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Mr Oliver Page
Chair, Capital Group
Basel Committee on Banking Supervision
Financial Services Authority
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5 October 2001

Copy to: Danièle Nouy, Chair, Models Task Force

Dear Mr Page,

Regulatory haircuts for securities financing transactions

One of the key issues raised in your May 2001 letter and debated at the Capital Group meeting where trade associations, including ISDA and The Bond Market Association (“TBMA”) were invited to present their views in July, was the appropriate application of collateral haircuts to securities financing transactions in the trading book.

The Capital Group requested guidance from the industry on how these haircuts may be calculated, and more importantly how they may be applied across a portfolio of transactions.

As stated at the meeting, each of ISDA, the London Investment Banking Association (LIBA) and TBMA has been reviewing the capital treatment of securities financing transactions. The following response, which we hope will be useful to the Capital Group, was elaborated jointly by ISDA and LIBA, and is supported by TBMA.

A methodology for calculating haircuts

Collateral haircuts reflect depreciation risk on collateral received. They are hence a measure of potential future exposure on the collateralised transaction, conceptually similar to the “add-ons” calculated on derivative transactions.

ISDA takes the view that the Basel Committee should recognise modelling of future exposure on a portfolio basis, considering that such modelling is common practice at firms and that the models used are in essence market risk models, already recognised for the purpose of computing market risk capital charges.

ISDA has detailed in Annex 1 of its response to the Basel Committee’s second consultation paper its proposed approach to measuring future exposure on derivatives. We refer the Capital Group to this Annex, which we will only briefly summarise here.

(a) OTC Derivatives

Our proposed approach to calculating future exposure on derivative contracts is based on “Expected Positive Exposure” (“EPE”), rather than VaR. This is because charging a tail end percentile credit risk charge - as is proposed under the IRB framework - onto a tail end measure of exposure (VaR) vastly overestimates risk. The amount of capital that would be necessary, were the add-ons based on VaR, would match a percentile on the loss distribution that is unlikely ever to be reached, except perhaps in the most extreme of circumstances. The Capital Accord is not intended to be calibrated to this standard. Using VaR would also introduce a serious discrepancy between derivatives and loans, the latter of which would carry a charge corresponding to a much lower percentile on the loss curve. It is further interesting to note that EPE is the only mathematical measure of risk that is compatible with the credit risk methodology underpinning the IRB approach. Finally, using EPE on a portfolio basis would reflect the impact of netting potential exposures across transactions under various market scenarios, thus measuring future exposure much more accurately than is possible under the current add-on based rules.

All the firms represented on the ISDA Counterparty Risk Working Group, a list of whom was communicated to the Models Task Force, strongly support EPE, and a substantial number of them already use this concept in setting economic capital for or pricing derivatives portfolios.

(b) Securities financing transactions

The conceptual similarity between securities financing transactions and OTC derivatives (e.g. both are principally trading transactions for which a loan equivalent exposure needs to be computed; a repo can be characterized as similar to a sale and

forward purchase) has led the Joint ISDA-LIBA Working Group to reflect on the appropriateness of the EPE approach to credit risk for the securities financing businesses. One important consideration in this respect has been the desire on the part of market participants to engage in cross product netting, encompassing both securities financing and derivative transactions, to further minimize counterparty risk. A significant incentive to encourage this practice would be regulatory recognition of a capital benefit of such arrangements. A number of trade associations, including ISDA and TBMA, have provided the industry with legal documentation that can be used to facilitate cross product netting and collateralisation¹. It is essential that the regulatory framework encourages good risk management practice, and particularly adequate collateralisation of exposures. Netting of future exposures among various businesses will, however, only be possible if common risk measures are used across the collection of products.

Our current view, based on analysis done to date, is that EPE is a valuable concept on which to build the regulatory calculation of collateral haircuts, at both the transaction level (for firms incapable of producing portfolio measures) and portfolio level, for securities financing transactions. We recognise, as ISDA has already commented to the Models Task Force (letter of 1 August attached for ease of reference), that the Basel Committee questions whether EPE as a methodology passes the “use test.” A number of ISDA and LIBA members can confirm that EPE is an established element within their firms’ risk management practices. Although it is not the sole methodology in use, and nor is it the sole regulatory approach that the firms wish to see adopted, the view of these firms is that the EPE approach should be one alternative made available within the new regulatory framework. By providing this option, the framework will satisfy the primary requirement that it does not stifle but rather allows for, and even encourages, the continued development of firms’ risk management practices.

