

13 March 2009

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Committee Members

**“Revisions to the Basel II market risk framework” (“MRF”) and
“Guidelines for computing capital for incremental risk in the trading
book” (“IRC Guidelines”)**

The Goldman Sachs Group, Inc. (“Goldman Sachs”) is pleased to have the opportunity to provide comments on these two consultative documents issued in January 2009 by the Basel Committee on Banking Supervision (“the Committee”). In doing so, we would like to express our appreciation of the efforts that have been made by the Committee, and by the members of the International Organization of Securities Commissions (“IOSCO”), to develop these proposals, the importance of which has been heightened by the financial crisis.

Goldman Sachs supports the central principle underpinning the Basel 2 Framework: a risk sensitive capital adequacy regime. In particular we are fully supportive of the Basel Committee’s stated goal of arriving at “significantly more risk-sensitive capital requirements that are conceptually sound”¹.

We believe the Basel Committee has moved away from this underlying principle in these consultation papers. In particular we are concerned that the new proposals will not address the material tail risks which VaR is not designed to capture and will stifle risk management development. We recommend a principles-based framework that will capture all material tail risks and promote risk management practice and modelling. We believe that a principles-based framework would need to be bolstered at the Supervisory

¹ Para 5 of the “International Convergence of Capital Measurement and Capital Standards” – June 2006

level by a more rigorous assessment and enforcement process that promotes consistency of coverage of the material tail risks, but that allows firms to adapt the methodology as appropriate for their portfolios.

We support a level playing field but note that it has not been recognised explicitly that some firms are already holding capital to cover many of the risks identified by the Basel Committee. It is apparent from public disclosures, that different firms report widely varying amounts of market risk-weighted assets relative to reported VaR. This leads us to the conclusion that some firms have been holding capital to cover various risks that are not captured by VaR models and that others have not. We believe the Committee should acknowledge in its proposals and in the Quantitative Impact Study that the starting point is different depending on the firm and jurisdiction.

We are concerned therefore that a firm such as Goldman Sachs, which has been holding capital for many such risks based on methodologies agreed with supervisors, will be required to discard these methodologies in favour of the standard rules set out in these proposals. We believe that the proposals do not address the event risks and other material risks associated with securitisation positions appropriately.

We understand that some firms' models and add-ons did not capture the tail risks observed during 2007/8, in particular where firms were using public credit ratings to manage and measure risk and capital. The solution to this is not a backwards step towards simplified approaches, but a more forward-looking Basel 2 framework which requires firms to hold capital for all material risks.

We believe that material event risks cannot be captured in VaR, but alternatively can be captured by suitable risk-based methodologies (including add-ons), and that the important aim is that there is sufficient capital to cover these risks. Under the current proposals (i.e. limited to credit ratings for securitisation positions), material risks will continue to be omitted from capital. We set out the reasons for this below.

We refute the common presumption that capital under the Trading Book Framework is necessarily lower than under the Banking Book Framework. In certain cases Trading Book positions can attract much higher capital charges and we think this is not inappropriate. In particular, illiquid assets in the Trading Book should attract more capital than the same position booked in the banking book at historical cost. We explain our thinking below.

The proposal to restrict netting to similar financial instruments in the IRC framework will have a very material impact on capital charges, and is incongruent with the AIRB framework which requires firms to consider exposure on an obligor basis. We suggest that netting on an intra-obligor basis should be permitted, and would be fully reflective of the way positions are managed and hedged within the Trading Book.

