

## ISDA/IIF Meeting with AIG/CTF LGD Working Group

– Commission Bancaire, Paris –  
– Wednesday 22<sup>nd</sup> June -

### Summary

Members of ISDA and the IIF once again met with the AIG/CTF working group on “downturn” LGDs at the French Banking Commission in Paris on Wednesday 22<sup>nd</sup> June. The meeting was a continuation of consultation with the industry at recent meetings held in Washington and London and followed the circulation of 2 new discussion papers from the regulators:

- The first discussion note outlines 5 principles for clarifying the requirements of paragraph 468 of the Framework document.
- The second paper contains 9 draft examples (a work-in-progress) intended to illustrate the application of the principles.

(ISDA and IIF members gathered in Paris prior to the meeting with the regulators to discuss feedback and prioritize the key messages on both the principles and the examples paper)

### General Comments on the principles

Alain Duchateau, co-chair of the AIG/CTF group, welcomed the industry group and introduced the 2 discussion notes, inviting industry comments on each of the principles in turn and on the examples paper. However, the industry chose to open up the meeting with more general comments and criticisms of the proposed principles and the fears and the concerns held in relation to the unrealistic expectations embodied in the 9 examples. As such one of the key messages delivered to the regulators was that the examples should not be included in the eventual publication.

Members reaffirmed their position against a Pillar 1 treatment of downturn conditions in the calculation of LGDs and restated that no further guidance or principles around P468 was necessary. Instead members once again expressed a preference to conduct regulatory discussions about “downturn” conditions within a Pillar II context. It should therefore not have been a huge surprise to regulators that the principles were not considered a welcome addition to the literature. We pointed out to the AIG CTF group that the paper appeared to make the assumption that positive correlation between default rates and recovery rates always existed, shifting a burden of proof onto the firms to prove otherwise (this was also reflected in the nine examples provided, where positive correlation existed in all nine cases). Key among our members’ other main concerns, expressed at the outset to the meeting, were fears that in the wrong hands (applied rigidly by national regulators, perhaps by line supervisors) these principles could lead to significantly higher numbers and a more uneven “playing field”. It was felt that applied wrongly these could lead to higher standards than P468 intended, and that the principles themselves embodied a level of granularity in firms’ internal estimates that was both unrealistic and very difficult to implement. The industry felt that resulting estimates used for regulatory purposes may only end up being used for regulatory purposes, and may therefore be

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inconsistent with the rest of the Basel II framework (although firms had no objection to reflecting downturn conditions, the principles suggested that only “downturn” LGDs would be supported by regulators?).

Erik Heitfield felt that many of these comments reflected the difficulties and challenges that the regulators have faced in balancing prescription with flexibility, and were the reasons why the industry asked for, and working group attempted to deliver, a principles-based approach. The regulators felt that the principles delivered a more reasonable and flexible approach to “downturn” LGDs, which seemed preferable to the more rigid approaches previously discussed, such as supervisory mapping functions. Alain Duchateau further indicated that their initial reaction was of surprise, as they had understood that the industry would favor a principles-based approach, which was an improvement over more prescriptive approaches. He commented on the likelihood of achieving a “level-playing field” through a Pillar II type solution, suggesting that perhaps the result would have been more uneven than the principles based approach outlined in the paper. However it was felt that to fully understand industry concerns the meeting should address each principle at a time.

## **The introduction**

Erik Heitfield explained that the introduction to the principles clearly established that downturn conditions were relevant for LGD calculation only when a positive correlation existed between PDs and LGDs. Where such correlation did not exist long-term default weighted average LGDs were sufficient for regulatory purposes. Members pointed out that it could be expected that regulators and banks would have different views on whether correlation existed or not? They added that the principles did not seem to address this point and that it would be down to the firms to disprove a presumption made on behalf of the regulators that such correlation existed, and that this could be very difficult to do.

