

the counterparty's positions with the broker-dealer, after applying specified netting agreements³⁶ and taking into account the value of certain collateral³⁷ received from the counterparty. Maximum potential exposure would be defined in paragraph (d)(4) of proposed Appendix E as the increase in the replacement value of the counterparty's positions with the broker-dealer, after applying the effect of specified netting agreements and taking into account the value of certain collateral received from the counterparty, that will not be exceeded with 99% confidence over a time horizon of one year. The broker-dealer would have to calculate maximum potential exposure using a VaR model meeting the applicable quantitative and qualitative requirements of proposed Appendix E.³⁸ The Commission requests comment on the proposed calculations of current exposure and maximum potential exposure, including the use of VaR models to measure maximum potential exposure as well as the impact of netting agreements and collateral.

The credit risk weight of the counterparty would be calculated under paragraph (d)(7) of proposed Appendix E using methods that are consistent with the computation of credit risk capital charges for OTC derivatives dealers under Appendix F to Rule 15c3-1. If a counterparty is rated by a nationally recognized statistical rating organization ("NRSRO"), the credit risk weight would range from 20% to 150% depending on the credit rating of the counterparty, which provides a measure of credit risk. If a counterparty is not rated by an NRSRO, the broker-dealer could apply to the Commission, either in its original application or by amending its application, for permission to determine a credit rating for the counterparty using internal calculations and to use the internal credit rating in lieu of a rating by an NRSRO for purposes of determining the credit risk

weight of the counterparty. We request comment on whether the broker-dealer should also be able to apply to the Commission for permission to determine the credit risk weight of a counterparty using internal calculations. For exposures covered by guarantees, where the guarantee is an unconditional and irrevocable guarantee of the due and punctual payment and performance of the obligation and the broker-dealer can demand immediate payment from the guarantor after any payment is missed without having to make collection efforts, a broker-dealer would be able to substitute the average of the credit risk weights of the guarantor and the counterparty for the credit risk weight of the counterparty.

Concentration charges are appropriate when a lack of diversification exposes the broker-dealer to additional risk. When evaluating the debt holdings of an entity, a lack of diversification would be evidenced by either a relatively (relative to the amount of the broker-dealer's tentative net capital) large exposure to a single party (the credit rating of that counterparty would, of course, affect the amount of additional risk) or a relatively large amount of unsecured debt holdings.

The second part of the credit risk capital charge, as provided in paragraph (d)(8) of proposed Appendix E, would take into account the additional risk of a relatively large exposure to a single party and would consist of concentration charges by counterparty that would generally apply when the current exposure of the broker-dealer to a single counterparty exceeds 5% of the tentative net capital of the broker-dealer. The amount of the concentration charge would be larger for counterparties with lower credit ratings and would range from 5% to 50% of the amount of the current exposure of the broker-dealer to the counterparty in excess of 5% of the broker-dealer's tentative net capital. The 5% is based on the OTC derivatives dealers rules and Commission experience.

The third part of the credit risk capital charge, as provided in paragraph (d)(9) of proposed Appendix E, would recognize the additional risk of holding a relatively large amount of unsecured debt and would consist of a portfolio concentration charge across all counterparties that would be the amount, if any, that the broker-dealer's aggregate current exposure across all counterparties for unsecured exposures exceeds 15% of the broker-dealer's tentative net capital.

The Commission requests comment on all aspects of the credit risk capital charge; in particular, the determination

of credit risk weights for counterparties. The Commission requests comment on whether an additional method of calculating credit risk weights, based on internal estimates of annual probabilities of default, should be included in proposed Appendix E. If such a method should be used, the Commission requests comment on whether the following table appropriately matches credit risk weights to annual probabilities of default:

CREDIT RISK WEIGHT OF COUNTERPARTY BASED ON ANNUAL PROBABILITY OF DEFAULT³⁹

Annual probability of default	Credit risk weight (in percent)
Less than .003%	2
0.05%	17
0.11%	30
3.80%	200
5.30% or higher	230
Event of default has occurred	1250

The Commission believes that calculating a credit risk capital charge on exposures arising from transactions in derivatives instruments using a qualifying VaR model to calculate maximum potential exposure is a more precise method than using a "notional add-on" to approximate maximum potential exposure. In addition, Commission reviews of risk management systems of large U.S. broker-dealers indicate that these broker-dealers use maximum potential exposure to measure and manage the credit risk of their portfolios. These broker-dealers would therefore incur small, if any, additional costs to calculate maximum potential exposure as opposed to "notional add-ons."

The Commission requests comment on all aspects of this approach to the calculation of credit risk capital charges on derivatives instruments, including the two concentration charges that are applicable both to individual counterparties and across all counterparties. The Commission also requests comment on the appropriate treatment of credit derivatives in this

³⁶ Only netting agreements that meet the requirements of paragraph (d)(5) of proposed Appendix E could be used to derive current exposure and maximum potential exposure. For example, the netting agreements would have to be legally enforceable in each relevant jurisdiction, including in insolvency proceedings. These proposed requirements are designed to allow a broker-dealer to reduce its credit risk capital charge only if the netting agreement reduces credit risk.

³⁷ Only collateral that meets the requirements of paragraph (d)(6) of proposed Appendix E could be used to derive current exposure and maximum potential exposure. For example, the collateral must have a ready market or consist of certain major market foreign currency or U.S. currency. These proposed requirements are designed to allow a broker-dealer to reduce its credit risk capital charge only if the collateral reduces credit risk.

³⁸ See proposed Rule 15c3-1(e).

³⁹ These credit risk weights are based on the formulas provided in the Advanced Internal Ratings-Based approach to credit risk proposed by the Basel Committee. *The New Basel Capital Accord*, April 2003. The credit risk weights were derived using a loss given default (the percentage of the amount owed by the counterparty the firm expects to lose if the counterparty defaults) of 75%. We believe that 75% is a conservative number for use in determining credit risk weights. We request comment on whether 75% is appropriate, or whether it should be increased or decreased.