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Mr Richard Gresser
Chairman of Counterparty Risk sub-group
Of the Models Task Force
Basel Committee of Banking Supervision
Bank for International Settlements
Central Bahnhofplatz 2
CH-4051 Basel
Switzerland

Dear Richard,

Re: Calculation of regulatory capital for counterparty risk.

Thank you for your letter of 25 July 2001. ISDA appreciates the opportunity to clarify its views in a dialogue with the MTF. The ISDA working group on counterparty risk have discussed your questions in more detail and we are pleased to present our reply.

We refer to our letter to Daniele Nouy, which was sent on 1st August 2001, and which is enclosed for your reference. There, we summarized our proposals and attempted to clarify the sense in which expected exposure passes the “use test” for banks. We raised the issue of scenario consistency and noted that, owing to the close relationship between OTC derivatives and secured financings, the approach to these two areas should be broadly consistent. We are not sure whether you had seen this letter at the time of writing, but we assume that you have now reviewed its contents, and so avoid detailed repetition of its arguments here.

Wrong way risk

Wrong way risk occurs when exposure to a counterparty is adversely correlated with the credit quality of that counterparty. Wrong way risk, as an additional source of risk, is rightly of concern to banks and regulators.

The ISDA working group distinguish between specific wrong way risk, which arises through poorly structured transactions, for example those collateralized by own or related party shares; and general or conjectural wrong way risk, where the credit quality of the counterparty may for non-specific reasons be held to be correlated with a macroeconomic factor which also affects the value of derivatives transactions. An example of conjectural wrong way risk is a supposed macroeconomic relationship between declining corporate credit quality and high interest rates: as current economic conditions show (being characterized by rising default rates in a climate of persistently low interest rates), this relationship does not reliably hold.

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The nature of general wrong way risk is too indefinite to permit capital to be allocated for this risk. To attempt to do so compromises the principle that regulatory capital should balance simplicity with risk sensitivity and seek to set an adequate overall level. More generally, internal risk management processes, and not capital calculations, are the ultimate source of assurance for risks which, while important to banks' financial health, are like general wrong way risk inherently complex and judgmental.

Hence, the working group believe that the assessment of general wrong way risk should take place via appropriate internal risk management practices, such as scenario analysis, which are able to assess the sensitivity of a bank to wrong way exposure without needing to assess an associated capital number.

In contrast, the ISDA working group feel that specific wrong way risk is in most cases readily identified, and the capital treatment should clearly set exposure at its worst value. Participants to the ISDA working group confirm that the identification and monitoring of this direct risk (such as trading options on its own shares) with worst case correlation between exposure and default is existing practice within their institutions.

Hence, for the treatment of wrong way exposure, the ISDA working group suggest that the definition of wrong way exposure be limited to specific wrong way risk.

Reservations about expected exposure: the “use test” and time horizon

You have asked about reconciliation between banks' internal planning horizons and the one year time horizon implicit in ISDA's proposals. We commented on this question in our letter of 1st August. As we said there, a variety of measures of exposure and risk for different purposes is used by credit institutions, and we feel that it is important to emphasize the context in which a given risk measure is being used.

PFE over the life of a transaction is commonly used for the management of individual counterparty exposure positions, while expected exposure is a measure at the portfolio level and is used for calculating economic capital (generally, over a one year time horizon). Expected exposure over the life of a transaction is used for pricing decisions.

Additionally, some institutions which do not use expected exposure have implemented more advanced measurements of capital for counterparty risk, generally based on Monte-Carlo simulation. These approaches should be seen as consistent with and an extension of the use of expected exposure rather than an alternative methodology.

