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May 27, 2005

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel, Switzerland

International Organization of Securities Commissions
Oquendo 12
SP-28006 Madrid, Spain

Re: Consultative Document -- *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects* (April 2005)

Dear Sir or Madam:

An Ad Hoc Committee ("the Committee") of the Securities Industry Association[1] ("SIA") welcomes the opportunity to comment on the above-referenced Consultative Document (hereinafter, the "CD"). The Committee is comprised of representatives of Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. The Committee was formed to provide comment with particular focus on Parts 4 and 5 of the Consultative Document dealing with the Trading Book and Settlement risk, and to offer suggestions to the Basel Committee on Banking Supervision ("Basel Committee")[2] regarding our concerns and observations. Each of the five firms, sometimes referred to as US investment banks, either has been recognized by the Securities and Exchange

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[1] The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (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. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated an estimated $227.5 billion in domestic revenue and $305 billion in global revenues. (More information about SIA is available at: www.sia.com.)

[2] Although the Consultative Document was a joint effort by working groups from both IOSCO and the Basel Committee, insofar as the resulting proposal primarily represents an effort to develop prudential treatments of certain exposures by banks, we have adopted the convention of referring to the "Basel Committee." However, as the Consultative Document itself recognizes, national supervisors may apply these rules to a variety of financial institutions, including the constituent members of the Committee.

Commission ("SEC") as a Consolidated Supervised Entity ("CSE")[3] or is in the process of gaining such recognition.

Our response to the CD is organized as follows:

I. General comments regarding the April 2005 Consultative Document
II. Executive Summary
III. Trading Book Observations and Recommendations
IV. Unsettled and Failed Trades Observations and Recommendations
V. Conclusion

I. General comments regarding the April 2005 Consultative Document

The Committee welcomes the opportunity to respond to the Basel Committee regarding the primary elements of the CD:

Part 1: The treatment of counterparty credit risk and cross-product netting
Part 2: The treatment of double default
Part 3: The short-term maturity adjustment in the IRB approach
Part 4: Improvements in the current trading book regime
Part 5: A proposed capital treatment for unsettled and failed trades

With respect to Parts 1, 2 and 3, the Committee endorses the comments and recommendations propounded by ISDA, IIF, LIBA, TBMA, EBF and BBA ("the Associations") in their joint response to the CD. Representatives of our firms contributed to the comment letter.

In particular, we welcome the adoption of EPE as the basis for computing capital for counterparty exposure. We would also like to express our appreciation for the efforts on the part of the regulatory community to engage in substantial dialogue over a considerable period of time with industry participants on these points. It is the view of the Committee that Parts 1, 2, and 3 of the CD, which developed from concerns raised in the development of the revised accord, are stronger because of that serious and thoughtful dialogue. We will not comment further on Parts 1, 2 and 3 in this document.

With respect to Part 4 of the CD, the Committee highlights that there is considerable agreement with comments from the Associations. Given the criticality of trading risk management in our firms, the Committee felt it important to separately provide detailed comments on this very important, and relatively new, set of proposals.

The Committee found it impossible in the brief time allowed for comment on the CD to prepare detailed alternative models, subject to impact analysis, to address in a comprehensive way the concerns shared by the firms on Part 4 of the CD. While there is clear agreement among firms that many aspects of Part 4 require revision, a clear and

[3] 17 CFR Parts 200 and 240; Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities [Release No. 34-49830; File No. S7-21-03].

compelling best alternative has not emerged. Consequently, we seek to provide principles under which effective alternatives can be constructed, consistent with the goal of the Basel II framers to better align risk and regulatory capital and to deter inappropriate application of trading book treatment for banking book activities.

The primary businesses of the investment banks are the trading and underwriting of securities, commodities and other financial instruments, and, accordingly, the interpretation and application of the trading book regime as well as the capital treatment of unsettled and failed trades is of very great importance to our firms in the determination of capital requirements under Basel II. As will be elaborated upon further below, we would like to emphasize the importance of "getting it right" so that regulatory capital is proportional to risk and proper incentives are in place.

The Committee feels that significant enhancements are necessary to regulatory proposals for capital requirements with respect to both credit risk in the trading book and failed and unsettled trades. Recommendations on both issues are discussed below.

