TESTIMONY OF

MICHAEL J. ALIX

SENIOR MANAGING DIRECTOR

BEAR STEARNS & CO, INC.

THE NEW BASEL ACCORD:
PRIVATE SECTOR PERSPECTIVES

BEFORE THE

HOUSE FINANCIAL SERVICES COMMITTEE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

AND CONSUMER CREDIT

JUNE 22, 2004

Mr. Chairman and members of the Subcommittee:

I am Michael J. Alix, a Senior Managing Director of Bear Stearns & Co, Inc., and Global Head of Credit Risk Management, and also the Chairman of the Securities Industry Association's[1] Risk Management Committee. I am speaking today on behalf of my firm and a group of those members of SIA that are most likely to be applicants under the Securities and Exchange Commission's new regulatory regime for Consolidated Supervised Entities ("CSE").

I applaud the Subcommittee for holding this hearing on the Bank for International Settlements' Basel Committee on Banking Supervision's (the "Basel Committee") efforts to develop a new Capital Accord ("Basel II") and for giving me the opportunity to testify on this

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[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated $209 billion in domestic revenue and $278 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

key issue. The new Capital Accord is crucial not only to U.S. financial market participants but also to financial firms throughout the world. The Subcommittee's oversight of Basel II and its implementation has been very helpful to the financial services industry, including those investment banks that likely will be applying for global risk-based supervision under CSE.

My testimony today comes from the somewhat unique perspective of an investment bank viewing Basel II through the prism of the CSE framework. I wish to make the following points:

- It is essential that there be a European Union ("EU") "equivalence" determination on the CSE framework *vis-a-vis* the EU's Financial Conglomerate Directive ("FCD") in the very near future;
- Regulators must coordinate and cooperate with their regulatory counterparts around the globe regarding the implementation of Basel II /CSE if the goal of Basel II is to be realized;
- In order to ensure competitive equality among financial institutions, both banking and securities regulators must address certain remaining issues with Basel II. The recent formation of the Basel/IOSCO Working Group on trading book issues is a very positive step in this direction;
- Given that the FGD will become effective well before Basel II, there must be flexibility with respect to timing and implementation of standards as firms migrate to Basel II/CSE;[2]
- The CSE framework presents challenges not only to the private sector but also to the SEC. For some time the SEC's Market Regulation Division has been successfully transforming itself into a 'prudential supervisor' comparable to any other regulator of the global capital markets. We want to encourage the continuation of that process, and ensure that the Division has the necessary resources to achieve and maintain that goal; and
- Certain technical amendments of a number of industry regulations need to be made in order to fully implement the risk-based capital regime of CSE.

[2] Directive 2002/87/EC of the European Parliament and of the Council of the European Union of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. The FCD becomes effective for institutions for their financial year beginning on or after January 1, 2005. In a May 11th press release, the Basel Committee announced that the standardized and foundation approaches of Basel II will be implemented from year-end 2006, and the advanced approaches as of year end 2007.

Why We Care About Basel II

Given the impact of Glass Steagall[3] in the evolution of the U.S. financial services industry, at first glance one might ask why securities firms are concerned with a capital standard being developed for banks. Part of the answer, of course, is that enactment of Gramm-Leach-Bliley in November 1999 essentially abolished the remaining barriers between commercial and investment banking. Perhaps more importantly from the perspective of the major independent investment banks, the EU is in the process of implementing the Financial Conglomerates Directive ("FCD")[4]. The FCD will require that any financial institution with a substantial presence in the EU's capital markets either directly submit to consolidated supervision under the FCD or if a non-EU based institution, demonstrate that it is subject to an "equivalent" form of consolidated supervision in its home country. The consequences are not entirely clear if a non-EU financial firm is unsuccessful in demonstrating that its home country supervisor provides an equivalent form of consolidated supervision. EU officials have indicated, however, that such institutions will be required to "ring fence" their EU operations from those elsewhere, and may have to submit to having the United Kingdom's Financial Services Authority ("FSA") serve as their consolidated supervisor. This would have a substantial and deleterious impact upon global firms' ability to compete in the capital markets.

