

# ISDA

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Mr Nicholas Le Pan,  
Basel Committee on Banking Supervision  
Accord Implementation Group  
Office of the Superintendent of Financial Institutions  
255 Albert Street  
Ottawa, ON  
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Dear Mr Le Pan,

The International Swaps and Derivatives Association (ISDA) appreciates the opportunity to establish a dialogue with the Accord Implementation Group at an early stage.

As you know, ISDA has taken a keen interest in the review of the Basel Accord. Besides responding to general consultation papers issued by the Basel Committee on Banking Supervision, we have also recommended changes to the capital treatment of credit risk mitigation instruments and to the measurement of future exposure for OTC derivatives and securities financing transactions. We have further extensively analysed both quantitative and qualitative aspects of the treatment of operational risk. We continue to be active in these fields.

Whilst there remain significant policy issues that need resolution, not least the treatment of securitisation and counterparty risk, firms are moving towards budgeting for the potentially massive task of implementing the New Accord. The implementation process will entail changes to their compliance functions, internal risk management systems, data gathering capacity, and information technology in general. As the process unfolds, it is not surprising that many questions are being asked to which no simple answer can be found in the current Basel Committee's proposals.

As you well know, the devil lies in the detail, but the detail is in many areas not yet available, which in turn hampers investment decisions. To give one example, it is unclear which validation tools supervisors will expect firms to have developed for the purpose of verifying the accuracy of their internal rating systems.

ISDA has therefore identified a number of areas for detailed implementation work this year. We will continue to contribute to regulatory thinking in these areas, and welcome the opportunity to establish an extensive dialogue with the BIS Accord Implementation Group (AIG). Although the following does not constitute an exhaustive listing of issues, we wish to bring to your immediate attention the topics below.

## **Supervisory transparency**

In paragraph 628 of CP2, the Basel Committee acknowledges the need for supervisory transparency, noting that supervisors should make public the criteria used to review internal bank capital assessments. The paragraph further states that the supervisor will be required to justify his decision to apply additional capital requirements as a result

of a supervisory review. These principles constitute a sound basis for ensuring that supervision applies consistently to institutions regulated by one supervisory body. However we believe that they should be supplemented in two ways; first, by means of enhancement to regulatory transparency at both the national and international level; and second, by adopting lead regulation agreements in order to avoid possible supervisory overlaps for globally active financial institutions and subsequent duplication of effort requiring time and resources on the part of the firms concerned.

**(i) *Enhancing supervisory transparency* :**

ISDA believes that supervisory transparency should be enhanced through the adoption of suitable practical measures by the supervisors, in particular :

- Publication by each supervisor of the criteria applied to assess the various risk management approaches [internal ratings, operational risk measurement and others], and publication by the BIS of a comparative table of these requirements across agencies.
- Publication by each supervisor of the approach taken to supervisory intervention. Supervisory agencies should disclose any impediment to the application of Pillar 2 approaches, whether in the form of legal or other formal restrictions placed upon them. For agencies systematically applying additional Pillar 2 capital charges, the methodology followed to produce these charges should also be disclosed.
- Disclosure by the BIS of the number of firms treated under each of the approaches proposed in the New Accord for the treatment of credit and operational risk, distinguishing as appropriate by country and portfolio or business line, and specifying in each jurisdiction, across firms subject to lead supervision, the percent of total assets eligible under each treatment.

For ease of implementation, it would be useful if the information listed above could be made available on the various G-10 regulator websites as well as the BIS website. Firms should further be able to identify easily who within each relevant regulatory authority is responsible for their reviews. Finally, supervisors and regulated entities would both save time if each regulator were to post “frequently asked” implementation questions and their answers on its website.

In addition, ISDA recognises that implementing the Accord might necessitate the training of staff responsible for supervision. We would be more than happy to assist with this training, particularly in fields such as legal documentation where we have a proven track record.

**(ii) *Promoting lead regulation* :**

Given the complexity of the proposed Accord, it is essential that a firm active in more than one jurisdiction be assigned one lead regulator. The principle of lead regulation is already recognised in the EU and can be extended to other G-10 countries, considering that the New Accord aims at fostering the adoption of consistent norms for the supervision of firms across the G-10.

