

April 30, 2012

Via Electronic Mail

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, DC 20551
Docket No. 1438
RIN: 7100-AD-86

Re: Enhanced Prudential Standards and Early
Remediation Requirements for Covered Companies

Ladies and Gentlemen:

The Goldman Sachs Group, Inc. ("Goldman Sachs") welcomes the opportunity to comment on the Notice of Proposed Rulemaking ("the NPR")¹ entitled "Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies." The NPR sets forth the Proposed Rules ("the Proposed Rules") for implementing Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), as well as an introduction and overview ("the Preamble") setting forth the reasoning of the Federal Reserve Board ("the FRB") in support of the Proposed Rules.

Goldman Sachs has participated in the preparation of several comment letters written by industry trade associations, and we support the comments and recommendations in those letters.² Because some aspects of the Proposed Rules are of particular concern and importance to us, we have chosen to supplement those letters with our own.

¹ 79 Fed. Reg. 594 (Jan. 5, 2012).

² These include the letter authored jointly by The Clearing House Association L.L.C., the Securities Industry and Financial Markets Association, the Financial Services Roundtable and the American Bankers Association, as well as the letter from the American Bankers Association Securities Association.

We appreciate the continued efforts of the FRB to strengthen the resiliency of the country's financial system. However, as we discuss in this letter, parts of the Proposed Rules appear likely to damage, rather than strengthen, the systemic safety of the U.S. financial sector and ultimately the U.S. economy.

We support robust counterparty risk management practices. However, we do not believe that the Proposed Rules, in their current form, contribute to this goal. To achieve robust risk management, banks and regulators alike require a system that accurately captures counterparty credit exposures.³ The Proposed Rules fail to do so, because their single counterparty credit limit ("SCCL")⁴ provisions utilize two troublesome methodologies: the Current Exposure Methodology ("CEM") and the assignment of credit exposure to protection providers ("the substitution approach"). These two approaches suffer from several flaws that cause them to overstate counterparty credit exposures. Specifically, by using CEM, the SCCL provisions fail to provide appropriate credit for the benefits of netting, portfolio diversification and collateral; and by using the substitution approach, the SCCL provisions significantly overstate the exposure arising from the purchase of protection, from eligible providers, in the form of eligible guarantees and eligible credit and equity derivatives. This aggregate overstatement of exposure exaggerates the level of interconnectedness among financial firms.⁵

Single counterparty credit exposures are generally subject to a limit of 25% of capital for each of the financial institutions covered by the Proposed Rules ("covered companies"). For the largest financial firms ("major covered companies"), however, the Proposed Rules, without justification, set a limit of 10%. The stringency of this lower standard is intensified by the deficiencies in the CEM and substitution approaches.

The Proposed Rules could have wide-ranging negative economic consequences. They are likely to damage market liquidity, generating lower returns for investors and driving higher funding costs for corporate debt issuers, as well as higher transaction costs for activities like hedging interest rate and foreign exchange exposures. This is likely to harm U.S. economic growth and international competitiveness. We estimate that the liquidity impact to the

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- 3 Section 165(e)(3) defines "credit exposure" to a company to mean: (a) all extensions of credit to the company, including loans, deposits, and lines of credit; (b) all repurchase agreements and reverse repurchase agreements with the company, and all securities borrowing and lending transactions with the company, to the extent that such transactions create credit exposure for the nonbank financial company supervised by the Board of Governors or a bank holding company described in subsection (a); (c) all guarantees, acceptances, or letters of credit (including endorsement or standby letters of credit) issued on behalf of the company; (d) all purchases of or investment in securities issued by the company; (e) counterparty credit exposure to the company in connection with a derivative transaction between the nonbank financial company supervised by the Board of Governors or a bank holding company described in subsection (a) and the company; and (f) any other similar transactions that the FRB, by regulation, determines to be a credit exposure for purposes of this section.
 - 4 The SCCL provisions contained in the Proposed Rules are designed to implement Dodd-Frank's prohibition on a covered company having credit exposure to any "unaffiliated company" that exceeds 25% of the covered company's capital stock and surplus, or "such lower amount as the Board of Governors may determine by regulation to be necessary to mitigate risks to the financial stability of the United States" (emphasis added). The companies that are subject to the Proposed Rules are bank holding companies with total consolidated assets of \$50 billion or more, along with nonbank financial companies that the Financial Stability Oversight Council ("the FSOC") has designated, pursuant to section 113 of Dodd-Frank, for supervision by the FRB. Under Dodd-Frank, sections 165 and 166 also apply to any foreign nonbank financial company designated by the FSOC for supervision by the FRB, and to any foreign banking organization with total consolidated assets of \$50 billion or more that is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956, pursuant to section 8(a) of the International Banking Act of 1978. The largest financial institutions are those with total consolidated assets of \$500 billion or more, as well as designated nonbank financial companies as described above; these companies are subject to a more stringent 10% credit exposure limit with respect to each other.
 - 5 According to the NPR's Preamble, a primary goal of the SCCL provisions is to reduce "interconnectedness" among major financial firms, which it implicitly defines as concentrations of credit exposures: "The financial crisis also revealed inadequacies in the U.S. supervisory approach to single counterparty credit concentration limits, which failed to limit the interconnectedness among and concentration of similar risks within large financial companies that contributed to a rapid escalation of the crisis." 79 Fed. Reg. at 610.

corporate bond market alone would reduce real GDP growth in the U.S. by 15 to 40 basis points over a year. This, in turn, could raise the unemployment rate by 10 to 20 basis points, eliminating 150,000 to 300,000 U.S. jobs.⁶ Given the current economic environment, it is unclear what the FRB could do to offset these impacts through monetary policy.

The Proposed Rules are also likely to increase systemic risk, rather than reduce it as the FRB intends, in a number of ways. They are likely to constrain the development of clearinghouses (central counterparties, or “CCPs”), which runs counter to the Congressional intent expressed elsewhere in Dodd-Frank. The Proposed Rules could destabilize markets that are dependent on market making to provide essential liquidity, such as the corporate debt market. Moreover, because exposures to non-U.S. sovereigns are limited, the Proposed Rules could damage sovereign debt markets, especially during periods of stress.

Given these constraints, we would expect some financial activities to migrate away from U.S. markets or to shift outside the highly regulated official banking sector.⁷ The latter outcome would be dangerous: though it might appear to reduce system-wide risk, in practice a shift toward this sector could create situations analogous to those created by entities such as the monoline insurers during the last financial crisis.

We discuss these SCCL issues in greater detail in the first section of this letter, and then recommend mitigating actions the FRB can apply to the final rules to address these problems. We provide a more technical discussion of several of the flaws within SCCL in the Appendices.

We also highlight other key concerns regarding the requirements in the Proposed Rules for specific operating structures, public disclosures, remediation actions and unencumbered assets. These requirements impose potentially harmful constraints on financial institutions and regulators alike.

