

2. Calculation of Consolidated Allowance for Market Risk

Paragraph (b) of proposed Rule 17i-7 would require that an SIBHC calculate a consolidated allowance for market risk daily for all proprietary positions. The SIBHC would calculate an allowance for market risk for each position using either a VaR model or, if there is not adequate historical data to support a VaR model, an alternative method. Generally, the allowance for market risk would constitute three times⁷² the largest amount the SIBHC could lose over a ten-day period with a 99% confidence level (as determined using the VaR model or alternative method).⁷³ An SIBHC would need to provide the Commission with information regarding any alternative method for computing allowance for market risk for particular positions during the Commission's review of its Notice of Intention so that the Commission could evaluate the method to determine whether it adequately measured the risks of those positions.

Paragraph (b)(1) of proposed Rule 17i-7 would require that each VaR model used to calculate allowance for market risk must meet the qualitative and quantitative requirements set forth in rules the Commission is also proposing today in a separate release, proposed Rule 15c3-1e(e).⁷⁴ The qualitative and quantitative standards set forth in proposed Rule 15c3-1e(e) are similar to the requirements for models used by OTC derivatives dealers and are consistent with the Basel Standards. The qualitative requirements would address three aspects of an SIBHC's risk management system: (i) The model would have to be integrated into, and thus relied upon, in the SIBHC's daily risk management process; (ii) the model would be required to undergo periodic reviews by the SIBHC's internal audit staff and annual reviews by an accountant; and (iii) the SIBHC would need to conduct backtesting of the model (the results of the backtests would be used by the SIBHC to determine the multiplication

factors to be used when calculating market and credit risk).⁷⁵ The quantitative requirements would set forth basic standards for each model including, (i) it must use a 99 percent, one-tailed confidence level and with price changes equivalent to a ten business-day movement in rates and prices for purposes of determining market risk, (ii) it must use an effective historical observation period that must be at least one year in length and include periods of market stress, and (iii) it must take into account and incorporate all significant identifiable market risk factors applicable to the affiliate group's positions.

Consistent with the Basel Standards, paragraph (b)(1) of proposed Rule 17i-7 would require that each VaR model used to calculate allowance for market risk also must be one that can be disaggregated by each line of business exposed to market risk and by each legal entity.

We request comment on all aspects of the proposed methods for calculating market risk, including whether any other quantitative or qualitative requirements should be applied to VaR models. In addition, we request that commenters address any perceived differences between the proposed methodology for calculating market risk and the Basel Standards. Further, we request comment on alternative methods for computing allowance for market risk, and the appropriateness of those methods.

3. Calculation of Consolidated Allowance for Credit Risk

Paragraph (c) of proposed Rule 17i-7 would require that an SIBHC calculate a consolidated allowance for credit risk daily using either a calculation consistent with the Basel Standards or the methodology set forth in paragraph (c)(1) of proposed Rule 17i-7, which is similar to the proposed New Basel Capital Accord. This choice would provide SIBHCs with some flexibility while the Basel Standards are under review. The methodology set forth in paragraph (c)(1) of proposed Rule 17i-7 would require that an SIBHC multiply the credit equivalent amount of certain asset and off-balance sheet items by the appropriate credit risk weight of the asset or off-balance sheet item, and then multiply the result by 8%.⁷⁶ In general, the asset and off-balance sheet items

subject to this allowance are loans and loan commitments receivable, receivables arising from derivatives contracts, repurchase and reverse repurchase agreements, structured financial products, credit substitutes, and other extensions of credit.

Consistent with the proposed *New Basel Capital Accord*, Paragraph (c)(1)(i) of proposed Rule 17i-7 would establish the manner in which the "credit equivalent amount" of a balance sheet item should be calculated. The credit equivalent amounts for receivables relating to (i) derivatives contracts, repurchase agreements, reverse repurchase agreements, stock loans, stock borrows, and other similar collateralized transactions; (ii) loans and loan commitments receivable; and (iii) other assets would be calculated differently, and are set forth in paragraphs (c)(1)(i)(A), (B), and (C) of proposed Rule 17i-7, respectively. Paragraph (c)(1)(i)(D) of proposed Rule 17i-7 would define the term "current exposure" to be the current replacement value of the counterparty's positions with the member of the affiliate group including the effect of netting agreements with that counterparty,⁷⁷ and taking into account the value of collateral from that counterparty⁷⁸ pledged to and held by any member of the affiliate group and the fair market value of any credit derivatives that specifically change the exposure to the counterparty (as long as the credit derivatives are not used to change the

⁷⁷ 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 51. Generally, the SIBHC could use a netting agreement that allows the SIBHC to net gross receivables and gross payables with a counterparty upon default of the counterparty if (i) the netting agreement is legally enforceable in each relevant jurisdiction, including in insolvency proceedings; (ii) the gross receivables and gross payables subject to the netting agreement with a counterparty can be determined at any time; and (iii) for internal risk management purposes, the SIBHC monitors and controls its exposure to the counterparty on a net basis.

⁷⁸ 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 51. Generally, the SIBHC could take the fair market value of collateral pledged to and held by the SIBHC into account, provided (i) the collateral is marked to market each day and is subject to a daily margin maintenance requirement; (ii) the collateral has a ready market or consists of major market foreign currency as defined in § 240.15c3-1a(b)(1)(i)(C) or U.S. currency; (iii) the collateral agreement is legally enforceable by the SIBHC against the counterparty and any other parties to the agreement; (iv) the collateral does not consist of securities issued by the counterparty or a party related to the SIBHC or to the counterparty; and (v) the collateral is not used in determining the credit rating of the counterparty.

⁷² Paragraph (b)(1) of proposed Rule 17i-7 would establish the initial multiplication factor (three); however the multiplication factor would subsequently be set based on the number of backtesting errors generated through use of the model. The initial multiplication factor was derived from the minimum requirement set forth in 17 CFR 240.15c3-1f(e)(1)(iv)(C) (the rule used by OTC derivatives dealers to calculate market risk capital charges). This initial multiplication factor would be used until sufficient backtesting results has been collected to use the Table set forth in 17 CFR 240.15c3-1e(e)(1)(iii)(C).

⁷³ *See supra*, note 51. Specifically, *see* proposed 17 CFR 240.15c3-1e(e)(2)(i).

⁷⁴ *See supra*, note 51.

⁷⁵ *See supra*, note 51. Specifically, *see* proposed 17 CFR 240.15c3-1e(e)(1).

⁷⁶ This is consistent with the calculation of credit risk used by OTC derivatives dealers (*See* 17 CFR 240.15c3-1f(d)(2)). In addition, the 8% basic multiplier to calculate credit risk capital charges is consistent with the Basel Standards.