Morgan Stanley

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April 8, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1401
RIN 7100-AD61

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219
Docket No. OCC-2010-0003

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Comments/Legal ESS
RIN 3064-AD70

Re: Risk-Based Capital Guidelines: Market Risk

Dear Madam or Sir,

This letter contains Morgan Stanley's comments on certain aspects of the proposed revised Market Risk Capital Rules ("MRR") as presented in 76 FR 1890 (January 11, 2011). Morgan Stanley has participated in the process of producing the letter of the joint industry associations[1], and our comments supplement the ones found therein.

Morgan Stanley's overarching concern is related to the <u>proliferation of risk measures</u> used to compute regulatory capital. Risk measures set an important part of the relative price of undertaking different types of financial activity. Risk measures that apply to different populations, using inconsistent horizons and concepts, can set relative prices that distort financial activity, potentially towards riskier and sub-optimal behavior.

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[1] The industry associations are the Clearing House Association L.L.C., the International Swaps and Derivatives Association, Inc. (ISDA), the Institute of International Finance (IIF) and the Securities Industry and Financial Markets Association (SIFMA).

A simple example highlights this problem. Under the existing rules for VaR and under the proposed rules for the Incremental Risk Charge (IRC), banking organizations can estimate the risk measure including all relevant products (and their hedges), thereby producing an economically meaningful measure. However, a reasonable interpretation of the proposed MRR for the Comprehensive Risk Measure (CRM) suggests that only products that have received specific risk approval for VaR may be included in the CRM portfolio. This has the potential to create a perverse incentive, unique to correlation trading, to fail to hedge unapproved correlation products, since their approved, correlation-related, hedges might be forced to appear naked in CRM.

Morgan Stanley therefore seeks clarification about those positions that may be included in the CRM and IRC. We believe strongly that firms should be allowed to include all relevant positions in the sub-portfolios constructed to estimate these measures. We urge that, subject to appropriate policies and procedures, the firm be able to include both unapproved products and internal trades in these measures. This is particularly relevant to CRM, since correlation trading portfolios typically contain large gross notional amounts, and accordingly the measure is particularly sensitive to hedging.[2] Morgan Stanley recognizes that discretion to decide on portfolio characteristics must be limited by policies and procedures submitted to the agencies in advance, and that unapproved products included in these sub-portfolios will nevertheless continue to attract standardized charges.

The balance of this letter consists of responses to particular questions posed in the Proposed MRC Rules.

Question 1: The agencies request comment on all aspects of the proposed rule and specifically on whether and for what reasons certain aspects of the proposed rule present particular implementation challenges. Responses should be detailed as to the nature and impact of such challenges. What, if any, specific approaches (for example, transitional arrangements) should the agencies consider to address such challenges and why?

Morgan Stanley takes this opportunity to seek clarity on the proposed rule as it relates to the Stressed VaR framework. Recent Basel Committee documents have highlighted that the Stressed VaR calculation can and should use an un-weighted 12-month window of stressed financial market conditions, even if the VaR calculation applies a weighting scheme to the data.[3] One interpretation of the proposed rule is that it would be inconsistent with this guidance, and require firms that use weighting schemes to replicate the weighting scheme in Stressed VaR. Morgan Stanley supports the Basel Committee's provision, which encourages the use of models that adapt to adverse market conditions for VaR, without unduly penalizing them in Stressed VaR.

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[2] If the agencies insist on excluding unapproved products from the CRM, then it is critical that banks have discretion to exclude approved products that serve as hedges for the approved products (while taking the resulting standardized charges), in order to avoid splitting hedges.

[3] Basel Committee on Banking Supervision, *Interpretive issues with respect to the revisions to the market risk framework*, February 2011, p.2, question 8.

Question 2: The agencies seek comment on the appropriateness of the proposed applicability thresholds. What, if any, alternative thresholds should the agencies consider and why?

Morgan Stanley has no comment on this question.

Question 3: The agencies request comment on all aspects of the proposed definition of covered position.

Morgan Stanley supports the revised definition of "covered position," subject to the concerns expressed in the Joint Industry letter. The proposed definition is better aligned to economic fundamentals than the GAAP accounting approach.

