

ability to pledge the equity securities of a subsidiary to secure the debt or to sell a subsidiary unless the pledgor or buyer agreed to assume liability for some portion of the debt?

- Would the inclusion of long-term debt in allowable capital affect the liquidation priority of the customers of entities which are part of the CSE in the event of the holding company's bankruptcy?

- What other provisions concerning the inclusion of long-term debt in allowable capital should be considered?

We request comment on all aspects of the calculation of allowable capital.

b. Group-Wide Calculation of Allowance for Market Risk

Under proposed paragraph (a)(2) of Appendix G, a CSE would calculate a group-wide allowance for market risk on all proprietary positions, using a VaR model or an alternative method approved by the Commission, multiplied by an appropriate multiplication factor to provide an adequate measure of risk during periods of market stress. The calculation of the allowance for market risk is important in determining what risk due to market factors the broker-dealer may be exposed to through its affiliates. The VaR model would have to meet the qualitative and quantitative requirements of paragraph (e) of proposed Appendix E.⁴³ The computation of the allowance for market risk under this proposal is consistent with the calculation of the market risk capital charge for the broker-dealer under proposed Appendix E. The Commission seeks comment on all aspects of the proposed method of calculating an allowance for market risk. In particular, should other qualitative or quantitative requirements be included in paragraph (e) of proposed Appendix E?

c. Group-Wide Calculation of Allowance for Credit Risk

Paragraph (a)(3) of proposed Appendix G would require that a CSE calculate an allowance for credit risk daily for certain assets on the consolidated balance sheet and certain off-balance sheet items. The allowance for credit risk would be computed using the methodology set forth in paragraph (a)(3)(i) of proposed Appendix G, which is consistent with the proposed New Basel Accord, or, pursuant to paragraph (a)(3)(ii) of proposed Appendix G, if the Commission approves the broker-

dealer's request, using a calculation consistent with standards published by the Basel Committee, as modified from time to time. This choice would provide CSEs with some flexibility while the Basel Standards are under review.

The methodology set forth in paragraph (a)(3)(i) of proposed Appendix G would require that a CSE multiply the credit equivalent amount of each asset or off-balance sheet item by the appropriate credit risk weight of that asset or off-balance sheet item, and then multiply the result by 8%.⁴⁴ In general, the assets and off-balance sheet items subject to this allowance are loans and loan commitments receivable and receivables arising from derivatives contracts, repurchase and reverse repurchase agreements, stock lending transactions, and similar collateralized transactions, and other extensions of credit.

Paragraph (a)(3)(i) of proposed Appendix G would establish the manner in which the "credit equivalent amount" of a balance sheet item should be calculated, which is consistent with the proposed New Basel Capital Accord. The credit equivalent amounts for receivables relating to (i) loans and loan commitments receivable; (ii) derivatives contracts, repurchase agreements, reverse repurchase agreements, stock loans, stock borrows, and other similar collateralized transactions; and (iii) other assets would be calculated differently. These calculations are set forth in paragraphs (a)(3)(i)(A), (B), and (E) of proposed Appendix G, respectively. We request comment on the credit conversion factors set forth in paragraph (a)(3)(i)(A) of proposed Appendix G. In particular, we request comment on the credit conversion factor for margin loans.

Paragraph (a)(3)(i)(C) of proposed Appendix G would define the "current exposure" of a member of the affiliate group to a counterparty as the current replacement value of the counterparty's positions with the member of the affiliate group after applying certain netting agreements,⁴⁵ taking into account the value of certain collateral⁴⁶ pledged to and held by a member of the

affiliate group, and subtracting the fair market value of any credit derivatives that specifically change the CSE's exposure to the counterparty (as long as the credit derivatives are not used to change the credit risk weight of the counterparty).⁴⁷

Paragraph (a)(3)(i)(D) of proposed Appendix G would define the "maximum potential exposure" of a member of the affiliate group to a counterparty as the increase in the net replacement value of the counterparty's positions with the member of the affiliate group, after applying certain netting agreements,⁴⁸ taking into account the value of certain collateral⁴⁹ pledged to and held by the member of the affiliate group, and subtracting the fair market value of any credit derivatives that specifically change the CSE's exposure to the counterparty (as long as the credit derivatives are not used to change the credit risk weight of the counterparty)⁵⁰ that is obtained daily using an approved VaR model meeting the applicable qualitative and quantitative requirements of paragraph (e) of proposed Appendix E.⁵¹

We request comment on whether the proposed method of calculating the credit equivalent amount is appropriate, or whether it should be changed. In addition, we request comment on whether the definitions of "current exposure" and "maximum potential exposure" are appropriate, or if they should be changed. If the proposed method for calculating credit equivalent amount or the definitions of "current exposure" or "maximum potential exposure" should be changed, please specify how they should be changed.

Paragraph (a)(3)(i)(F) of proposed Appendix G provides that credit risk weights would generally be determined

⁴⁷ The fair market value of any credit derivatives that specifically change the CSE's exposure to the counterparty may be used to calculate "current exposure" and "maximum potential exposure" only to the extent that the credit derivative is not used to change the credit risk weight of the counterparty as set forth in paragraph (a)(3)(i)(I) of proposed Appendix G.

⁴⁸ See *supra*, note 36.

⁴⁹ See *supra*, note 37.

⁵⁰ See *supra*, note 47.

⁵¹ The quantitative requirements for a VaR model used to calculate maximum potential exposure would include that the model use a 99 percent, one-tailed confidence level with price changes equivalent to a five-day movement in rates and prices for repurchase agreements, reverse repurchase agreements, stock lending and borrowing, and similar collateralized transactions (See paragraph (c)(1)(i)(E) of proposed Appendix G) and to a one-year movement in rates and prices for other positions (See proposed paragraph (e)(2)(ii) of proposed Appendix E) (as opposed to a ten business-day movement in rates and prices for VaR models used to calculate the allowance for market risk. (See paragraph (e)(2)(i) of proposed Appendix E).

⁴³ See *supra*, discussion of the broker-dealer's calculation of its market risk capital charge using a VaR model under proposed Appendix E.

⁴⁴ This is consistent with the calculation of credit risk under the OTC derivatives dealers rules (See 17 CFR 240.15c3-1f(d)(2)). In addition, use of the 8% basic multiplier to calculate credit risk is consistent with the Basel Standards.

⁴⁵ Only netting agreements that meet the requirements set forth in paragraph (d)(5) of proposed Rule 15c3-1e could be used to reduce current or maximum potential exposures. See *supra*, note 36.

⁴⁶ Only collateral that meets the requirements set forth in paragraph (d)(6) of proposed Rule 15c3-1e could be used to reduce current or maximum potential exposures. See *supra*, note 37.