I. Shortcomings in the single counterparty credit limit approach overstate risk and interconnectedness

The technical flaws in CEM⁸ and the substitution approach together substantially overstate counterparty credit exposures when compared to more risk-sensitive methodologies, such as the Internal Model Methodology (“IMM”) that has been approved by the FRB in the context of capital requirements. The degree of overstatement depends on the nature of the portfolio and is particularly acute for interbank portfolios characterized by a large number of transactions and low net risk. A preliminary examination of 50 such portfolios indicates that the overstatement is in the range of four to eighteen times the actual counterparty exposures as measured by IMM.⁹

6 These estimates are based on a combination of our assessment of the impact on the corporate debt market and a modified version of the Goldman Sachs U.S. Economics Research Financial Conditions Index, which was adapted to allow for more precise calibration of the impact of wider corporate bond spreads.

7 Activity may, at least in the near-term, also move away from U.S. bank holding companies that are covered by the Proposed Rules to the U.S. operations of foreign banks, which are not subject to the Proposed Rules. Even when the FRB does propose rules that will cover those foreign institutions with significant U.S. operations, differences between the two sets of rules, and the timing of their implementation, may competitively disadvantage U.S. banks. We discuss this issue in more detail in Appendix C.

8 We discuss the calculations in the CEM methodology in detail in Appendix A.

9 We examined 50 counterparty portfolios; these were not selected scientifically, but rather were a convenient group of real-world portfolios. We think this analysis provides a clear demonstration of the potential overstatement of risk in the CEM and substitution methodologies. It

(footnote continued)

As a consequence, many financial institutions would already be well beyond their counterparty exposure limits if the Proposed Rules were implemented as written,¹⁰ even though in many cases, more accurate models would have indicated that counterparty exposures were well controlled. This problem is particularly acute for the largest financial firms subject to the stricter 10% limit.

Reliance on CEM rather than IMM seems incongruous with Dodd-Frank, which emphasizes improved risk management standards. IMM was developed, in the words of the Basel Committee on Banking Supervision, “in response to the limited risk sensitivity of CEM.” Regulators have broadly supported the use of IMM in the context of capital requirements, with the U.S. Treasury, the FRB and other agencies writing in their final Basel II rule on Risk-Based Capital Standards that “the advanced approaches [in reference to IMM] provide more substantial incentives for banks to improve their risk measurement and management practices than do the other approaches.” In its guidelines on valuing counterparty risk exposures, the U.K. Financial Services Authority wrote that IMM “provides the most risk-sensitive approach to calculating exposure values and ... is aligned to internal risk management practices.”¹¹ The IMM approach continues to be developed and to be made more conservative under Basel III, including model enhancements such as an increased margin period of risk and counterparty credit risk capital requirements based on stressed inputs. CCPs also use a variation of IMM to determine initial margin levels and concentration charges.

A. CEM and “substitution” contain multiple shortcomings that lead to risk overstatement

First, the CEM approach contained in the Proposed Rules fails to fully recognize the impact of legally enforceable bilateral netting on covered companies’ portfolios. These portfolios can be thought of in two ways. The first is as a series of stand-alone contracts that each generates a discrete exposure (the sum of the absolute value of these exposures is termed “gross exposures”); this approach does not take into account legally enforceable master netting agreements. The second is as an aggregate set of exposures that takes account of positions that offset each other and thus creates reduced actual counterparty credit risk under netting (“net exposures”); the positions may completely cancel each other so they create no actual net counterparty risk.

CEM employs the gross approach instead of the net one.¹² This means that even two trades that are exactly offsetting in term of risk exposures, that are subject to a legally enforceable qualifying master netting agreement,

(footnote continued)

does not, however, provide a reasonable basis to calculate the “normal” bias in CEM, and in fact the wide range of estimates (at four to eighteen times) indicates that such a calculation is unlikely to be meaningful, as the bias is simply too sensitive to the structure of the portfolio to be characterized in a simple manner.

- 10 See the letter relating to the Proposed Rules dated April 27, 2012, from The Clearing House Association L.L.C., the American Bankers Association, the Financial Services Forum, The Financial Services Roundtable and the Securities Industry and Financial Markets Association.
- 11 Basel Committee on Banking Supervision, “The Application of Basel II to Trading Activities and the Treatment of Double Default Effects” (2005), see <http://www.bis.org/publ/bcbs116.pdf> ; Department of the Treasury Office of the Comptroller of the Currency, Federal Reserve System, FDIC, Department of the Treasury Office of Thrift Supervision, “Risk-Based Capital Standards: Advanced Capital Adequacy Framework - Basel II” (2007), see <http://edocket.access.gpo.gov/2007/pdf/07-5729.pdf> ; Financial Services Authority explanatory note, “BIPRU 13: Counterparty risk” see <http://www.fsa.gov.uk/pubs/international/bipru13.pdf> ; Basel Committee on Banking Supervision, “Basel III: A global regulatory framework for more resilient banks and banking systems - revised version June 2011”.
- 12 A modest attempt is made to adjust for possible netting, but as the subsequent analysis shows, that adjustment is not nearly sufficient to account for the actual benefits of a valid master netting agreement.

and that therefore create no counterparty risk in any economic or market environment, will still be deemed to generate potentially significant counterparty credit exposures under CEM.

It is possible to get a sense of the size of the overstatement problem by taking a representative covered company's existing portfolio and netting it down by using a TriOptima¹³-style approach, a netting method that is recognized by the FRB and encouraged by the CFTC.¹⁴ That netted portfolio can then be re-run through CEM and the result compared to the original gross portfolio. For the portfolios described earlier, this analysis indicates that using gross rather than net portfolios – without addressing any of the other drawbacks of the proposed approach – overstates the counterparty credit exposure by roughly 40% to 50%.¹⁵

Second, by calculating CEM for each individual position rather than for the portfolio in the aggregate, CEM does not take into account the risk-reducing effects of portfolio diversification, causing it to overstate risk even if it were to assess the netted portfolio. This overstatement is particularly large in the context of portfolios with a large number of positions and low net risk – the type of portfolio that typifies interbank exposures. In a 2011 study, the International Swaps and Derivatives Association (“ISDA”) found that CEM understated the benefits of diversification in interest rates portfolios by a factor of roughly 2.5.¹⁶

Third, as the Proposed Rules are written, CEM does not fully recognize mitigants that have been put in place to manage counterparty risk. Most importantly, CEM does not appropriately take into account the benefits of future collateral (in the form of variation margin), which reduces potential future losses. This approach overstates risk and is inconsistent with how the interbank market actually operates. Margin is designed to cover exposure up to the last margin payment; because positions are typically marked to market at least daily, this means that exposure is generally covered up through the close of the last business day before default. The remaining exposure is limited to

13 TriOptima is a company that provides post-trade derivatives infrastructure. It offers a service called Tri-Reduce, which delivers portfolio compression services for interest rates, credit and energy derivatives. When using this service, two or more broker-dealers each submit a portfolio of trades, which are matched to determine the trades eligible for compression, with the aim of creating a new portfolio with the same economic characteristics, but with a lower gross notional value and number of trades. Broker-dealers specify how much change in market risk they will accept, if any, and across what tenor periods. These tenor periods are called “buckets” and may be in three-month, six-month or other increments of time out to 50 years. The result is risk-neutral within the tolerances set by all participants. Once participants have accepted the TriOptima proposal, the redundant transactions are legally terminated.