Morgan Stanley agrees with the industry's concerns relating to the proposed definition of "securitization exposures." The proposed definition is so broad as to be effectively useless in distinguishing positions that are genuine securitization exposures from other forms of debt. The fact that the definition needs explicitly to exclude certain exposures in sections 5-7 itself reflects the overly broad definition of securitization in sections 1-4. The rule as written, in its application to the banking and trading books together, would likely lead to many thousand exemption requests from Morgan Stanley alone, and the capital costs of failing to approve the exemption requests would be in the tens of billions of dollars. The Basel definition capturing the ability of junior tranches to absorb losses without interrupting payments to senior tranches is, we believe, more appropriate.

Question 4: Under what circumstances should the agencies require a model-specific capital supplement? What criteria could the agencies use to apply capital supplements consistently across banks? Aside from a capital supplement or withdrawal of model approval, how else could the agencies address concerns about outdated models?

Morgan Stanley is not in favor of *ad hoc* capital supplements for specific models. Such supplements raise several concerns.

First, neither a discretionary nor a rules-based approach to capital supplements is likely to lead to desirable outcomes. Discretionary capital supplements introduce an additional layer of uncertainty into capital requirements and planning. As stressed earlier, regulatory capital requirements are an important component of decision-making by banking organizations and trading desks. While some elements of uncertainty in regulatory capital requirements are inevitable (for example, cyclical changes in VaR), discretionary changes based on supervisory decisions would introduce an additional element of risk. On the other hand, if the capital-supplements envisioned are rules-based, they will likely depend on criteria such as backtesting performance or market liquidity. But in this case, they will inevitably further increase the already undesirable pro-cyclicality of capital requirements. Therefore, neither discretionary nor rules-based capital supplements are desirable.

Second, the supplements could operate either at the level of individual banks, or at the level of the industry as a whole. Industry-wide capital supplements are likely to be a blunt tool which fails to reward development of suitable models by individual banks. Firm-specific capital supplements pose the risk of inconsistent application across banking organizations. This could have a range of undesirable outcomes. For example, banks that have gained relatively favorable capital treatment for particular models would also gain an artificial advantage over their competitors in those areas, potentially leading to unduly concentrated market share to the detriment of the overall stability of the system.

Morgan Stanley suggests that ongoing review, coupled with conditional extensions of model approval, is the best mechanism to ensure ongoing relevance of models. The conditions should be restricted to a limited set of clear criteria, to be completed within a specified period of time.

Question 5: The agencies request comment on any challenges banks may face in formulating the measure of trading loss as proposed, particularly for smaller portfolios. More specifically, which, if any, of the items to be excluded from a bank's measure of trading loss (fees, commissions, reserves, intra-day trading, or net interest income) present difficulties and what is the nature of such difficulties?

Morgan Stanley supports formulating the cleanest possible test of VaR performance, and to that end exclusion of non-risk elements of P&L is appropriate. Systematically stripping out such components, however, will require some time to implement, and we therefore urge regulators to phase in this requirement gradually. In particular, we advocate that these requirements be introduced strictly prospectively, so that systems are not required to calculate P&L excluding these elements on days before the introduction of the rule (for the purpose of creating a backtesting history).

Question 6: The agencies request comment on what, if any, challenges exist with the proposed subportfolio backtesting requirements described above. How might banks determine significant subportfolios of covered positions that would be subject to these requirements? What basis could be used to determine an appropriate number of subportfolios? Is the p-value a useful statistic for evaluating the efficacy of a bank's VaR model in gauging market risk? What, if any, other statistics should the agencies consider and why?

Morgan Stanley already backtests many subportfolios of its overall portfolio and shares the results of these backtests with the agencies. We believe that the existing level of granularity and formality is appropriate. The problem with adopting a prescriptive standard with respect to subportfolios is that *a priori* standards may not match internal risk management practices. Ideally, the subportfolios subject to backtesting should correspond to economically meaningful trading units of the firm, so that the regulatory backtests correspond to those discussed and understood by senior management. Backtests that cut across business areas or artificially split hedges are unlikely to be as revealing to regulators or management. Because different firms organize their business and trading units' hierarchies according to different logic, clear prescription is difficult.

However, guidance could be given along the lines that the agencies expect to see backtests of major business areas of the firm that meet a minimum level of VaR, such as a stand-alone VaR that is on average at least 15 percent of the total regulatory VaR of the banking organization.

Morgan Stanley supports the efforts of the agencies to extend consideration of the success of VaR models beyond the current focus purely on unconditional backtest exceptions. The p-value represents an interesting possible development in this direction. We are concerned, however, at introducing such a requirement without a clear understanding of how it might be used or what standards of statistical testing might be applied. The recent Basel Committee review of academic lessons for market risk measurement did not find a clear consensus concerning additional tests of VaR model performance.[4] In light of these uncertainties, Morgan Stanley suggests that this aspect of the NPR merits further consideration in pursuit of a more clearly articulated goal for additional backtesting requirements.