Notwithstanding that U.S. securities firms have been required to make risk-assessment reports to the SEC with respect to their material affiliates for more than 10 years[5], it did not appear likely that the EU would conclude that the existing regime of U.S. securities regulation was "equivalent" to the consolidated supervision standard to be implemented under the FCD. Partly in response, the SEC began developing two new regulatory structures that would clearly provide 'equivalent' consolidated supervision for securities firms and their affiliates, including holding companies. One such structure, Supervised Investment Bank Holding Company

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[3] What is commonly known as Glass-Steagall is actually the Bank Act of 1933, which erected a wall between commercial banking and investment banking. Although eroded over the decades, it remained largely intact until enactment of Gramm-Leach-Bliley in 1999.

[4] Under the "Financial Conglomerates Directive" -- also sometimes referred to as the "Financial Groups Directive" -- a financial entity need not technically be a 'conglomerate' to fall within its terms.

[5] Rule 17h-2T – Risk Assessment Reporting Requirements for Brokers and Dealers.

("SIBHC"), was mandated by GLB.[6] The other framework is CSE[7], and the major independent U.S. investment banks[8] seem certain to register pursuant to that framework.[9] As the capital adequacy provisions of CSE are largely based upon Basel II, the major independent investment banks have a keen interest in Basel II, though as mediated through the mechanism of CSE.

Consequently, though they have long complied with varied local capital requirements at the affiliate level, major independent U.S. investment banks will soon be applying an international capital standard at the holding company, or group-wide, level for the first time. In the U.S., the SEC's capital requirements for broker/dealers are strict and comprehensive. However, this regime of local regulation contrasts significantly with major commercial banks, including those with securities subsidiaries, which have been subject to the Basel I standards on a consolidated basis for years. The day-to-day experience with Basel I and the leading role of their regulators was a key reason why commercial banks were involved closely in the development of Basel II. The major investment banks and the securities supervisors were, by comparison, "late to the table" with respect to key policy discussions with the framers of Basel II.

As investment banks began to comprehend the impact of Basel II across their global businesses, it became clear that the commercial-bank oriented approach, as reflected in the Accord's third consultative paper, could be problematic.[10] The composition of businesses typical of a major investment bank varies considerably from those typical of a traditional commercial bank – for example greater focus on short-term trading and secured financing, less (if any) emphasis on hold-to-maturity lending – and the investment banks observed that the apparent Basel II capital requirements for some of their key businesses were out of line with perceived risk and actual loss experience. Outsized capital requirements could cause firms to reduce activity (and by extension liquidity) in certain securities markets, so it was critical that the investment banks' concerns be addressed. I can report that firms have made significant progress

[6] Release No. 34-49831; File No. S7-22-03.

[7] Release No. 34-49830; File No. S7-21-03.

[8] The five institutions are: Bear Stearns; Goldman Sachs; Lehman Brothers; Merrill Lynch; and Morgan Stanley.

[9] In addition to the independent investment banks, we understand that a number of banks with substantial broker-dealer activities may also ultimately choose to register under CSE.

[10] The various drafts of Basel II have taken the form of "Consultative Papers," the most recent of which, Consultative Paper 3 ("CP 3") was published in April 2003. Last summer, the US Federal banking regulators published their version of CP 3 in the form of an Advanced Notice of Proposed Rulemaking ("ANPR").

in the last year in clarifying how the calculations should be made and conveying important technical flaws in the Accord through direct constructive discussions with Basel Committee members. Detailed technical discussions with officials of the Federal Reserve Board, the Federal Reserve Bank of New York, and the SEC enabled four large investment banks to refine their calculations and complete a comprehensive quantitative impact study that served as the basis for comments late last year on the Board's ANPR.[11] The recent formation of a task force by the Basel Committee and IOSCO to follow up on many of our concerns provides important evidence that the Basel Committee takes seriously the unique perspective of the investment banks.

Aspects of CSE

In addition to providing a means for the major U.S. investment banks to demonstrate consolidated supervision on an equivalent basis to the standard required under the EU's FCD, there are other key benefits of CSE. One is that the framework will permit securities firms registered under it to determine the regulatory capital for their broker-dealers by means of approved Value at Risk ("VaR") models.[12] This will better align capital requirements with the true risks of the securities business, with the added benefit of harmonizing the SEC's capital rules with global standards as represented by Basel II. Another key benefit is that firms that choose to register under CSE will have to demonstrate group-wide adherence to rigorous risk management practices. Reaffirming the old adage of "no pain, no gain," firms starting the application process report that the exercise is arduous, but also say that the result is sure to be further enhancement of regulators' confidence that there is a documented set of robust and resilient risk management practices and internal controls in place at these firms.