14 In March 2011, major derivatives dealers committed to engage in portfolio compression, in response to strong encouragement from the OTC Derivatives Supervisors Group (“ODSG”), an interagency group of regulators including the Federal Reserve Bank of New York and the CFTC. See industry letter to the Federal Reserve Bank of New York, p. 18-20, “portfolio compression” (<http://www.newyorkfed.org/newsevents/news/markets/2011/SCL0331.pdf>), and the Federal Reserve Bank of New York response (<http://www.newyorkfed.org/newsevents/news/markets/2011/an110405.html>). See also CFTC, Notice of Proposed Rulemaking: Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 81519, 81625-6 (Dec. 28, 2010).

15 TriOptima netting is not implemented in all markets today. This in part reflects the work required to implement it, such as developing algorithms and other necessary elements of the netting process. Even in markets where TriOptima netting operates today, differences in how participating firms manage the impact of derivatives outside of market risk, such as differences in funding preferences and practices, can make compression cycles impactful to participants' revenues and can make reaching agreement among counterparties more complex. Even where TriOptima may not currently be implemented, the risk profiles of each participant can be captured by the netted portfolio, even if no trades are actually canceled.

16 See <http://www2.isda.org/attachment/MzlwMA==/CEM%20vs%20EPE%20Research%20Note%20final.pdf>, which analyzes a variety of randomly constructed portfolios of rates products. The measure of diversification used is the ratio of model-based Expected Positive Exposure (“EPE”) to the sum of the EPEs of the individual positions in each portfolio. The average diversification for large portfolios in the analysis is 4%. For smaller, undiversified and unmargined portfolios, the EPE/CEM is near 100%. For large, diversified and unmargined portfolios with a 4% diversification ratio, the EPE/CEM is no greater than 40%. Based on this, we estimate that CEM understates the benefit of diversification by a factor of roughly 2.5.

any changes in market value that occur between the last margin payment and the time the risk is replaced following a counterparty default. This period of time is usually measured in days rather than weeks. CEM takes a different approach, with the potential future exposure component of the CEM calculation assuming that no collateral would be collected through to the final maturity date of the contract. In practice, this would not occur: if a counterparty failed to comply with the terms of the contract, a default would be declared well before the final maturity date, and the trades under the qualifying master netting agreement would be closed out and settled on a net basis.

The use of variation margin to significantly reduce counterparty risk has proven itself over an extended period, even in the most severe circumstances. It sits at the core of risk management not only in the interbank market, but also for clearinghouses, and U.S. banking regulations have recognized the risk mitigation provided by collateral in several contexts, including capital requirements and lending limits applicable to national banks. If CEM more appropriately recognized the value of variation margin in assessing counterparty credit risk, its assessment of that risk in some representative portfolios could fall by as much as 80%.¹⁷

These three factors – netting, diversification and variation margin – interact in complex ways, so that their effects cannot simply be summed to understand their cumulative impact. Yet it is clear that, as the Proposed Rules are written, CEM’s treatment of these three factors leads it to significantly overstate credit exposures and therefore interconnectedness. Ultimately, this means that an appropriate measurement requires a more risk-sensitive approach, such as the FRB-approved IMM methodology.

The overstatement of risk is compounded by the Proposed Rules’ treatment of credit exposures to eligible protection providers that result from the purchase of protection in the form of guarantees or credit and equity derivatives (“the substitution approach”).¹⁸ A simple example will best illustrate the problem arising from this approach. Bank A is a covered company that purchases, from Bank B (which is an eligible protection provider under the Proposed Rules), a CDS contract referencing \$100 million of Company C’s investment grade debt, to hedge Bank A’s existing position in Company C’s debt. Under CEM, Bank A would have an exposure to Bank B of \$5 million for the CDS,¹⁹ based on the assessed risk that Bank A has exposure to Bank B only in the event that Company C defaults, and based on any collateral already received (beyond the first day of the contract) to cover losses. But because of the substitution approach, Bank A’s credit exposure to Bank B would also be increased by the full \$100 million of the reference loans, for a total of \$105 million. This is \$5 million more than the actual *maximum* loss that Bank A could possibly incur – a loss that Bank A would realize only if it had no collateral to mitigate this exposure *and* if both Bank B and Company C defaulted simultaneously, with no recovery from either party.²⁰ The \$105 million exposure is also more than 20 times what the counterparty exposure to Bank B would be if Bank B were an ineligible protection

17 We calculated the 95th percentile exposure over the life of trades in a representative portfolio and compared those results to the 95th percentile exposure over a two-week period (assuming it would take two weeks to close out the risk from terminated trades after a credit event and assuming margin payments were made up until that credit event).

18 Dodd Frank does not require that covered companies “substitute” one counterparty’s credit exposure for that of another. The statute does require the inclusion in “credit exposure” of guarantees written by the covered company, but does not mention the treatment of guarantees purchased by the covered company.

19 CEM = Current Exposure (CE) + Potential Future Exposure (PFE), as we discuss in more detail in Appendix A. Thus the CEM calculation for a fully collateralized \$100 million notional contract (assuming this contract is based on an investment grade underlier and is Bank A’s sole contract with Bank B) is as follows: (CE = 0) + (PFE = 0.4 * 100mn * 0.05 + 0.6 * 100mn * 0.05 * 1) = 5mn.

20 It is also more than the maximum exposure Bank A would have to Bank B if it simply held \$100 million of Bank B’s bonds without purchasing protection on them.

provider (such as a hedge fund) – or between 15 and 50 times the counterparty exposure generated by the more risk-sensitive IMM, depending upon the maturity of the CDS.

As we noted earlier, our analysis indicates that the problems with CEM and the substitution approach, taken together, overstate risk in representative portfolios by a factor of four to eighteen times, depending on the nature of the counterparty, when compared to the more risk-sensitive IMM.

Finally, as we discuss in more detail in Appendix B, the Proposed Rules' aggregation requirement also creates difficulties by casting the net too broadly. It requires covered companies to aggregate all "controlled" subsidiaries, defined as 25% or more of the voting shares or equity, which will be difficult for covered companies to do in practice.

B. The 10% limit on major covered companies compounds the overstatement

Compounding the overstatement of interconnectedness is the fact that the Proposed Rules, without justification, set a 10% limit on SCCL exposures among the largest financial firms. This 10% limit would be quite stringent even if it were applied against a measure of risk and interconnectedness that more closely reflected economic reality than CEM does. The limit is considerably more restrictive than the 25% limit that is required by the statute and that the FRB intends to impose on smaller U.S. financial firms. It is also more stringent than the limits in other major financial jurisdictions.²¹

Because this 10% limit appears without justification in the Proposed Rules, it is impossible to assess whether there is a less expensive or more efficient way to attain the FRB's goal.²² Given the lack of rationale for the lower limit, or an appropriate demonstration that the limit meets the statutory standard of "necessary," the 10% limit appears not only to be punitive, but also arbitrary and capricious.

