BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

February 17, 2010

The Honorable Alan Grayson
House of Representatives
Washington, D.C. 20510

Dear Congressman:

Thank you for your letter of July 27, 2009, inquiring about the Goldman Sachs Group, Inc. ("Goldman"). As you know, Goldman is among a group of companies, including Morgan Stanley and Merrill Lynch & Co. (in connection with its acquisition by Bank of America Corporation), that were formerly subject to group-wide supervision by the Securities and Exchange Commission ("SEC"), and recently became subject to supervision by the Federal Reserve.

In your letter, you raise concerns about whether Goldman and the public are at risk from Goldman's use of SEC-approved models to calculate its market-risk capital requirements, pursuant to a temporary exemption granted to Goldman, as well as to Morgan Stanley and Bank of America Corporation with respect to Merrill Lynch. These firms, as bank holding companies or parts of bank holding companies, are required to comply with applicable capital and other requirements established by the Federal Reserve in the same manner as other bank holding companies. As you noted, the Federal Reserve provided these firms with a transition period in which to conform to the rules of the Federal Reserve. In taking supervisory action with respect to a bank holding company, including granting transition periods, the Board carefully assesses the risk to the bank holding company and its subsidiaries, as well as to the financial system and the public. The Board believes that the transition periods provided to these firms to bring their internal models into compliance with Board regulations while maintaining robust internal systems and controls were reasonable. The Federal Reserve reviewed and required enhancements to internal models of these firms during the transition period.

I have asked my staff to prepare responses to each of your questions. These responses are enclosed.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Staff Responses to Questions Posed by Members of Congress

Background

Banks and bank holding companies ("BHCs") whose trading assets and liabilities exceed certain thresholds must calculate capital requirements according to the Board's Market-Risk Measure (the "Market-Risk Rule" or "MRR"),[1] which requires such banking organizations to calculate and hold regulatory capital against market risk for "covered positions," which generally include all exposures in the institution's trading account as well as foreign-exchange and commodity exposures.[2] Banking organizations subject to the MRR are required to calculate their capital requirement for general market risk using an internal Value-at-Risk ("VaR") model.[3] They also must calculate a capital requirement for specific risk using a standard regulatory formula or using an internal model approved by the Federal Reserve.[4] In addition, such banking organizations must meet certain qualitative requirements, including having internal models integrated into their daily risk management process.

The Goldman Sachs Group, Inc. ("Goldman), Morgan Stanley, and Merrill Lynch & Co. (collectively "new bank holding companies" or "new BHCs") received temporary exemptions from the MRR that allowed them to continue to use models approved by the Securities and Exchange Commission ("SEC") for purposes of determining their capital requirements for market risk for a period up to one year, ending on December 31, 2009.[5] The transition periods granted by the Board to the new BHCs were designed to ensure that they maintained adequate capital during the time required for examiners to conduct a comprehensive review of their market risk models and systems and for the new BHCs to adapt their systems to the Board's regulatory requirements. The Federal Reserve examiners have been reviewing the new BHCs' market-risk models on a model-by-model basis to ascertain whether the models meet the requirements established by the Board. During their one-year transitions to the MRR, the new BHCs were required to maintain regulatory capital "add-ons", or fixed additional capital requirements, determined using SEC supervisory requirements, in addition to their modeled specific risk capital requirements.

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[1] 12 CFR parts 208 and 225, Appendix E. Goldman's temporary exemption from the MRR also extends to Goldman's subsidiary bank, Goldman Sachs Bank USA, which converted to a state member bank.

[2] See 12 CFR part 225, parts 208 and 225, Appendix E, § 2(a).

[3] 12 CFR parts 208 and 225, Appendix E, § 4.

[4] 12 CFR parts 208 and 225, Appendix E, § 5.

[5] See Board letters to Sarah Smith (The Goldman Sachs Group, Inc.), dated February 5, 2009 (Goldman Letter); Gregory A. Baer (Bank of American Corporation), dated February 5, 2009 (BAC Letter); and Colm Kelleher (Morgan Stanley), dated February 5, 2009 (Morgan Letter).

All BHCs are required to meet all applicable Federal Reserve regulatory and supervisory standards, regardless of their particular business model. The new BHCs were required to implement all other aspects of the Board's Capital Guidelines without a transition period, which include capital requirements for traditional lending, counterparty credit risk, and securitization activities.[6] To ensure that the new BHCs are operating in a safe and sound manner, the Federal Reserve conducted frequent targeted examinations or reviews at each institution during 2009, and will continue frequent reviews in 2010.

