

ISDA

International Swaps and Derivatives
Association, Inc
360 Madison Avenue
New York, NY 10017
Telephone: 1 (212) 901-6017
Facsimile: 1 (212) 901-6001
email: isda@isda.org
website: www.isda.org

THE BOND MARKET ASSOCIATION

360 Madison Avenue
New York, NY 10017
Telephone 646.637.9224
Fax 646.637.9126
www.bondmarkets.com

Department of the Treasury
Office of the Comptroller of the Currency
250 E Street, S.W.
Public Information Room, Mailstop 1-5
Washington, D.C. 20219
ATTN: Docket No. 03-14

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C., 20551
ATTN: Docket No. R-1154

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

November 3, 2003

Ladies and gentlemen:

The International Swaps and Derivatives Association and The Bond Market Association ((ISDA and TBMA, hereafter the “Associations”) appreciate the opportunity to comment on the Advance Notice of Proposed Rulemaking on the New Basel Accord (“ANPR”) issued by the United States Federal banking regulatory agencies (“Agencies”). In the ANPR, the Agencies have requested comment on a wide spectrum of issues associated with the implementation of the New Basel Accord in the United States. The Associations have commented more extensively on the New Accord, most recently in their comment letter on the third consultative paper of the Basel Accord (CP3), which is attached as Appendix 1 (“CP3 Response”). This comment letter will address the following issues:

1. Advanced IRB approach: Conceptual overview
 - a. Expected losses versus unexpected losses
 - b. Role of internal models
2. Credit derivatives
 - a. Double default effects and the substitution approach
 - b. Restructuring
 - c. Accounting treatment of credit derivatives
 - d. Treatment of counterparty risk for credit derivative contracts
 - e. Maturity mismatches
3. Counterparty risk of privately negotiated (OTC) derivative and repo-style transactions
 - a. The treatment of potential exposure for OTC derivative transactions should be revisited promptly.
 - b. Transactions that are economically similar and exhibit similar risks should receive uniform treatment under the New Accord and ANPR.
4. VaR-based approach for repo-style transactions
 - a. VaR models should be validated by appropriate supervisory review and not be subject to a rigid backtesting regime.
 - b. The level of multipliers associated with the backtest is unnecessarily punitive and conceptually unjustifiable.
 - c. Current VaR backtesting regime should allow flexibility.
 - d. Enforceable netting arrangements should not be a prerequisite for the use of VaR models.
5. The treatment of maturity should be revisited to more appropriately account for short-term exposures
6. Unsettled transactions
7. Operational risk

The Agencies have also asked for comments on the supervisory guidance documents issued at the same time as the ANPR. While the Associations recognize the importance of the national implementation issues raised in those documents, our comments focus on the broader conceptual issues raised by the ANPR.

Advanced IRB Approach: Conceptual overview

Expected losses versus unexpected losses. Should the A-IRB capital regime be based on a framework that allocates capital to EL plus UL, or to UL only? Which approach would more closely align the regulatory framework to the internal capital allocation techniques currently used by large institutions? If the framework were recalibrated solely to UL, modifications to the rest of the A-IRB framework would be required. The Agencies seek commenters' views on issues that would arise as a result of such recalibration.

ISDA recommended in its comment on the first New Basel Accord proposal that unexpected loss (UL) alone form the basis for bank capital requirements. A framework that allocates capital to UL only would more closely align the regulatory framework to internal capital allocation techniques currently used by large institutions. The Basel Committee acknowledged the industry's arguments on this subject in its October 11, 2003, announcement that they would "adopt an approach based on unexpected losses." As a means of aligning regulatory capital standards with industry practice, the Associations generally support the Basel Committee's October 11 proposal and recommend that the Agencies consider the approach for the U.S. implementation of the New Accord, subject to the qualifications set out below. ISDA plans on commenting in more detail on the Committee's October 11 proposal by the end of the year.

