Ad Hoc Working Group of U.S. Investment Banks

ATTN: Docket No. R-1154
Advanced Notice of Proposed Rulemaking: Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue
Washington, DC 20551

Re: Advanced Notice of Proposed Rulemaking Comment Letter, Docket No. R-1154

Four large U.S.-based global investment banking firms formed an Ad Hoc group to undertake a study of the impact of the ANPR on their firms. This ad hoc group represents a majority of the U.S.-based internationally active investment banks. This group is pleased to offer you comments on the Advanced Notice of Proposed Rulemaking: "Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord" ("ANPR Basel II"). Although the Federal Reserve's rules may not directly impact the four firms, they are important to us as a leading example of Basel II implementation in the United States.[1] Our comments are based largely on the impact study that was conducted, which indicates that for many of our core activities Basel II prescribes capital requirements that appear to be excessive relative to risk and loss experience. As a result of this study, we believe there are a few key modifications and clarifications that can address the concerns we have identified and foster a more appropriate risk-based capital regime.

In particular, based on the pro-forma calculations of the four investment banks which measure the impact of moving from Basel I to Basel II, we have identified a number of areas in which the results of the calculation have been impacted materially by (1) substantive differences in trading book versus banking book treatment for similar asset classes, (2) the proposed treatment of OTC derivative transactions, and (3) differing interpretations of the Basel I accord across jurisdictions, particularly in regard to Securities Financing Transactions.

1. **Trading Book / Banking Book treatment**

    We note that 3 of our 4 firms do not have a "banking book" per se, and solely utilize trading book, mark-to-market approaches in both financial reporting and risk management practices. (We also note that the firm with a banking book follows trading book approaches where deemed appropriate). We observe that there is substantial divergence between the risk weighted assets that are generated

[1] We note that the Securities and Exchange Commission has issued a proposal that provides, among other things, for consolidated supervision using Basel II standards. We intend to comment separately on this proposal.

for similar asset classes depending on whether a banking book or a trading book methodology is used. In particular, the choice of methodology generates significantly different risk weighted assets when dealing with trading portfolios of corporate loans and pools of purchased and originated assets that are being warehoused in preparation for securitization. We recommend that the Federal Reserve apply a standard consistent with that found in CP3 of the Basel II Capital Accord[2] when determining whether trading book or banking book treatment is warranted, the key requirements of which are mark-to-market accounting and intent to sell. We believe that this treatment is appropriate since it reflects the way that the firms actually manage the risks of their respective businesses. In assessing capital levels for these trading book activities, we believe the Basel II Accord appropriately provides for review and approval of models for assessing risk; any concerns about the adequacy of capital levels for these activities should be alleviated through testing the effectiveness of the models. Additionally, utilizing a banking book approach would require considerable expense to develop systems and collect the data necessary to calculate expected and unexpected losses on a par basis, while yielding no tangible benefit relative to current risk management practices.

2. Securities Financing Transactions – Interpretative Differences

The results of the study revealed that substantive differences in interpretation of the Basel I capital accord yield materially different results as to the impact of moving from the Basel I capital accord to the Basel II capital accord. In particular, the treatments of repo-style transactions and the recognition of collateral specified under Regulation Y versus that accepted by the Financial Services Authority (FSA) in the United Kingdom yields results so divergent as to change directionally the impact of moving from Basel I to Basel II for the firms surveyed in the study.

a. **Treatment of repo-style transactions.** The treatment of repo-style transactions specified under Regulation Y requires firms to apply a 20% risk weight on the collateralized portion of any government-collateral reverse repurchase transaction in which the value of the outstanding contract is greater than the value of collateral securing the loan, and to apply the counterparty risk weight to the unsecured portion.[3] Conversely, the FSA Basel I approach uses a replacement cost methodology that requires firms to apply risk weights only to the unsecured portion of repo-style transactions, and not to the secured portion. These different approaches result in directionally different movements when measuring the impact of progressing from Basel I to Basel II, as applying a 20% risk weight to the secured balance of repo-style transactions results in very large risk weighted assets.
b. **Definition of eligible financial collateral**. Along a similar vein, the definition of eligible financial collateral is far more restrictive under