Proposals relating to Securitisation Exposures

Tying to the Securitisation Framework

We fundamentally disagree that banking book securitisation risk weights should be used to calculate trading book specific risk capital requirements for the following reasons:

- Risk weights are based on public credit ratings. This is not risk sensitive – there are other dominant factors that have driven price changes, in particular the risk associated with the correlation structure. AAA-rated ABSs attracting 7% risk weight are a good example of how, under this method, capital would have been inappropriate and unresponsive to changes in market value, particularly where firms are marking to market. The banking book securitisation framework should apply only to held to maturity securitisation positions recorded at historical cost because the probability of default is the key driver of their value. If trading book securitisation positions are forced into a ratings based framework, the resulting capital requirements will not capture the price risks (or potential changes in value) that ratings are not designed to capture.
- Carving out securitisation positions from a trading desk's portfolio will lead to an incoherent picture of the risk, affecting capital charges for the portfolio in an unpredictable way and resulting in varying and, in some cases, potentially lower capital charges than under the current framework. Risk sensitivity should be the overriding principle of the Basel Committee's proposals – capital should be aligned to the material risks in the portfolio.

Dealer exemption

We strongly advocate the re-insertion of paragraph 718 (xcv) that contains the exemption language for firms whose positions are part of market-making activity. Without this exemption language, firms with significant correlation trading business, or who offer tranching protection to financial institutions, will experience multiple fold increases in capital requirements not commensurate with risk. The exemption was inserted into the Basel 2 Framework in recognition of the fact that firms with correlation books have dynamically hedged portfolios that are re-valued on a daily basis and are subject to active risk management. It is not appropriate to regard such portfolios as directional portfolios (e.g. long only strategies that suffered severe deterioration in value during the recent financial events). Rather they are portfolios which manage "correlation risk". As such it is correlation risk which needs to be appropriately captured in the capital charge.

Such portfolios typically contain bespoke tranche synthetic positions that are not rated by external rating agencies. As such, most positions are likely to be treated as equity tranches and deducted from capital under these proposals, even though there may be dynamic hedges in place or the tranches may be

unrated mezzanine tranches. Whilst we do not disagree that capital levels should be increased for some firms' portfolios with tranching exposures, capital levels should not be set by the securitisation framework which relies on public credit ratings agencies that to date have not been rating synthetic tranches, and anyway would only capture the default probability.

It has become apparent that some firms that were net long securitisation exposures and recorded significant mark to market losses may have been relying on public credit ratings to determine and manage the level of risk in the portfolio. The proposals should not compound this error by requiring all firms to use public credit ratings for capital requirements purposes as set out in the Securitisation Framework.

Market making activity in credit markets will be severely disrupted by the proposed rules. We believe that the Basel Committee should set a broader policy objective of promoting active, liquid capital markets. Following on from this, the proposals should steer clear of setting capital requirements that are poorly aligned with risk. Otherwise there is a serious risk that capital markets will suffer materially from a loss in liquidity and price transparency, which will have knock on effects on underlying debt liquidity and prices.

We fully support the arguments in the ISDA/LIBA/IIF/IBFed industry response that describe in more detail the correlation trading business and why this exemption is fundamental to dealers.

Arbitrage

Furthermore, we believe that the securitisation exposure proposals have the potential to result in a perverse outcome for unhedged long securitisation positions in the trading book which are marked to market. The combination of existing trading book specific and general market risk charges together with recognition of any losses on a mark-to-market basis will almost certainly result in a larger impact to capital than if the positions were held in the banking book. Applying banking book charges will incentivise banks to hold in the banking book positions that are in fact held with trading intent. Please see comments below with respect to trading book versus banking book classification.

Backwards step

We would suggest a proper risk based measure that would take into account more than just the capital charge derived from a public credit rating. Properties of such a measure would allow for some diversification benefits, taking into account long and short positions, both synthetic and physical. We note that the UK FSA standard position risk requirements for credit derivative positions are considerably more risk sensitive than the Basel proposals.

Incremental Risk Charge

Reduced scope

We are disappointed that the scope of the IRC has been reduced to cover default and migration risks for positions that have specific interest rate risk and instead would advocate returning to the scope outlined in July 2008 (i.e. all material price risks for all products except non-default interest products, commodities and FX). The reduced scope is not forward looking. We suggest a high level principle that firms must capture material price risks and to cover all positions including securitisation positions.

