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30 July 2003

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 Consultative Document (CP 3), The New Basel Capital Accord (April 2003).

In our last formal submission on implementation and interpretation of the minimum requirements (letter to Nick Le Pan, dated 20 December, 2002) we highlighted two main concerns for the industry, (i) the lack of knowledge and understanding in the area of internal ratings validation and (ii) the confusion between time assessment horizons in ratings and assessment horizons used for estimating probabilities of default (PDs). We also outlined a number of suggested changes to the paragraphs in Section H on compliance, rating system design, rating system operations, and risk quantification. Finally we requested further guidance in areas where the industry felt international regulators would need to be consistent in their implementation of the rules. This guidance, by clarifying the intentions of the Accord and identifying the scope of interpretation, would go a long way to promoting an even playing field for international regulatory capital requirements. The key areas where we identified the need for guidance were:

- following the QIS 3 submissions, a report on the different definitions for immateriality used by firms and how they might differ from those identified by accounting standards;
- the extent to which immateriality is demonstrated in a "roll out" plan, distinguishing between those exposures that do not require IRB approval, and those requesting an extended transition period;
- the likely consequences of disclosing immateriality (should additional capital requirements be applied the overall charge for the exposures concerned should not be greater than the capital charge under the standardized approach);
- and guidance on international regulatory efforts in relation to firms' use of external data.

Since December 2002, work on implementation has gathered pace, and understanding of the issues improved; however the minimum requirements for the IRB approach, as set out in the latest version of the Accord by and large remain unchanged. The concerns of our membership therefore remain the same.

ISDA still believes that CP 3 is too prescriptive and leaves regulators little choice but to implement detailed and complex rules that often fail to capture how internal ratings systems work. This has led some commentators to

suggest that large chunks of the Accord be removed (for instance the 30 pages following paragraph 351!). In this letter we restate some of our key concerns in the light of a greater appreciation of the issues.
We include an extract on Pillar 2 from the main body of our overall response to CP 3 (Appendix); we consider the conclusions from the results of the Internal Ratings Validation Study, and share with you additional work that has been carried out on assessment horizons. We hope that by doing this within the formal consultation period for CP 3 we will be more successful in initiating changes with a view to improving the minimum requirements for the IRB approach. If successful this would allow for more flexibility in implementation, while helping to establish the IRB approach as a more effective and consistent international regulatory standard.

There are two key issues that ISDA would like to re-emphasise. The first relates to the contents of the Internal Ratings Validation Study. The Study concludes that firms employ a wide range of techniques and diversity of practice with respect to internal ratings validation. The Study shows that rating validation is not an exact science and is heavily dependent upon the availability of data, data integrity, and expert judgement. Even where banks are able to employ statistical techniques to assess model performance they do not employ absolute triggers or thresholds in the validation process. There was a strong feeling among participants that not enough time had been spent on discussing acceptable validation techniques for these types of systems. For some exposure classes – notably banks and sovereigns – it is likely that there will never be enough default data to allow robust statistical estimates of default rates with a granular rating scale. Techniques other than statistical analysis will therefore be necessary to assess the adequacy of banks' rating systems and PD estimates.

All of these points have been widely acknowledged by regulators, but have yet to be addressed in the actual words of the Accord. The minimum requirements for the IRB approach described in CP 3 do not recognise data scarcity, issues with data integrity, or expert judgement (example, paragraph 464). Consequently national regulators are left on their own to develop workable solutions on a country-by-country basis, and applications of the IRB approach may lack consistency and fail to represent a truly international risk-based standard.

The second issue relates to further work carried out by ISDA on assessment horizons. Assessment horizons are included in CP 3 in both the definition of default probabilities and also in the assignment of ratings to obligors (paragraphs 376-378 and 409). ISDA recognises that there is considerable scope for additional clarity on the requirements of the Basel Committee as it relates to assessment horizons. The references in CP 3 are open to interpretation by each national regulator and if taken literally could lead to excessive capital requirements that could impact on firm's decision-making in key areas of business. The focus of ISDA discussion on assessment horizons has been around regulatory confusion between their use in ratings and when used for estimating and calibrating probabilities of default. It is important when looking at internal ratings systems to distinguish between the estimation of a PD and the assigning of a rating (n.b. not all models in use today produce a rating, but rather estimate the PD directly).