II. Technical flaws could create real-world harm

If the Proposed Rules are implemented as written, these technical flaws will likely hurt both U.S. markets and the U.S. economy. They are likely to raise the cost of capital for U.S. companies, which will reduce economic growth and undermine the international competitiveness of the U.S. They are also likely to raise transaction costs for end-users, such as companies that hedge a variety of market risks, and to lower returns for investors. Moreover, while the Congressional intent behind Section 165, and indeed behind Dodd-Frank as a whole, was clearly to reduce systemic risk, the Proposed Rules may inadvertently increase it instead.

21 Substitution is not required in the E.U., where counterparty exposures are generally limited to 25% of the bank's capital base; nor are they required in the U.K., where the rules also recognize and adopt the regulator-approved exposure calculation models and provide exemptions for CCPs and certain low-risk sovereigns. In Switzerland, the highest limit for individual risk concentrations is 25% of eligible capital. In Japan, single customer exposure limit rules apply mainly to loans, guarantees and capital investments and do not extend to off balance sheet credit risk and derivatives, and the exposure limit to a single counterparty is 25% while on a "group" basis it is 40%. In Hong Kong, institutions supervised by the Hong Kong Monetary Authority are subject to a statutory limit of 25% of their capital base, but various exemptions are available; notably, exposures to other authorized institutions are exempt.

22 The Proposed Rules go beyond the statute by imposing the 10% limit on major covered companies, despite the fact that under the statute any such lower limit must first be determined, by regulation, to be "necessary." There is no explanation in the Proposed Rules as to why the 10% limit would mitigate risks to financial stability, or why other approaches would not be sufficient, (i.e. why 10% is "necessary"), nor is there any explanation as to why \$500 billion is an appropriate threshold for this lower limit.

A. Higher funding, hedging and transaction costs

Any interference in banks' ability to effectively hedge the risks they assume on behalf of their clients will reduce their ability to provide liquidity. This will translate into higher funding, hedging and transaction costs for the clients themselves.

The SCCL mis-measurement issues appear particularly acute in the economically vital \$7.8 trillion corporate debt market, in which U.S. corporations raise more than \$1 trillion in financing each year. As the Proposed Rules are written, SCCL-driven limitations on covered companies' ability to reduce their own risks by transacting with each other are likely to reduce bond market liquidity and thus widen bid/offer spreads. If this occurs, corporate borrowing costs would rise. Facing a higher cost of capital, U.S. firms would become less competitive than their global peers and less able to expand and create jobs. As we indicated earlier, the impact on the corporate bond market alone could drive the elimination of 150,000 to 300,000 American jobs. These estimates are based on a combination of our assessment of the impact on the corporate debt market and a modified version of the Goldman Sachs U.S. Economics Research Financial Conditions Index, which was adapted to allow for more precise calibration of the impact of wider corporate bond spreads. Smaller companies that lack access to alternative sources of capital – and that drive job creation – would be hardest hit.

Consider an example of a covered company underwriting a corporate bond issuance on a fully-bought basis. The covered company will assume the full risk of the underwriting and distribute that risk over time as it sells the bonds to clients; during that time it will need to hedge the risk of its remaining holdings. The most effective way to hedge may be to purchase CDS referencing the issuer, most likely from one of the other covered companies, which tend to be the primary providers of CDS. However, if the covered company is credit constrained against the major CDS providers (as it certainly would be under limits calculated according to CEM), it will need to turn elsewhere to hedge. The resulting hedge is likely to be less effective or more expensive, because the covered company must rely on multiple smaller counterparties, many of whom will lack depth in this market and many of whom may be less creditworthy than larger counterparties. Speed of execution also affects the transaction cost, since the covered company will typically need to open the hedge quickly and then close it quickly as the underwriter sells the bonds. Hedges of this sort are easily managed within the interbank market where liquidity and velocity are highest, but are inappropriate for investors with a longer-term horizon to assume. To compensate for its own higher risk or to cover its own higher costs, the covered company will pass along its higher hedging costs to the corporate client via a larger new issue discount. This will reduce the amount of capital the company can raise and deploy.

The Proposed Rules are likely to increase transaction costs in many markets. For instance, we estimate that companies whose bonds have a liquid CDS market benefit from lower borrowing costs. By impairing liquidity in the corporate CDS market, the Proposed Rules could increase borrowing costs, which we estimate could translate into a \$5.7 billion increase in annual borrowing costs for corporate new issues over the next decade. Investors would also suffer from reduced liquidity and wider bid/offer spreads, and annual transaction costs in this market alone could rise by \$13 billion.²³ In the interest-rate swaps market, lower liquidity and higher transaction costs could make these

23 We derive the \$5.7 billion estimate by regressing new issue returns against a series of factors, including whether the corporate had CDS. With statistically significant results, issuers that did not have actively traded CDS paid 25 basis points more to borrow funds, on average, than those that did. That allows us to estimate the impact on the corporate debt market of making the CDS market materially less liquid as \$2.8 billion (0.0025 * \$1.1 trillion). If we also assume that CDS bid/offer spreads widen by 10 basis points, this translates to an incremental cost of \$2.9 billion (5 basis point spread widening (50% of bid-offer widening) * 0.75 (because the cash market will not react as strongly as
(footnote continued)

products too expensive for some corporate debt issuers, leaving them holding unwanted pro-cyclical interest rate exposures.

There are distributional consequences to the Proposed Rules as well. While covered companies may be able to move the most liquid CDS contracts to CCPs, other contracts referencing smaller companies, particularly in the technology and utility sectors, are illiquid and therefore poorly suited for clearing. This means that the liquidity impact of the Proposed Rules will likely be particularly acute for U.S. corporations in these sectors and for those with smaller market capitalizations. In general, larger, multi-national borrowers will have access to more competitive financing from foreign banks and international financing markets. But smaller and mid-sized U.S. companies that cannot access offshore capital will likely be left at a competitive disadvantage. In addition to higher funding costs, they will also face higher hedging costs in managing risks relating to interest rate, foreign exchange and commodity exposures. If they are priced out of those markets, they may be left holding un-hedged risks that increase the volatility of their earnings.

B. Higher risk of systemic dislocations

The Proposed Rules could inadvertently disrupt markets, particularly those where market making provides essential liquidity during periods of stress, such as the corporate debt market, or those in which CCPs play a critical role. This is because market makers might quickly run up against the single counterparty credit limits during stressed markets characterized by significant or largely one-sided client transactions.

The fact that counterparty limits are imposed on exposures to CCPs²⁴ could be destabilizing. In a stressed market where participants are concerned about availability of dealers' capacity with clearinghouses, the existence of these limits could incentivize a first-mover advantage that could accelerate a sell-off. For instance, if a client that is reducing significant exposure to a cleared product through a standard novation process believes that one of its primary dealers is near its limit with a CCP, the Proposed Rules will encourage the client to accelerate its selling so that it can use that dealer's remaining CCP capacity while it is still available. Once that capacity is gone, pressure will shift to the next dealer that is close to its limit with the CCP, and so on, until ultimately no major bank will be able to trade with the clearinghouse. Such activity could create "flash-crash" type behavior, and could significantly destabilize a particular security or market.

