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Stephen Bland
BIS Models Task Force
Financial Services Authority
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22 February 2002,

Dear Stephen,

ISDA appreciates the opportunity to comment on the Basel Committee's revised reference definition of default.

Whereas the Association views this definition as broadly satisfactory, we believe that it would be helpful if the Committee could clarify (i) the meaning of "credit related economic loss" and (ii) the relationship between the IRB definition of default and the operational requirements imposed on credit default swaps and guarantees.

Our first concern relates to the exact scope of the definition of credit-related economic loss. ISDA has proceeded under the assumption that credit risk means default risk under the new Basel Accord; such a definition underpins applied accounting and risk management standards. The proposed definition, however, mentions distressed sales, which suggests that transition risk might be included as well. ISDA is concerned that, if the definition of credit risk were extended to include pure transition risk, a major discrepancy would exist between the regulatory definition of default on the one hand and the definition currently used by banks in the banking book, on the other. The unintended consequence could be that the Committee might invalidate widely used forms of credit risk protection, including guarantees and credit default swaps, which do not normally cover transition risk related losses. ISDA would therefore urge the Basel Committee to clarify what form of credit losses are to be capitalized against.

ISDA recognises that it will not be possible for the Committee to identify objective criteria by which to differentiate between distressed and non-distressed sales. Spreads in today's markets have widened to a point where substantial losses may be incurred from selling good quality assets, which would not reflect a decline in creditworthiness, but rather a contraction in market liquidity. Banks should be capable of separating between counterparties which are truly on the verge of default, to which we believe "distressed" properly applies, and the rest.

It is furthermore unclear why firms should count losses owing to the subordination of an asset in a restructuring as "defaults". Under the IRB approach, the loss given default assigned to an asset is adjusted

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to reflect its subordination. Categorising subordination events as default events would lead to double counting of loss by increasing the probability of default.

Finally, ISDA strongly believes, as already emphasized in its comments on CP2¹, that the definition of default under IRB and the definition of default used for recognising credit protection should not encompass the same set of events. The reason is that some of the credit events listed in the IRB definition- restructuring of bilateral loans, specific provisioning and distressed sales, for example- are initiated at the option of the protection buyer. So long as credit protection previously acquired [in the form of a guarantee, or credit default swap] does not encompass these events, the protection buyer will normally refrain from exercising its option to trigger them. Market practitioners have expressed concern that requiring restructuring and distressed sales to be covered under credit default swap contracts could lead to protection being triggered in the absence of objectively identifiable events of default. This moral hazard effect, in which protection sellers lack objective information about the likely actions of protection buyers, would introduce uncertainty into the pricing of risk and most probably lead to market illiquidity. ISDA acknowledges that it makes sense for a bank to track restructuring/distressed sales as part of the IRB definition of default [subject to comments made above], but believes it would be inappropriate for the Basel Committee to require that the triggers mentioned above be systematically included under credit default swap contracts or guarantees. We have debated this issue with the Capital Group on past occasions and would be pleased to discuss it again with the Models Task Force.

Yours sincerely,



Emmanuelle Sebton
ISDA
Head of Risk Management

¹ See Section 3 “Credit Risk Mitigation”, page 23. This document is available on our website at www.isda.org