Although the CSE framework was published in final form only a few weeks ago, it was not created out of whole cloth, and there is a substantial history behind it. Among the most important milestones: firms began 17(h) risk assessment reports in 1992; also, a group of the largest firms active in the OTC derivative markets (these positions were largely carried outside a registered entity) created the Derivatives Policy Group ("DPG") in 1995, and committed to

[11] Attached as appendix A is a copy of the comment letter on the ANPR.

[12] At the risk of over simplifying, a VaR model is a statistical technique used by firms to estimate how much money is at risk for a firm over a given period of time and with a specified degree of probability.

supplying the SEC with various monthly reports on their derivatives positions, and benchmarks for enhancing their risk management and internal controls. Subsequently the SEC created a regime for limited-purpose broker-dealers ("B/D lite") with the first entity registered under those provisions starting operations in 1999. Finally, in June 2001, the SEC's Market Regulation Division initiated a series of monthly meetings with major firms to review their risk reports in considerable detail. The SEC's Market Regulation Division should be congratulated for creatively building upon that background in developing CSE, and for recognizing the benefits of utilizing a form of "regulatory best practices" in incorporating Basel II for the capital adequacy element. CSE should be seen as part of a continuing evolution rather than an *ad hoc* creation.

Remaining Steps

First and most importantly, it is essential that we obtain an EU determination that the CSE's form of consolidated supervision is "equivalent" to that required by the FCD. Since the United Kingdom's FSA serves as the "lead" regulator for virtually all major U.S. firms operating in the EU, that body will be making the equivalence determination. It will do so based upon guidance set forth by the EU Banking Advisory Committee. Originally, the guidance was to be announced by the end of April 2004, with the FSA scheduled to make its first set of equivalence judgments by June 2004. We are concerned that these timetables have slipped. We ask that the Subcommittee and your colleagues on the full Committee monitor this situation carefully.

Second, if the goal of developing a new Capital Accord is to be realized, it is essential that all regulators coordinate and cooperate with their regulatory counterparts around the globe on implementation issues involving Basel II /CSE. Doing so will permit regulators to leverage their resources, help ensure that no entity is subject to duplicative or inconsistent requirements, and help ensure that supervisory responsibility is lodged with the supervisor or regulator best situated to exercise such responsibility. It would also help promote reciprocity, which is crucially important in the context of global capital markets.

Flexibility with respect to the timing and implementation of Basel II and CSE will be very important. U.S. securities firms, other than those that are part of an entity that is already subject to comprehensive consolidated supervision, have not been subject to Basel standards on a firm-wide basis, and thus have not been obligated to build a "Basel infrastructure." Thus, we

request flexibility as to which Basel standard applies to those firms, particularly during the period before Basel II is implemented. That flexibility is necessary in order to avoid the undue expense and burden of requiring that CSE applicants comprehensively implement a standard that is destined to be superseded in the relatively near future. Of course, such flexibility must be exercised in a manner that maintains consistency with international supervisory standards and avoids competitive disparities.

The collaborative process must continue for international capital standards to more fairly reflect the risks inherent in the investment banking businesses, without imposing large and unnecessary costs. Though we expect a "final" version of Basel II within weeks, we believe that our remaining significant concerns can be addressed through later interpretive guidance or amendments within the implementation timeframe. Perhaps most significant among many still open items is whether the SEC and other global regulators will recognize the reality that much of our risk-taking relates to trading, rather than banking, activities that meet both the spirit and the letter of the Basel Committee's definition of a trading book.

There is yet another – and fundamental – difference in the way banks and investment banks manage their activities, and we would ask regulators to be particularly aware of this distinction in the application of Basel II and CSE to investment banks. Banks and securities firms operate and report under substantially different accounting frameworks – banks generally accrue earnings and establish formula reserves, while securities firms mark-to-market and would expect to treat virtually all business lines as part of the trading book.[13] Mark-to-market accounting forces firms to immediately recognize changes in the risk profile of any position or business, and to take timely action to reallocate capital to address problems or opportunities. In contrast, banks maintain their assets at original book value, but establish reserves – generally on a formulaic basis -- to recognize concerns about credit erosion. If, in the application of Basel II or CSE to investment banks, regulators required investment banks to compute capital requirements for trading activities as though a part of the banking book, investment banks would be taking a "double hit" in the computation of their requirements.

[13] Appendix B is a one page summary of the current trading/banking book accounting for U.S. financial firms.