While the Associations believe the Committee proposal is an improvement, at least conceptually, over an approach that covers both EL and UL, we would like to bring three concerns to the Agencies' attention.

First, the Associations appreciate the necessity for ensuring appropriate treatment of expected losses (EL), but would prefer to see it addressed under Pillar 2. We believe Pillar 2 treatment would allow national supervisors to take into consideration differences in accounting treatment of reserves without adding undue complexity to the New Accord.

Second, in considering the adequacy of provisioning for EL, it is not clear to us why future margin income (FMI) is no longer part of the New Accord framework under the October 11 proposal. It is our understanding that, at least for some banks active in retail credit card activity, FMI is an important means of covering EL. Again, Pillar 2 treatment might be a more suitable place to consider what should be considered as available resources to cover expected losses.

Finally, we suggest the Agencies consider the appropriate role of reserves in a mark-to-market framework. In traditional banking markets, credit losses create a gap between accrual values and economic values; reserving practices help bridge this gap. In a mark to market environment, in contrast, the adjustment of current values captures credit losses; there is consequently no need for separate credit reserves. We believe that market risk capital standards for the trading book are adequate to assess capital adequacy in such an environment. Where a firm marks to market to cover expected loss, and can demonstrate robust valuation practices, there should be no capital requirements with respect to expected loss. We would appreciate a clarification that the provision adequacy tests described by the Committee are not intended to apply to trading book assets. Further, we believe that the Agencies and the Committee should clarify the appropriate treatment of credit valuation adjustments that are intended to cover EL on OTC derivative transactions.

Role of internal models. *What are the advantages and disadvantages of the A-IRB approach relative to alternatives, including those that would allow greater flexibility to use internal models and those that would be more cautious in incorporating statistical techniques (such as greater use of credit ratings by external rating agencies)?*

The Associations support the eventual recognition of internal portfolio models of credit risk for the direct calculation of capital charges. Using internal models would help meet the New Accord's goal of aligning regulatory capital more closely with economic capital by, for example, allowing concentration risk to play a role in determining minimum capital requirements. We argue below for the use of internal counterparty potential exposure models to calculate capital for counterparty credit risk; we expect that in due course internal credit portfolio models will be accepted for calculation of credit risk arising from lending and other credit products as well.

When the Basel Committee issued its first version of the New Accord in June 1999, it decided not to allow banks to use the results of internal economic capital models in setting regulatory capital requirements. The Committee suggested, however, that it might reconsider the use of internal economic capital models in the future.¹

The Associations view the use of internal economic capital models as the necessary next step in aligning regulatory capital with the true risk of the underlying exposures. We therefore appreciate the Agencies' request for industry comment regarding greater flexibility to use internal models. In the light of this request, as well as of the Basel Committee position quoted above, ISDA and other trade associations are currently in the process of organizing a study of the convergence of economic capital models. In that study, the organizations will look for evidence that internal credit portfolio models provide economic capital measurements that are sufficiently consistent as to form the basis for regulatory capital adequacy determination. Whatever the outcome, ISDA looks forward to sharing the results of the study with the Agencies and with the Basel Committee.

Credit Derivatives

Double default effects and the substitution approach. *The Agencies are seeking comment on the proposed nonrecognition of double default effects...The Agencies also are interested in obtaining commenters' views on alternative methods for giving recognition to double default effects in a manner that is operationally feasible and consistent with safety and soundness. With regard to the latter, commenters are requested to bear in mind the concerns outlined in the double default white paper, particularly in connection with concentrations, wrong-way risk (especially in stress periods), and the potential for regulatory capital arbitrage. In this regard, information is solicited on how banking organizations consider double default effects on credit protection arrangements in their economic capital calculations and for which types of credit protection arrangements they consider these effects.*

The Associations have consistently argued that the substitution approach in the proposed New Accord is excessively conservative because it does not accurately reflect the risks of

¹ "A New Capital Adequacy Framework," June 1999, p. 41.

hedged exposures. We have urged the Basel Committee to correct this flaw by taking account of double default effects in setting risk weights for hedged exposures. The Associations therefore appreciate the Agencies' request for comment on the subject.