We believe CCPs should be exempted from the SCCL provisions because they are designed to be resilient against loss and are subject to substantial oversight. We also believe they should be exempted because more derivatives trading will need to flow through CCPs in the future, even though the eligibility, terms and conditions for clearing are still developing today,²⁵ reflecting the Dodd-Frank mandate that all OTC derivatives contracts for which

(footnote continued)

the CDS market to the Proposed Rules) * \$1.15 trillion annual corporate issuance * 6.5 average duration). The same calculation can be used to determine the incremental cost to investors of \$13 billion (10 basis point CDS spread widening (50%) * 0.75 cash bid/offer widening * \$5.2 trillion annual volume traded * 6.5 average duration).

24 While Sections 165 and 166 of Dodd-Frank do not explicitly address CCPs, the Proposed Rules include exposures to CCPs in credit concentration limits, which would subject them to a 25% exposure limit.

25 The extent of clearing is difficult to ascertain, but the Financial Stability Board's report on "Implementing OTC Derivatives Market Reforms" (2010) provides estimates as of September 2010. As a share of notionals outstanding, CCPs cleared 31% of interest rate derivatives, including 47% of interest rate swaps, 20%-30% of commodity derivatives and 13% of CDS contracts. No equity derivatives or foreign

(footnote continued)

clearing is available must be cleared.²⁶ As a result, we anticipate that the volume of trading between CCPs and covered companies could be significantly larger than it is today. Covered companies may already be constrained with CCPs when exposures are calculated under the Proposed Rule's methodology, making it all the more likely that they will quickly reach their credit limits with CCPs in the future as clearing expands.

In fact, by including exposures to CCPs in the concentration limits, the Proposed Rules could discourage the use of CCPs. Congress recognized the inherent benefits of netting that clearing can provide, and this section of the Proposed Rules seems to contradict the Congressional intent expressed in Dodd-Frank to increase the number of transactions flowing through CCPs. Undoubtedly, given the high barriers to entry for CCPs, it will take time for more clearing capacity to become available. The proliferation of multiple smaller CCPs in response to these constraints is not an optimal policy outcome; it would almost certainly increase systemic risk, given that size, capital requirements and stringent clearing membership standards are critical determinants of safety for CCPs.

By failing to exempt foreign sovereigns from the credit exposure limits,²⁷ the Proposed Rules also have the potential to weaken sovereign debt markets, especially during periods of stress. During such times, primary dealers are likely to see strong client selling ahead of a sovereign debt auction, which would raise their sovereign exposures. Primary dealers that are covered by the Proposed Rules might find it impossible to fulfill their obligation to stabilize the market and accept inventory. This could potentially cause them to withdraw from acting as primary dealers, which would further undermine the subsequent auction and could disrupt the broader market. Even in less stressed periods, limiting covered companies' ability to accept collateral in the form of non-U.S. sovereign debt could distort and undermine confidence in these critical markets.

The Proposed Rules could also harm systemic safety by moving activity away from U.S. regulators' oversight. In some markets, activity might migrate to foreign banks or shift outside the highly regulated official banking sector. This could substantially reduce U.S. regulators' oversight, while still leaving the U.S. economy exposed to the risk.

(footnote continued)

exchange derivatives were cleared, according to the report. The report notes that it may underestimate the volume of cleared trades because some trades may have been netted into a smaller number of trades.

- 26 The statutory intent of Title VII was to promote clearing as a means of reducing outstanding exposures through the inherent netting that results from central clearing. It was also expected that clearing would reduce leverage through the use of standardized daily margining, increase transparency and increase regulatory control over the derivatives markets. Title VII addresses the systemic risks that may arise from CCPs by granting the FRB and other Federal regulators broad authority to establish standards for, and to monitor, the safety and soundness of CCPs. For instance, a derivatives clearing organization (DCO) that clears swaps must register with the CFTC and comply with 18 "core principles" in the Commodity Exchange Act (CEA), as well as CFTC regulations. These core principles cover membership and governance standards, product eligibility, risk management, margin requirements, operational and settlement issues, default rules, dispute resolution and other issues. The CFTC efforts are intended to "to enhance legal certainty ... to strengthen the risk management practices of DCOs, and to promote financial integrity for swaps and futures markets." CFTC, Final Rule: Derivatives Clearing Organization General Provisions and Core Principles. 76 Fed. Reg. 69334, 69335 (Nov. 8, 2011). The CFTC also requires that a DCO must be able to withstand the default of a member "creating the largest financial exposure in extreme, but plausible, market conditions." 17 C.F.R. § 39.11(a)(1). In addition, under Title VIII, the FSOC has the authority to designate major CCPs as "systemically significant financial market utilities." This allows the SEC and CFTC to prescribe risk-management regulations and capital requirements for these CCPs and gives the FSOC oversight authority over the stringency of the SEC and CFTC regulations.
- 27 Dodd-Frank does not require the FRB to extend concentration limits to foreign sovereigns, mandating the adoption of concentration limits only with respect to exposures to other "companies." The term "company" is not specifically defined in the statute, but would not generally be understood to include a sovereign entity. The NPR acknowledges this, but draws on the FRB's general "safety and soundness" authority to include foreign sovereigns in the definition of counterparty. The Proposed Rules explicitly exempt U.S. federal obligations, on the other hand, as well as the obligations of Fannie Mae and Freddie Mac (as long as they are subject to conservatorship or receivership), from the credit concentration limits. Proposed Rule 292.97(a)(2).

Pushing activity into less highly-regulated entities might appear to lower system-wide risk, but in practice it could create situations analogous to the monoline insurers during the last financial crisis.

III. Proposed modifications to the SCCL approach

To address these issues with the SCCL approach contained in the Proposed Rules, we encourage the FRB to make several modifications in the final rules:

1. We recommend that the FRB, before finalizing the rules, conduct a full quantitative impact study (“QIS”) on the overstatement of exposure and interconnectedness under the SCCL approach, and the implications of that overstatement for U.S. financial markets and U.S. economic activity.
2. We urge the FRB to apply a 25% limit on SCCL exposures to all covered companies, regardless of asset size. The FRB should first monitor the impact of a 25% limit in the context of the many other regulatory reforms affecting U.S. financial markets before determining whether, at what level, for whom and when a lower limit should be imposed.²⁸
3. We recommend that the FRB allow covered companies to apply the FRB-approved IMM approach instead of the CEM methodology when calculating single counterparty credit exposures.²⁹ Any necessary adjustments should be made by improving the IMM models themselves, rather than by replacing them with a less sophisticated approach that overstates credit exposures. Alternatively, the FRB might consider applying individual counterparty-level stress testing. This would involve developing stress-test parameters similar to what the FRB uses in its Comprehensive Capital Analysis and Review (“CCAR” or “stress tests”) and applying them to assess the portfolio of risks associated with a single counterparty. The FRB would determine which stress factors would be applied to the single-counterparty portfolio, and the portfolio would then be re-priced daily on that basis. The outcome would be compared daily to the relevant single counterparty credit limits and assessed on that basis. A stress-test approach would have several benefits: it would be consistent across covered companies, it would take collateral, legally enforceable netting and portfolio diversification into account, and it would complement the CCAR stress tests.
4. We believe that the substitution approach is unnecessary, given that an appropriately calibrated and effective counterparty credit exposure model should already capture the risk associated with eligible guarantees and eligible credit and equity derivatives. We recommend that the FRB first conduct a QIS to assess whether there are specific circumstances that might not be captured by these models and that thus might require the use of the substitution approach, and then tailor the final rule to address those specific cases only.
5. We recommend excluding clearinghouses from the proposed concentration limits given the special role they play and the extensive oversight to which they are already subject. Alternatively, we recommend deferring the

28 The FRB asked for comment on this issue in Question 29 on page 616 of the NPR, in which it asked what other limits or modifications to the proposed limits on aggregate net credit exposure the Board should consider.