We address each of your specific questions below.

1) *In the letter granting a regulatory exemption to Goldman Sachs, you stated that the SEC-approved VaR models it is now using are sufficiently conservative for the transition period to bank holding company. Please justify the statement.*

The BHC MRR exemptions were granted after Federal Reserve staff conducted a preliminary review of models that the new BHCs had developed under the SEC's market risk capital framework for large, complex investment banks ("SEC rule"). The SEC rule is similar to the MRR in that the capital requirement for trading assets under both rules consists of a multiple of a VaR-based measure and specific risk capital requirements, which may be modeled or standardized. In implementing its market risk capital requirements, the SEC permitted wider use of modeled specific risk capital requirements than the Board has allowed. These modeled capital requirements generally are lower than the standard specific risk capital requirements of the MRR. However, the SEC required that each entity subject to the SEC rule calculate additional add-on capital requirements to cover substantial risks not adequately captured by the entity's general VaR model and specific risk models. In contrast, although neither the Board nor the other federal banking agencies impose such add-ons under the MRR, the Board has been more conservative in approving an institution's modeling of specific risk and has more frequently required banks and BHCs subject to its MRR to use standard specific risk capital requirements.

Model reviews conducted by the Federal Reserve to grant approval for specific risk models are extensive and time-consuming. At the time the new BHCs became subject to Federal Reserve supervision, their internal models, as well as the related internal controls, were specific to SEC requirements and not to the Board's regulatory and supervisory requirements. Therefore, the Board expected that review of the new BHCs' models for compliance with the MRR would require a period of time, as would any resulting adjustments to bring them into compliance with the MRR. In light of the size and complexity of the new BHCs' operations, it was important for them to have time to adjust the internal systems and controls surrounding their models. Robust internal controls are critical because they support the accuracy and reliability of a BHC's risk

[6] 12 CFR part 225, Appendices, A, D, E, and G.

measurement and managements systems.[7] Moreover, rather than focusing on making temporary fixes to their systems to approximate their MRR requirements, the Federal Reserve judged that the new BHCs' resources were better focused on managing their responses to the period of unusual and severe economic and market conditions of the past year and making more permanent adjustments to comply with the Board's capital rules.

We note that as a result of transition to the Board's Capital Guidelines, the capital requirements for many of the new BHCs' credit risk exposures increased substantially. Overall, in the fourth quarter of 2008, the regulatory capital requirements for these firms increased as a result of the transition to the BHC regime from the SEC regime. Furthermore, the Board did not grant the new BHCs any exemptions from the general risk-based capital rules, despite a firm's request to continue to use SEC-approved methods to determine risk-based capital requirements for merchant banking investments that are not covered exposures and not subject to the MRR. Like other exposures that are not covered positions, these investments are subject to the Board's risk-based capital measure for general credit risk,[8] which do not include models-based capital requirements.

For all of the above reasons, the Board determined that permitting the new BHCs to calculate their market risk capital requirements using SEC-approved models and capital add-ons for one year would facilitate an orderly transition to the MRR. During that time, under the review of Federal Reserve examiners, the new BHCs worked to adapt their internal systems and controls to the MRR.

2) *If Goldman Sachs were required to adhere to standard Market Risk Rules imposed by the Federal Reserve on ordinary bank holding companies, how would its capital requirements differ from the current regulatory regime?*

   Please refer to our answer to Question 1 above.

3) *What is the difference in exposure to the taxpayer between the two regulatory regimes?*

Capital provides an important buffer that is available to absorb unexpected losses at a firm. However, capital requirements alone are not sufficient to protect investors, taxpayers, and the financial system from the effects of disorderly failure of a systemically important firm. Critical to reducing this exposure is robust risk identification and risk management at each firm. This responsibility begins with each firm. The appropriate supervisors for the firm should also be empowered, and have sufficient resources and expertise, to monitor and require that the firm implement strong risk management policies and systems. The Federal Reserve encourages

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[7] See Goldman, BAC, and Morgan Letters, p. 3.

[8] 12 CFR part 225, appendix A.

BHCs to establish and implement risk management systems through the examination and supervisory process created by statute.

In the case of BHCs such as the new BHCs, the Federal Reserve conducts targeted exams mentioned above related to models. In addition, the new BHCs are subject to continuous supervision and monitoring to ensure that they are operating in a safe and sound manner in accordance with a program of mandatory consolidated supervision that applies to all BHCs. In contrast, the SEC regime was a voluntary program that relied primarily on meetings between SEC staff and selected management at consolidated supervised entities. Through the Federal Reserve Banks, the Board has a significant on-site presence at large, complex BHCs, such as the new BHCs, while the SEC regime was generally limited to off-site monitoring.