Question 7: What specific standards of creditworthiness that meet the agencies' suggested criteria for a creditworthiness standard outlined above should the agencies consider for these positions?

Morgan Stanley concurs with the concern expressed in the Joint Industry letter that satisfactory alternatives to ratings will be difficult to define in the near future. Consistent with our suggestions in Question 9, we believe the Loan To Value (LTV) ratio for underlying loans would provide a useful criterion for establishing creditworthiness of securitization or resecuritization positions.

Question 8: What, if any, specific challenges are involved with meeting the proposed due diligence requirements and for what types of securitization positions? How might the agencies address these challenges while still ensuring that a bank conducts an appropriate level of due diligence commensurate with the risks of its covered positions? For example, would it be appropriate to scale the requirements according to a position's expected holding period? How would such scaling affect a bank's ability to demonstrate a comprehensive understanding of the risks of a securitization position? What are the benefits and drawbacks of requiring public disclosures regarding a bank's processes for performing due diligence on its securitization positions?

The proposed due diligence requirements are punitive and severely cumbersome. Large firms may hold hundreds or thousands of securitization positions on their trading books at any point in time, and any given trade could also involve a very large number of separate securities. Doing detailed due diligence with respect to all of these securities is neither feasible nor economical. Nor can such requirements readily be scaled according to a position's expected holding period, in the absence of clearly defined standards for expected holding periods. Fundamentally, requiring explicit due diligence for market-makers is qualitatively different from imposing due diligence requirements on buy-and-

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[4] Basel Committee on Banking Supervision, *Messages from the academic literature on risk measurement for the trading book*, Workping Paper No. 19, 31 January, 2011.

hold investors such as asset managers or insurers, and is likely to reduce liquidity in effected markets.

If due diligence requirements are to be imposed on positions held in the trading book, these requirements should at a minimum recognize the differences in risk characteristics across different types of securitized assets, and should be imposed only on those securities which are relatively more risky. For example, due diligence requirements might be more appropriate for securities with an original LTV for the underlying loans greater than 90% and which are issued after 2010 than for older or less risky securities.

Contingent on imposing due diligence requirements on some risky securities, we believe that public disclosure regarding the due diligence process is appropriate and increases transparency in financial markets.

Question 9: What alternative non-models-based methodologies could the agencies use to determine the specific risk add-ons for securitization positions? Please provide specific details on the mechanics of and rationale for any suggested methodology. Please also describe how the methodology conservatively recognizes some degree of hedging benefits, yet captures the basis risk between non-identical positions. To what types of securitization positions would such a methodology apply and why?

Morgan Stanley suggests that a suitable non-model based approach would be to adapt the Supervisory Formula Approach to use original LTV of loans rather than agency ratings. Using historical analysis of losses and default correlations, capital charges could be calculated using standard copula methods, calibrated to the 99.9 percent tail level.

The challenge in the non-model based approach is to recognize hedging benefits appropriately. We suggest that hedging benefits for securitized exposures should be applied at the level of the disaggregated components of the exposures in order to give effect to netting benefits. Furthermore, we believe the following rules should apply:

1) If longs and shorts are both in synthetic space (index and single name CDS) and all the underlyings are same, the positions should be eligible for 20% of the capital charge of the worst leg.
2) If a synthetic position hedges a cash position but the underlying names are the same, the positions should be eligible for 50% of the capital charge of the worst leg. The basis widening between cash and synthetic even during the worst of the 2007/8 crisis was substantially less than 50%.

Ultimately, we favor allowing qualifying banks to adopt a CRM-style model-based methodology for securitization positions. Such an approach should specify that the model must:

- capture the behavior of the underlying collateral at loan level
- incorporate relevant macroeconomic variables (such as house prices and interest rates)
- incorporate historically observed volatility in observed prices such as the CMBX and the ABX

- project cash flows dependent on the simulated market variables and the particular characteristics of each securitization position.

Question 10: What are the benefits and drawbacks of the supervisory stress scenario requirements described above and what other specific stress scenario approaches for the correlation trading portfolio should the agencies consider? For which products and model types are widely applicable stress scenarios most appropriate, and for which product and model types is a more tailored stress scenario most appropriate? What other stress scenario approaches could consistently reflect the risks of the entire portfolio of correlation trading positions?

