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TO: Credit Risk Contact Group
FROM: Matthew Elderfield *ME*
REF: bakrednote2
DATE: 31 July 1998

— For Information —

CREDIT RISK FOLLOW-UP: BAKRED

Please find attached, for your information, a note of a meeting held last week with the BAKred (German Federal Supervisory Banking Authority) on ISDA's credit risk and regulatory capital proposals amongst other matters. As you will see, we received a generally positive response, although reservations were expressed on various points of detail. The BAKred were especially interested in our views on operational risk and pressed us to set out our position in the future when I explained that we had not yet agreed one and were focusing on credit risk only for the time being.

May I ask that you treat this note in confidence.

Summary Note of meeting with Bundesaufsichtsamt für das Kreditwesen on Monday, 20 July, 1998 in Berlin

Present: Messrs Dohr, Conert, Poppe and Traber and Dr Neumann, BAKred; Mr Elderfield and Ms. Papesch, ISDA; Dr Parche, Bayerische Vereinsbank; Dr Beck, Deutsche Bank; Dr Knippschild and Mr Hattori, Dresdner.

Mr Dohr chaired the meeting for the BAKred. Mr Elderfield chaired the meeting for ISDA. Ms. Evans sent her apologies for not attending due to her honeymoon. Dr. Sanio sent his apologies for not attending due to a meeting to discuss consolidation of German regulators.

I. Credit Derivatives

BAKred Plans

- BAKred have circulated draft capital guidelines to German banks and will publish interim rules in autumn following consultation.
- BAKred had been delaying action in hope of common Basle position, but this is not likely to be possible in short-term

Trading Book/Banking Book Split

- Mr Elderfield noted importance of not limiting trading book eligibility, eg for loan reference asset credit derivatives. BAKred explained that underlying reference asset must itself be eligible for trading book for credit derivative to be eligible. However, the drafting of the current list of eligible financial instruments is quite broad and loan reference asset credit derivatives would be eligible

Banking Book Rules

- Mr Elderfield asked that the BAKred consider the French and UK treatment of maturity mismatches in the banking book, where 70% capital risk weighting is possible rather than no relief (eg, 100% risk weighting). BAKred said they were open to this suggestion.

Trading Book Standardised Rules

- BAKred said they did not intend double charges under trading book standardised rules if there is a mismatch
- However, BAKred said they reserve right to impose some charge even if fully matched; they doubted that 100% specific risk offset was always justified

Simplified Models

- BAKred were generally positive about the possibility of using simplified models, so long as firms can justify whatever they propose to their models review unit

II. Credit Risk and Regulatory Capital

- Mr Elderfield outlined the ISDA proposals for an "evolutionary models-based approach" set out in the paper Credit Risk and Regulatory Capital
- BAKred focused primarily on the unbundling question: if credit risk capital is reformed, what about operational and other risks. They would be interested in ISDA setting out its position in this area in due course

- BAKred were open minded to the use of credit risk models and broadly supportive of the evolutionary framework. However, they expressed concern about the risk of reductions in systemic capital charges
- BAKred said they were examining operational risk issues in the Basle context
- Basle are developing common position on how to tackle reform process. Decisions (again, just on process) are expected by year-end
- BAKred expressed concern that some banks in some countries could gain a competitive advantage via modelling
- BAKred expressed concern about their lack of resources to undertake model reviews. ISDA offered training assistance
- BAKred felt more work needed to be done to develop internal control regime applicable to credit risk models
- BAKred were doubtful that all positions within a group world-wide could automatically be included in a model and netted with other positions. Positions may be ring fenced in some jurisdictions
- BAKred felt more work was needed on impact of credit risk reform on large exposure rules

III. ISDA Documentation Developments

- Ms.Papesch provided an update on ISDA's current documentation and opinion gathering projects
- Mr Elderfield provided a brief update on ISDA's emerging markets work in central and eastern Europe

IV. Netting

Netting Approval Procedures

- Mr Elderfield noted ISDA's work on best practice standards for supervisory netting approval procedures. This indicated the need for greater reliance on firms themselves in the approval process. In this respect, particular aspects of the BAKred procedures gave cause for concern
- BAKred said that, in the initial start-up phase for netting approval, they believed a comprehensive and conservative approach was justified, involving detailed review of each agreement and opinion prior to approval. However, they were now preparing to move to a less conservative approach, allowing firms to go ahead and net subject to review afterwards by BAKred. This change would be notified to German banks for consultative purposes and adopted in October or later.
- ISDA warmly welcomed this change

Amendments to Master Agreements

- Messrs Beck and Elderfield note concern over the requirement to obtain additional opinions in case of amendments to the ISDA Master Agreement. Such opinions should only be required if the amendments are truly material, i.e they change the core netting provisions. BAKred agreed and indicated they would be willing to rely on banks themselves to make a formal determination as to whether an amendment was material and a new opinion was needed

On-Balance Sheet Netting

- Mr Elderfield noted that ISDA has submitted a response to Basle on this topic. ISDA supports the move to netting recognition and opposes limiting this with maturity and currency tests. Also, on- vs off-balance sheet netting should be contemplated

- Mr Elderfield also noted that German members were concerned about the restrictions on repo netting
- BAKred said they had no objections in principle to on-balance sheet netting or to repo netting. The key question was the accounting, legal and directives framework that applied. They would, however, review this point.

V. Collateral Law Reform

- Mr Elderfield noted that ISDA's paper on credit risk had called for reform of collateral capital rules and had urged action on collateral law reform
- BAKred were pessimistic about any immediate capital rule changes, but acknowledged that the subject was on the supervisory agenda and would come up in any Basle reform discussions.
- Mr Beck expressed concern with a possible interpretation of BAKred rules for recognition of collateral under the ISDA Credit Support Annex. He agreed to provide more information on this point later.

VI. Commission Strategy Review Group

- Mr Elderfield highlighted ISDA's key objectives in this group: addressing ISD implementation problems; credit risk and collateral reform; and more flexible EU legislative procedures. He urged the BAKred to support less use of prescriptive EU legislation and more informal, non-legislative means to ensure common approaches in the EU
- BAKred said they were think about this issue and would be forwarding comments to the Finance Ministry