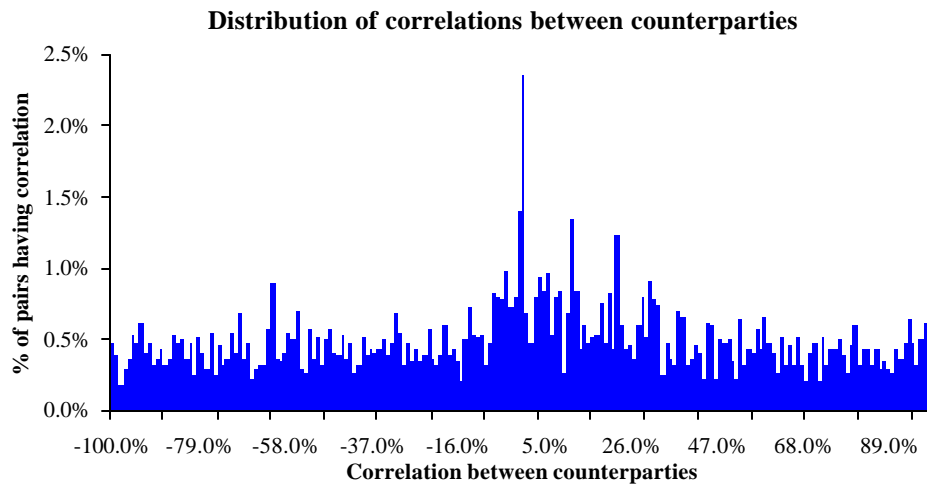
Under the ISDA proposals, the risk weights applied to credit equivalent exposures under the IRB approach would be the same as those applied to loan exposures, and so would include the same maturity adjustments as for fixed exposures. As for fixed exposures, there is no clear cut consensus on how the maturity dimension of capital should be estimated, with practitioners holding a variety of views. Based on the approximate notion of adjustment for value changes at the horizon, the working group feels that applying common maturity adjustment to lending and counterparty risk is an acceptable balance of simplicity and accuracy.

Weak independence

With regard to your question on “weak independence across counterparties”, the working group point out that, in general, it is reasonable to believe that sophisticated banks have counterparties taking a variety of positions in a large number of underlying markets. These are the conditions required for weak independence. By this we mean that although pairwise correlations between the values of positions with individual counterparties picked at random from the portfolio may vary and be positive or negative,

depending on those counterparties’ particular portfolio compositions, the average correlation across the portfolio should be zero.

The working group would like to remind you of a demonstration of this prepared by CSFB based on their OTC derivatives portfolio. You will recall the graph below from CSFB’s presentation of the ISDA proposals to the Counterparty risk subcommittee of the MTF in New York on the 18th July 2001.



We observe that correlations are scattered quite uniformly on the allowed interval, with only a weak tendency to cluster around their average value. Although they are widely dispersed, the *average* of these correlations is approximately 1%, that is, extremely close to zero.

Validation

The ISDA working group recommend that validation be part of an institution’s internal risk control framework with policies and procedures to test the validity of the exposure models. We feel it is appropriate on cost-benefit grounds for regulators to rely for validation on their overview of the soundness of a bank’s risk management practice and their knowledge of models in use at the bank and internal testing and validation regimes.

The most appropriate technique for validation is back-testing and the working group suggest two tests which should be appropriate.

Direct exposure back-testing

This is a test that compares expected exposure and / or other measures such as PFE assessed at the inception of a transaction, with subsequent actual realised exposure information over time. Because this test is for exposure directly without calling for default events, data to which to apply this test is richly available. On the other hand, this test has the weakness that it cannot detect interactions between exposure and the default event. Direct exposure back-testing is similar to VaR back-testing.

Default event back-testing

A complementary test looks at actual exposures in cases of default only, ignoring those time series which did not terminate in a default event. The value of this test is limited due to the likely small number of default events, particularly for derivatives counterparties, but on the other hand, the test has the advantage of directly testing the relevant measure, and hence capturing wrong way exposures if any.

ISDA hopes that consideration will be given to the comments in this letter and we are keen to co-operate with the Committee to improve the capital treatment of OTC derivatives. Should you have any further questions, do not hesitate to contact us.

Yours sincerely,

Katia D'Hulster
Policy Director
ISDA