Securities Industry Association

120 Broadway, New York, NY 10271-0080, (212) 608-1500, Fax (212) 608-1604
1401 Eye Street, NW, Washington, DC 20005-2225, (202) 296-9410, Fax (202) 296-9775
info@sia.com, http://www.sia.com

December 31, 1996

The Honorable Arthur Levitt
Chairman
Securities & Exchange Commission
450 Fifth Street N.W.
Washington, D.C. 20549

Re: Possible Amendments to the Net Capital Rule

Dear Mr. Chairman:

The Securities Industry Association ("SIA") has recently decided to form a Risk Management Committee, and I have been asked to serve as Chairman, which I have accepted. In that capacity, I have received a copy of some correspondence between yourself and SIA's 1996 Chairman, Buzzy Krongard of Alex Brown.[1] Of particular interest in the exchange of letters was the discussion concerning possible amendments to the Net Capital Rule. But before addressing that issue, please permit me to tell you a bit about the decision to create a Risk Management Committee.

Creation of Risk Management Committee

In the past year, a number of issues touching upon risk management have risen that suggested the advisability of SIA creating a permanent committee to represent the views of our member firms on these issues. For example, at the recent annual meeting of the International Conference of Securities Associations ("IOSCO") in Montreal, SIA in conjunction with the London nvestment Banking Association ("LIBA") sponsored a presentation on value-at-risk (VAR) models. Also, the New York Stock Exchange recently formed a Committee to recommend changes to the Exchange's margin rule (Rule 431). As part of that effort, the NYSE has created a subcommittee to consider margining on a portfolio basis. Finally, regulators both in the U.S. and internationally have been becoming more concerned about the scope and content of the internal controls of financial firms. In light of these developments and in view of SIA lacking a permanent, on-going vehicle to respond to such issues, it was decided to create a Risk Management Committee.

In establishing the new Committee, it was determined that it would be necessary for it to receive input from a variety of professional disciplines within firms, and that its focus would be on *all* the risks arising within modern securities firms, not limited to those arising from particular products. In addition, it was agreed that the purpose of the Committee would be two-fold: a) to act as an educational forum on risk management issues both among the firms themselves, and with respect to assisting regulators in understanding contemporary risk management practices at the leading securities firms; and b) to act as a vehicle reflecting the views of those firms in responding to regulatory initiatives relating to risk management.

Value-at-Risk Models

As you know, value-at-risk ("VAR") models are increasingly used by major banks and securities firms as an internal tool for managing market and credit risk. We believe that these models also hold promise as a methodology for determining regulatory capital standards, as indicated by the actions of bank regulators to permit banks to utilize models in assessing their capital requirements.

In Buzzy Krongard's letter to you, he referenced several studies that suggest that the ability of the Commission's Net Capital Rule to judge the capital adequacy of securities firms has been surpassed by other methodologies. Of particular interest are two studies, one by Professors Elroy Dimson and Paul Marsh of the London Business School, [2] and the other a study undertaken by senior staffers of the New York Federal Reserve Bank.[3]

The Dimson & Marsh study compared three different regulatory methods of determining capital required to cover market risk in equity portfolios of market makers in London. The three approaches studied were the strategy-based or "comprehensive" approach utilized in the net Capital Rule; the "building block" approach that has been utilized by some banking regulators; and the "simplified portfolio" approach used by the Securities and Futures Authority in the United Kingdom. The study concluded that the portfolio approach worked best, while the comprehensive approach was the least satisfactory, since under the latter methodology there was no correlation between the relative riskiness of a portfolio and the amount of capital required.

Those conclusions were consistent with the study undertaken by the staffers of the New York Fed, which was similarly critical of non-portfolio approaches. Their study focused on the market and credit risks of option contracts and reviewed several different methods of measuring the risk of such instruments. It determined that the portfolio based Value at Risk ("VAR") approaches were far more accurate than strategy-based rules.

Rule 431

Although the regulatory goals of the Net Capital Rule and of NYSE Rule 431 are distinct, we believe that the same principles that apply to questions of capital adequacy should also apply to margin questions. The imposition of collateral requirements on each specific position in a portfolio is a crude device for regulating credit exposures. This point is made very well in the recent paper on "Regulatory Competition and the Efficiency of Alternative Product Margining Systems," by Paul H. Kupiec and A. Patricia White, economists at the Federal Reserve Board.[4] The paper demonstrates that the portfolio margining approach is a much more efficient system for collateralizing the one-day risk exposures of equity derivatives portfolios and achieves substantially the same market risk protection as the strategy-based system of Regulation T (an approach similar to that of the Net Capital rule) but with collateral levels that are mere fractions of those required by Regulation T. In light of the greater statistical rigor that VAR models introduce into efforts to measure risk, we hope that the Commission will look favorably upon the attempts to amend Rule 431 so as to permit portfolio margining.

Conclusion

We believe that VAR modeling is the most powerful tool presently available for quantifying market risk in a portfolio of diverse financial instruments, allowing for comprehensive risk assessment across different risk types and markets. Integration of VAR models into the regulatory scheme for broker-dealers would have the important benefit of creating closer links between internal risk management and supervisory standards, and could establish a consistent framework within which regulators, traders, and risk managers could examine and discuss questions of risk. Capital charges based on VAR models would also explicitly permit recognition of the risk reducing benefits of portfolio diversification allowing for a more accurate assessment of the incremental risk (or risk reduction) posed by adding an additional position to a portfolio.

While we attach great importance to securities regulators finding a means to incorporate VAR models into the regime for determining regulatory capital standards, we also are cognizant that no quantitative risk measurement methodology will fully reflect every subtle aspect of risk in a complex portfolio. Therefore, VAR analysis represents but one element of modern risk management, and should be supplemented by other risk management methods, above all, by a robust internal control framework.

In conjunction with SIA's Capital Committee, we look forward to commenting on the Commission's forthcoming release on the Net Capital Rule. If you or your staff have any questions about this letter, or wish to discuss any of the topics mentioned in it, please feel free to contact either of the Committee's staff advisers, Gerard J. Quinn (212) 618-0507; David G. Strongin (212) 618-0513, or me directly (212) 761-6701. Thank you.

Sincerely,

Steven M. Benardete
Chairman, Risk Management Committee

Footnotes

[1] Letter to The Honorable Arthur Levitt, from A.B. Krongard, July 31, 1996; letter to Mr. A.B. Krongard from Arthur Levitt, September 13, 1996.

[2] Dimson, Elroy and Paul R. Marsh, "Capital Requirements for Securities Firms," *Journal of Finance*, 50:3, pp. 1219-1233.

[3] Estrella, Arturo, Darryll Hendricks, John Kambhu, Soo Shin, and Stefan Walter, *Options Positions: Risk Measurement and Capital Requirements*, Federal Reserve Bank of New York, Research Paper #9415 (September 1994).

[4] Paul H. Kupiec and A. Patricia White, *Regulatory Competition and the Efficiency of Alternative Derivative Product Margining Systems*, Federal Reserve Board, Washington, D.C., Finance and Economics Discussion Series, 96-11(February 1996).

For more information, please contact Gerard Quinn or David Strongin.