II. Executive Summary

1. **We accept the regulatory concern that VaR-based trading book capital calculations (i.e. 3*VAR_10-day_99%CL) for certain positions may result in insufficient regulatory capital, particularly related to credit exposures in the trading book, and endorse the concept of additional capital charges if VaR models are deemed to be inadequate.**

2. **However, we do not believe that all 3*VAR_10-day_99%CL calculations are de-facto inadequate for regulatory capital purposes for credit assets.**

3. **We strongly support definitions of eligible trading book assets contained in the revised accord, which are consistent with leading risk management practice, and disagree with the CD's proposed exclusion of positions that would otherwise satisfy the definition.**

4. **We seek to replace the CD language that addresses situations in which a regulator determines that 3*VAR_10-day_99%CL does not adequately capture default risk with specific, alternative language that provides for a continuum of risk-based capital that approaches the Banking Book charge in the case of a long-only, un-hedged, illiquid portfolio.**

5. **We appreciate that the CD recognizes the need for flexibility in the determination of any Incremental Default Risk Capital calculation and further emphasize the importance of it also being grounded in risk-based principles.**

6. **We believe that an increase in already inappropriately conservative standardized risk weights is unwarranted. We further believe that standard**

weights should be revisited and reformulated to apply a more risk-sensitive measure.

7. **The Committee is concerned that the Pillar 3 requirement to disclose "the amount of internal capital allocated for trading portfolios" is premature, given the likely lack of comparability and risk of misinterpretation of such data.**

8. **The proposals for the treatment of failed transactions create a significant operational burden and provide a punitive capital result for risks that are primarily operational in nature, well-controlled, and have not resulted in meaningful losses in the experience of our firms.**

III. Trading Book Observations and Recommendations

1. **We accept the regulatory concern that VaR-based trading book capital calculations (i.e. 3*VAR_10-day_99%CL) for certain positions may result in insufficient regulatory capital, particularly related to credit exposures in the trading book, and endorse the concept of additional capital charges if VaR models are deemed to be inadequate.**

   The Basel Committee's *Trading Book Survey: A Summary of Responses* ("Survey") provides insight into the Basel Committee's analysis of the capital requirements for positions within a trading book. Section 2.2.2 of the Survey documents various risks that respondents cited as difficult to capture by use of a VaR methodology. A common theme expressed in the Survey was the wide variety of practices employed by respondents. Members of the Committee have not had the opportunity to review the breadth of approaches used for trading book VaR modeling which the Survey has afforded the Basel Committee. Consequently, we accept that certain VaR models may yield insufficient regulatory capital. The emphasis of our response thus becomes: 1) the determination of adequacy, and 2) the approach used to address any inadequacy.

2. **We do not believe that all 3*VAR_10-day_99%CL calculations are de-facto inadequate for regulatory capital purposes for credit assets.**

   While some risks are difficult to capture, the Committee believes that the risks cited by the Basel Committee (e.g., position concentration, basis and correlation risks) can and should be captured by VaR models. The Committee concurs with the recommendation of the CD (Paragraph 312, Section 2), which defines criteria for inclusion of specific risk in VaR models. Importantly, the Committee believes many investment banks and banks have captured effectively those risks identified as material to their businesses. The Committee recommends that any determination by a national supervisor that the VaR model of a bank or investment bank does not capture specific risk or default risk be based on an assessment of whether or not the model adequately captures the material risks of the portfolio to which it is applied – as opposed to a comparison of risks captured with a predetermined list of risks generally applicable to disparate lines of business. The Committee recognizes the critical importance of Pillar 2 within the Basel capital accord framework and accordingly seeks the opportunity to demonstrate the adequacy of 3*VAR_10-day_99%CL for credit assets in the trading book.

3. **We strongly support definitions of eligible trading book assets contained in the revised accord, which are consistent with leading risk management practice, and disagree with the CD's proposed exclusion of positions that would otherwise satisfy the definition.**

   The Committee endorses the definition of the trading book contained in Paragraphs 685-689 of the Revised Framework. We believe these paragraphs should serve as the foundation for including transactions in the trading book. We recognize that regulators are concerned about the potential for regulatory arbitrage that might occur if banking book exposures are artificially transferred to the trading book for no economic purpose other than lowering regulatory capital. However, regulators have the power and the opportunity to review transactions placed in the trading book on a case-by-case basis under Pillar 2. Transactions that do not meet the standards of trading intent in paragraph 687 should either be excluded from the trading book or have a capital requirement set at the banking book level.

   As long as positions meet the criteria of paragraphs 686-689, they should not be excluded from the trading book. As noted above, national supervisors have the power and the opportunity to review trading book assets to see if they are, in fact, being managed with trading intent. This includes the actual track record of the firm in acting to hedge the economic exposures inherent in the positions. Because national supervisors already have the option to challenge trading book classification, the proposals in paragraph 689a and 689b are not needed and should be deleted.

   A second reason for not excluding positions from the trading book if they are being managed with trading intent is that there will be related hedges. These hedges will become open exposures, creating a distortion of the VaR, which will, in turn, generate a distorted capital number.