The Federal Reserve has advocated changes in the supervisory framework for financial firms to ensure that all systemically important financial firms are subject to a statutory framework of supervision that includes comprehensive consolidated supervision as well as macro-prudential supervision. In addition, the Federal Reserve has advocated establishment of a resolution regime that would allow Federal supervisors to reduce risk to taxpayers and the economy by resolving systemically important financial firms in an orderly fashion that ensures that losses are borne by the firm's shareholders and creditors.

4) *What is the difference in total risk to the portfolio between these two regulatory regimes?*

The probability of loss above the minimum regulatory capital requirement for the new BHCs' trading portfolios is unlikely to be substantially different across the two regulatory regimes. Although there are not significant differences on the limits that the two regimes place on trading activities, the Bank Holding Company Act and the Board's Regulation Y materially limit BHCs' engagement in certain risky activities, such as private equity and real estate investments.[9]

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[9] 12 U.S.C. § 1841, et seq.; 12 CFR part 225.

5) *Goldman Sachs stated that "As of June 26, 2009, total capital was $254.05 billion, consisting of $62.81 billion in total shareholders' equity (common shareholders' equity of $55.86 billion and preferred stock of $6.96 billion) and $191.24 billion in unsecured long term borrowings." As a percentage of capital, that's a lot of long-term unsecured debt. Is any of this coming from the Government? In this last quarter, how much capital has Goldman Sachs received from the Federal Reserve and other government facilities such as FDIC-guaranteed debt, either directly or indirectly?*

Goldman's statement refers to the accounting concept under generally accepted accounting principles of total capital, which includes both equity and long term debt. It does not refer to regulatory or equity capital. Total capital is useful in describing how a firm may fund its assets. As of September 30, 2009, Goldman reported tier 1 capital of $59.4 billion, total regulatory capital (tier 1 capital plus tier 2 capital) of $73.3 billion, and a tier 1 leverage ratio of 6.91 percent, (more than double its regulatory minimum of 3 percent).[10]

Goldman participates in the TLGP which involves FDIC guarantees. None of this debt qualifies as regulatory capital. The TLGP was established to facilitate continued lending by sound banks to support the broader economy. Since November 2008, Goldman Sachs has issued $19.2 billion of debt under the TLGP, all of which was issued before the second quarter of 2009.

6) *Many risk-management experts, most notably best-selling author Nassim Taleb, note that VaR models can dramatically understate risk. What is your overall view of Taleb's argument, and of the utility of Value-at-Risk models as regulatory tools?*

The Board has been aware of the shortcomings of VaR models for some time. Consequently, the Board believes that multiple measures of market risk should be used for measuring risk, as there is no single measure that adequately describes all price risks.

This belief has translated into the Board's capital adequacy framework. From the time it began requiring banking organizations to use models to calculate minimum regulatory capital requirements under the MRR in 1996, the Board has supplemented the general VaR model with additional capital requirements. The MRR includes the specific risk capital requirements to mitigate some of the shortcomings of a general VaR model as a capital measure. In addition, the MRR requires that other measures of market risk, such as stress tests, be used to supplement VaR for risk management purposes. Beginning in 2005, the Board led Basel Committee on Banking Supervision ("BCBS") efforts to develop additional requirements, including incremental risk requirements and stress VaR requirements, to supplement the VaR and specific risk capital requirements. These changes are now reflected in the BCBS document entitled "Revisions to the

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[10] See 12 CFR part 225, Appendix D, § II.a.

Basel II market risk framework" (July 2009). The Board is currently working with the other federal banking agencies to implement these revisions for U.S. banking organizations.

Despite their shortcomings, VaR-based measures remain a useful starting point for assessing capital requirements associated with market risk. They allow aggregation of the market risk arising from different trading instruments in a consistent measure that is comparable across institutions. VaR remains a sound measure of the day-to-day risks of liquid trading portfolios. It is less useful for assessing the extraordinary risks resulting from a financial crisis. The Board continues to study additional capital measures to identify risks not well captured in VaR and will continue to support and work toward improvements in VaR-based and other measures of capital adequacy.

We hope this information is helpful. If you or your staff has any additional questions, please feel free to contact David K. Lynch, Senior Supervisory Financial Analyst, at (202) 452-2081, April C. Snyder, Counsel, at (202) 452-3099, and Benjamin W. McDonough, Counsel, at (202) 452-2036.