Securities Industry Association

August 5, 2003

Basel 2003 Capital Proposal
Board of Governors of the Federal Reserve System
Mail stop 155
20th Street and Constitution Avenue
Washington, DC 20551

Re: Basel Accord / Third Consultative Paper

Dear Board Members:

The Risk Management Committee of the Securities Industry Association[1] is pleased to offer you comments on the third consultative paper ("CP 3") on the new Basel Capital Accord ("Basel II"). As globally active financial institutions primarily engaged in the investment banking and securities businesses ("investment banks"), we offer these comments in the expectation that the interaction of the European Union's Financial Conglomerates and Capital Adequacy Directives will result in the application of Basel II to our firms within EU and US regulatory frameworks. We note that our mix of risk-sensitive businesses differs materially from the credit-intensive businesses of commercial banks typically subject to Basel II. Our analysis, which is continuing, indicates that for many of our core activities Basel II prescribes capital requirements that appear to be excessive relative to risk and loss experience. Nonetheless, we believe there are a few key modifications and clarifications that can address the concerns we identify and foster a risk-based capital regime appropriate for commercial banks and investment banks alike.

We recognize the scope and complexity of the Committee's efforts in the development of a new Capital Accord and commend the Committee for establishing within Basel II a comprehensive framework for the assessment of credit risks and credit risk management. We firmly believe that a flexible capital regime that relates regulatory requirements to observable risk will promote innovation and enhance financial stability.

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of more than 600 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 employs nearly 700,000 individuals. Industry personnel manage the accounts of more than 92-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated $222 billion in U.S. revenue and $356 billion in global revenues. (More information about SIA is available on its home page: http://www.sia.com.)

Hence, we focus primarily on assessing the proposal's effectiveness in relating capital to risk for the businesses and markets in which we operate.

We believe that our larger, globally active firms are among the world leaders in market and credit risk measurement, and so can provide a valuable perspective on the effectiveness of Basel II capital charges in reflecting relative risk. We continue to work on developing more precise data on the impact of Basle II on our lines of business. As this work progresses, we intend to share our analysis and data with our local regulators and other appropriate parties in order to enable a more comprehensive impact assessment.

Based on our review of Basel II and our analysis to date, we are able to offer preliminary observations. Investment banks typically value risk assets, including loans, on a mark-to-market basis, and estimate risk to that market value using various tools, including robust VAR models. Risk models are continuously enhanced to incorporate new products and markets, and may be used by investment banks to measure the risk of activities that are considered under Basel II as part of a "banking book." (Investment banks place virtually all their financial instruments in the "trading book.") Our initial analysis suggests that an internal models-based approach to calculating risk capital (such as adopted in the 1996 market risk amendment) is more effective at estimating risk for many credit sensitive assets than the weightings-based approach for banking book assets under Basel II. To the extent that an institution can produce reliable mark-to-market values and robust VAR-based risk estimates, we recommend that the Committee permit a trading-book approach in lieu of a banking book approach. Such an election could be permitted at the discretion of the primary regulator, after review of the applicable models.

Most investment banks' mix of credit risk-sensitive business is dominated by product lines (e.g. secured financing transactions and OTC derivatives) for which CP 3 imposes capital charges that are higher than are warranted by the underlying risks. Comprehensive analysis supporting our assertion is included in the July 31, 2003 comment letter (with appendices) submitted by the International Swaps and Derivatives Association ("ISDA") and The Bond Market Association ("BMA"), which we endorse. Many of our firms' most experienced risk management professionals contributed to the ISDA and BMA analysis. We highlight the following items that are of particular concern to SIA firms:

Securities Financing Transactions (SFTs)

- Capital required for securities lending and prime brokerage activities should be calculated using a VaR-based exposure model as long as the transactions are subject to daily mark to market and daily remargining, and relevant netting and collateral provisions meet high standards of legal enforceability.

- Risk reduction for exposures with original or remaining maturity below one year is not adequately reflected in the proposed computation. Investment banks typically have many short-dated instruments, including overnight repos. De minimis historical losses in activities such as securities lending and prime brokerage indicate that credit risk declines to essentially zero as the original maturity drops to a few days.

- In addition to the low expected loss of such short exposures, capital required should be extremely low because losses that occur over a horizon of one or two days have a correlation of nearly zero with losses that occur over a one-year horizon. This occurs due to the diversification of systematic market changes over time. This is not reflected in the current maturity adjustment.

- The proposal can be interpreted as disallowing non-investment grade and unrated bonds as collateral for firms using "own estimate" haircuts. Own estimate haircuts may be used only if stringent qualitative requirements are met. In particular, firms must take into account the liquidity of lower-quality assets, substantiated with stress tests. This is already the practice of sophisticated firms. Therefore, non-investment grade and unrated bonds should be allowed as collateral for firms using "own estimate" haircuts.

Potential Exposures associated with OTC derivatives

- Enhancements to the exposure computations for OTC derivatives should be implemented at the same time as the other provisions of the Accord, particularly with respect to the add-ons. In addition, the guidelines should recognize the benefit of collateral support agreements, which greatly reduce potential future exposure.

Substitution

- Where loans have been hedged with credit derivatives, recognition should be given to risk reduction using a "double default" approach reflecting the joint probability of default rather than a substitution approach.

Operational Risk

- Many firms question whether statistical techniques can be used to reliably quantify operational risk by 2006, and have significant work ahead to collect and validate data on industry-wide historical operational losses. Because proposed revenue-based approaches yield operational risk estimates that are grossly exaggerated relative to the industry's experienced losses, we suggest further study focused on investment banks before finalizing an approach that will provide a reasonable cushion against losses not encompassed in the market and credit risk capital calculations.

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We will continue to devote substantial resources to evaluating the impact on our firms and the financial markets in which we are active. We look forward to a continuing dialogue with our regulators and, if desired, with the Board and/or Committee as you refine risk-based capital standards appropriate for global financial firms.

We are pleased to have this opportunity to comment on the Accord and would be happy to discuss our views with Board members at greater length. For additional information, please feel free to contact me (212) 272-7597, or our staff adviser, Jerry Quinn (212) 618-0507, at your convenience.

Sincerely,

Michael Alix
Chairman
Risk Management Committee

cc: Basel Committee on Banking Supervision