4. **We seek to replace the CD language that addresses situations in which a regulator determines that 3*VAR_10-day_99%CL does not adequately capture default risk with specific, alternative language that provides for a continuum of risk-based capital that approaches the Banking Book charge in the case of a long-only, un-hedged, illiquid portfolio.**

The Committee has a significant objection to the language as written on p72 of the CD which is designed to be an amendment to Section B.8 Paragraph 3 of the Market Risk Amendment. However, we are optimistic that the alternative language that we propose below will address our concerns in a manner consistent with regulatory intentions and objectives. We suggest that this aspect of the CD be referred to as the requirement for "Incremental Default Risk Capital". We believe such terminology to be consistent with regulatory objectives and find it important to clarify that any such addition recognizes the existing contribution to capital for this risk within robust VaR models.

Our first specific suggestion is the removal of the example provided in the CD on page 72. The objectionable language begins with "One way a surcharge may be calculated …" and ends with "… of recovery in a downturn". We find this example to be based upon a simple "long-only" portfolio and written in such a way as to increase the potential for regulatory interpretations that could materially violate some of the key principles that we feel should guide any Incremental Default Risk Capital surcharge.

We would further suggest the following modification to the beginning portion of paragraph 3 on page 72 of the CD. "In addition, the bank must have an approach in place to capture the *incremental* default risk for its trading book positions in its regulatory capital *if such risk is deemed to be not fully captured by its VaR based capital calculation*. No specific approach is prescribed; it may be part of the bank's internal model or a surcharge from a separate calculation. Any approach should be calibrated to produce a level of capital consistent with a banking book capital requirement when applied to an unhedgeable credit exposure with a liquidity horizon of one year. The calculation should reflect the economics of systematic and idiosyncratic default risk in the trading book, including the impact of liquidity, hedging, optionality, and diversification. Rollover risk, where it exists, should be considered based on the principle of a constant risk position*.*"

5. **We appreciate that the CD recognizes the need for flexibility in the determination of any Incremental Default Risk Capital calculation and further emphasize the importance of it also being grounded in risk-based principles.**

Importance of grounding in risk-based principles
The power of Basel capital standards, and their value to the industry, derives from their foundation in risk management principles and models. Consistent with this, models of default risk in the trading book should be based on accepted risk management principles:

- Liquidity is a key factor underlying default risk in the trading book. The benefit of liquidity should be included in models. Most credit-risky positions in trading books are extremely liquid, and firms rebalance their positions to maintain the desired risk levels. We will expand further on liquidity below.

- Where default risk in the trading book includes "rollover" risk, rollover risk should be based on constant risk in the trading book over time, not on fixed positions. Since the great majority of default events occur as the result of a slide over time, there should be a liquidity adjustment to translate one-year default probabilities to the default probability of a position that is rolled over during the year with a fixed VaR level.

- Correlations should be included in a financially appropriate way. The benefit of diversification should be recognized, as it already is within the trading book and (implicitly) within the banking book. These correlations should be recognized across trading positions, and also between market risk and default risk. Default risk includes both systematic and idiosyncratic elements. Therefore, it does not simply add up due to the impact of diversification. These economic facts are inconsistent with the wording of the Consultative Document in Paragraph 312, Section 3(c). Basel capital rules are founded in economically reasonable risk models; therefore, it is essential that the impact of diversification be recognized.

- Trading positions include a large number of short positions. The benefit of these short positions is already included in VaR and should also be included in a reasonable model of default risk in the trading book. Short positions are very common in trading books, and profoundly impact the economics. This is particularly important in assessing the impact of systematic risk in the portfolio. Short positions in one position offset much of the systematic risk caused by long positions in other positions. Exclusion or limitation of the benefit for hedges would produce a result without economic credibility. Alternatively, the existence of such complicated portfolios increases the importance of the need for careful attention to the design of a calculation of Incremental Default Risk Capital.

Impact of liquidity

When considering capital charges for illiquid assets, it is important to choose an economic definition of liquidity. The Committee would like to express that the liquidity horizon should be defined by the shortest of three time periods:

- The time to sell an instrument, based on observed trading patterns in the market;
- The time for an instrument to mature;
- The time to hedge the instrument's material sensitivities to systematic and idiosyncratic market factors. In this case, there are multiple liquidity horizons for the risks in a single instrument.

We strongly disagree with the comments made in paragraph 292 in the Consultative Document. "While the composition of the firm's trading book may change over time, the proposed standard assumes that a firm's current positions are the best proxy available for its exposure to default in the aggregate over the one year assessment horizon." What is constant over the horizon is the level of risk, not the individual positions. If the level of risk (VaR) is maintained, the best estimate of the default risk is to multiply the existing positions by the unconditional default probabilities, adjusted for both rollover and rebalancing.

