Meeting Between Federal Reserve Staff
and Members of the Securities Industry Association (SIA)
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Participants: Norah Barger (FRB); David Jones (FRB); Eric Heitfield (FRB); Darryll Hendricks (FRBNY); Dianne Dobbeck (FRBNY); John Kambhu (FRBNY); Seth Fliegler (FRBNY); Patricia Moser (FRBNY)

Michael Alix (Bear Steams); Cheryl Kallem (Bear Steams); Lisa Zonino (Morgan Stanley); Adam Gilbert (JPMorgan); Cynthia McNulty (JP Morgan); Tom Gregory (Merrill Lynch); Mark Holloway (Goldman Sachs); Jerry Quinn (SIA)

Staff of the Federal Reserve Board and the Federal Reserve Bank of New York ("Federal Reserve") met with the Securities Industry Association (SIA), which represents investment banks, broker-dealers and mutual fund companies, to discuss the recently issued Advance Notice of Proposed Rulemaking (ANPR) relating to the implementation of the New Basel Capital Accord.

The discussion focused on the SIA's concerns regarding the potential impact of Basel II on their activities. In particular, five areas of concern were discussed. Of greatest interest was the distinction between the trading book and banking book capital treatments and what activities would fall under each category. In addition, the SIA had concerns about counterparty charges for over-the-counter (OTC) derivatives, as well as the lack of recognition of double default when determining the capital requirements for hedged exposures.

SIA members also mentioned their concern with the Basel Accord over the gap between theory and practice. According to the SIA, the models proposed by the Basel Committee and the capital charges they imply are not sensitive enough to capture the actual losses experienced by securities firms. Further, they recommended increased communication and coordination between home and host supervisors.

More specifically, the SIA recommended that their industry activities be considered trading book as opposed to banking book exposures, the latter of which they viewed as carrying higher capital charges. According to SIA members, the transactions their firms engage in have the characteristics of short-term securities: they are marked-to-market and are held for sale rather than held as investments. They also argued that some instruments that may look like investments, such as real estate mortgage assets, are only held for a short time (six to nine months) before they are sold or securitized, and, therefore, should be considered under the trading book capital guidelines. As a representative from one SIA member firm stated, they do not want a "moving business to be treated as a storage company." Placing an increasing number of activities in the banking book would, according to the SIA, place a heavy cost burden on firms.

In terms of counterparty charges for OTC derivatives, the SIA believes that maintaining the current treatment will result in inconsistencies with the application of the Basel I1 advanced approaches permitted for determining capital on other exposure types. Members described the notional based add-on treatment for OTC derivatives as wholly inappropriate in calculating a risk-based capital charge. Although the recognition of double default (meaning that both the borrower and guarantor would have to default for the bank lender to experience a loss) was not the SIA's principal concern, members did call for further examination of this issue. Overall they believe that the substitution approach for determining capital for hedged exposures is inappropriate.

In general, the SIA does not believe that the IRB risk weight functions introduced in the Basel I1 proposal are capable of recognizing the sensitivities of the firms' individual experiences. Members noted that firms have instruments (e.g. repos, security lending) that in practice have experienced little or no losses even though the proposed treatments would suggest the possibility of greater losses and, therefore, require greater capital charges. Firms do not have concerns about the theory, but do question its application. In addition, as stated above, the SIA recommended greater coordination between local and global supervisory regulators.

Currently, the members of the SIA are estimating the impact of the proposed advanced internal ratings-based (IRB) approach on their exposures, but have yet to reach any final conclusions. As a result, their comments on the ANPR will be slightly delayed.