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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 comment on the minimum requirements for the IRB approach as set out in Section H of the Technical Guidance for the Quantitative Impact Study 3 (QIS 3).

As you know, ISDA has taken a keen interest in the review of the Basel Accord. The Internal Ratings Working Group (IRWG) of ISDA was set up in 1999 to contribute to regulators' education on Internal Ratings in the context of the Basel Accord reform. The IRWG contributed to the letter to the Models Task Force on the definition of default (February 2002), to the Letter to the Working Group on Overall Capital on the treatment of expected losses and future margin income (October 2001), and to the letter to the Models Task Force on the granularity adjustment to the IRB function (July 2001).

There are two key issues that ISDA would like to emphasise in this letter. The first is that, in the area of internal ratings validation, little is known and current practices are not well documented. We would therefore ask the Committee to refer to the results of a survey recently launched by ISDA, the RMA (Risk Manager's Association) and the BBA (British Banker's Association) on Internal Ratings Validation. Financial institutions from Canada, US, UK, Europe, and Asia are currently completing the survey (on-line), which will be followed up in the New Year by a series of interviews, before reporting in April 2003. We believe the results will be of benefit to the AIG and to national regulators by providing an overview of the diversity of techniques among institutions in various countries. Further, the information should help avoid the adoption of inflexible or overly prescriptive standards that could lead to reduced incentives for continued innovation and improvement of existing methods and models.

The second point that we would like to emphasize in this letter and that we believe needs further guidance and clarity is on the distinction between time assessment horizons in ratings and assessment horizons used for estimating probabilities of default. ISDA feels that the Technical Guidance does not make an effective distinction, and that if taken literally could lead to excessive capital requirements that could impact on firms decision-making in key areas of business.

Part H presents the minimum requirements for entry and on-going use of the IRB approach. The minimum requirements are set out in 11 separate sections, and our comments, below, are ordered in relation to those sections where we have comments to make.

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2. Compliance with minimum requirements

Para 340: guidance will be required in three areas: (i) the definition of immateriality, (ii) the process by which immateriality is to be demonstrated, and (iii) the consequences of disclosing immateriality. ISDA seeks the right balance between setting rules too prescriptive in nature to ending up with something tangible that all firms can work with. It is noted that firms have been asked to provide their own definitions of materiality in QIS 3, and we would expect the Committee to take into account the full range of answers submitted before issuing further guidance.

(i) A definition of immateriality. The International Financial Reporting Standards (IFRSs) state that materiality can never be judged purely on the basis of absolute size. The nature and circumstances of an item can be of such importance to users that a size threshold is of little practical significance in determining materiality. We would recommend that guidance for determining a definition be based on those indicators of materiality identified by the accounting standards.

(ii) The process by which immateriality is to be demonstrated. Firms intending to use internal ratings approaches must provide the regulator with a roll out plan. The roll out plan must draw the distinction between areas of the business that are immaterial (and not seeking approval for use of the IRB formula) and those that are material but require an extended transition period before IRB can be implemented. The roll out plan should include references to both areas of the business demonstrating immateriality where firms are not requesting approval to use internal ratings and also the firm's commitments to moving to IRB where they will be seeking approval at some time in the future.

(iii) The consequences of disclosing immateriality. Additional capital requirements may be applied if the bank is not in complete compliance with the IRB eligibility requirements; it should be noted that the additional capital charges, where applied, should not bring the bank's capital requirement for the portfolio concerned above the standardised capital charge.

3. Rating system design.

Para 345: it is unclear why Foundation IRB banks would need to have in place a rating system for LGD or EL, on top of one for PD (note the same issue arises in paragraph 379 where Foundation IRB banks are encouraged to retain relevant LGD data and again in paragraph 453 when foundation IRB banks are to compare their realised LGDs/EADs with the supervisory estimates). It is noted in addition that information on realised LGDs/EADs should normally form part of the banks' internal economic capital model. This seems far from guaranteed, as not all banks have economic capital models, and only a few have models encompassing the totality of their exposures. ISDA strongly objects to these requirements for Foundation IRB banks and would want regulators to encourage any bank with access to this kind of data to move to an Advanced IRB approach.