Data was previously submitted to the Basel/IOSCO Working Group regarding the impact of surprise defaults. That data suggests that surprise defaults represent a small proportion of total defaults.

The liquidity adjustment should be calibrated so that a position that is held for one year uses the one-year default probability. However, positions with a shorter liquidity horizon receive an increasing benefit from their liquidity.

Need for flexibility
We expect a variety of models would be reasonable to effectively capture default risk in the trading book for risk-based capital purposes. Given a diversity of effective approaches, we do not believe any single, unique model should be prescribed by regulators as the right way to treat default risk in the trading book. Utilizing one would approach would be undesirable because:

- There is not an industry consensus on the best way to model these risks, or to measure the key parameters that would drive such a model.
- There has not been adequate time to build such a model, or to assess its impact on required capital.
- Different firms have different types of positions in their trading book and different philosophies to manage these positions.

Each firm should engage in a dialogue with their national supervisor under Pillar 2. The result of this dialogue should be a model used to compute a capital charge under Pillar 1. It is expected that this would be an evolutionary process, so initial models would be less sophisticated, with enhancements over time. Regulators must accept that initial model approvals must not depend on perfect models and/or parameters.

6. **We believe that an increase in already inappropriately conservative standardized risk weights is unwarranted**. **We further believe that standard weights should be revisited and reformulated to apply a more risk-sensitive measure.**

Specific risk add-ons, as currently defined, have no theoretical foundation and should be discarded in each case where a firm moves to capital charges based on financially sound risk models.

- If specific risk represents idiosyncratic risk, then specific risk charges should be allowed to diversify across positions, not add up.
- If specific risk represents systematic risk (either spread risk or default risk) then it appropriate for these charges to be additive across reference names.

In this case, short positions should be treated as a capital credit, not a capital charge.

- With respect to individual reference names, the application of "specific risk" add-ons unless there is matched maturity creates artificial penalties. In fact, the default risk of such a position is net of longs and shorts.

Because specific risk add-ons ignore diversification and hedge benefits, specific risk charges greatly overstate the impact of default risk in a credit portfolio. It would be inappropriate to increase the charges, and serious consideration should be given to reducing them to reasonable levels.

7. **The Committee is concerned that the Pillar 3 requirement to disclose "the amount of internal capital allocated for trading portfolios" is premature.**

The Committee firms have had relatively little dialogue with regulators regarding details of their internal economic capital calculations and consequently question if regulators have a basis to be confident that such calculations are relatively comparable across firms. Given that comparisons will be made across firms following such disclosures we suggest that a more prudent approach to this issue would be for regulators to study the comparability of such calculations prior to instituting a Pillar 3 requirement.

IV. Unsettled and Failed Trades Observations and Recommendations

8. **The proposals for the treatment of failed transactions create a significant operational burden and provide a punitive capital result for risks that are primarily operational in nature, well-controlled and have not resulted in meaningful losses in the experience of our firms.**

In Part 5, the CD puts forward a proposal for computing capital requirements for failed transactions, with a view towards establishing a consistent treatment within the regulatory community. In brief, the proposal requires deductions from capital for the positive current exposure from failed DvP transactions five days after settlement date and the full value of failed non-DvP transactions two days after settlement date. Recognizing that the securities industry experiences few, if any, material losses from failed transactions, the Committee believes the Joint Committee's proposal to be unduly punitive. The Committee would point out that the primary reason for a transaction to fail for an appreciable period of time is the lacking of availability of the security – and not deterioration in the credit quality of counterparts. Accordingly, the Committee views the requirement for a deduction from capital as unwarranted and the time frame for the recognition of a significant capital requirement as far too short.

The Committee believes that a financial institution should record any loss from a default as soon as default is recognized. Given the industry's loss history, the Committee recommends treating the secured value of a failed trade as a secured exposure and the positive current exposure, marked-to-market on a daily basis, from a failed transaction as an unsecured exposure for the first 90 days from settlement date for purposes of computing capital requirements for failed transactions. The Committee would recommend treating the positive current exposure from a failed transaction as a deduction from capital after 90 days have passed.

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V. Conclusion

The Committee appreciates the opportunity to offer you our comments on the Consultative Document, and look forward to further dialogue with IOSCO and the Basel Committee on the important issues it addresses. If you have any questions concerning our letter, please do not hesitate to contact the undersigned at (212)272-7597, or the SIA staffers to the Committee, Kyle Brandon at (212)618-0580, or Jerry Quinn at (212)618-0507.

Sincerely,

s/ Michael J. Alix,
on behalf of the Committee