ISDA, in cooperation with the London Investment Banking Association and the International Association of Credit Portfolio Managers, are submitting comments directly to the authors of the Federal Reserve White Paper on Double Default. The comment letter is attached as Appendix 2, and presents these arguments in greater detail.

The Associations further submit that, if the New Accord were to recognize double default effects, the list of New Accord exemptions from the three basis point floor on probability of default should be expanded to include exposures hedged by credit derivatives when both the reference credit and protection seller are of high quality.

***Restructuring.** The Agencies invite comment on [the CP3 proposal regarding control over restructuring], as well as consideration of an alternative approach whereby the notional amount of a credit derivative that does not include restructuring as a credit event would be discounted.*

The Associations applaud the proposed change brought by CP3 to the treatment of restructuring risk arising from the use of certain credit default swaps (CDS). The new approach is better aligned with risks borne by protection buyers, who are exposed to restructuring risk only where they have no control over the occurrence of restructuring events. But even where such control is not demonstrated to exist, having acquired credit protection in the form of a CDS excluding restructuring does offer some degree of protection. We therefore welcome the Basel Committee's attempt at measuring this quantum of protection via a discount applied to full capital relief, although we believe the discount should only be applied to credit protection in which control over restructuring does not exist. More importantly, this discount will only be meaningful if the substitution approach is abandoned. It is therefore essential that, before considering a discount factor, the substitution issue should be addressed as argued above.

The Agencies, however, appear to have reservations about the CP3 approach of requiring restructuring only if the protection buyer has no control over restructuring: In the ANPR, the Agencies express "concerns that this approach could have the incidental effect of dictating terms in underlying obligations in ways that over time could diverge from creditors' business needs." Further, the Agencies question the efficacy of risk transfer when restructuring is not covered, "particularly as many credit derivatives hedge only a small portion of a banking organization's exposure to the underlying obligation.

The Associations believe these concerns are misplaced and that acting on them could lead to unintended consequences. First, we believe the issue of including restructuring is a business decision, which properly belongs to the market to determine. Indeed, ISDA is actively involved in developing acceptable solutions to restructuring risk in its credit derivatives documentation. We are confident that the credit default swap market will solve this problem as part of its evolution as an industry.

Further, whether a firm actually makes use of its control over restructuring depends on the specific terms of a transaction and on the firm's global relationship with the counterparty. Assume, for example, that a hedged exposure accounts for only 10 percent

of total global exposure to a counterparty. A firm might prefer in this case to restructure – despite the CDS not triggering in a restructuring – rather than let the counterparty go bankrupt. The key point is that the firm has the means to prevent a restructuring if doing so makes economic sense. As argued above, the Associations respectfully submit that financial institutions – and not regulators – are in the best position to make business decisions; mandating restructuring would inappropriately reverse these roles.

Finally, the Associations fear that regulatory attempts to dictate the terms of market transactions could hamper the development of liquidity in the market. Of particular concern is the possibility that mandating restructuring would discourage the entry of some potential protection sellers, thereby reducing the channels for risk transfer and possibly increasing systemic risk. Such an unintended consequence would be contrary to the objectives of the Basel Committee.

Comment is sought on the appropriate level of discount and whether the level of discount should vary on the basis of, for example, whether the underlying obligor has publicly outstanding rated debt or whether the underlying obligor is an entity whose obligations have a relatively high likelihood of restructuring relative to default (for example, a sovereign or PSE). Another alternative that commenters may wish to discuss is elimination of the restructuring requirement for credit derivatives with a maturity that is considerably longer—for example, two years—than that of the hedged obligation.

As mentioned above, we believe the discount factor should not be applied to credit protection in which control over restructuring exists, but instead to contracts in which control does not exist. The discount in such cases should be a function of the relative incidence of restructuring events vis-à-vis other forms of default events, as well as of any discrepancy between loss given restructuring and loss given default.