Para 361 – 363 and 394: A fundamental difference exists between ratings and associated probabilities of default, in terms of assessment horizon. Internal ratings tend to be assigned on a hold to economic maturity basis. By economic maturity, we mean the maturity which statistically is associated with the asset. This might be shorter than the contractual maturity: long term mortgages for instance tend to repay substantially before contractual maturity date. The effective maturity formula proposed by the Committee can be seen as a proxy for economic maturity. In para 362, the Committee suggests that ratings should be assigned based on stress test scenarios. ISDA would like to emphasize that ratings typically reflect the expected behaviour of the counterparty in a number of scenarios, both favourable and unfavourable. We do not perceive the need for assigning ratings purely based on the latter. Indeed, if this was the case, then the PD used in the IRB formula, instead of reflecting a long term average, would, by definition, reflect a stress scenario, and regulatory expected loss would exceed true expected loss. By transitivity, regulatory capital would exceed the targeted 99.9th percentile, resulting in requirements potentially so constraining for firms that they would impact on business choices. ISDA accordingly recommends that the Committee remove the mention to stress scenarios from para 362.

Furthermore, ISDA understands that the probability of default underpinning the IRB function is a long term average. We know that a number of our members use "point in time" PDs, rather than long term averages, in

relation to some of their exposures, particularly in the corporate world. We believe that point in time PDs can be reconciled with long term averages in a number of ways: they may for instance be mapped to a rating scale to which long term PDs are associated.

In the light of practice, and the useful information embedded in "point in time" PDs, we would recommend that the regulators refrain from excluding them from the scope of the Accord, but review, as part of Pillar 2, the methodologies used by firms to extract regulatory compliant information from these PDs. We would also ask the committee to refer to the findings of the ISDA, BBA, RMA Internal Ratings Validation survey which plan to shed some light on current practise in this area.

4. Risk rating system operations

Para 376: ISDA agrees in principle that data should be stored and data gathering be well-documented, however, members have expressed their concern at the level of detailed requirements laid out in the guidance (to include rating histories, date of past rating assignments, key data/ models used, name of person responsible). In general ISDA believes that all data maintenance requirements should weigh costs against benefits and allow flexibility in this regard as long as the validation requirements are met.

Para 378: ISDA questions why, along with the firm's LGD estimate, firms would be required to store a complete history of the key data used to derive the estimate. If you were to store all of the data used to derive the estimate you would no longer need to store the estimate itself. We feel that the validation requirements should take account of any concerns in this area. We would also like to refer the committee to the ISDA RMA LGD data pooling facility that we will present to members of the AIG in early 2003.

Para 381 to 384: ISDA understands the need for stress testing but would not require firm's to hold capital according to "stressed" scenarios. ISDA believes that it would suffice to ask firms to demonstrate that in "sensitive" periods they are capable of raising additional capital under a Pillar 2 review. If the committee decides however that "stressed" data should remain as a requirement within the technical guidance in Pillar 1, then more clarity is needed on how this might impact on the firm's capital number and how this is dealt with in relation to PD estimates that are already required to be "stressed".

7. Risk quantification

Para 397: where use of external data might be allowed for PD estimation, ISDA feels that more guidance would be helpful as to what will be allowed (e.g. US data vs. UK exposure). ISDA would also like to draw the committee's attention to the further inconsistency in requiring that market conditions underlying external data match the current situation, whilst in paragraph 394 the guidance requires a definition of PD based on long run averages (not based on the current economic climate).

Para 407 :ISDA notes that indirect costs cannot by definition be allocated to individual facilities and should therefore be excluded. (Please refer to the paragraph on the "definition of loss" in ISDA's overall response to QIS 3)

Para 409: Where only limited data is available to assign a PD, a suitable degree of conservatism must be used. ISDA notes that for AAA exposures, the regulators via the 3 basis points PD floor already impose conservatism.

Para 410: ISDA recommends consistency in the length of observation periods, with the same transition period, whatever the data, including LGD estimation. We recommend an observation period of at least five years.

Para 415: Once again ISDA would call for more consistency in the way the guidance treats PD and LGD estimation. Many of our members are against the use of stressed data.

Para 419/425: ISDA recommends consistency in the length of observation periods, with the same transition period, whatever the data, including LGD and EAD estimation. We recommend an observation period of at least five years.

8. Validation of internal estimates

Para 449: We would ask the Committee, once again, to refer to the findings of the ISDA, BBA, RMA Internal Ratings Validation survey. In the meantime ISDA discussed how firms might compare realised default rates with estimated PDs for highly rated counterparties and felt that the guidance could offer some help here. We discussed the possibility of using existing data on downgrades or on migrations, but the Committee felt that more work was required by the regulators before detailed requirements were established for highly rated counterparties.

We look forward to discussing these comments with you in more depth on January 6th 2003.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Ed Duncan', with a long horizontal flourish extending to the right.

Ed Duncan
ISDA
Risk Management