



## ADVISORY BULLETIN 2005-AB-06

June 10, 2005

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### *Federal Housing Finance Board Office of Supervision*

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**To:** Federal Home Loan Bank Presidents, Directors, Chief Financial Officers, Risk Management Officers, Asset-Liability Managers, and Directors of Internal Audit

**From:** Stephen M. Cross  
Director  
Office of Supervision

**Subject:** Changes to Internal Market Risk Models

#### **Summary:**

The Federal Housing Finance Board (Finance Board) is further streamlining the process by which a Federal Home Loan Bank (Bank) may obtain approval to make changes to a previously approved internal market risk model.<sup>1</sup> This Advisory Bulletin (AB) outlines the new process and describes the type of documentation that is required for a Bank to avail itself of the notification process.

#### **Background:**

Finance Board regulations require each Bank to obtain approval of its internal market risk model prior to implementing its new capital plan.<sup>2</sup> Further, section 932.5(d) of Finance Board regulations requires a Bank to obtain prior approval before making any material adjustments to its market risk model after it has been approved. Specifically, section 932.5(d) states:

Each Bank shall obtain Finance Board approval of an internal market 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.

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<sup>1</sup> The process described in this Advisory Bulletin will satisfy the regulatory requirement of prior Finance Board approval of material adjustments to a market risk model. 12 C.F.R. § 932.5(d).

<sup>2</sup> See 12 C.F.R. §§ 932.1 and 1932.5(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).

Regulatory Interpretation 2004-RI-01 (June 24, 2004) announced a process by which Banks meeting certain conditions could implement changes to a market risk model without explicit Finance Board approval. One of those conditions was a 30-day advance notice requirement. As discussed below, the 30-day notice requirement will be waived under certain specified conditions. This Advisory Bulletin supersedes Advisory Bulletin 2003-AB-10, which requires explicit Finance Board approval of changes to previously approved risk models. This AB also establishes a standard timeframe for reviewing model changes that do not qualify for the notification process.

**Guidance:**

A Bank may implement model changes immediately upon notification of the Finance Board provided each of the following conditions is met:

- The Bank's condition was characterized as "Fair" or "Satisfactory" in the most recent Finance Board Report of Examination (ROE);
- The ROE contains no weaknesses or violations pertaining to the Bank's risk modeling;
- The proposed model changes do not decrease the Bank's estimated Value at Risk by more than 10 percent relative to the existing approved model; and
- The Bank provides appropriate documentation (see below).

Banks not meeting these requirements are required to obtain the Office of Supervision's prior approval before making any material changes to their risk models pursuant to Finance Board regulations or are required to meet the conditions specified in 2004-RI-01 prior to making model changes including relevant prior notice provisions.

The Finance Board retains the authority to require model changes if it deems them necessary. See 12 C.F.R. § 932.5(d).

Documentation requirements. Banks proposing model changes, or notifying the Office of Supervision of implementation of a model change pursuant to the requirements of this AB, must provide the following documentation:

- Assumptions template (see attached);
- Detailed, instrument- and subportfolio-level results of parallel runs and any other testing the Bank has performed, along with any internal analysis of these results the Bank has performed in order to satisfy itself that the model change is an improvement relative to the model currently in place;
- Any spreadsheets used to prepare input data for the model, to the extent these are affected by the proposed model change;
- Certification that the proposed model change meets the Bank's Information Technology signoff requirements, e.g. change control procedure, and that it has received any other Bank required signoffs and approvals and copies of the appropriate signoffs and approvals. Model changes for which additional Bank internal approvals are pending will not be considered or approved by the Office of Supervision.

Timeline for approval of model changes. Those Banks that do not qualify to implement modeling changes in accordance with this AB relating to immediate notification standards can expect the following timeline to apply for obtaining approval of changes to a previously-approved internal risk model.

The Office of Supervision will determine whether a Bank's supporting documentation is complete within 30 calendar days of receiving a Bank's proposal to change an internal market risk model, and will advise the Bank, in writing, whether any additional documentation is needed. Once the Office of Supervision has determined that the documentation is complete, review of the documentation will be completed within 60 calendar days.<sup>3</sup>

Notification. Banks that make model changes pursuant to the immediate or 30-day notification requirements must notify the Office of Supervision by transmitting a letter signed by an officer of the Bank addressed to the Director of the Office of Supervision. Banks also should transmit the letter in electronic format, along with any supporting documentation, by electronic mail to ModelChanges@fhfb.gov.

**Principal Finance Board Contact:**

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Attachments

An Advisory Bulletin is a staff document through which the Office of Supervision provides guidance to the Federal Home Loan Banks and the Office of Finance regarding particular supervisory issues. Although an Advisory Bulletin does not have the force of a regulation or an order, it does reflect the position of the Office of Supervision on the particular issue and as such will be followed by examination staff. If non-compliance with an Advisory Bulletin is cited as the basis for a supervisory determination, any such determination will be subject to review by the Board of Directors pursuant to the procedures of 12 C.F.R. § 907.9. Advisory Bulletins are effective upon issuance.
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<sup>3</sup> A Bank may rely on 2004-RI-01 to implement the modeling change before the end of this 60-day review period, absent an affirmative objection from the Finance Board and provided the Bank has properly notified the Finance Board at least 30-days prior to instituting the change. The Bank's right to implement the change would be subject to all of the conditions set forth in 2004-RI-01 and this AB.