

credit derivative for the credit risk weight of the counterparty. The second would be to adjust the current exposure and the maximum potential exposure by the value of the credit derivative.

Certain accounting differences may cause differences in application of the Basel Committee's recommendations when applied to securities firms rather than banking firms. For instance, the broker-dealers must mark all positions to market, whereas banks may use cost as a basis to value securities held for investment purposes. These differences may require the Commission to apply adjustments to the Basel Committee's recommendations, or not to apply adjustments that are in the Basel Committee's recommendations. The Commission solicits comments on how the differences in accounting standards might affect 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 as to whether the proposed rule is consistent with the Basel Standards as they have been implemented. In addition, we request comment as to whether the proposed rule is consistent with the present version of the proposed *New Basel Capital Accord* and how various financial regulators have proposed to implement the proposed *New Basel Capital Accord*. Should an SIBHC have other alternative methods for calculating the allowance for credit risk?

4. Calculation of Consolidated Allowance for Operational Risk

Under proposed Rule 17i-7, an SIBHC would be required to calculate an allowance for operational risk consistent with the appropriate standards published by the Basel Committee. The Basel Committee has proposed three methods for the calculation of an allowance for operational risk (i) the basic approach; (ii) the standardized approach; and (iv) the advanced measurement approach. For a complete discussion of the proposed operational risk calculation, please refer to the proposed *New Basel Capital Accord*.⁹¹ 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. The standardized approach maps these revenues to eight business lines. The allowance for operational risk is then a percentage of revenues net of interest expense, ranging from 12% to 18%, attributed to each business line. 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 these three methods for calculating consolidated allowance for operational risk. In addition, we request that commenters address whether any of the three methods is preferable and, if so, explain why. Further, could any changes be made to these methods that would better accommodate the broker-dealer business? Finally, should we allow an SIBHC to choose one of the three methods, or should the proposed Rule require that SIBHCs use the advanced measurement approach?

5. Alternative Capital Assessment

Under paragraph (e) of proposed Rule 17i-7, an SIBHC would be permitted to compute a capital assessment using the Basel Standards that the SIBHC already is required to submit to a financial regulator or supervisor in lieu of the computations described in paragraphs (a) through (d). This proposed Rule is intended to allow an entity that may already be subject to certain consolidated supervision requirements to continue to use its present systems and methodologies to compute a capital assessment for reporting purposes for the affiliate group so long as that computation is consistent with the Basel Standards.

6. General Questions Regarding Proposed Rule 17i-7

We believe the requirements set forth in proposed Rule 17i-7 are necessary to keep the Commission informed as to the SIBHC's financial condition.

We request comment on whether we should allow this alternative standard or whether some other approach may be warranted.

We are proposing what we believe are prudent parameters for computing an SIBHC's risk allowances, although in some cases these parameters may be more conservative than some firms may believe are necessary to account for risk. For example, the proposal requires that the VaR model used to calculate market risk be based on a ten business-day movement in rates and prices and that

a 99% confidence level be used, and that the VaR measure be multiplied by a factor of at least three. These parameters are based on our experience and existing Commission rules (e.g., Appendix F of Rule 15c3-1) and rules of other regulatory agencies where there are similar risk factors in the regulated entities. We ask for comment on all these parameters.

7. Other Questions Regarding Capital Calculation

Proposed Rules 17i-6 and 17i-7 would apply a capital reporting requirement consistent with the Basel Standards to the SIBHC. The Basel Committee is currently developing a new international agreement, the proposed *New Basel Capital Accord*. The proposed *New Basel Capital Accord* specifies three "pillars" for the group-wide supervision of internationally active banks and financial enterprises. The first pillar, "minimum regulatory capital" requirements, requires calculations for credit and operational risk and, for firms with significant trading activity, market risk. The second pillar, "supervisory review," requires that capital be assessed relative to overall risks and that supervisors review and take action in response to those assessments.

The third pillar requires certain disclosures which will allow market participants to assess key pieces of information concerning, for example, the capital, risk exposures, and risk assessment processes of the institution. The purpose of the third pillar is to complement the minimum capital requirements and the supervisory review process by encouraging market discipline.

The third pillar is discussed in the U.S. banking agencies' Advanced Notice of Proposed Rulemaking on the proposed *New Basel Capital Accord*.⁹² As the banking agencies noted, an integral part of the advanced approaches is enhanced public disclosure practices. Specific disclosure requirements would be applicable to all institutions using the advanced approaches and would encompass capital, credit risk, credit risk mitigation, securitization, market risk, operational risk, and interest rate risk.

We request comment on whether any additional disclosures by U.S. broker-dealer firms, their holding companies, and affiliates should be required to meet the requirements of the third pillar of the proposed *New Basel Capital Accord*.

⁹¹ See the *New Basel Capital Accord* (April, 2003).

⁹² See *Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord*, 68 FR 45900 (August 4, 2003), beginning at 45943.