Back in January 2000, the Basel Committee recognised in a discussion paper entitled "Range of Practices in Banks' Internal Rating Systems" that the time horizon and methods selected for analysis were sometimes opaque, surmising that banks assign ratings based on all available relevant information. Current market practice in relation to assessment horizons varies enormously, not just from firm to firm but within firms from model type to model type. However there seems to be general agreement that ratings should be forward looking and based on all relevant material. The sentiment regarding acceptable practice here is highly significant. However the approach outlined above is not reflected in the wording of the Accord.

ISDA strongly recommends that assessment horizons are not specified for assigning ratings. Assessment horizons and historical data pools vary across ratings, and appropriate controls, documentation, and senior management oversight ensure that firms take account of all the relevant inputs. For regulators this means putting in place a broad framework that does not specify the assessment horizons firms employ in their internal ratings systems (though of course, as we know, the final PD estimate should be a 1yr PD). Ratings systems are a product of their times and it is important that the final version of the Accord can be implemented in such a way as to ensure the continuing evolution of risk management practice.

> N.b.The concept of time and assessment horizons also presents itself as a challenge when considering the likely requirements for conducting "stress tests" under the new regime. The application of specific

appropriate stress scenarios will be a mechanism for banks seeking compliance. ISDA's concerns are outlined in the extract on Pillar 2 from the main body of our response to the Committee on CP 3.

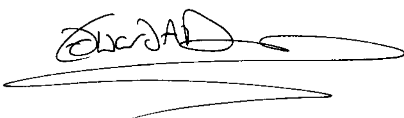
ISDA would like to see the following outstanding issues with the minimum requirements addressed: -

- on the design of the rating system, it is still unclear why Foundation IRB banks would need to have in place a rating system for LGD or EL (paragraph 360), on top of one for PD (note the same issue arises in paragraph 394 and again in paragraph 468). 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.
- as stated in our December letter, 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. The industry appreciates that having more data is a good thing ("its nice to have"), but many firms consider the requirement that firms store data to allow for retroactive reassignment of ratings (paragraph 391), unreasonable. In our more recent discussions on data with the Accord Implementation Group (AIG, Washington, April 2003), the regulators felt that this was a key requirement, while ISDA doubted whether or not it was achievable. With increased sophistication in risk management techniques, new key drivers of risk emerge, this means that ratings systems of the future may be based on criteria that didn't exist in the past, making retroactive reassignment impossible. ISDA recommends that this minimum requirement be removed from the text of the Accord.
- further over-regulation is apparent in the requirement that the person assigning the rating should be recorded (paragraph 393). It is not clear what should be recorded if two people have had the joint-responsibility for the assigning of a rating, or as is often the case a whole credit committee (do we record all of the names who are present?).
- ISDA notes that indirect costs (paragraph 422), whether material or not, cannot by definition be allocated to individual facilities and should therefore be excluded from the Accord.
- ISDA agrees with the use of a default-weighted average for LGD, but does not see the relevance of the additional requirements that "the firm must use LGD estimates that are appropriate for an economic downturn" (paragraph 430). We believe this is both conceptually wrong and practically burdensome. As most defaults occur in periods of economic downturn, a firm's average recovery experience will automatically be weighted towards such periods and to require a yet more extreme "worst case" calculation makes the calculation unreasonably conservative.

Finally, ISDA would like to offer its continued support to the work of the Accord Implementation Group (AIG). The AIG was set up to discuss and debate issues surrounding the implementation of the new regulatory capital framework. If the New Accord is to become anything like an international standard, then co-operation and harmonisation on interpretation and implementation is essential. ISDA would like to see the AIG given a more prominent role, with a wider mandate, and clearer objectives. We would like to see the concept of a "level playing field" promoted and pursued more aggressively, with more transparency from a wider range of international regulators. We would also be interested to hear views from the AIG on each of the areas of national discretion and the responsibilities of the home and host regulator.

