

credit risk weight of the counterparty as provided in paragraph (c)(1)(ii)(E)).⁷⁹ Finally, paragraph (c)(1)(i)(E) of proposed Rule 17i-7 defines the term "maximum potential exposure" to be the increase in the net replacement value of the counterparty's positions with the member of the affiliate group, including the effect of netting agreements with that counterparty,⁸⁰ and taking into account the value of collateral from that counterparty⁸¹ 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 credit risk weight of the counterparty as provided in paragraph (c)(1)(ii)(E)).⁸² Paragraph (c)(1)(i)(E) of proposed Rule 17i-7 also states that maximum potential exposure would be required to be calculated daily using a VaR model that meets the same qualitative and quantitative standards as required for models used to compute the allowance for market risk.⁸³

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 elaborate as to how they should be changed.

Paragraph (c)(1)(ii) of proposed Rule 17i-7 provides that credit risk weights would generally be determined according to the standards published by

the Basel Committee, as modified from time to time.⁸⁴ An SIBHC may also use internal credit ratings⁸⁵ or calculate credit risk weights using internal calculations⁸⁶ when calculating its allowance for credit risk.

In addition, paragraph (c)(1)(ii)(D) of proposed Rule 17i-7 would allow SIBHCs to adjust credit risk weights of receivables covered by certain types of guarantees,⁸⁷ and paragraph (c)(1)(ii)(E) of proposed Rule 17i-7 would allow SIBHCs 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)⁸⁸ in recognition of the benefits 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 Rule 17i-7. 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 DEFAULT

Annual probability of default	Credit risk weight (in percent)
Less than .003%	2
0.05%	17
0.11%	30
3.80%	200

⁸⁴ See paragraph (c)(1)(ii)(A) of proposed Rule 17i-7.

⁸⁵ See paragraph (c)(1)(ii)(B) of proposed Rule 17i-7.

⁸⁶ See paragraph (c)(1)(ii)(C) of proposed Rule 17i-7.

⁸⁷ 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 SIBHC 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 SIBHC 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 an SIBHC to reduce its allowance for credit risk only if the guarantee contains features that make it more reliable.

⁸⁸ 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.

CREDIT RISK WEIGHT OF
COUNTERPARTY BASED ON ANNUAL
PROBABILITY OF DEFAULT—Continued

Annual probability of default	Credit risk weight (in percent)
5.30% or higher	230
Event of default has occurred	1250

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.⁸⁹ We have derived the credit risk weights 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 75% to be a conservative number for use in determining credit risk weights. We request comment as to whether 75% is appropriate, or whether it should be increased or decreased.

The Commission believes that calculating a credit risk capital charge on exposures arising from transactions in OTC derivatives instruments using a VaR model that meets that qualitative and quantitative requirements set forth in proposed § 240.15c3-1e(e)⁹⁰ 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 generally use maximum potential exposure to measure and manage the credit risk of their portfolios. These broker-dealers 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 OTC 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 an SIBHC'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

⁸⁹ See the *New Basel Capital Accord* (April, 2003).

⁹⁰ See *supra*, note .

⁷⁹ The fair market value of any credit derivatives that specifically change the SIBHC'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 (c)(1)(ii)(E).

⁸⁰ See *supra*, note 77.

⁸¹ See *supra*, note 78.

⁸² See *supra*, note 79.

⁸³ However, the quantitative requirements for a VaR model intended to calculate maximum potential exposure would be required to use a 99 percent, one-tailed confidence level and 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 Rule 17i-7) and to a one-year movement in rates and prices for other positions (See proposed 17 CFR 240.15c3-1e(e)(2)(ii)) (as opposed to a ten business-day movement for VaR models used to calculate the allowance for market risk (See proposed § 17 CFR 240.15c3-1e(e)(2)(i)).