## **Principle One**

The industry expressed three main concerns around principle one as currently drafted: -

- I. Members were unclear as to whether the wording assisted in adding any clarity to firms and regulators seeking to implement P468? Where P468 talked about “downturn” conditions in terms of periods of higher credit losses, principle one brought in additional concepts, such as, periods where recovery rates were expected to be “substantially lower than average”, and/or periods of “negative GDP growth and elevated unemployment rates” or where “collateral values are shown to be highly correlated with default rates”?
- II. The industry was also concerned as to the level of granularity at which firms were required to conduct the analysis. The principle suggested that “downturn” conditions were to be identified for both each supervisory asset class and across each jurisdiction. Some members felt that this would compound the criticism that diversification of “downturn” LGDs across portfolios is not being properly considered. The more granular the segments, the more likely that there will be peak default rates in different years. If one then takes downturn LGDs for each of these segments and applies them on a bottom up basis, the more likely it will be that “downturn LGD diversification” considerations across segments of the portfolio will be ignored.
- III. We also made clear that this approach may be impractical where default rates across various jurisdictions are not necessarily coincident and default data is scarce. In particular we referred to the industry’s work on Low Default

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Portfolios (ISDA LIBA BBA papers dated August 2004 and January 2005), previously discussed with the AIG, in which principles of good risk management practice were outlined incorporating, internal ratings model testing and model validation, expert judgement, the use test, management reporting and corporate governance. It was felt that the level of granularity envisaged in this latest paper seem to take a step backward from this work.

We also asked the regulatory group, what would happen if a firm's internal estimates of LGD did not comply with principles one (or two for that matter)? Alain Duchateau responded to the point on diversification by suggesting that the industry had pushed for greater recognition of diversification in other areas of the Accord, and therefore offered an exception in principle one for those exposures that crossed international boundaries (such as large international corporate exposures). Erik explained that regulators interpreted P468 reference to "periods of high credit losses" as periods where high PDs and high LGDs are observed and the two are correlated. He added that where firms were unable to identify "downturn" conditions (perhaps the case for sovereign or interbank exposures), and therefore seemingly not comply with principle one, they would expect firms to conduct further analysis of the risk drivers and/or ratings migrations to identify potential periods of stress. This would be different from a Pillar II type analysis as the outcome would affect the risk parameters within the Pillar I charge.

## **Principle Two**

Although firms were happy and willing to conduct a correlation analysis, members expressed concerns around where the burden of proof lay. It was felt that as long as the firms could prove conservatism in their estimates that the burden of proof on correlation should not lie with them. The materiality question was also raised with some firms concerned that this analysis would be required for every single portfolio? Furthermore, the industry objected to the repetitive use of the "rigorous and well documented" language in principles one to three, feeling that this was unnecessary and set the wrong tone for discussions between IRB firms and their regulators.

## **Principle Three**

Erik Heitfield explained that where firms were able to demonstrate no material correlation existed, firms could use the long-run defaulted weighted average numbers, otherwise, principle three required you to report LGD numbers you would expect to generate in "downturn" conditions identified in the principle one type analysis. The key industry concern was the implication that firms would be required to discard data from the "good" years, and therefore be required to ignore variants in LGD numbers. The industry felt that low variance in LGD numbers extremely important information, however, the regulators said that there was always a trade-off between "bias" and "variance" and defended the principle suggesting data is not discarded as it has been used to identify "downturn" conditions at the outset. Members reiterated the argument already presented in previous meetings that regulators should allow for a positive recognition of improvements in underwriting and lending behavior by banks, which were often brought about after negative lending past experiences. Bankers insisted that in many occasions past data was not reflective of current practices and that therefore some adjustments should be able to be recognized. Other participants argued that not allowing such adjustments would be equivalent to penalizing those banks with larger sets of data (as LGDs of banks with less data would not be affected by past downturns in the economy). Erik

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Heitfield stated that nothing in the principles would prevent banks from making adjustments to reflect better and improved underwriting practices.

## Principle Four

The AIG CTF group clarified up front that this principle was still to be discussed by the regulators, and in particular how it might tie-in with “downturn” LGD numbers (and that this was why no examples on firms’ use of appropriate or otherwise discount rates were provided). Erik described the objectives of this principle as deterring firms from using a risk-free rate, while not seeking to impose a *vulture* rate, rather, require firms to use a risk premium rate (describing this as a simple NPV calculation). The example given to illustrate this point was where two identical defaulted assets in recovery were due to pay out fifty cents in the dollar, one with more certainty than the other. As such they should not be treated identically, and under principle four firms would be required to calculate a different NPV for each exposure.