29 The FRB asked for comment on this issue in Question 38 on page 618 of the NPR. We would emphasize that the use of CEM will require a new and parallel risk measurement system, in addition to current risk and capital measurement systems, and that such a system would need to have contemporaneous monitoring capabilities. This will impose significant incremental costs, not only for covered companies, but also for the FRB itself in terms of monitoring and auditing. A new system may also create uncertainty and operational risks. While we already use a methodology similar to CEM in the calculation of risk-weighted assets under Basel I, we do this on a post-trading basis, rather than on the pre-trade ongoing basis that would be required by the Proposed Rules.

inclusion of CCPs from the application of the Proposed Rules until the FRB can observe and assess the effects of other regulatory initiatives on CCPs.³⁰

6. We recommend that credit exposures to high-quality foreign sovereigns, as defined according to criteria to be established by the FRB, should be exempted.³¹
7. As we discuss in more detail in Appendix B, to address the fact that the Proposed Rules overstate exposures by requiring covered companies to aggregate all “controlled” subsidiaries when calculating credit exposures, we recommend that the definition of “control” be limited to subsidiaries that are consolidated for financial reporting purposes.³²

Extended conformance period could mitigate the impact of the Proposed Rules to the economy

We urge the FRB to allow an extended conformance period for the SCCL rules. At a minimum, we suggest that the FRB use the authority granted to it in Dodd-Frank to extend the conformance period to July 2015. With the final rules unlikely to be issued before late 2012, we see a risk of significant market disruptions if covered companies are simultaneously forced to reduce their exposures to each other in less than a year.

We also urge the FRB to phase-in the implementation of the rules over an additional five years beyond the effective date of July 2015. The FRB could do so by adopting the final rules with an effective date of July 2015, implementing monitoring of covered companies’ credit exposures once the rules become effective, and establishing an extended transition process under the final rules for the application of the new limits.³³

This additional time would allow covered companies to carefully reduce their excess exposures. Some exposures would mature; more products could become eligible for multi-lateral netting; and CCPs’ capacity to clear more products would expand. Allowing time for this to occur would reduce the risk of “fire sales” or serious market disruptions. We believe that providing this opportunity for an orderly restructuring of existing positions is clearly in the public interest and is fully consistent with the Dodd-Frank objective of reducing the risk that the failure of any one covered company would contribute to the failure of another.

The FRB has indicated in the NPR³⁴ that it intends to propose rules “shortly” to implement the requirements of Section 165(e) on foreign banking organizations. To avoid competitive disadvantages for U.S. companies, we believe it is critical that the Proposed Rules do not become effective in any way before the corresponding rules for foreign banking organizations have become effective, as we discuss further in Appendix C. We also urge the FRB to be cognizant of the competitive disadvantages that uneven application of the final rules would create for U.S. financial institutions.

30 The FRB asked for comment in Question 39 on page 618 of the NPR and in Question 60 on page 622 of the NPR.

31 The FRB asked for comment on this issue in Question 26 on page 615 of the NPR.

32 The FRB asked for comment on this issue in Questions 22 and 23 on page 614 of the NPR.

33 The FRB asked for comment on this issue in Question 21 on page 614 of the NPR.

34 NPR, 77 Fed. Reg. at 595.

IV. Other key concerns with the Proposed Rules

Beyond SCCL, we have concerns about several other provisions in the Proposed Rules. We highlight the key issues below:

A. Regulation should not interfere with covered companies' freedom to choose an effective operating structure

While we support improvements to prudential standards for risk management, we note that robust risk management practices can take multiple forms, and we believe that covered companies should have the flexibility, under regulatory supervision, to adapt their risk management structures over time to meet changing business conditions. We believe that the prescriptive approach in the Proposed Rules interferes with covered companies' ability to structure themselves most effectively, and takes a "one-size-fits-all" approach that fails to capture diversity across covered companies. We also believe that the Proposed Rules blur the distinction between the role played by covered companies' boards of directors (which have oversight responsibilities and protect the interests of shareholders) and the role played by management teams (which make business and operational decisions). Blurring these roles creates operational complexity and reduces the effectiveness of both.

Thus, we recommend that the final rules remove the requirement that the board of directors and the board's risk committee have operational responsibilities, such as liquidity risk management. We also recommend that the final rules eliminate the requirement that the Chief Risk Officer report directly to the Chief Executive Officer or to the risk committee of the board, as different reporting lines may be more effective within different companies.³⁵

We also urge that the final rules not preclude covered companies from managing liquidity in a manner that is most relevant for their business. For example, rather than require a specific type of cash flow projections, we believe the rules should allow each covered company to formulate liquidity and funding projections in a manner that is most appropriate for its business model, generating projections that are relevant to the way it manages liquidity.³⁶

B. Public disclosure should be balanced by the protection of highly sensitive information

Dodd-Frank requires annual supervisory stress testing and semi-annual company-led stress testing, the "summary"³⁷ results of which must be made public. We support the use of forward-looking stress tests as both a management and a supervisory tool. However, we encourage the FRB to carefully consider the substance and timing of the associated disclosures, given market sensitivity to and potential misuse of this information.

35 The FRB asked for comment on this issue in Questions 65 and 66 on page 624 of the NPR, and in Question 69 on page 625.

36 The FRB asked for comment on these issues in Questions 10 and 11 on page 605 of the NPR, and in Question 16 on page 611.

37 The summary is required to include the following information: (1) a description of the types of risks being included in the stress test; (2) a high-level description of scenarios developed by the company under the Proposed Rules, including key variables used; (3) a general description of the methodologies employed to estimate losses, pre-provision net revenue, allowance for loan losses and changes in capital positions over the planning horizon; and (4) aggregate losses, pre-provision net revenue, allowance for loan losses, net income and pro forma capital levels and capital ratios (including regulatory and any other capital ratios specified by the FRB) over the planning horizon, under each scenario (baseline, adverse and severely adverse). Proposed Rules § 252.148(b).

We recommend that public disclosures of stress test results be limited to the severely adverse economic scenario.³⁸ By requiring baseline case disclosures, the Proposed Rules as written effectively require covered companies to disclose earnings guidance, and could enable the reverse-engineering of confidential planned capital actions and other strategic initiatives. And given that the adverse scenario results are effectively subsumed within the severely adverse scenario, we are concerned that disclosure of the adverse scenario results could actually create more confusion, and thus undermine the goal of improving transparency.

