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Ms. Norah Barger  
Chair, Credit Risk Mitigation Sub-group  
Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel  
Switzerland

19 March 2003,

Dear Norah,

The International Swaps and Derivatives Association (ISDA), the London Investment Banking Association (LIBA), The Bond Market Association (TBMA) and the Risk Management Association (RMA, and collectively with ISDA, LIBA and TBMA, the "Associations") welcome the interest expressed by the Credit Risk Mitigation Sub-group in our latest proposals concerning backtesting of VaR models used to measure counterparty exposure. We understand in particular that the sampling process described in our November 2002 letter is likely to inspire the approach retained by the Committee in CP3. We strongly welcome the CRM Sub-group's support in this matter.

*Multipliers in QIS3*

We are, however, disappointed with the indication that the multipliers mentioned in the QIS 3 Technical Guidance paragraph 144 are likely to remain unchanged in CP3. As stated in our November 2002 letter, we believe multipliers above the levels suggested therein are technically unjustifiable. The multipliers proposed by the Associations were based on the methodology used to determine those in the 1996 Market Risk Amendment. It is important to understand that the multipliers introduced by the Market Risk Amendment do not, contrary to those in paragraph 144, embed the "cliff effect" of doubling – at a minimum - the output of the VaR model. Crossing the backtest threshold under the Market Risk Amendment only results in a capital charge increase of 13 % (= 3.4/3). The current proposals on multipliers, in our opinion,

unpick the parallelism which the Committee is trying to achieve between the Market Risk Amendment and the proposed repo VaR multipliers.

Furthermore, the Associations believe that the multipliers in QIS 3 are so penal as to deter firms from developing the models necessary to calculate portfolio VaR measures of repo counterparty exposure. Some of our member firms have tested the proposed multipliers against the more basic approaches offered by the Committee for calculating counterparty exposure. Such tests have demonstrated that applying a multiplier of 2 – the lowest multiplier set out in QIS 3 - on portfolio VaR estimates can produce higher capital requirements than using the own-estimates or standardized collateral haircut approaches. We believe that the QIS3 data will confirm this finding on a broader scale and we ask the CRM Sub-group and Committee to re-consider its recommended multipliers in the light of this information.

Although we understand that the Committee may have intended there to be a significant “cliff effect” of the QIS 3 multipliers, we are concerned that this regulatory approach may also increase systemic risk. Such potential systemic risk would result from the generation of a high level of exceptions as a result of unusual market activity or volatility experienced during times of market stress. An increase in the number of exceptions beyond the acceptable threshold amount would, at a minimum, result in doubling the VaR counterparty risk value used to calculate counterparty exposure. Given the size of the repo markets,<sup>1</sup> the amount of capital that would need to be set aside would probably be substantial. Such sudden and substantial increase in risk-based capital may preclude financial institutions from being able to ensure continued liquidity in times of market stress. The potential for systemic risk is increased further by the fact that repo activity is concentrated among a relatively limited number of financial institutions<sup>2</sup> – most likely the same financial institutions that would be likely to utilise VaR models to determine counterparty risk for their repo portfolio.

In the light of the above, the Associations believe that the multipliers suggested in QIS 3 would not serve the goal of the Basel Accord to “develop a more flexible and forward-looking capital adequacy framework – one that better reflects the risks facing banks and encourages them to make ongoing improvements in their risk assessment capabilities.”<sup>3</sup> We therefore again urge the Basel Committee to adopt a more

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<sup>1</sup> Average volume of total outstanding repo agreements for the first three quarters of 2002 totalled \$3.64 trillion. This figure represents financing activities of U.S. primary dealers reporting to the Federal Reserve Bank of New York, and includes repo and reverse repo agreements utilizing U.S. government, federal agency, mortgage-backed agency, and corporate securities. Research Quarterly, The Bond Market Association, November 2002, p. 8, available at: <http://www.bondmarkets.com/research/RQ1102.pdf>. The total value of repo contracts outstanding on the books of the 76 financial institutions surveyed by the International Securities Markets Association (ISMA) in December 2002 was EUR 3.38 trillion.

<sup>2</sup> According to a recent white paper jointly issued by the Federal Reserve Board and the Securities and Exchange Commission, out of approximately 1700 dealers, the trading of U.S government securities – both on an outright basis and through repo transactions – is concentrated largely among 22 primary dealers. Interagency White Paper on Structural Change in the Settlement of Government Securities : Issues and Options, May 2002, Appendix I, available at : <http://www.federalreserve.gov/BoardDocs/Press/other/2002/20020509/>.

<sup>3</sup> Remarks by William J. McDonough, President and Chief Executive Officer, the Federal Reserve Bank of New York, Chair, Basel Committee, at the Bond Market Association’s 2003 Legal and Compliance Conference, February 4, 2003.

reasonable set of multipliers, of a size comparable to that suggested in our November 2002 letter.

*Conforming Risk-Measures Cross-Product*

We also would like to express our hope that the counterparty risk treatment of repos will be revised alongside that of OTC derivatives as soon as possible after the Accord has been finalised. It is essential for these economically close products to be treated in a consistent manner, allowing cross product netting of future exposure. We would welcome a clear indication in the New Capital Accord of the Committee's intention to conduct such review. Absent such mention, a risk exists of the issue not being appropriately addressed in the new Capital Adequacy Directive in the EU. This would result in EU regulators not being able to implement the necessary changes within the same timeframe as their non European peers.

As always, the Associations appreciate the willingness of the Basel CRM Sub-group to engage in open dialogue on these issues. Please feel free to contact Emmanuelle Sebton (+44-20-7330-3571 or [esebton@isda-eur.org](mailto:esebton@isda-eur.org)), Katharine Seal (+44-20-7796-3606 or [Katharine.seal@liba.org.uk](mailto:Katharine.seal@liba.org.uk)), Omer Oztan (+1-646-637-9224 or [ooztan@bondmarkets.com](mailto:ooztan@bondmarkets.com)) or Tracy Coleman (+1-617-664-2546 or [TAColeman@StateStreet.com](mailto:TAColeman@StateStreet.com)) if you have any further questions.

Kind regards,

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