Non-VaR capital add-ons

VaR does not capture all risks. Therefore the proposals should be underpinned with the key principle that all material risks should be captured in capital, through a combination of VaR and separate risk-based add-ons. Separate event risk methodologies remain part of the suite of risk management tools. We believe the Committee should not want to distort VaR by requiring it to cover risks which it is not designed to do. Banks using capital add-on methodologies must be able to demonstrate that the capital is sufficient to capture all material risks.

Following on from this, we are concerned by the re-addition of the wording “capture event risk” in para 718(LXXXViii) and by the continued deletion of para 718 (LXXXiX). Together, these amendments require firms to capture event risk in VaR models. We believe this may not be possible in some cases and strongly advocate that the Basel Committee should clarify that it is necessary to ensure capital is sufficient to capture event risk, but this does not necessarily mean it will be covered within firms’ VaR models. Many event risks will be tail events not likely to be captured in 1 year historical data periods or within the confidence intervals measured by VaR models. Concentrations and lack of liquidity can result in impacts to capital from tail events that would be better captured by add-on type capital charges designed to be calibrated to the potential impact on the firm’s portfolio, and more in line with stress testing techniques. We believe this would address the Committee’s concern with more clarity as well as, importantly, would be likely to raise capital for the tail risks. Therefore we would ask for 718 (LXXXiX) to be reinstated but amend the words “internal capital assessment” to “additional Pillar 1 capital charges” using a methodology to be agreed between a firm and its regulator.

Soundness standard

Whilst we agree that the trading book *should meet a safety and soundness standard equivalent to that used for the banking book*, we believe that it is an absolutely fundamental requirement the proposals explicitly recognise that trading book positions should, in general, attract different capital requirements compared to the same position held in the banking book. Setting the

soundness standard to 99.9% 1 year is not the same as setting the same absolute capital level for a given position regardless of where it is booked.

Trading Book Behaviour

As a firm with predominantly trading activity, we are acutely aware of the importance of strong risk management and measurement. In particular, we see mark to market as a core *discipline*, not just, as is more commonly perceived, a “valuation methodology”. As such, trading book positions are subject to active management on a daily basis with daily valuations. Traders and risk managers make decisions based on this information. Therefore we believe there should be explicit recognition that capital charges should be different for the same position if booked in the trading book rather than the banking book.

Constant level of risk assumption and Minimum liquidity horizon

The constant level of risk assumption is not adequate and cannot apply to trading book positions. We do not believe that a requirement to rollover positions to a one year horizon is appropriate for the trading book, since it does not reflect actual trading and risk management practice, either in *benign or stressed environments*.

It is clear that firms have been reducing trading positions and have not been attempting to take on new risk during the recent stressed period. For positions that are illiquid, concentrated and of low quality, capital charges should be increased. However we believe it is wholly inappropriate and inconsistent with the evidence of firms’ behaviour during the crisis, to presume that firms will consciously increase trading risk in stressed environments. Therefore we propose that capital should be set according to the applicable liquidity horizon and to a soundness standard of 99.9%.

In combination, prescribed minimum liquidity horizons, and the incongruent rollover to a single, arbitrary horizon, will, perversely, deemphasise the illiquid, low-rated and concentrated positions the Committee is rightly most concerned about in the capital calculation.

Netting restrictions

Basel has proposed that netting should only be allowed where positions refer to the same financial instrument, i.e. intra-obligor netting is no longer permitted. This requirement is burdensome and inconsistent with the AIRB framework which requires firms to consider credit exposures at the risk party level. Intra-obligor offsets should be permitted but there should be an explicit requirement that material basis risks should be adequately capitalised.

Trading book versus banking book

We strongly disagree with the suggestions to treat Trading Book positions under the Banking Book framework.

On the contrary, we would argue that the Banking Book treatment is inferior given its limitation to credit risk, coupled with less stringent requirements to risk manage on a frequent and dynamic basis. Positions accounted for using fair value that would be treated under the banking book framework would not require capital for material price risks. In downturn scenarios, where asset prices are depressed, banking book capital requirements would be insufficient. Also under the banking book approach, interest rate risk is addressed in the Pillar 2 framework only and does not necessarily require further capital. The banking book framework should apply only to held to maturity assets recorded at historical cost because the probability of default is the key driver of the value of such assets.

