



Securities Industry Association

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May 31, 2001

Federal Reserve Board
Basel 2001 Capital Proposal, Mail Stop 179
21st and C Streets, NW
Washington, DC 20551
Attn: Norah Barger

New Basle Capital Proposal

Dear Board Members:

The Risk Management Committee (“the Committee”) of the Securities Industry Association¹ is pleased to offer you its comments on the proposal for the new Capital Accord (“the Accord”) released by the Basle Committee on Banking Supervision in January. The Committee welcomes the decision of the Basle Committee to propose a global regulatory capital standard that encourages market discipline and appropriate capital allocation and, in particular, appreciates the Accord’s increased emphasis on risk sensitive approaches to the measurement of capital adequacy. The Committee also recognizes the efforts of the Multidisciplinary Working Group on Enhanced Disclosure² and the Working Group on Public Disclosure as supportive of the Basle Committee’s purposes.³

¹ The Securities Industry Association brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 80-million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2000, the industry generated \$314 billion of revenue directly in the U.S. economy and an additional \$110 billion overseas. Securities firms employ approximately 770,000 individuals in the U.S. (More information about SIA is available on its home page: <http://www.sia.com>.)

² *Multidisciplinary Working Group on Enhanced Disclosure; Final Report to Basel Committee on Banking Supervision; Committee on the Global Financial System of the G-10 central banks; International Association of Insurance Supervisors; International Organization of Securities Commissions; April 26, 2001.*

³ *Working Group on Public Disclosure; Letter to Lawrence H. Meyer, Member, Board of Governors, Federal Reserve System, January 11th, 2001.*

As risk practitioners, we want to highlight a significant issue that the Accord does not address, which is mark-to-market (or fair value) accounting. We interpret the Basel Committee's 1996 Amendment to the Accord to Incorporate Market Risks as allowing a financial institution to apply mark-to-market accounting to that portion of its assets constituting its trading book, with the Accord's recommended disclosure requirements applying only to the remaining portfolio, and our comments below reflect that understanding.

The Committee members consider mark-to-market accounting to be a critical pillar within our own risk management infrastructures, and, in our view, mark-to-market accounting contributes to the stability of the financial markets. In the management of a financial institution, the use of mark-to-market accounting forces recognition of changes in the risk profile of any position or business and timely action to reallocate capital to address both problems and opportunities. With respect to the goal of reducing systemic risk, the adoption of mark-to-market accounting to a broader range of credit sensitive instruments would strengthen market discipline by requiring a larger population of participants to recognize impaired or problematic market and credit exposures at an early stage. A timely and reliable system of disclosing mark-to-market values is an effective means of providing risk information to investors, lenders, regulators, commercial partners and other stakeholders.

In its analysis of the Accord, the Committee viewed mark-to-market accounting as the observable basis for evaluating the appropriateness and adequacy of critical components of capital charges determined under the most complex and sophisticated methodologies within the Accord. The Committee recognizes and commends the increased emphasis on risk-based capital charges set out in the Accord. In that context, and given our position on the importance of mark-to-market accounting as a component of our risk management process, we would recommend the following amendments to the Accord:

1. With respect to Pillars 1 and 2, that the Accord allow for the definition of the "Trading Book" to include all portfolios including products such as traded loans, loan commitments, repos and OTC derivatives subject to mark-to-market accounting⁴, where such accounting *incorporates the pricing of the credit risk inherent in the positions*.

Background: Mark to market practices of investment banks for debt securities such as bonds and floating rate notes have always reflected credit spreads as well as the general level of interest rates. Credit spreads, the rate differential from the relevant base risk-free rate, reflect the market's assessment of expected defaults. Investment banks have captured the uncertainty concerning future assessments of defaults for bond portfolios through VaR computations, which the Basle Committee continues to recognize as the basis for determining capital requirements for trading portfolios. As the natural extension of their experiences,

⁴ For the purposes of this letter, we comment within the accounting model used within the Accord.

investment banks applied the same procedures for marking-to-market and computing VaR to traded bank loans within their portfolios. Today, investment banks mark-to-market the counterparty credit exposures associated with OTC derivatives positions (e.g., fixed income swaps), and investment banks mark-to-market inactively traded financial instruments through reference to market values, derivatives modeling and matrix pricing and other forms of interpolation.

As a result of all of these experiences, the Committee recommends that all credit sensitive positions that are subject to mark-to-market accounting, whether debt securities or other contracts such as traded loans, loan commitments, repos and OTC derivatives, have capital requirements calculated on a consistent basis

2. With respect to Pillar 3, that the Accord should allow a financial institution adhering to mark-to-market accounting to follow disclosure requirements aimed at the description of their policies and procedures for the valuation of assets and to require market risk disclosures to be broadly in line with those outlined in the report submitted by the Multidisciplinary Working Group on Enhanced Disclosures and recommended by the Working Group on Public Disclosure.

The Committee recognizes that for some financial institutions the adoption of mark-to-market accounting for all assets may be impractical. However, as markets evolve, price transparency should continue to improve, making mark-to-market accounting more practical for a broader range of financial instruments.

While we have chosen not to comment on other issues, such as the Accord's proposed treatment of operational risk, our silence on these matters should not be interpreted as acquiescence on these issues.

We are pleased to have this opportunity to comment on the Accord and would be happy to discuss our views with you. For additional details, please feel free to contact me (212) 902-2423 or our staff adviser, Jerry Quinn (212) 618-0507, at your convenience.

Sincerely,

Robert Litzenberger
Chairman
Risk Management Committee

cc: Kim Olson, Federal Reserve Bank of New York
Laura S. Unger, Securities and Exchange Commission
William J. McDonough, Chairman, Basel Committee on Banking Supervision