ISDA would be happy to discuss any of these issues in relation to CP 3 in more depth with the AIG at some point in the future.

Yours sincerely,



Ed Duncan
ISDA
Risk Management

Appendix – extract from ISDA-TBMA response to CP 3

“ **Pillar 2**

The consistency and quality of the new capital regime will depend crucially on supervisory practice. The industry believes that convergence and transparency of supervisory practice are essential to the success of the new regime.

a. Convergence of supervisory practice

The Associations support the overall purpose of Pillar 2 and recognise the importance of supervisory review.

Lead supervision :

ISDA has commented, in a letter to Nicholas Le Pan[1], Chairman of the Accord Implementation Group (AIG), on the need to avoid duplication of supervisory reviews for firms active in more than one jurisdiction. We in particular advocated the designation of lead supervisors, in keeping with a practice already established in the EU. The Associations would strongly support the recognition of lead supervision in the Accord.

The lead supervisor 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 supervisor 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 adopting 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. The Associations recognise that certain definitions 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.

We furthermore believe that the recognition of lead supervision would create a strong incentive for regulators to (i) ensure that a common answer is brought to similar implementation issues by the various G-10 participants; and (ii) harmonise their approach to supervision, including by encouraging joint training of their staff and exchanges of staff.

Purpose of supervision :

Of paramount importance is the need to achieve a common understanding of the purpose of Pillar 2. It seems to us that Pillar 2 is to be used for three distinct purposes :

(i) Assess firms’ eligibility under the intermediate and/or advanced credit, market and operational risk approaches;
(ii) Assess the adequacy of Pillar 1 assumptions with respect to risks not directly capitalised under Pillar 1. Additional capital may be required as a result of this part of the review.
(iii) Evaluate the adequacy of firms’ internal capital assessment.

We would like to offer the following comments in respect of each of the points above :

(i) Eligibility under intermediate/advanced approaches : a number of issues arise in relation to this part of the supervisory review, for instance the determination of materiality thresholds for applying partial use, the definition of IRB validation criteria, etc. It is essential that regulators identify these issues and

[1] Letter to Nicholas Le Pan, dated 24 May 2002, www.isda.org

discuss them within the relevant Basel Working Groups (the AIG and the RMG) with a view to adopting common definitions. Otherwise, there would be a significant risk of similar firms being subject to different hurdles by their respective supervisors. ISDA stands ready to assist the Basel Working Groups in this process. We have recently released an Internal Ratings Validation Survey, launched jointly with the Risk Management Association and the British Bankers' Association, with a view to informing the AIG on the diversity of approaches employed by member firms.

(ii) Evaluation of risks not directly capitalised under Pillar 1 : a distinction must be drawn between those risks approximated and those utterly disregarded under Pillar 1.

For instance, correlation risk is not ignored under Pillar 1, but approximated by postulating a set of "average" constant correlation factors under the IRB function. Similarly, legal risk arising from the use of credit risk mitigation techniques is not excluded from scope: firms are required to verify the legal soundness of transactional documentation before recognising risk mitigation. Legal risk is also covered explicitly in the operational risk charge.

By contrast, some forms of risk are excluded from the proposed framework ; interest rate risk in the banking book and concentration risk are prime examples.

ISDA believes that the emphasis of supervisory review should depend on the type of risk under review:

-for risks already capitalised under Pillar 1, supervisors should simply validate that the conditions required for application of the relevant Pillar 1 treatment are met. For instance, where a firm uses credit derivatives, the supervisor should verify that the operational requirements for recognition of mitigation are complied with. Lack of compliance should result in a warning being sent to the firm that capital relief might be confiscated unless corrective measures are adopted within a reasonable time frame.