C. The FRB should retain its flexibility in determining event-specific remediation actions

The circumstances surrounding the insolvency of a major financial institution are likely to be unique, and we are concerned that some of the predetermined remediation efforts contained in the Proposed Rules might actually hasten, rather than prevent, the failure of financial institutions in certain circumstances. To reflect this, we encourage the FRB to retain its discretion under its existing prudential and supervisory authority to respond to each event differently, and to tailor crisis-specific remediation actions accordingly.³⁹

D. The final rules should redefine “unencumbered assets”

In defining “unencumbered assets” for the purpose of the proposed liquidity requirements, the NPR states that assets that are co-mingled with, and/or hedge a trading position (“hedge assets”) do not qualify for inclusion in a firm’s pool of highly liquid assets.⁴⁰ The definition seems to assume that firms must actually sell an asset in order to generate liquidity from it, although selling would eliminate the hedging benefit of the asset. This stance is not consistent with the economic reality of liquidity risk management. Hedge assets are available to support liquidity in the same way that a pool of segregated liquid assets would be, and the fact that an asset is co-mingled with, or hedges, a trading position does not prevent a covered company from using the asset for liquidity risk management purposes.

Moreover, adding a requirement that assets be segregated in order to qualify as unencumbered would add operational complexity and cost to the practice of liquidity risk management, without a commensurate liquidity benefit. Therefore, it is our view that the definition of “unencumbered” assets should include assets that are co-mingled with or used as hedges on trading positions.⁴¹

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38 The FRB asked for comment on this issue in Question 73 on page 630 of the NPR.

39 The FRB asked for comment on this issue in Question 80 on page 638 of the NPR.

40 Proposed Rule § 252.14(n).

41 The FRB asked for comment on these issues in Questions 14 and 15 on page 510 of the NPR.

Board of Governors of the Federal Reserve
April 30, 2012

We appreciate your consideration of our comments and suggestions on the Proposed Rules. We would be pleased to provide additional information or to discuss our comments and suggestions with you in more detail. Please feel free to contact Esta Stecher, Steve Strongin or me at (212) 902-1000.

Sincerely,



Craig W. Broderick
Chief Risk Officer
The Goldman Sachs Group, Inc.

cc:

Michael F. Silva
Federal Reserve Bank of New York

Appendix A: CEM's shortcomings cause it to dramatically overstate exposure and interconnectedness

Dodd-Frank specifies the types of transactions that constitute "credit exposures," but does not specify how "credit exposure" is to be measured. The Proposed Rules apply the concentration limit to the "aggregate net credit exposure" of a covered company to a single counterparty. In the case of derivatives that are subject to a "qualifying master netting agreement,"⁴² this "aggregate net credit exposure" is defined as "equal to the exposure at default amount calculated under 12 CFR part 225, appendix G, § 32(c)(6)."⁴³ The reference is to a method for calculating risk-based capital, and it is commonly referred to as the Current Exposure Method ("CEM").

With the encouragement and approval of supervisors, the majority of large U.S. banks with significant trading activity, and their international peers, have transitioned away from CEM to the more risk-sensitive Internal Model Method ("IMM") used under Basel II. A version of CEM was first included in the original 1988 Basel Accord, and was revised when Basel I was amended in 1996 to add the "market risk capital" component. Over time this revised CEM was also recognized as risk-insensitive, leading supervisors to develop the model-based IMM approach as part of the Basel II framework in 2004. In the U.S., the IMM approach has been implemented for large banks with significant trading activities, and is subject to back-testing, validation and quality controls. IMM models have been subject to extensive examination by regulators, have been evaluated both individually and across institutions, and have been substantially enhanced to reflect experience gained through the recent financial crisis (including the further development of IMM standards as part of the Basel III framework).

However, the Proposed Rules require financial institutions to revert to using CEM in calculating their counterparty credit exposures, even if they are eligible to use IMM under appendix G and the Basel II international standards. The NPR does not articulate why the CEM methodology is preferred to the IMM approach.

CEM significantly overstates counterparty credit exposures. To illustrate this point, consider the case of two trades with the same counterparty that are perfectly offsetting. The first is a fixed-for-floating rate \$100 million notional swap with a 72-month tenor and semi-annual payments. The second is a floating-for-fixed rate \$100 million notional swap with a 72-month tenor and semi-annual payments. The fixed and floating rate terms match exactly on both contracts. The cash payments of the two swaps are exactly opposite and equal and are subject to a qualifying master netting agreement. As a result, the actual economic exposure associated with these trades is \$0, which is also the exposure under the IMM approach. However, under the CEM, the exposure for these two trades is \$1.2 million, as the CEM fails to capture the offsetting nature of these two trades. The effects of risk overstatement become larger as the portfolio of trades grows.

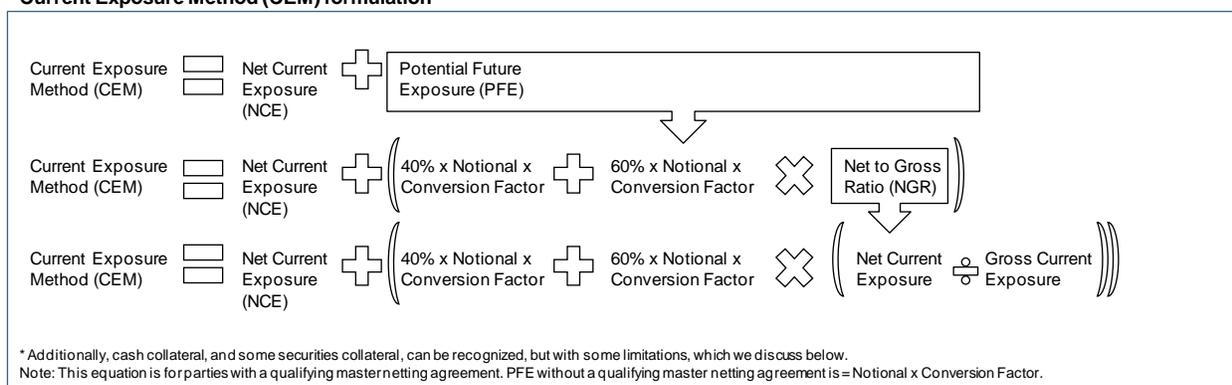
42 A qualifying master netting agreement is an agreement that (i) creates a single legal obligation for all individual transactions covered by the agreement upon an event of default (including a bankruptcy default), (ii) provides a party to the contract with the right to accelerate, terminate and close-out on a net basis all transactions under the agreement and to liquidate or set-off collateral promptly upon an event of default, and (iii) meets a number of specific criteria designed to ensure that these rights are fully enforceable, documented and monitored by the party. We understand that market-standard master agreements, such as the 1992 and 2002 ISDA Master Agreements, would constitute "qualifying master netting agreements." Ensuring the enforceability of netting of derivatives exposures has been the subject of extensive regulatory and industry efforts since the Basel I accords were amended in 1993 to permit the recognition of netting to determine capital charges for derivative transactions. U.S. regulators adopted rules permitting the recognition of netting in 1994. Today, ISDA has received legal opinions in 56 countries representing the vast majority of countries with significant trading involvement. The FRB and the Federal Reserve Bank of New York have sponsored working groups supporting these efforts, have advocated for and obtained legislative changes to resolve issues identified through legal efforts, and have conducted their own studies to evaluate netting enforceability.

