



INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.



## **NEWS RELEASE**

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### **ISDA, IACPM Study Supports Internal Credit Models Approach**

**NEW YORK, Wednesday, September 27, 2006** – The International Swaps and Derivatives Association (ISDA) and the International Association of Credit Portfolio Managers (IACPM) have published a credit capital model study that suggests regulators should consider an internal models-based approach for the calculation of regulatory capital, similar to the use of VAR models for market risk.

The study, which compares the results of economic capital models (both off-the-shelf vendor models and in-house methodologies) applied to simple hypothetical credit portfolios, demonstrates that advances in the modeling of credit risk and credit portfolios have not only created more sophisticated models, but have also increased understanding of how these models behave and how they compare. The study finds that model results converge when parameters and calculation choices are controlled and allow firms to consistently capture critical effects of portfolio composition. The study also finds that when results do not converge, it is possible to account for the divergence.

Under the revised Basel Capital Accord ('Basel II'), the Basel Committee allows an internal ratings-based, but not internal models-based, approach to regulatory capital. Firms are therefore permitted to use their own parameters, such as default probabilities, exposures and loss rates to calculate required capital, but not credit portfolio models that take account of correlations and concentration among credits. The Committee has indicated, however, that it would continue to follow progress in this area and would seek a continuing dialogue on the evolution of credit modeling.

“A benefit of harnessing credit capital models to the process of calculating capital adequacy is that the models capture the important effects of portfolio composition in an intuitive and understandable manner,” said Michel Araten, Managing Director, Global Credit Risk Management at JP Morgan Chase and chair of the project’s steering committee. “We have reached a point in the evolution of credit models such that an internal models approach should be considered for the calculation of regulatory capital.”

“Basel II regulatory capital calculations currently ignore the effects of credit capital models,” said David Mengle, Head of Research at ISDA. “It is arguably these effects—concentration of risk, lack of diversification—that have the most potential to do harm.”

“We are pleased to be able to provide regulators with this valuable new research,” said Som-lok Leung, Executive Director of IACPM. “Our study provides compelling evidence to support the promotion of an internal models-based approach for credit portfolios.”

The study, which involved 28 financial institutions, spanned almost two years. Model outputs were collected by Rutter Associates. The hypothetical portfolio is available as a database from ISDA and IACPM upon request. The organizations encourage interested practitioners to use the portfolio.

### **About ISDA**

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 725 member institutions from 50 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).

### **About IACPM**

The IACPM is an industry association established in 2001 to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas. The Association, currently made up of 66 members located in 11 countries, represents the interests of its members before legislative and administrative bodies in the U.S. and internationally, holds annual conferences and regional meetings, conducts research on the credit portfolio management field, and works with other organizations on issues relating to the measurement and management of credit portfolio risk. Information about IACPM is available on the Association's web site: [www.iacpm.org](http://www.iacpm.org).

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