[2] See 3rd Consultative Document, Part 2, Section VI.A – Definition of the Trading Book.
[3] Regulation Y, Pt. 225, App. A, Attachment 3, Section C.2.c, page 221, 1/1/03 edition

Regulation Y than it is under the FSA approach. Specifically, collateral in the form of corporate obligations (i.e., corporate bonds, convertible securities, and equity securities) takes a 100% risk weight under Regulation Y, whereas it is treated as effective credit risk mitigation under the FSA approach, which does not haircut financial collateral. The impact of this difference in interpretation is substantial – for example, the entire book of Regulation T compliant margin debits would be considered equivalent to a book of unsecured loans under the Regulation Y interpretation, thus attracting a 100% risk weight. Under the FSA approach, a margin loan, which is typically substantially overcollateralized, would generate zero risk weighted assets. Similarly, a repo-style transaction that uses corporate bonds or convertible securities as collateral is treated as an entirely unsecured loan under Regulation Y, which generates high risk-weighted assets relative to the economic risk and structure of the transaction.

3. OTC Derivatives

We endorse the positions expressed in the joint comment letter submitted on November 3, 2003 by the International Swaps and Derivatives Association and The Bond Market Association ("ISDA/TBMA"). Specifically, as argued by ISDA/TBMA, both the Basel I and Basel II treatments of OTC derivatives are unreasonable insofar as the add-on levies an effective "tax" on the notional amount of transactions, which can only be ameliorated through a decrease in volume. We support the ISDA/TBMA proposal that the treatment for OTC derivatives be revisited promptly, and recommend that the treatment for transactions that are economically similar and exhibit similar risks, such as repo-style transactions and OTC Derivatives, should receive uniform treatment, e.g., utilizing a potential exposure or expected exposure methodology, under the New Accord and ANPR.[4]

Additionally, our firms observed that the proposed treatment for OTC derivatives has the effect of raising the capital requirements for all of the firms that participated in the study when moving from Basel I to Basel II, primarily due to the removal of the 20% risk weight on OECD banks, the removal of the 50% cap on non-bank counterparty risk weights, and the addition of a maturity adjustment to the risk weight function. Further, certain types of collateralized derivative transactions, e.g., sold covered options, do not entail any credit risk but, illogically, generate credit risk-weighted assets under the proposed methodology. It is our opinion that the risk weighted assets generated by the ANPR Basel II methodology do not on the whole reflect the economic risk associated with the business, and in certain particular cases these risk weighted assets are generated in cases where no credit risk actually exists.

a. **Proposed calculation raises capital requirements across the industry.** The proposed calculation raises capital requirements relative to Basel I

[4] See ISDA/TBMA joint comment letter regarding the ANPR, November 3, 2003, pages 7-8.

due to the removal of the 20% risk weight for OECD banks and the 50% cap on non-bank counterparty risk weights, as well as the addition of a maturity adjustment to the risk weight function. Based upon the provisional probabilities of default and loss given default parameters employed in our quantitative study, capital requirements begin to increase for any OECD bank counterparty rated in the single "A" range and below, while requirements increase for non-bank commercial counterparties rated in the "BBB" range and below, based upon a 1-year maturity. These requirements increase even more for derivatives with greater than one year maturity.

b. **Covered trades.** We refer to forward and options transactions in which the underlying instrument is pledged and held in custody by the bank in sufficient amount to fully satisfy the settlement or exercise obligation as "covered trades." An example of such a trade is an equity call option in which the counterparty sells an option and simultaneously pledges to the bank the amount of the underlying shares deliverable under the option terms. Because the value of the underlying security will move in tandem with the value of the derivative and the bank is fully secured, no credit risk arises from the transaction. However, credit risk weighted assets are generated due to the fact that the methodology requires that equity collateral be haircut by 25% and does not account for the fact that any future movement in the exposure related to the derivative will be matched entirely by movements in the value of the underlying security held in custody.

We are pleased to have this opportunity to comment on the ANPR and would be happy to discuss our views at greater length. For additional information, please feel free to contact us at your convenience.

Sincerely,

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