

according to standards published by the Basel Committee, as modified from time to time. If the Commission approves an application by the broker-dealer in its initial application or an amendment to the application, the CSE may use internal credit ratings⁵² or calculate credit risk weights using internal calculations⁵³ when calculating its allowance for credit risk.

In addition, paragraph (a)(3)(i)(f) of proposed Appendix G would allow a CSE to adjust credit risk weights of receivables covered by certain types of guarantees,⁵⁴ and paragraph (a)(3)(i)(I) of proposed Appendix G would allow a CSE to adjust credit risk weights of receivables covered by certain credit derivatives (such as credit default swaps, total return swaps, and similar instruments used to manage credit risk)⁵⁵ in recognition of the credit protection these instruments provide.

The Commission requests comment on the determination of credit risk weights. In particular, 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 G.⁵⁶

The Commission believes that using a VaR model that meets the applicable qualitative and quantitative requirements of paragraph (e) of proposed Appendix E 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 and their affiliates indicate that these firms generally use

maximum potential exposure to measure and manage the credit risk of their portfolios. These firms would therefore incur little, if any, additional cost to calculate credit risk using maximum potential exposure as opposed to "notional add-ons."

We request comment on this approach to the calculation of credit risk on derivatives, repurchase agreements, reverse repurchase agreements, stock lending and borrowing, and similar collateralized transactions. In addition, we request comment on the proposed requirements for guarantees used to reduce a CSE's allowance for credit risk. We also request comment on the appropriate treatment of credit derivatives in this context. Credit derivatives could enter into the calculation of credit risk in two ways. The first would be to substitute the credit risk weight of the writer of the credit derivative for the credit risk weight of the counterparty for the portion of the exposure covered by the credit derivative. This is the method set forth in paragraph (a)(3)(i)(I) of proposed Appendix G. Another method would be to adjust the current exposure and the maximum potential exposure by the value of the credit derivative. We request comment on these and other methods of treating credit derivatives.

Certain accounting differences between securities firms and banking firms may necessitate certain modifications to the Basel Standards when they are applied to securities firms. For instance, broker-dealers must mark all positions to market, while banks may use historical cost for securities held for investment purposes. The Commission solicits comment on how accounting differences might affect the computation of the allowance for credit risk, and what modifications the Commission should make to the proposed rules to address those differences.

The Commission seeks comment on all aspects of the proposed method of calculating the allowance for credit risk. Because the Basel Standards have been implemented by many financial regulators, we request comment on whether the proposed method is consistent with the Basel Standards as they have been implemented. In addition, we request comment on whether the proposed rule is consistent with the proposed New Basel Capital Accord and whether it is consistent with how various financial regulators have proposed to implement the proposed New Basel Capital Accord. Should a CSE have other alternative methods for calculating the allowance for credit risk?

d. Group-Wide Calculation of Allowance for Operational Risk

The calculation of an allowance for operational risk is intended to measure risks faced by the firm other than market and credit risk; for example, operational risk would include the risk that the prescribed procedures of the firm may not be followed in a particular transaction, causing the firm to incur potentially significant losses. Such losses incurred by the holding company or an affiliate of a broker-dealer could have a significant adverse effect on the broker-dealer. The proposed rule would, therefore, require that the CSE calculate an allowance for operational risk.

Under proposed Rule 15c3-1g(a)(4), the calculation of the allowance for operational risk must be consistent with the proposed New Basel Capital Accord. The Basel Committee has proposed three methods for the calculation of an allowance for operational risk: the basic approach, the standardized approach, and the advanced measurement approach.⁵⁷ The basic and standardized approach calculations are based on fixed percentages. Under the basic approach, the allowance is 15% of consolidated annual revenues net of interest expense averaged over the past three years. For the standardized approach, the allowance for operational risk is a percentage of revenues net of interest expense, ranging from 12% to 18%, for each of eight business lines. The advanced measurement approach requires a system for tracking and controlling operational risk and provides that the allowance for operational risk is the largest operational loss that might be expected over a one-year period with 99.9% confidence.

We solicit comment on all aspects of the proposed allowance for operational risk, including how to best measure operational risk and when a calculation of operational risk should be required. We request comment on whether any of the methods is preferable and, if so, why. Further, could any changes be made to these methods or percentages used to calculate the charges that would be more appropriate for the broker-dealer business? Finally, should we allow a holding company to choose one of the three methods, or should the proposal require holding companies to use the advanced measurement approach?

⁵⁷ See The New Basel Capital Accord (April 2003).

⁵² See paragraph (a)(3)(i)(G) of proposed Appendix G.

⁵³ See paragraph (a)(3)(i)(H) of proposed Appendix G.

⁵⁴ The guarantee would be required to be an unconditional and irrevocable guarantee of the due and punctual payment and performance of the obligation and the holding company or member of the affiliate group can demand payment after any payment is missed without having to make collection efforts. Further, the guarantee would be required to be evidenced by a written obligation of the guarantor that allows the holding company or member of the affiliate group to substitute the guarantor for the counterparty upon default or nonpayment by the counterparty. These proposed requirements are designed to allow a CSE to reduce its allowance for credit risk only if the guarantee contains features that make it more reliable.

⁵⁵ The credit derivative would be required to be one that (i) provides credit protection equivalent to a guarantee, (ii) is used for bona fide hedging purposes to reduce the credit risk weight of a counterparty, (iii) is not incorporated into the VaR model used for deriving potential exposures, and (iv) is not held for market-making purposes.

⁵⁶ See *supra*, discussion of proposed credit risk capital charge calculation for the broker-dealer.