In the Associations' CP3 Response, we propose a 35 percent discount factor for the Foundation IRB Approach (Appendix 1, pp. 2-3). The ANPR envisions, however, that core and opt-in banks will only be allowed the A-IRB approach, for which the Associations believe banking organizations should have the ability to measure the discount themselves, subject to supervisory review. In order to show the feasibility of such a calculation, the Associations attach a calculation of the 35 percent discount factor as Appendix 3.

In considering this discount factor, it is important to note the concluding point in Appendix 3 that, if the New Accord retains the substitution approach, applying a discount factor will essentially nullify the benefits of hedging with a credit default swap. Indeed, it is even possible that, because the substitution approach is so conservative, the total capital charge using a discount factor with substitution could lead to a capital charge higher for the hedged than for the unhedged exposure. In order to avoid the unintended consequence of discouraging market liquidity and increasing systemic risk, we believe that reform of the treatment of joint default exposures should be revised to account for double default effects.

Accounting treatment of credit derivatives. *Agencies are considering ...non-recognition on credit default swaps where mark-to-market gains in value are recognized in income and, thus, in Tier 1 capital, but no offsetting deterioration in the hedged obligation is recorded... Comment is sought on this matter, as well as on the possible alternative*

treatment of recognizing the hedge in these two cases for regulatory capital purposes but requiring that mark-to-market gains on the credit derivative that have been taken into income be deducted from Tier 1 capital.

Under current accounting standards for many institutions, , loans are not marked to market but credit default swaps are. The Associations are therefore concerned that the above non-recognition proposal would essentially make credit default swaps useless as hedges. Viewed in comparison with non-recognition, the alternative proposal of deducting mark-to-market gains seems reasonable. Yet if one were to accept the logic of the alternative proposal, consistency would suggest that mark-to-market losses on a CDS referencing an improving credit be added into capital.

These issues stem from a conflict between capital standards and accounting standards. The Associations believe that the correct solution is to address the accounting treatment — namely, the inability under current U.S. accounting standards to mark loans to market — rather than jury-rigging capital standards. The Associations would be pleased to work with the Agencies in order to develop more information on which to base a decision.

Treatment of counterparty risk for credit derivative contracts. *The Agencies are seeking industry views on the PFE add-ons proposed [in the ANPR] and their applicability. Comment is also sought on whether different add-ons should apply for different remaining maturity buckets for credit derivatives and, if so, views on the appropriate percentage amounts for the add-ons in each bucket.*

The Associations' membership views the proposed add-ons as overly conservative and inconsistent with their internal assessment of counterparty exposure on CDS contracts. ISDA found in its commentary on the QIS3 Technical Guidance that an add-on of 3 percent was more appropriate than 5 percent. ISDA also advocated introducing a maturity dimension to the calculation of the add-ons at that time. The Associations believe these results, which are attached as Appendix 4, call into question the size of the add-on retained for protection buyers hedging qualifying underlyings.

Maturity mismatches. *The Agencies have concerns that the proposed formulation does not appropriately reflect distinctions between bullet and amortizing underlying obligations. Comment is sought on the best way of making such a distinction, as well as more generally on alternative methods for dealing with the reduced credit risk coverage that results from a maturity mismatch.*

As previously stated in our CP3 Response, the Associations believe that capital requirements to capture forward credit risk arising from a maturity mismatch should be calculated using the maturity adjustment of the A-IRB approach.

Revisiting Counterparty Risk for OTC Derivative and Repo-Style Transactions

The treatment of potential exposure for OTC derivative transactions should be revisited promptly. The Associations were pleased to see the New Accord reaffirm the commitment to revisit the treatment of potential exposures associated with privately negotiated — commonly referred to as over-the-counter (OTC) — derivatives,² and were

² See “Overview of the New Basel Capital Accord,” paragraph 63.

further pleased to see the Basel Committee recently reiterate their commitment to revisit the treatment of certain credit risk mitigation techniques generally.³ The Associations were surprised, however, that the ANPR did not explicitly state a similar intention to revisit the treatment of OTC derivative transactions. The Associations request that the Agencies clarify that they will take into account the changes expected to be made to the current treatment of OTC derivative transactions under the New Accord in the implementation of the New Accord in the U.S.