The lead regulator should in principle be the home country regulator. The home country will in most cases be the main place of business, determined based on the share of total assets accounted for in each jurisdiction where the group is active. Where this is not the case, an agreement should be sought among the relevant regulators with a view to selecting the lead, taking into account, as appropriate, the views of the firm concerned, but also having regard to the location of “mind and management” of the group.

The lead regulator should have responsibility for the global supervision of a consolidated group. In some instances, and particularly where resource constraints apply, it may be necessary to delegate parts of the supervisory process to host country regulators. This accentuates the need for the adoption of a consistent approach to Pillar 2 supervision across the G-10. Importantly, duplication of model (internal ratings, loss given default, operational risk losses or otherwise) reviews should be avoided, notably where modelling is a centralised function and where the pools of data used to calibrate the models span several jurisdictions. ISDA recognises that certain parameters in the proposed Pillar 1 framework are country sensitive, for example the definition of default. It would therefore make sense that regulatory validation of such factors should rely upon expert input from the host country regulator.

Whilst uncertainties surrounding the regulatory proposals make it difficult for us to comment on the details of implementation, ISDA has identified practical implementation issues where additional industry input into the regulatory process would prove useful.

### **Proposed assistance on practical implementation issues**

#### ***(i) Internal ratings validation***

ISDA, the Risk Management Association and the British Bankers' Association are jointly launching an internal ratings validation survey. The goal of the project is to address the regulatory concerns expressed in Paragraphs 231 and 232 of CP2 by outlining current practices at financial institutions. The objective is to describe the diverse spectrum of solutions to the validation problem and their limitations. The project will consider techniques using historical data as well as those relying on simulations. It will also cover not just ratings of large corporate credits, but of middle market and retail credits as well. We hope to be able to share our findings with the Accord Implementation Group in the spring of 2003.

#### ***(ii) Data requirements***

ISDA acknowledges that many financial institutions will have to supplement their own datasets with external data in order to calibrate and/or validate the internal risk models used under Pillar 1. In some areas, external databases are already available. In others, where this is not the case, ISDA has promoted, and intends to continue promoting the building of industry wide datasets.

We, jointly with the Risk Management Association and the British Bankers' Association have launched a loss given default data collection exercise. Our first User Committee meeting in Europe took place on 20 March. We now have 11 institutions participating, and hope to attract more interest in the coming months. The database is being expanded into Asia. We would be pleased to present this project to the AIG at your convenience.

We are further considering gathering other forms of data, particularly operational risk loss data.

#### ***(iii) Operational risk***

The role of Pillar 2 is crucial here, although there remain issues whose affiliation to either Pillar 1 or Pillar 2 is unclear. Key issues include the implementation of AMA qualifying criteria; the role of the "Sound Practices" standards currently in development by the Risk Management Group (where we have filed a detailed comment letter); data validation; loss scaling; the recognition of insurance, internal correlation and diversification assessments, in addition to coverage of expected loss.

### **Issues where clarification is expected from the AIG**

#### ***(i) Counterparty risk in the trading book***

There is a need for regulators to clarify how the New Basel Accord is intended to apply to the Trading Book. For instance, aspects of the qualifying criteria for Internal Ratings may not be appropriate for Trading Book exposures. Loss data may be less readily available, given the low level of loss experience in the Trading Book, so the regulators should consider data source and requirement issues.

#### ***(ii) Implementation of partial use***

If, as our membership strongly hopes, it is possible for firms to use the most advanced regulatory approaches only partially, it will be important for regulators to define realistic and achievable safeguards against cherry picking under Pillar 2. More clarity is required on exactly how partial use will be recognised, and what the specific requirements will be for banks seeking such recognition. These may include materiality thresholds and/or floors, which should be specified reasonably quickly. It would further be useful to know whether a staged implementation of the New Accord is envisaged if at all.

***(iii) Risks not capitalised for under Pillar 1***

Were the AIG to specify its approach to concentration risk, or the management of legal risk arising from the use of risk mitigation techniques under Pillar 2, ISDA would very much appreciate the opportunity to discuss these issues with the Group. We have commented extensively in the past on each of these topics<sup>1</sup>.

We look forward to learning more about your work programme, including the proposed timeframe, and how we might provide support.

Yours sincerely,

Emmanuelle Septon  
ISDA  
Head of Risk Management

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<sup>1</sup> See in particular ISDA's response to CP2, May 2001, available on [www.isda.org](http://www.isda.org)