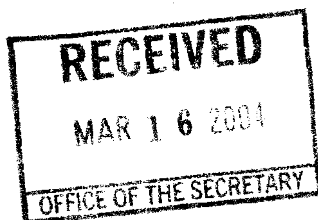
BEAR STEARNS



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S7-22-03

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March 15, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street N.W.
Washington, D.C. 20549-0609

Re: Proposed Rule on Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities and Proposed Rule on Supervised Investment Bank Holding Companies (Releases No. 34-48690 and No. 34-48694; Files No. S7-21-03 and No. S7-22-03)

Dear Mr. Katz,

The Bear Stearns Companies Inc., Bear, Stearns & Co. Inc. and Bear, Stearns Securities Corporation (collectively, "Bear Stearns" or "the firm") appreciate the opportunity to comment on the U.S. Securities and Exchange Commission's risk-based capital proposals for Supervised Investment Bank Holding Companies (68 Fed. Reg. 62910, November 6, 2003) and for Consolidated Supervised Entities (68 Fed. Reg. 62872, November 6, 2003) (together, the "Proposals").

Bear Stearns is an internationally active investment bank with a significant interest in the potential application of proposed new risk-based capital standards at both the holding company and broker-dealer levels. Under the auspices of trade associations such as the Securities Industry Association ("SIA") and the International Swaps and Derivatives Association ("ISDA"), senior managers overseeing the firm's risk management and regulatory capital functions have participated actively in the assessment of international capital standards developed by the Basel Committee on Banking Supervision ("Basel II") and related implementing proposals in both the United States and Europe.[1,2] Additionally, during 2003, Bear Stearns joined the Ad Hoc Working Group of U.S. Investment Banks in commenting on the U.S. Federal banking regulators' Advance Notice of Proposed Rulemaking on the New Basel Capital Accord (the "ANPR")[3]. The

[1] SIA Comment Letter on the Consolidated Supervised Entity Proposal, February 27, 2004.
[2] ISDA Comment Letter on the Consolidated Supervised Entity Proposal, February 4, 2004.
[3] Ad Hoc Working Group of US Investment Banks, ANPR Response Letter, December 19, 2003.

firm fully endorses the analysis and substantive recommendations contained in these comment letters and is pleased to comment now on the SEC Proposals.

We will not repeat all of the detailed comments contained in the above-referenced letters; rather, we will amplify a few issues of particular importance to our firm. We preface our specific comments by noting the firm strongly supports the evolution of risk-based capital standards consistent with leading risk management practices. We further support the suggestion that models and methods utilized to compute regulatory capital should reflect those used by management in the normal course of business. In order to align firm risk management practices with capital requirements and to promote consistency with international standards, we believe it is important that risk-based capital calculations for activities in the broker-dealer are consistent with those for comparable activities elsewhere in the consolidated group. Thus, we advocate revisions to the proposed new broker-dealer capital requirements that will make them more consistent with holding company requirements (including over time the inclusion of a separate risk-based calculation for operational risk).

Our areas of focus include:

(1) the proposed credit risk treatment of margin loans at the broker dealer,
(2) the proposed credit risk treatment of Over-the-Counter (OTC) Derivatives, and
(3) the proposed treatment of market risk

I. **Margin Loans**: The Proposals require a 5% credit conversion factor for all margin loans at the consolidated level. Our experience with these typically highly over collateralized loans indicates that such a level is unjustifiably high. Most margin loans are held in broker dealer affiliates, in which the application of customer margin requirements often exceed the conservative minimums prescribed by Federal Reserve Board Regulation T and New York Stock Exchange Rule 431. These requirements, combined with strict operational controls for collateral valuation, margin calls and, if indicated, liquidations, substantially minimize risk of loss of margin lending. Actual realized losses for this activity over many decades have been de minimus. Additionally, we suggest that the Commission reconsider existing broker dealer capital requirements related to margin lending. Specifically, we recommend that firms be allowed to adopt a portfolio-specific risk-based methodology, consistent with Basel II, for determining the appropriate amount of capital related to margin lending regardless of whether the loan is held at a broker dealer or non-broker dealer affiliate. The risk-based approach would

consider volatility, diversity and liquidity of underlying collateral, in lieu of a calculation that applies an arbitrary factor to the net debit balances in customer accounts. Such approach would be subject to back-testing.

II. **OTC Derivatives**: The proposed credit risk treatment of OTC derivatives, in which exposure at default is equivalent to the current exposure less collateral on hand plus the 1-year maximum potential exposure, represents a conceptual improvement upon the notional add-on treatment that applies under the current Basel accord. We support the Commission's move to a more risk-sensitive formulation and urge continued study and adoption of more refined approaches, such as the expected positive exposure measures advocated by ISDA. While the Commission's proposed treatment incorporates a standard measure of future credit exposure, we observe a methodological flaw in measurement for collateralized credit arrangements. The proposed method does not take into account the risk-mitigating benefit of future contractually required collateral movements. Failure to provide collateral as agreed is an event of default which triggers termination and effectively shortens the relevant time horizon over which adverse market movements may occur. Our credit risk management models are designed to measure potential adverse market moves during a conservatively estimated period before which transactions either mature or could be terminated. Where collateral is required, this period is shorter than either the contractual maturity of the transactions or the Commission's proposed 1-year minimum. For example, where counterparties are required to post collateral based on a daily mark-to-market of both the derivative transaction and the collateral held, we estimate the period over which the market could influence the size of the exposure at 10 business days. Without a maturity adjustment to the models, exposure-at-default would be overstated. Because credit risk managers require collateral for lower-rated counterparties, which would have higher probabilities of default, the application of associated higher risk weights to an exaggerated exposure at default estimate exacerbates the overstatement of the capital requirement.

III. **Market Risk**: The proposed treatment of market risk, with its phase-in period for the use of Value-at-Risk ("VAR") modeling, is inconsistent with that proposed by CP3 of the New Basel Capital Accord[4] as well as that proposed by the ANPR. At the broker-dealer level, the phase-in and exclusion of certain securities from VAR model-treatment would require a risk system

[4] Basel Committee on Banking Supervision, 3rd Consultative Document, July 31, 2003, paragraph 646.

separate from that used by management, which would be costly, inefficient, burdensome and inconsistent with the principles of both the Basel requirements and the Proposals themselves. Furthermore, the broker-dealer level approach deviates from established practice under existing Basel rules, in place since 1996. We believe it is critical that the Commission adopt fully the Basel Committee's definition of trading book activities and permit the immediate use of VAR models for capital calculations for those activities, whether transacted in the broker-dealer or elsewhere within the group. Such a change would ensure that firms could use the same risk management system, with models validated by back-testing and subject to Commission review, at both the holding company and broker dealer levels.[5] In some cases, consistent with the Proposals, capital requirements may be raised by increasing multipliers (such as where back-testing data is incomplete) or by use of reasonable scenario analyses. However, the Commission should clarify circumstances in which it will require firms to add to its model-generated capital charges. Any add-ons should be based solely on market-related risks.

Again, Bear Stearns appreciates the opportunity to comment on the Proposals and would be happy to discuss our comments with appropriate SEC staff. If you have any questions, please feel free to contact me at 212-272-0531 or Michael Alix, Senior Managing Director, at 212-272-7597.

Sincerely,

cc: Michael Alix
Robert Neff
Joseph Noto

[5] These points about Trading Book / Banking Book are further elaborated in the Ad Hoc Working Group of US Investment Banks response letter, *op. cit*, pages 1-2.