The Associations believe that the treatment of potential exposures for OTC derivative transactions should be reviewed as soon as practicable. Given the need for financial institutions to review and implement changes to their current counterparty risk measurement, it is important that they have as much advance notice as possible to implement such changes ahead of the implementation of the New Accord in 2007. Were changes to the treatment of OTC derivative transactions made under the New Accord close to its implementation date, the Associations believe it would be imperative that the Agencies allow firms a transition period to make the requisite changes to their systems to ensure the smooth adaptation of such changes.

Transactions that are economically similar and exhibit similar risks should receive uniform treatment under the New Accord and ANPR. The Associations wish to reiterate their view that OTC derivative and repo-style transactions should receive uniform treatment under the New Accord. In this regard, the Associations have previously encouraged the Basel Committee to take this sensible approach by reviewing the treatment of repo-style transactions when it revisits the treatment of potential exposure in OTC derivative transactions.

The Associations believe that OTC derivative transactions and repo-style transactions should be treated in a similar manner because they often exhibit similar risks. As the Associations pointed out in a recent letter to the Basel Committee (submitted jointly with the London Investment Banking Association (LIBA)), establishing separate capital standards for OTC derivatives and for repo transactions conflicts with emerging risk management practices:

[T]he New Capital Accord draft differentiates between securities financing transactions (SFTs) and derivatives for counterparty credit risk purposes, regardless of the fact that SFTs closely resemble forwards in economic terms and give rise to similar counterparty credit risk. The Committee continues to use fixed notional percentage add-ons as a measure of future exposure for derivatives, whereas for SFTs, it has improved on previous approaches by permitting the use of Value at Risk models. The former approach is outdated and risk insensitive, while the latter is risk sensitive, but resource-intensive and overly conservative. More to the point, these approaches produce different measures of risk for comparable products. The use of two different approaches makes it impossible for the New Capital Accord to encourage best risk management practices, by not recognising the risk mitigating effects of cross product netting and the

³ See Press Release, “Basel II: Significant Progress on Major Issues”, October 11, 2003.

management of potential future exposure at the counterparty, rather than the transaction, level.⁴

Financial institutions are increasingly managing the risks exhibited by OTC derivative and repo-style transactions in a coordinated manner. A coordinated approach to determining future exposure for each of these markets would have the benefit both of reducing the operational burden of managing risks presented by these transactions and of encouraging increased use of risk mitigation techniques. In particular, the recognition at the counterparty level of the effects of netting future exposure cross-product would encourage financial institutions to engage in what has been widely recognized as a prudent risk management technique.

In addition, we have also previously requested that the Basel Committee clarify that “repo-style” transactions as a category include margin lending transactions, in addition to repo and securities lending transactions. Margin lending transactions, like other repo-style transactions, are financing transactions and are generally subject to the same risk management practices as repo transactions, such as daily marking-to-market and subject to daily re-margining. The Associations therefore request that the ANPR clarify that margin lending transactions are subject to the same requirements as other “repo-style” transactions and may use the same methodology as repo-style transactions in the calculation of risk-based capital requirements.

VaR-Based Approach for Repo-Style Transactions

VaR models should be validated by appropriate supervisory review and not be subject to a rigid backtesting regime. The Associations are opposed to a rigid backtesting regime. As previously argued, the Associations believe that it would be more appropriate to allow firms to validate their models based on supervisory review, and scale up risk-based capital treatment accordingly. And as the Basel CRM Subgroup has itself noted, the imposition of a prescriptive backtesting methodology is operationally burdensome.⁵ In addition, the Federal Reserve has recently allowed for the use of VaR models to determine risk-based capital requirements for certain securities lending transactions without imposing a specific backtesting regime.⁶ As such, the Associations continue to question the propriety of the prescriptive backtesting approach — set out in the New Accord and restated in the ANPR — instead of an approach allowing individual firms to validate such models based on a supervisory-approved process.