-for concentration risk and interest rate risk in the banking book, there is a case for considering the application of additional capital requirements where the risk concerned is material. In assessing the rationale for applying supplementary charges, due account should be taken of requirements already imposed under national or international regulations distinct from the Accord. Large exposures, for instance, give rise to additional capital requirements under the Large Exposures Directive in the EU. Pillar 2 charges for concentration risk should not duplicate existing requirements. A review of such existing rules should be performed, at the international level, to ensure that the most appropriate and consistent approach is adopted to treating the risk under consideration.

The Committee also requires that strategic risk be assessed and actively managed. The implication is that firms should endeavour to measure this risk more accurately and capitalise it. The Associations question this line of thinking. Strategic choices made by management entail costs and may result in unexpected losses [hence impacting on Pillar 1 capital], but are primarily expected to produce income and profits. Because the proposed regulatory framework mostly ignores earnings, it is impossible for it to incorporate strategic risk ex ante in any meaningful way. It would be highly inappropriate for regulators to interfere in the elaboration of banks' strategies by imposing Pillar 2 capital requirements for strategic risk.

(iii) Evaluation of the adequacy of firms' internal capital assessment : it is essential that supervisors, prior to evaluating firms' internal capital assessments, understand the differences between the firms' internal modelling and the regulatory capital model.

The magnitude of these differences depends on the type of risk under consideration : for market and operational risk, where significant reliance can be placed on the firms' own modelling to derive regulatory capital, the discrepancy between internal and regulatory capital can be minimal and will overwhelmingly depend on the horizon and confidence interval retained by the firm. For credit risk, a vast number of parameters have been standardised by the regulators, and a direct comparison between internal capital assessments and regulatory capital is much more arduous: internal capital excludes expected loss, where regulatory capital generally includes it; LGD and EAD estimates will typically

differ between Foundation IRB and the firm's internal model; modelling of default correlation and maturity is standardised in the IRB function, but more refined in internal models; concentration risk is ignored in the New Accord but accounted for in internal models; some firms model changes in asset values linked to spread variations, whereas regulators ignore them, and so forth. Understanding the detail of calibration discrepancies between firms' own credit risk models and the New Accord is essential if supervisors are to reconcile regulatory and internal capital measures.

It seems unclear to the Associations what conclusions might be drawn from the comparison above in terms of regulatory capital adequacy. A firm might, for instance, use a lower default correlation assumption than is implied in the IRB function; this obviously should not imply that the internal assumption needs scaling upwards. Conversely, some firms will aim for a more stringent loss percentile than the Capital Accord's, and may hold internal capital in excess of their Pillar 1 regulatory capital. This should not result in additional capitalisation under Pillar 2. While the Associations hope that the supervisors' desire to achieve a better understanding of economic capital modelling indicates their willingness to move towards recognising these models in the future, we would be concerned if it constituted an attempt at systematically bumping up Pillar 1 capital. The Committee's intentions would merit clarification in the New Capital Accord.

Capital allocation across business lines and asset types is another area where marked differences are likely to arise between internal models and the regulatory model. Such discrepancies exist under the current Accord, and will continue to exist, although to a lesser extent, under the New Accord. Only by placing more reliance on firms' own modelling of portfolio credit risk (and notably, excluding EL from the scope of regulatory capital), can the Basel Committee bring internal and regulatory capital estimates into closer agreement. Capital allocation is likely to be heavily influenced by the contribution of each facility to the overall loss profile at the confidence interval retained by the firm. This will crucially depend on the correlation of the asset loss profile with that of the rest of the portfolio. The Associations question how the supervisors intend to assess the adequacy of correlation estimates used by firms. We strongly oppose the principle of applying additional Pillar 2 requirements to cater for misallocation of capital (para 714 of CP3), where the regulatory model itself does not demonstrably result in a sensible allocation of capital.

Finally, stress tests feature prominently in CP3, at paragraphs 396 (general stress testing regime), 397 – 399 (specific testing for mild recession) and Pillar II, paragraphs 708 (general requirement to consider unforeseen events in assessing capital adequacy) and 724 (requirement to hold capital covering the stress tests in paragraphs 396 – 399).

