach NPR, p. 52,897.

organizations at a competitive disadvantage vis-à-vis foreign organizations and increasing the risk of regulatory arbitrage. Notably, in the proposed Capital Requirements Directive IV (CRD IV) framework, the European Union has assigned a 20 percent risk-weight to banking organizations' exposures to securities firms.[27]

More importantly, however, the proposed treatment of securities firm is unnecessary, as many such firms are subject to "supervisory and regulatory arrangements comparable" to those applicable to banking organizations, including with respect to capital requirements.[28] The SEC's ANC Rule requires securities firms to apply market risk standards adapted from the Basel Accord and Basel credit risk standards for derivatives exposures. In addition, ANC Rule securities firms must maintain a robust capital position and notify the SEC if the firm's tentative net capital declines below $5 billion.[29] The comparability of regulatory regimes is particularly striking for securities firms that register as swap dealers or securities-based swap dealers, since registration will subject them to extensive supervision and governance requirements, including heightened regulatory capital standards.[30] Finally, as a result of the financial crisis, many securities firms have restructured themselves as bank holding companies, subjecting the firms to inspection and regulation by prudential regulators, just like insured depository institutions.

Accordingly, Morgan Stanley respectfully recommends that the Agencies revise the proposed regulatory capital treatment of exposures to securities firms to permit 20 percent risk weighting for exposures to any firm (1) that is subject to the ANC Rule,[31] (2) that has registered as a swap dealer or a securities-based swap dealer or (3) that is a registered broker-dealer consolidated subsidiary of a bank holding company.

F. The risk-weights applicable to cleared transactions should better reflect the economic reality and risks of these transactions.

In 2009, leaders of the G-20, including the United States, agreed that all standardized derivatives should be cleared through central counterparties, where appropriate. The following year, Congress passed the Dodd-Frank Act, which generally requires swaps to be cleared with derivatives clearing organizations ("**DCO**") registered with the Commodity Futures Trading Commission ("**CFTC**").[32] In August 2012, the CFTC published a proposed rule identifying the

---

[27] *See* CRD IV Regulation (July 20, 2011), *available at*: http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0452:FIN:en:PDF

[28] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (2006) ¶ 65 ("Claims on securities firms may be treated as claims on banks provided these firms are subject to supervisory and regulatory arrangements comparable to those under this Framework (including, in particular, risk-based capital requirements).").

[29] 17 C.F.R. § 240.15c3–1(a)(7).

[30] Commodity Exchange Act ("**CEA**") § 4s(e); Securities Exchange Act § 15F(e).

[31] As of May 2011, six broker-dealers had been approved to calculate their regulatory capital requirements under the ANC Rule. *See* SEC, Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, 76 Fed. Reg. 26550, 26555 n. 40 (May 6, 2011).

[32] CEA § 2(h), as amended by Dodd-Frank Act § 723(a).

first categories of swaps that will be subject to mandatory clearing in the United States.[33] In sum, there is an emerging global consensus to support greater clearing of derivatives transactions.

To facilitate greater clearing, however, the regulatory capital rules must accurately reflect the economic reality and risks of cleared transactions. Morgan Stanley is concerned that the NPRs unnecessarily penalize cleared transactions, which may frustrate the G-20 directive to encourage clearing as quickly as possible for as many product classes as possible.

1. *Banking organizations should be permitted to use IMM to calculate the hypothetical capital requirement for a QCCP.*

The Basel III Accord requires banking organizations with exposures to a QCCP's default fund to calculate a hypothetical capital requirement for the QCCP. This calculation is then used to determine the organization's exposure to the QCCP and, in turn, the organization's corresponding capital requirement related to that exposure. While Morgan Stanley agrees with the underlying logic of this capital requirement, we are concerned that the NPRs' reliance on CEM to calculate a QCCP's hypothetical capital requirement will result in exposure calculations that greatly exaggerate the underlying economic risks of QCCP exposures. Banking organizations will be forced to reflect elevated QCCP default fund capital charges in the pricing for cleared transactions, which may in turn make clearing uneconomical for many categories of derivatives.

As explained more fully in Part II.D of this letter, IMM is a far superior method to CEM for calculating regulatory capital requirements. The use of IMM is particularly appropriate in the case of QCCP hypothetical default fund exposures, since QCCPs, like Advanced Approaches banks, have large derivatives and SFT exposures. By contrast, reliance on CEM to calculate capital requirements will raise the cost of cleared transactions through excessive default fund capital charges that do not provide any meaningful additional protection against systemic risk and, in fact, may weaken financial stability by preventing the emergence of a robust clearing market.

2. *The BCBS clarifications published in July 2012 should be fully reflected in the final rules.*

The Agencies released the NPRs in June 2012, following which the BCBS published, in July 2012, an interim framework for determining capital requirements for bank exposures to central counterparties (the "**Interim Framework**").[34] The Interim Framework makes several

[33] CFTC, *Clearing Requirement Determination Under Section 2(h) of the CEA*, 77 Fed. Reg. 47170 (Aug. 7, 2012).
[34] BCBS, *Capital requirements for bank exposures to central counterparties*, July 2012.

significant improvements to the treatment of cleared transactions, including a higher NGR and introduction of a new method for calculating exposures to QCCPs' default funds (Method 2). Morgan Stanley believes these revisions improve the overall soundness of the regulatory capital framework applicable to cleared transaction, even if the revisions stop short of supporting the general application of IMM to cleared transactions. We urge the Agencies to incorporate the revisions from the Interim Framework into the final rules implementing the Basel III Accord in the United States.

3. Clarifications are needed to ensure the appropriate treatment of omnibus accounts and credit derivatives that are cleared as well as ensure that CCPs registered with the CFTC or SEC are deemed QCCPs.

The Agencies should make several clarifications to the NPRs to ensure that cleared transactions receive appropriate capital treatments. In particular, although the preambles to the Standardized Approach NPR and the Advanced Approaches NPR indicate that the Agencies intend for omnibus accounts to be eligible for two percent risk-weighting, the proposed rules are unclear on this point.[35] We urge the Agencies to clarify this issue in the final rules.

Similarly, the Agencies should clarify that credit derivatives cleared through a QCCP can reduce a banking organization's wholesale exposures under the Advanced Approaches, similar to the credit risk mitigation benefits that the Agencies' existing Advanced Approaches rules recognize. In this case, the final rules should clarify that if a wholesale exposure is hedged by a cleared credit derivative that receives a two percent risk-weight, the banking organization may apply a two percent risk-weight to the portion of the exposure hedged by the derivative.

Finally, the Agencies should clarify in the final rules that any CCP registered with the CFTC as a DCO or with the SEC as a Securities-Based Swap Clearing Agency ("**SBSCA**") will qualify as a QCCP under the Agencies' capital rules. Congress created a comprehensive regulatory regime for DCOs and SBSCAs in the Dodd-Frank Act, including rigorous capital requirements, and the Agencies' capital rules should incorporate the DCO and SBSCA framework rather than create a separate process for qualification of a CCP as a QCCP.

[35] *See* Standardized Approach NPR, p. 52,906; Advanced Approaches NPR, p. 52,988.

III. Conclusion

The Basel III Accord significantly strengthens global regulatory capital standards and Morgan Stanley appreciates the opportunity to comment on the Agencies' proposed implementation of the Accord through the NPRs. Please contact me at (212) 762-4219 or candice.koederitz@morganstanley.com, or David Bonnar, Managing Director, at (212) 276-7824 or david.bonnar@morganstanley.com, if discussion of any points raised in our comment letter would be helpful.

Respectfully submitted,

Candice Koederitz

Candice Koederitz
Managing Director