The industry questioned the objectives of this principle (and how it related to “downturn” LGDs) and suggested that it would not accomplish further convergence in practice as firms could continue to apply a range of different rates while still complying with the principle. There were also continued concerns around the “doubling up” of conservatism in imposing both “downturn” LGDs and higher discount rates.

The industry questioned how many discount rates a firm could use and sought clarity on the footnotes (that they did not intend to prevent the use of a contract rate, consistent with accounting convention). While theoretically weak, in the sense that the contractual rate does not necessarily reflect a systematic risk premium over the risk free rate, some banks feel that choosing this rate would take into account Basel II downturn requirements and not create a conflict with an accounting standard. Erik Heitfield explained that in principle a firm would use the rate appropriate to the asset in question (whether it be a residential mortgage or a corporate bond) however, admitted that in practice this principle would make this more difficult. In response to the explicit question of whether firms could use market prices the regulators said that nothing in the principles would prevent a bank from using such data. Finally, Alain Duchateau confirmed that their intention was not to prevent firms from aligning Basel II rates with accounting convention rates, and that although this would be allowed under this principle, further analysis would be required.

## Principle Five

On principle five the industry was most concerned about the potential difficulty and additional cost associated with reporting two LGD numbers. We also doubted whether this was worded as a “principle” at all, as most of the industry seemed to interpret “principle five” as providing additional minimum requirements (reading more like rules rather than a principle). We therefore sought clarity from the regulators on their intentions and expectations for this final principle, was this intending to impose a floor (where the DLGD could not be lower than the long run default weighted average), was this requirement intended to replace the validation requirements of the IRB approach (and therefore benchmarking and/or back testing no longer required), and what benefit was there in providing regulators with this information?

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The regulators felt that principle five would provide a very useful validation tool, insisting that the gap between firms' long-run default-weighted average numbers and DLGDs could be the one form of benchmarking made available to supervisors. At least one supervisor present expressed doubts on whether LGD numbers could ever be "back tested" effectively, stating that this requirement could represent the only quantitative aspect to the validation process. Firms however were doubtful of the benefits of providing such information and extremely worried as to the costs of maintaining multiple LGD numbers. Other members were also concerned that at this stage of the application/implementation process assumptions based on P468 had already been built into LGD models, and further changes could damage and delay implementation plans. There was a strong feeling from the industry side that promoting and maintaining two different concepts of LGD (and perhaps implying even more concepts of LGD, such as "expected LGD", "observed LGD", "economic capital LGD" etc) would undermine the meaning of LGD as a significant risk component contributing to the regulatory capital charge. The regulators were concerned that principle five was perceived to be onerous and costly to implement, and suggested that they would look at ways in which these requirements could be made less burdensome.

## **Examples and Conclusion**

As time was running out, the industry were able to briefly address the AIG CTF examples that had been circulated the previous week and stated clearly, upfront, that the group had not had a chance to go over each example in detail (the examples were made available somewhat later than the draft principles). Nevertheless we were able to conclude that the examples seemed to imply a much higher standard than that implied by the principles. Firms further commented that the examples were not considered helpful and appeared to be both unrealistic and aspirational. As such we expressed a strong preference for further work and consultation with the industry, on providing better more realistic examples (perhaps with the AIG following any planned publication of principles)?

At the close of the meeting Erik updated ISDA IIF members on their current timetable, with the AIG CTF working group aiming to complete the work by the next meeting of the CTF in mid-July. This meeting was scheduled to take place just before the full Basel Committee meeting, tying up not only the LGD work but also the on-going trading book review additions.

ISDA and the IIF hope to follow-up with Erik and Alain over the next few days to obtain further feedback from the AIG CTF group following the meeting with our members, and following a further day's discussion in Paris and subsequent conference call among the regulators.

ENDS.