The Associations agree that stress testing is an important technique in a risk manager's toolkit, and forms part of a robust capital planning and management regime at any large institution.

However, we have severe reservations about the detailed prescription contained in paragraph 398. Such prescription contradicts the purpose of supervisory review to achieve a tailored understanding of the individual position and risks assumed by each institution, working in conjunction with internal risk management. The prescription in paragraph 398 does not come close to a complete specification of the stress testing regime and therefore does not ensure consistency between institutions (an objective that is not attainable in this area, even if desirable), yet it imposes an artificial framework which banks and their supervisors are likely to find a distraction from the genuine considerations needed to successfully manage capital.

We do not believe it can be appropriate for supervisors to issue guidance about the construction and execution of stress tests as suggested at paragraph 399. As noted above, the Associations believe that the fundamental purpose of Pillar II is to enable oversight tailored to each institution. We believe that supervisors will find the expectation that they issue uniform guidance not only contradicts this purpose, but is also extremely burdensome.

We are fundamentally opposed at the conceptual level to the specific stress test set out at paragraphs 397 – 399 and the expectation, expressed in paragraph 724, that banks automatically hold capital covering the results of this test.

The central notion, expressed at paragraph 399, appears to be that of a rating system that would result in no change to capital during or after a mild recession, in other words, a rating system that produced the same PD for each obligor over time regardless of the external economic circumstances. If a bank has a rating system that is not of this

supposed type, it will, in the structure set up by paragraphs 397 – 399 and 724, always and at all times be expected to hold more capital than the IRB minimum requirements.

The Associations find the rating system implicitly described here wholly unacceptable. It implies that a rating assigned to an obligor upon origination should not change as economic conditions change. This in turn implies that (i) either the quality of each obligor's rating will gradually deteriorate over time as it becomes stale and eventually completely useless; (ii) or the bank is expected to be able to foresee all the possible economic circumstances that will arise over the life of the exposure, and assign the initial rating accordingly. Clearly, such a system is not sensible at a basic level. All estimates associated with risk management activity, including ratings, are based only on information or judgment available up to the current time, and are therefore subject to update and change including potential deterioration as new information becomes available, quite regardless of their structure or design. Therefore, all risk sensitive rating systems will be adversely affected by unexpected periods of zero growth or recessionary downturn.

The Associations believe that a key intention in developing this provision is to mitigate any potential procyclical variation of capital by introducing a buffer of capital that would be available to cover additional requirements arising during or after an economic stress. However, the stress test set out at paragraph 397 is in practice merely an additional minimum capital requirement.

The Associations believe that adequate protection against procyclicality can only be achieved with a flexible and proportionate approach to capital planning by each individual bank including, where appropriate and available, maintenance of a modest buffer of capital. The stress test at paragraph 397 will not indicate the size of any such buffer and, unless it is deliberately manipulated, will simply indicate a requirement to hold a buffer at all times. An essential ingredient of capital planning is the ability to materially reduce the buffer when needed, but, as the stress test will never be able to provide a justification for such reduction, it will in any case fall to supervisory judgement to ignore the results of the stress test when it is in the best interests of the bank or the banking system to do so. This process would clearly be simplified with no adverse effect by eliminating the stress test at paragraph 397 and associated capital requirement at paragraph 724.

b. Supervisory disclosure

The Associations strongly support the Committee's proposal that supervisors should disclose national standards. We however would also find useful the disclosure of aggregate statistics on the impact of national implementation. It would notably be helpful to know what proportion of firms have achieved the more sophisticated approaches (Credit Risk IRB, Model recognition for Market Risk and AMA for operational risk), the average capital required under the supervisory review process and recognised ECAIs in each jurisdiction.
This information could inform debate on any material divergences in implementation, to the extent that they may threaten the competitiveness of some financial institutions or require that policy be amended to foster greater convergence in supervisory practice. "