The Basel Committee and the Agencies have nonetheless chosen to prescribe a backtesting model (albeit one recommended by the Associations, LIBA and the Risk Management Association (RMA) in our November 8, 2002 letter, attached as Appendix

⁴ Letter to Mr. Jaime Caruana, October 6, 2003.

⁵ See letter dated April 14, 2002 to the Associations, (“Backtesting each counterparty VaR generated on a daily basis could pose operational challenges to institutions.”)

⁶ See letter dated May 14, 2003, to Gregory J. Lyons, P.C., Goodwin Procter LLP, on behalf of State Street Bank and Trust Company (stating that, while State Street “will be required to conduct regular and rigorous backtesting procedures” subject to supervisory review, it “will not be subject to a formal backtesting procedure requirement at this time.”)

5). The Associations wish to submit the following in connection with such backtesting approach.

The level of multipliers associated with the backtest is unnecessarily punitive and conceptually unjustifiable. We believe that the level of multipliers set out in the New Accord and incorporated into the ANPR is unjustifiable conceptually, and may potentially increase, rather than decrease, systemic risk. Utilizing the methodology set out in the 1996 Market Risk Amendment — ostensibly the methodology from which the VaR treatment for credit risk is based on in the New Accord and ANPR⁷ — would produce a significantly lower level of multipliers. In addition, the exceptions generated to an institution’s VaR model during a market crisis may radically increase their risk-based capital requirements given the application of the current level of multipliers; such sudden increase in risk-based capital requirements during a market crisis could adversely impact the ability of such financial institution to provide needed liquidity to the marketplace, increasing systemic risk.

Current VaR backtesting regime should allow flexibility. In connection with the backtesting regime set out in the ANPR, the Associations wish to highlight the following points:

- The description of the backtest in the ANPR sets out a “clean” backtesting approach (i.e. comparison of each day’s end of day profit/loss). While the Associations believe that such approach is a conceptually sensible, the Associations further believe that the ANPR and the New Accord should allow firms the flexibility to use either a “clean” or “dirty” (i.e. taking into account intraday movements of P/L) approach. In this regard, the Associations would note that the backtesting regime set out in the 1996 Market Risk Amendment does not dictate either a “clean” or “dirty” backtest approach.
- The Associations respectfully request that the Agencies clarify that financial institutions, if they so choose, will be allowed to use a static sample of counterparties for each quarter the backtest is performed, determined at the outset of each quarter in the manner set out in the ANPR, without having to readjust such sample on a daily basis.
- The Associations also ask the Agencies to clarify that financial institutions should have the flexibility of using an actual or hypothetical portfolio when backtesting their VaR model. As noted in discussions the Associations have had with the Basel CRM Subgroup, the resources necessary to perform backtesting in the manner set out in the New Accord and ANPR on an actual vs. hypothetical portfolio vary on a firm-by-firm basis. As such, the Associations respectfully request that the implementation of the New Accord in the U.S. allow firms the flexibility to backtest their VaR model on either an actual or hypothetical basis. A description of backtesting on a hypothetical portfolio is set out as an annex to the November 8, 2002 letter.

⁷ See, e.g., New Accord, paragraphs 149, 150, ANPR, p. 56.

Enforceable netting arrangements should not be a prerequisite for the use of VaR models. The ANPR incorporates the New Accord’s requirement that enforceable netting arrangements must be in place before a financial institution is allowed to use a VaR model to calculate counterparty risk for repo-style transactions. The Associations wish to emphasize the observation — made in our CP3 Response — that, even in the absence of netting, portfolio diversification effects mitigate risk given that all transactions are not likely to move simultaneously against a financial institution. A VaR model can account for the risk mitigating effects of portfolio diversification without reflecting the netting of exposures provided under a netting agreement. As such, the Associations ask the Agencies, in addition to the currently contemplated VaR approach, to allow financial institutions to use VaR models even when a netting arrangement does not exist, of course, subject to the requirement that such VaR models would not reflect the netting of future exposures.