Morgan Stanley believes that the uses of the supervisory stress scenarios should be more completely articulated as part of the proposed rule. Morgan Stanley suggests that, as the main purpose of the supervisory stress scenarios is likely to be to benchmark the CRM, the agencies should adopt an approach similar to that used in the Comprehensive Capital Analysis program of the Federal Reserve. That is, the agencies should specify time periods to use to benchmark the shocks, and candidate risk factors for banks to use in specifying the scenarios, while making banks responsible for choosing and implementing the final form of the shocks. This approach ensures that the shocks chosen are comparable across banks, but are relevant to each bank's portfolio. As in the Comprehensive Capital Plan, the agencies will be able to benchmark shocks across banks to ensure comparable shock definitions are used.

We believe that prescriptive stress scenarios, focusing on particular types of shocks or particular products, are likely to be difficult to implement and may lead to misleading results. Implementation difficulties may arise because of the many ways in which different products may be modeled across institutions. Interpretation difficulties might arise for a variety of reasons, including particularly problems defining populations and splitting hedges.

Question 11: What, if any, specific challenges exist with respect to the proposed modeling requirements for correlation trading positions? What additional criteria and benchmarking methods should the agencies consider that would provide an objective basis for evaluating whether to allow a bank to apply a lower surcharge percentage in calculating its comprehensive risk measure? What are the advantages and disadvantages of the proposed floor approach and the other potential floor approaches described above? What other alternatives should the agencies consider to address the uncertainties identified above while ensuring safe and sound risk-based capital requirements for correlation trading positions?

Morgan Stanley notes that it is impossible to benchmark the CRM against actual experience, given the deep tail loss, at a relatively long horizon, that it purports to capture. Morgan Stanley suggests that, pragmatically, the agencies can take a two-pronged approach to benchmarking CRM results. First, does the distribution of market risk factor shocks that produces the CRM match reasonably well with historical experience at lower confidence levels, under shorter horizons, or in stress scenarios? For example, does the 99th percentile of weekly hazard rate shocks, on average, match the 99th percentile of empirical weekly hazard rate shocks? Do the moves in the tail of the CRM, for those risk factors which drive the CRM charge, broadly match the scale of moves in supervisory stress scenarios based on historical stress situations?[5] Second, is there any element of the pricing or market risk factor simulation technique that suggests that the deeper tail or longer horizon of the CRM is inadequately summarized by the shocks examined?

The approach in the proposed rule appears unduly punitive relative to Basel 2.5, is not risk-sensitive, and places US structured credit dealers at a disadvantage relative to their European counterparts. Nor does the surcharge appear consistent with usual practice, that more punitive charges are phased in gradually over time. In that regard, the objective of placing a particularly punitive charge on positions already in the portfolios of banking organizations appears not well founded. Rather than impeding the ability of banks to do business now, when capital is scarce and new credit structurings are rare, the more important objective should be to set appropriate rules before new structuring activity takes place. Therefore, Morgan Stanley does not see any advantage in the interim surcharge approach in section (2)(i), and instead believes the agencies should immediately adopt the floor approach described in section (2)(ii).

Question 12: The agencies seek comment on the effectiveness of the proposed disclosure requirements? What, if any, changes to these requirements would make the proposed disclosures more effective in promoting market discipline?

Morgan Stanley supports further disclosure requirements where such transparency leads to greater market understanding of positions and risks. We note, however, that it is not clear that certain types of disclosures, in particular those relating to model outputs, fall into this category.

A simple example is existing VaR disclosures. Because banking organizations employ windows of varying lengths in estimating VaR, different banks can report quite different VaRs for the same portfolio of positions depending on the state of the risk cycle. Our experience is that attempts to explain these differences in model methodologies often meet with limited success at best. At worst, such differences in model output could lead to a race to the bottom, to minimize VaR for a given set of exposures. Morgan Stanley therefore favors disclosure requirements that promote the greatest possible comparability across reporting banks.

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[5] Note that, because of standard diversification effects, the expected percentile rank of risk factors at the 99.9th percentile tail of the P&L distribution is not generally the 99.9th percentile of the stand-alone distributions. In particular, for risk factors that have relatively little influence on P&L in the tail, we expect the tail realization of the risk factor to be significantly less than the 99.9th percentile.

We appreciate the opportunity to provide our comments. Please feel free to contact us if you have any questions.

Yours sincerely,

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