Standard haircuts would hence be based on EPE, as indeed the standard derivative add-ons mentioned in ISDA’s response to the Basel Committee. We would further strongly recommend that firms using their own portfolio-based measures of collateral haircuts be allowed to use their own liquidation period assumptions in relation to collateralised transactions.

As noted in the comment letter submitted by TBMA on May 30, the liquidation period for securities financing transactions (including both fixed-income and equity

¹ ISDA and eight other internationally active trade associations, including LIBA and TBMA, jointly published a standardized form Cross-Product Master Agreement (“CPMA”) in February 2000 designed to allow netting across various financial markets products documented under various types of master agreements, including securities financing and derivatives. Legal opinions as to the enforceability of the CPMA under US and English law have been obtained, and opinions are in the process of being obtained for several other jurisdictions. In addition, ISDA has published established “bridges” between its own Master Agreement and other types of financial markets equivalent contracts, which allow set-off of final settlement amounts. ISDA has obtained opinions from thirty five netting jurisdictions confirming that the underlying netting opinion is not adversely affected by the use of the “bridge” addition.

securities lending transactions) is quite short, because securities financing close-outs are effected rapidly by buying in or selling out the underlying securities. This close-out can be effected for many repo and securities lending transactions in as little as one day. The capital rules should promote this prompt close out. The following table contains indicative values for EPE-based haircuts, using a very conservative assumption of a four-day liquidation period.

Issue rating	Residual Maturity	Sovereigns	Banks/Corporates
AAA/AA	<=1 year	0.0	0.0
	>1 year, <=5 years	0.1	0.2
	> 5 years	0.2	0.5
A/BBB	<=1 year	0.0	0.1
	>1 year, <=5 years	0.2	0.3
	> 5 years	0.5	0.7
BB	<=1 year	1.0	
	>1 year, <=5 years	1.0	
	> 5 years	1.0	
Main index equities		0.7	
Other equities listed on a recognised exchange		1.0	
Cash		0.0	
Gold		0.5	
Surcharge for foreign exchange risk		0.5	

The Associations are still considering the correct approach to netting, particularly in the light of recent guidance issued by the Capital Group in connection with their latest impact study. TBMA continues to evaluate different options as to how netting should apply to most accurately reflect risk and legal netting rights in secured financing transactions. However the joint ISDA –LIBA Working Group is of the view that netting under the standard rules could apply as follows:

- only positions in the same security would be netted;
- the haircut percent would apply to the absolute amount of the net position;
- all haircuts to be added;
- if the net market value of the portfolio is positive, the haircut amount would be added on top; if it was negative, no netting would apply between the net MTM and the haircut.

Wrong way exposure

One further issue mentioned in the Capital Group’s letter was the need for wrong-way risk to be identified and properly covered by regulatory capital. This issue was also identified by the Models Task Force in relation to OTC derivatives. ISDA commented in a letter dated 7 September 2001 (attached for reference).

In keeping with these comments, both the Joint ISDA-LIBA Working Group and TBMA believe that a clear distinction should be drawn between specific wrong-way risk, which arises through poorly structured transactions, for example those

collateralised by own shares; and general 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 its securities financing transactions. Specific wrong-way risk is generally identified and the capital treatment should clearly set exposure at its worst value. In contrast, the nature of general wrong-way risk is too indefinite to permit a specific capital charge to be allocated for it. The Joint Working Group and TBMA 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.

We hope that the above will assist the Capital Group in defining a treatment for stock lending and repo haircuts that is a true reflection of firms' risk management practice, and does not deter the use of risk mitigation techniques as essential as cross product netting. We are happy to discuss these topics at your convenience.

Yours sincerely,

Katharine Seal

A handwritten signature in dark ink, appearing to be 'ES' with a flourish.

Emmanuelle Sebtou
ISDA

Katharine Seal
LIBA