There are other critical areas for improvement, including methodologies used for the calculations for over-the-counter derivatives, securities financing transactions, and short-term unsettled transactions. We also support flexibility for regulators in their decisions about the models used in advanced measurement approaches to operational risk capital determinations to ensure that they fairly reflect the nature of such risks in investment banks. Our firms remain fully committed to devoting all the necessary resources, systems, and people to ensure a successful implementation of Basel II and CSE, and we are willing and eager to play an active part both in any fine-tuning of Basel II before the implementation date, and in any subsequent efforts to develop the next Capital Accord.

Implementation of CSE (or Basel II) presents many challenges to the firms expecting to be governed by it, and requires a very serious commitment of resources and staff. A challenge is also presented to the SEC, as the agency will be required to assume new responsibilities and develop a more comprehensive and intensive oversight of CSE firms. In our view, the SEC's Market Regulation Division and Office of Compliance, Inspections & Examinations have been doing a remarkably good job in meeting that challenge and developing into a 'prudential supervisor' comparable to any other in the global capital markets. That being said, we want to encourage the continuation of that process, since both the public and private sector must continually deal with the evolution of financial markets. To make that a reality will require that those units have the necessary resources, and we hope that the Subcommittee and your Congressional colleagues will ensure adequate funding for that purpose.

Lastly, certain rules that now limit the expansion of some business lines within U.S. securities firms and would continue to do so even for CSE registrants, need to be amended in order to make full use of the risk-based capital regime of CSE. In particular, we believe that amendments to existing margin requirements and position limits at a number of the self-regulatory organizations will be critical, thereby permitting an expansion of the OTC derivatives business within broker-dealers. Facilitating an expanded range of activity within the U.S. broker-dealer would reduce the number of different entities through which firms book activities, resulting in a variety of benefits and efficiencies for both affected firms and their customers.

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We very much appreciate the Subcommittee's interest in the adoption and implementation of Basel II. We look forward to working with Congress, the Administration, and regulators on finalizing and implementing the new Capital Accord, particularly as it is a key component of the CSE framework.

Thank you very much.

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

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[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,

Michael Alix
The Bear Stearns Companies, Inc.
(212) 272-7597

Christopher Hayward
Merrill Lynch & Co., Inc
(212) 449-0778

Ralph J. Silva
The Goldman Sachs Group, Inc.
(212) 357-8710

Lisa Zonino
Morgan Stanley
(212) 762-2480

cc: Michael Macchiaroli, Securities and Exchange Commission
cc: Norah Barger, Federal Reserve
cc: Oliver Page, Financial Services Authority
cc: Jerry Quinn, Securities Industry Association

APPENDIX B

Current Trading/Banking Book Accounting for U.S. Financial Firms

	Securities Firms	**Banks (Mixed Attribute Model[1])**
Trading Book	All financial instruments[2] held in inventory (longs and shorts) must be accounted for at fair value, with changes in fair value recognized in earnings.	Loans, derivatives, securities, and other financial instruments held for trading purposes must be accounted for at fair value, with changes in fair value recognized in earnings.
Accrual Book	Does Not Apply	Loans and loan commitments not held for trading are accounted for at cost, less an allowance for potential credit losses. Securities held for investment purposes are also accounted for at cost, provided management has the intent to hold to maturity. Selling such securities prior to maturity is frowned upon and only allowed in limited circumstances. Only when sold or impaired are changes recognized in earnings.
Available For Sale	Does Not Apply	Securities available for sale (generally for asset-liability management purposes) are accounted for at fair value, but instead of the changes recognized in earnings, changes are recognized through the equity accounts. Only when sold or impaired are changes recognized in earnings.

Derivatives

Derivatives are accounted for at fair value, but banks utilize hedge accounting[3] to a considerably greater extent than securities firms, owing to the mixed attribute model they follow. Securities firms' use of hedge accounting is generally limited to their long-term debt, which is not permitted to be accounted for at fair value.

[1] Under a mixed attribute model, a bank accounts for financial instruments depending on its intent with respect to the instrument.

[2] For securities firms, the term "financial instruments" includes loans, loan commitments, financial guarantees, securities, and derivatives.

[3] Generally speaking, hedge accounting is the ability to offset changes in the fair value of the derivative against changes in the fair value of the hedged item, provided the hedge meets a number of effectiveness tests. Hedge accounting is a complicated subject (the U.S. GAAP rules are over 900 pages). FASB has noted that the rules would be much shorter and simpler if all financial instruments were accounted for at fair value.