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ISDA/IIF Meeting with AIG/CTF LGD Working Group

- ISDA, One New Change, London –
- Monday 18th April -

Summary

Members of ISDA and the IIF met with the AIG/CTF working group on “downturn” LGDs at ISDA in London on Monday 18th April. The meeting was a follow on from the one that took place in Washington DC in early February, after which an industry note on discount rates, and a AIG/CTF paper entitled “*Preliminary ideas to move forward on LGD quantification*” (04/01/05) were circulated between the groups. The latest paper outlines current regulatory thinking, and asks the industry questions on five approaches to clarifying supervisory expectations regarding LGD quantification. Alain Duchateau, co-chair of the AIG/CTF group, summarized the background and aims of the paper with the key questions for the group to consider described as:

1. What is a downturn period and how severe should it be;
2. What might be the appropriate discount rate; and
3. What level of aggregation & stress might be appropriate and how to deal with any portfolio specific concerns?

It was agreed that the best format for the meeting might be to run through each of the sections of the regulatory paper, and refer to the industry note on discount rates when we arrived at the relevant section.

General Comments on the “Preliminary Ideas...” paper

ISDA expressed the industry’s disappointment in the overall approach outlined in the paper, with much uncertainty around how the various regulatory measures being considered would impact internal estimates of LGD. Members pointed out that the cumulative affect of each regulatory measure would lead to punitive estimates for regulatory capital that would bear no relation to the firms’ own internal estimates, throwing into doubt whether they could ever properly be validated or pass the “use test” under Pillar I. Members were once again keen to point out that this was supposed to be an “internal rating based” approach, but the way things were going, regulatory capital numbers could well exceed those of the firms’ own economic capital models, causing great distress for the business. The industry were also disappointed that all the available regulatory tools to impose “downturn” conditions on firms’ LGD estimates were still being considered, including an emphasis on specific data from “downturn” years, potentially conservative discount rates, further LGD floors, mapping functions, stress testing, and once again, the requirement for firms to report two LGD numbers (both an expected and downturn LGD).

Erik Heitfield, co-chair of the AIG/CTF group, felt that some approaches had indeed been ruled out very early on in the process, including the idea of tying LGD to 99.9% confidence levels. Heitfield went on to defend the paper, insisting that the starting point for assessment was always intended to be the firms’ own estimates. The regulators described “a tension” at the Basel level, between allowing firms to use internal estimates and achieving some element of consistency in firms’ implementation and supervisory standards. Heitfield was keen to reaffirm that all they were trying to do in offering guidance around P468 was allow firms to use their own estimates, however, industry participants were

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quick to point out a widely held perception that current regulatory thinking seemed to be moving requirements further and further away from expected estimates.

Clarifying paragraph 468

The idea of providing regulatory guidance concerning how the magnitude of downturn conditions should be expressed (for instance, using “X standard deviations above the average”) and at what level of aggregation (e.g. Basel level portfolios, corporate, retail etc) was not well received by members. Firms felt that it was important they use the maximum amount of data available to them, and that this approach may result in data from good years being discarded. JPMC also had concerns around the relevant level of aggregation at which to assess downturn conditions, particularly if required to apply them at an individual portfolio level? It was felt that there was still a high degree of correlation between the Basel portfolio categories, and a distinction across geographical lines would also be necessary. There were also concerns raised around the practicality of such an approach for firms that had merged at some point during the data history, with potential difficulties in extracting relevant elements in those peak years from a number of the firms from different regions that had subsequently merged. Industry members felt that a number of these problems could be addressed by allowing firms to use the “default-weighted” average LGDs, and we observed that not many firms currently looked at LGD in this way. The regulators felt that identifying some guidelines around the assessment of what merited a “downturn” period at the Basel portfolio level would be a good compromise.

What is the appropriate discount rate?

The AIG/CTF group saw this as a particular area where firms practice diverged and a high level principle, with sufficient flexibility (e.g. cash claims could use a risk free rate, while, where collateral existed, some sort of premium might be appropriate) could achieve some consistency and get a bit more conservatism in the estimates. Members pointed out that when reviewing conservatism in LGD estimates the discount rate could not be considered in isolation and that systematic factors in the discount factor would also have to be considered. ISDA voiced the preference of many members to use the contract rate, recognising that although not theoretically correct; using such a rate would remove an important difference between GAAP and Basel II minimum requirements.