43 Proposed Rule § 252.94(a)(11).

To further illustrate the scale of the risk overstatement problem, consider another example: under a bilateral qualifying master netting agreement, Covered Company A purchases 1 million calls on XYZ Corporation from Covered Company B, which are struck at \$100. Covered Company A also sells 1 million calls on XYZ Corporation to Covered Company B (under the same master netting agreement), which are struck at \$101. The options mature in six months. Under CEM, the credit exposure associated with these two positions is \$2.4 million. The economic reality, however, is that the maximum possible loss under default is only \$1 million. That is, even in the extreme case that Covered Company B defaults, the master netting agreement will net both trades, leaving only an exposure of at most \$1 million. In this specific case, CEM overstates the maximum risk of loss by nearly 2.5 times.

To better understand the technical issues that cause CEM to significantly overstate risk, it is helpful to first show the CEM approach to calculating credit exposures in more detail:

Current Exposure Method (CEM) formulation*



Much of the overstatement that occurs under CEM comes from its use of gross notional exposures, rather than net notional exposures. In particular, netting of the Potential Future Exposure (“PFE”) component of the CEM calculation is not allowed for 40% of the portfolio’s notionals. This 40% figure, which is not linked to the likelihood of offset in the event of bankruptcy, was set in the mid-1990s, when qualifying master netting agreements were relatively new and thus not proven to withstand counterparty defaults. Over the past 20 years, however, the strength and validity of qualifying master netting agreements has been demonstrated many times. In the most recent crisis, for example, qualifying master netting agreements enabled counterparties to find replacement counterparties for derivatives contracts on a net basis in the wake of the Lehman Brothers bankruptcy.

Second, PFE relies on static conversion factors, based on broad product type, and for some products on maturity buckets. This blunt gradation also contributes to the overstatement of risk. Further, PFE ignores maturity in the conversion factor for credit derivatives. This means that the PFE on a credit derivative with a five-year maturity is the same as the PFE on the exact same credit derivative with a one-year maturity. Clearly the underlying economic risk associated with these two instruments cannot be the same, although CEM would imply that it is. For comparative purposes, the five-year maturity instrument would have approximately three times the exposure of the one-year maturity instrument under IMM.

Third, PFE only considers the value of currently posted collateral and ignores the significant risk-reducing value of future collateralization, which typically occurs via the daily collection of variation margin. In other words, it assumes that the portfolio will be uncollateralized through to the final maturity date of each contract in the portfolio,

which is clearly not the case in practice. In managing collateralized derivatives counterparty exposure, parties also consider the potential for a change in mark-to-market value after a counterparty's insolvency but prior to liquidation of any non-cash collateral; during this period, which is typically in the range of five to ten business days, additional exposure could arise. This additional exposure is mitigated by the use of haircuts on the value of non-cash collateral and potentially also by initial margin, both of which are valuable risk-reduction tools and should be taken into consideration.

Finally, the definition of the Net to Gross Ratio ("NGR") should be amended so that it is clear that enforceable cash collateral can be included in the net current exposure component (the numerator) of the NGR. Doing otherwise would fail to give covered companies credit for the risk mitigation techniques employed throughout OTC derivatives markets.

Appendix B: Aggregation requirement creates further unnecessary challenges

The Proposed Rules require a covered company to aggregate credit exposures to a counterparty, including exposures of controlled subsidiaries.⁴⁴ This “control” standard creates a number of problems. First, it will be extremely difficult – if not impossible – for covered companies to comply with this requirement vis-à-vis their counterparties because the information that would enable them to determine whether an entity holds 25% or more of the voting shares or equity of another entity is often not publicly available. Second, a covered company will often make a minority investment in a company that exceeds 25% of a class of voting stock or total equity but that does not give it rights to monitor or control the transactions in which that company engages, meaning that it does not truly exercise “control.” Lastly, the Proposed Rules would include non-consolidated entities for exposure limit purposes in circumstances where the covered company does not get the benefit of the “subsidiary’s” capital in determining the basis for the limit.

The Proposed Rules, as written, would seriously limit the ability of covered companies to have minority investments in companies or sponsorship of funds. We would also note that the Legal Lending Limit currently applicable to U.S. banks does not extend beyond subsidiaries that are consolidated for accounting purposes, and we do not believe that this has resulted in prudential weakness. Thus we recommend that the definition of “control” be limited to subsidiaries that are consolidated for financial reporting purposes. We also believe there should be a limited exemption for pooled investment vehicles seeded by a covered company, in order to support the development of covered companies’ asset management businesses.⁴⁵

44 A “subsidiary” is a company that is “directly or indirectly controlled by” another company, and a company “controls” another company if it: (i) owns, controls, or has the power to vote 25% or more of a class of voting securities of the company; (ii) owns or controls 25% or more of the total equity of the company; or (iii) consolidates the company for financial reporting purposes.

45 Financial holding companies are permitted to organize and offer traditional asset management products, including both registered mutual funds and private funds. Before a company can offer a new investment strategy to its clients, it is often required to invest its own capital for an initial seeding period to develop a track record of success for the strategy. It generally cannot attract unaffiliated investors until it has established a proven track record. The ability to create and seed new funds in this manner is an essential part of the asset management business. Application of the proposed counterparty credit limits to a fund during the launch period may hinder the ability of sponsors to launch funds and therefore should not be required to be aggregated regardless of ownership level or whether they are consolidated for financial reporting purposes.

Appendix C: Treatment of foreign financial institutions could disadvantage U.S. financial institutions

The Proposed Rules create a significant competitive advantage for non-U.S. banks – certainly temporarily and perhaps permanently. While the statutory language of Dodd-Frank itself clearly captures foreign banks, the FRB explicitly excludes them from the Proposed Rules.⁴⁶ The FRB provides no explanation for treating U.S. bank holding companies that are owned by foreign parents differently from their direct competitors that are not. Carving foreign banks, and their U.S. subsidiaries, out of the Proposed Rules raises a significant risk that U.S.-based financial institutions will be disadvantaged relative to their foreign and domestic competitors that are not subject to the Proposed Rules.

The fact that the FRB will propose separate rules for foreign banking organizations implies that there will be some difference in the way these rules operate between U.S. and non-U.S. financial institutions. Achieving parity between the two sets of rules will be a complex effort, requiring a careful balance of the two factors to which the FRB is required to give “due regard” – “the principle of national treatment” and the “equality of competitive opportunity.” We see it as inappropriate to crystallize the rules applicable to U.S. financial institutions before developing those for non-U.S. financial institutions operating in the U.S. Doing so could increase the risk that U.S. institutions will be unduly harmed competitively in their own backyard.

46 Under Dodd-Frank, the single counterparty concentration limit applies to both “covered companies” (including “covered companies” that are subsidiaries of foreign banks), as defined by the Proposed Rules, and to foreign banking organizations – foreign banks with U.S. branches and agencies. However, the Proposed Rules do not apply to foreign banking organizations themselves or to their subsidiaries that are not otherwise “covered companies.” Furthermore, the rule carves out, until July 21, 2015, even those companies that would be “covered companies” if they were not subsidiaries of foreign banks, so long as those companies rely on the Federal Reserve’s Supervision and Regulation Letter SR 01–01.