Therefore, we would suggest as an alternative, that assets that are valued on a fair value basis, but are booked in the banking book, should be subject to forward looking capital charges that capture the material price risks, and are not limited to credit risk charges. Such a regime should set capital requirements at a level higher than positions held in the Trading Book because, importantly, such positions carry all of the same price risks but have none of the discipline required under a rigorous risk management process in the Trading Book. Factors that are used to arrive at the fair value of an asset should also be used in assessing the potential value deterioration for the purpose of determining a risk-based capital requirement. This would be consistent with Basel's proposal to extend prudent valuation guidance to all positions subject to fair value accounting (para 9 of the MRF). Therefore any asset marked at fair value should be subject to capital charges that are aligned with the underlying risk factors, regardless of whether the asset is booked in the trading book or banking book. Only assets that are held at historical cost (less impairment), should be eligible for banking book treatment i.e. treatment that only capitalises against the default of the underlying name(s).

The above suggestion would need to be coupled with the increased scope as set out above i.e. that all material price risks for all trading book positions should be caught by the Incremental Risk Charge. For example, a less liquid tranchised credit position, whether booked in the trading book or banking book, will attract a capital charge to cover default risk, migration risk, interest rate risk and correlation risk. This would clearly be a better outcome than booking this in the banking book and attributing a 7% risk weight to the position according to the default risk only.

Stressed VaR

Purpose lacks clarity

The goal of the stressed VaR additional capital requirement is not clear. We do not believe the proposals clarify whether it is intended to address procyclicality or deficiencies in a firm's VaR model.

If the aim is to compensate for models which are not sufficiently responsive to changes in market conditions, we believe there are better ways to address that concern. For example, the plus factors for backtesting breaches could be increased. There is evidence which would suggest that firms with many backtesting breaches also suffered severe losses in their trading books over the recent period. Alternatively, as the Committee itself has recognised², some firms have used weighting schemes for historical data to ensure that VaR models are more responsive to changes in market conditions.

Event risk

Importantly, the stressed VaR measure does not capture any of the tail risks which have been central to market losses during the crisis. Tail events need to be captured by an increased scope in the IRC guidelines as set out above. We believe the increased capital levels resulting from the stressed VaR concept will provide a false sense of security. Although capital in the system will increase for trading book positions, there is still clear potential for some firms with less liquid and more risky (in terms of tail risk) positions to continue to have insufficient capital resources.

Risk insensitivity

The Stressed VaR concept will result in capital levels that are much less responsive to changes in risk. As such we believe the proposal is counter effective and inconsistent with the core Basel principle of a risk based capital framework. It is important that a risk based capital measure should capture and react quickly to risks. Without this, the proposals do not incentivise good risk management practice.

Perverse incentives

The Stressed VaR proposal incentivises a lower core VaR number and a simpler model. Models that have a fast decay are more reactive and responsive to a market stressed environment, and can lead to increased capital requirements of 2-3 times compared to benign economic environments. A stressed VaR measure therefore has level playing field issues in that firms with more reactive VaR measures will be penalised more than firms with less reactive VaR measures.

² Para 8, "Revisions to the Basel II market risk framework", January 2009

In closing, we wish to repeat our support of the efforts of the Committee, and to express our desire to assist the Committee in any way that would be helpful.

Yours sincerely

A handwritten signature in dark ink, appearing to read "Robert Charnley". The signature is fluid and cursive, with a long horizontal stroke at the end.

Robert Charnley

cc. Ms Norah Barger, Deputy Director, Division of Banking Supervision & Regulation, Federal Reserve System

Mr Thomas McGowan, Assistant Director, Division of Trading & Markets, Securities & Exchange Commission

Mr Paul Sharma, Director of Wholesale and Prudential Policy, Financial Services Authority