Recording of LGDs

Heitfield acknowledged the Basel Committee had agreed that calculating separate LGDs was not appropriate, however the AIG/CTF group had been considering expected LGDs (ELGDs) for the purposes of validation, perhaps providing a useful benchmark. Regulators felt that the difference between “expected” and “downturn” LGDs could be a useful supervisory tool, and were considering requiring firms to report both sets of estimates. At the meeting they were interested in whether this would be considered useful information, how costly such a requirement might be, whether such a proposal was operational, and also, what form the reporting might take (part of the IRB approval process or Pillar III public disclosure or something in between?)? ISDA reflected the industry's concerns around the additional costs this would generate at such an advanced stage of the IRB approval process. We also felt that a Pillar III type disclosure, with firms reporting 2 numbers could be misleading and result in confusion. Heitfield suggested that he could see no reason why firms with enough data and correlation evidence could not report the same number (for ELGD and DLGD).

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There followed a discussion around the necessary model adjustments or model assumptions required to distinguish between ELGD and DLGD, and how detailed and at what level disclosures of 2 numbers would be required. It was clear that this idea had not yet been fleshed out however the industry warned the AIG/CTF members that developing such an approach would cause considerable extra work and additional cost for the firms, while possibly leading to confusion for the users of the reports.

Option for cases where data are limited

The question asked here was whether firms wanted a fallback position and whether supervisory floors, mapping functions, etc would be appropriate in cases where “downturn” estimates could not be built on existing data (e.g. no “downturn” had occurred). Heitfield stated that this was the same problem as for estimates for PDs, only more difficult to solve. ISDA IIF members were opposed to a regulatory solution being forced upon them, and stated a preference for dialogue at a national level (particularly in relation to regionally “blessed” portfolios, e.g. UK residential mortgage market). ABN discussed the problem in relation to sovereign portfolios and inter-bank exposures, where the whole concept of DLGDs gets called into question. Members also addressed their concerns about the use of further regulatory floors, as these may encourage firms to re-examine the way they segment their portfolios with a view to making adjustments that would not reflect good risk management practice. We also suggested that, although data pooling should be encouraged (e.g. for benchmarking purposes), it was unlikely to provide enough data regulators and firms could rely on for sovereign or inter-bank exposures.

Clarification of the relationship between downturn LGD and stress testing

The AIG/CTF recognised that the stress testing language in the framework document was open to interpretation, and nothing indicated how stress testing requirements under Pillar II were to interact with minimum requirements under Pillar I. This was an area where, by their own admission, AIG/CTF thinking was less developed, and the regulators were most interested in our general thoughts on stress testing and how collateral values for certain portfolios could be stressed to satisfy regulatory requirements. In the discussion, JPMC referred to the “dynamic” management of exposures heading towards default but not yet defaulted, where borrowers are actively encouraged to reduce their exposure and/or made to put up new or additional collateral and how these actions would make any stress testing requirements less useful. Conditions beyond a “downturn” were discussed, and members felt that rather than try to create additional “hypothetical” stress testing within Pillar I, these concerns could more easily be addressed under Pillar II. HSBC gave an example (similar to previous examples given from Citigroup) of how during a recent Asian downturn, with work-out periods between 5-7 yrs and therefore outlasting the downturn, recoveries were perhaps better than expected and LGDs at the bank did not go up.

Conclusion

The AIG/CTF members were keen to defend P468, and arrive at a Pillar I solution to quantifying “downturn” LGDs. The main regulatory concerns were that they were creating the wrong incentives for portfolio management by requiring stress in PDs but not for LGDs. It was felt that a Pillar I answer would help to balance these incentives. The regulators were also eager to point out that some LGDs (submitted as part of the QIS exercise) were perceived to be too low, and that it

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was clear not all portfolios had experienced "downturn" conditions. ISDA IIF members reaffirmed their preferences for a Pillar II type approach, stating as the main reason the firm specific nature and idiosyncratic risk of LGD estimates. However, members felt that should the AIG/CTF group go down this route, it should be made clearer that any further guidance or high level principles should expressly use as their starting point, firms' own internal estimates of long-run average LGD.

ENDS.