



REGULATORY INTERPRETATION 2004-RI-01

Date: June 24, 2004

Subject: Approval of Changes to an Internal Risk Model

Request Summary:

In the interest of more effective supervisory oversight, Federal Housing Finance Board (Finance Board) staff is adopting a process by which a Federal Home Loan Bank (Bank) wishing to make changes to a previously-approved internal risk model may report changes to the technologies, procedures and assumptions used in that model in calculating risk-based capital requirements. Banks may implement changes described in the report absent a specific objection from the Finance Board. This Regulatory Interpretation outlines this process, and addresses how it satisfies section 932.5(d) of Finance Board regulations (12 C.F.R. § 932.5(d)), which requires prior approval by Finance Board of any material adjustments to an approved internal market risk model. This Regulatory Interpretation supersedes language in Advisory Bulletin 03-10 requiring explicit Finance Board approval of changes to previously approved risk models.

Conclusion:

The procedures described herein will allow a Bank to implement changes to a previously approved internal risk model after proper notification to the Finance Board, absent an affirmative objection. These procedures satisfies the requirements of section 932.5(d) that a Bank obtain approval before making a subsequent material adjustment to a previously-approve internal risk model.

Background:

Finance Board regulations require each Bank to obtain Finance Board approval of its internal market risk model prior to implementing its new capital plan.¹ Further, section 932.5(d) of the Finance Board regulations requires Finance Board prior approval of subsequent material adjustments to each Bank's internal market risk model and requires a Bank to make such adjustments to its model as may be directed by the Finance Board. Specifically, section 932.5(d) states in relevant part that:

¹ See 12 C.F.R. §§ 932.1 and 932.5(d). Initial approval of a Bank's internal risk model is provided by the Office of Supervision in accordance with the procedures set forth in 12 C.F.R. § 907.7. See, e.g., 2002-APP-04 (September 19, 2002) and Resolution Number 2002-20 (May 8, 2002). This Regulatory Interpretation supersedes language in Advisory Bulletin 03-10 requiring explicit Finance Board approval of changes to previously approved risk models.

Each Bank shall obtain Finance Board approval of an internal risk model . . . , including subsequent material adjustments to the model made by the Bank, prior to use of any model. Each Bank shall make such adjustments to its model as may be directed by the Finance Board.

Several Banks presently are moving toward adopting modifications to their internal market risk models. Questions have arisen regarding procedures for obtaining approval of changes to a Bank's internal market risk model under section 932.5(d). Finance Board staff believes that effective supervisory oversight can best be served by allowing Banks to implement modeling changes after the Bank provides suitable notice to the Finance Board, absent a Finance Board objection.

Banks with internal market risk models approved by the Finance Board that wish to take advantage of the alternative approval procedures described herein should first report to the Finance Board, using the enclosed reporting template, information about the Bank's modeling technology, procedures and assumptions underlying the internal market risk calculations that are used for purposes of calculating the Bank's risk-based capital requirements.² Banks may use their own chart of accounts but should use the remainder of the enclosed reporting template as given. Once a Bank has filed a template that is accepted by the Finance Board, the Bank could satisfy the requirements of section 932.5(d) with regard to subsequent changes to the model by filing an updated template at least 30 days before the changes are implemented.³ The use of this reporting template should promote greater transparency and facilitate more open discussion and dialog.

Discussion:

Section 932.5(d) does not establish a specific process that must be followed for obtaining approval of "subsequent material adjustments" to an internal risk model. In the absence of specific procedures in a regulation for obtaining a required approval, the procedures in section 907.3 of the Finance Board rules governing approvals generally apply. *See* 12 C.F.R. § 907.3. *See also* 12 C.F.R. § 907.6. Section 907.3 specifically allows the Finance Board to set by "policy" or otherwise "to prescribe additional or alternative procedures for any application for Approval of any transactions, activity or item." The Finance Board could, therefore, institute alternative procedures for obtaining approval of subsequent changes to an internal risk model.

The proposed procedures would allow a Bank to implement reported changes to its internal risk model under section 932.5(d), unless the Bank receives notification that the Finance Board objects to the change. A lack of objection from the Finance Board, however, would not affect or otherwise waive the Finance Board's right to direct a Bank to make changes or adjustments to its model at any time in the future, including requiring a Bank to reverse any changes previously made to the model. The authority to direct a Bank to make changes to its model is distinct from

² For ease of communication, the template should be sent by electronic mail to Associate Director William Segal at segalw@fhfb.gov.

³ Current procedures require a Bank to submit any proposed changes to the Finance Board for review and approval at least 30 days prior to the effective date of the changes per Advisory Bulletin 03-10. Thus, under this Regulatory Interpretation the Finance Board would have similar amounts of time for an initial review of any reported changes submitted by the Bank as under current procedures.

the model approval requirements and is meant to give the Finance Board the ability to override any previous approval. Thus, the Finance Board would retain authority to prohibit or modify any alterations to a model either immediately or at some future date.

The procedures herein represent a change in process rather than a change in the substance of the Finance Board's supervisory oversight. As required under current procedures, the Finance Board would continue to expect a Bank to maintain, and to provide upon request, documentation supporting the modeling changes, including testing results for any modified software, algorithms, procedures and assumptions. Finance Board staff will review a Bank's internal risk model during regularly scheduled examinations and could undertake a special review if circumstances warrant.

This Regulatory Interpretation applies only to the particular transaction or activity described therein, and is subject to modification or rescission by action of the Board of Directors of the Finance Board. 12 C.F.R. part 907.