Maturity

The treatment of maturity should be revisited to more appropriately account for short-term exposures. The ANPR appears to incorporate the New Accord’s treatment of short-dated transactions by allowing the maturity factor (M) to be set as low as one day for transactions with a maturity of less than three months, or no less than five days for such transactions that are subject to a master netting agreement. The ANPR also makes clear that a maturity adjustment is applied to the calculation of a wholesale exposure in order to take into account the greater likelihood of “migration risk”, i.e. the increased potential for a higher credit obligor to deteriorate in quality than a lower quality credit.

As noted in the Associations’ CP3 Response, as an initial matter, the Associations believe that the short-term maturity adjustment should be allowed for all transactions with less than a year of maturity, and not be limited only to those transactions of less than three months of maturity.

The Associations agree with the Agencies’ view on migration risk in relation to longer-dated exposures. However, it is unclear from the ANPR whether it also adopts the Associations’ view that migration risk is only relevant for longer-dated exposures, specifically those longer than one year. For shorter-dated exposures, “default risk” (i.e. the risk of a default under the terms of the transaction), not migration risk, is the relevant risk present in such exposures, and therefore the risk that should be reflected in calculating capital requirements for such exposures.

As such, the Associations reiterate their request, set out in the Associations’ CP3 Response, that the method of maturity adjustment for short-term exposures under one year be revised to better reflect default risk. Specifically, this would involve adjusting the probability of default for such short-dated exposures, with the imposition of one of two alternatives to apply capital adjustment factors to add a degree of conservativeness to short-term maturity adjustments made in this manner. The Associations’ CP3 Response sets out a detailed description of our proposals in this regard .

Treatment of Fails

Neither the New Accord nor the ANPR explicitly account for the treatment of transactions which fail to settle on settlement date (“fails”). Given the importance of clarity on this issue, the Associations ask that the Agencies clearly address this issue in the implementation of the Basel Accord in the U.S.

With regard to the calculation of exposures for fails, the Associations believe that a grace period should apply before the application of any additional capital requirements. As noted in the Associations’ CP3 Response, a majority of fails occur as a result of operational issues and generally resolve themselves within a short period of time. Such treatment would be consistent with the current regulatory treatment for U.S. broker-dealers⁸ and in the EU.⁹ The Associations believe that such grace period should extend for a period of 5 business days from the time of the fail. After the expiration of the grace period, the exposure should be calculated as a collateralized exposure of a receivable. This approach would measure exposure based on the receivable (i.e. the cash or securities owed) taking into account the collateral held (i.e. cash or securities to be exchanged for the receivable).

Operational Risk

The Associations support a risk-sensitive approach to operational risk under Pillar 1. We have previously commented on operational risk in an appendix to our CP3 Response; the comment is attached as Appendix 6.

⁸ See, e.g., Rule 15c3-1, which generally requires broker-dealers to hold capital for fails outstanding beyond a certain grace period.

⁹ Annex II of Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions.

As mentioned above, the Associations are grateful for the opportunity to discuss the issues raised in the ANPR. The process of developing a New Accord has been characterized by extensive openness and thoughtful consideration on the part of the regulatory bodies involved. The Associations applaud the Agencies for continuing the process in this same manner.

We look forward to your response and to further consultation. If you have questions, please feel free to contact David Mengle, ISDA, at dmengle@isda.org or 1-212-901-6017; or Omer Oztan, TBMA, at 1-646-637-9224 or ooztan@bondmarkets.com.

Very truly yours,



David L. Mengle
Head of Research
International Swaps and
Derivatives Association



Omer Oztan
Vice President and Assistant
General Counsel
The Bond Market Association