

**ISDA**

International Swaps and Derivatives  
Association, Inc  
One New Change  
London, EC4M 9QQ  
Telephone: 44 (20) 7330 3550  
Facsimile: 44 (20) 7330 3555  
email: [isda@isda-eur.org](mailto:isda@isda-eur.org)  
website: [www.isda.org](http://www.isda.org)

**LIBA**

London Investment Banking  
Association  
6 Frederick's Place  
London, EC2R 8BT  
Telephone: 44 (20) 7796 3606  
Facsimile: 44 (20) 7796 4345  
email: [liba@liba.org.uk](mailto:liba@liba.org.uk)  
website: [www.liba.org.uk](http://www.liba.org.uk)

**TBMA**

The Bond Market Association  
St Michael's House  
1 George Yard  
London, EC3V 9DH  
Telephone: 44 (20) 7743 9300  
Facsimile: 44 (20) 7743 9301  
email: [TBMAEurope@bondmarkets.com](mailto:TBMAEurope@bondmarkets.com)  
website: [www.bondmarkets.com](http://www.bondmarkets.com)

Mrs Norah Barger  
Basel Committee on Banking Supervision  
Bank for International Settlements  
Centralbahnplatz 2  
CH-4002 Basel  
Switzerland

7 June 2004

Dear Norah,

Each of the International Swaps and Derivatives Association (ISDA), the London Investment Banking Association (LIBA), and The Bond Market Association (TBMA, and collectively with ISDA and LIBA, the "Associations") wish to thank you for your letter dated February 25, 2004 in connection with the anticipated treatment of credit risk mitigation techniques in the Basel Accord. The Associations commend the CRM Subgroup for their continued dialogue with the industry on these very important issues.

The Associations are writing in response to the potential treatment of unsettled transactions, as set out in your letter. While recognising that the consideration of this issue is still in its early stages, we would like at this time to emphasise the concern that this issue has raised.

In particular, the Associations caution that the potential costs of implementing systems changes contemplated by the February 25<sup>th</sup> letter are likely to be significant and disproportionate to the very low levels of potential exposure presented by transactions which remain unsettled for a limited amount of time.

Monitoring pre-settlement credit risk exposure for all counterparties is disproportionate

Your February 25<sup>th</sup> letter states that, before the Accord's finalisation of the treatment of unsettled transactions, "banks will be strongly encouraged to develop, implement, and improve systems for tracking and monitoring the credit risk exposures arising from those transactions, on a counterparty-by-counterparty basis, from the trade date." It appears that unsettled transactions could be treated as collateralised exposures in the Accord. If such assumption is correct, this would involve firms expending considerable resources to implement tracking systems, on a counterparty-by-counterparty basis, to measure exposure from trade date.

Specifically, the Associations believe that requiring firms to track *all trades with all counterparties* from trade date, and obtain information necessary to calculate credit risk capital for all trades (including probabilities of default and loss given default) would entail great expense that the immaterial risk presented by unsettled transactions fails to justify. This would require firms to track potentially many times more securities transactions than they currently monitor,

significantly increasing the volume of transactions that credit systems handle. In addition, under the IRB approach, firms would be required to rate many times more securities counterparties than currently done in order to calculate risk-based capital for unsettled transactions. Firms already undertake some credit assessment and perform due diligence before trading with new counterparties on a DVP basis but any additional monitoring of credit risk exposure on a counterparty by counterparty basis would require costly system development to track minimal risk and is consequently inappropriate.

In essence, we view as premature and unjustified the admonition in your letter to implement systems for monitoring the credit risk exposures arising from transactions prior to their settlement. At a minimum, a cost benefit analysis should be performed contrasting system development charges with the potential exposure presented by unsettled transactions, before concluding that such systems must be built.

#### Unsettled transactions outstanding for a limited amount of time give rise to minimal risks

A typical unsettled bond purchase/sale transaction, entered into by counterparties rated BBB, would attract a minimal credit risk capital charge, reflecting the insignificant amount of counterparty risk arising from the trade. Utilising a VaR-based method for calculating counterparty exposure, with a 99% confidence level, and assuming a five-day holding period, the resulting capital charge equals approximately 0.02% of the transaction notional. One firm, having performed a similar analysis on its entire portfolio of unsettled transactions, has concluded that the counterparty risk capital charge would represent no more than 1% of their overall risk-based capital.

It should be noted that, modest as the above capital requirement is, it is actually an overly-conservative estimation. As previously noted by the Associations, we believe VaR-based methods of calculating future exposure are by definition too conservative.<sup>1</sup> Were such calculation conducted in line with more appropriate and commonly used methods of determining risk-based capital, the resulting requirement would be reduced.

#### Potential capital requirements for unsettled transactions conflict with existing regulation

##### *Capital for unsettled transactions could duplicate operational risk requirements*

The introduction of a capital charge for unsettled transactions runs the risk of overlapping with the requirements set out in the New Accord for operational risk and failing to acknowledge the current clearing and settlement infrastructure. The occasional instance of an unsettled transaction arises generally from operational issues, owing to administrative or human errors. Indeed, as central clearance facilities continue to develop and settlement cycles become even shorter, it seems unlikely that unsettled trades will become a source of material loss in future. The insignificant number of transactions remaining unsettled for a limited period of time owing to mere credit risk will make it difficult to validate any credit risk capital charge. Industry is concerned that, by imposing an additional credit risk requirement on unsettled transactions, the charge already imposed by the Accord for operational risk may be duplicated.

##### *Change from existing regulation*

Both the SEC Net Capital Rule 15c3-1 for U.S. broker-dealers and the European Union Capital Adequacy Directive (CAD) permit a grace period starting from the failure to deliver on settlement date before capital charges accrue. Requiring risk-based capital prior to any failure at settlement date would be a marked change from these existing regulations. The Associations believe that

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<sup>1</sup> See, e.g., May 25, 2002 letter from the Associations to Basel CRM Subgroup, available on the Associations' websites.

existing regulatory treatment, which allows a grace period from the time of a fail, appears to recognise the largely theoretical nature of “pre-settlement” risk, and more accurately reflects actual risk presented by transactions which remain unsettled past settlement date for a limited amount of time<sup>2</sup>.

In addition, well-designed securities clearing houses net and novate trades, have mechanisms for identifying and margining failed trades and have established procedures and resources for addressing participant failures. Against this background, charging regulatory capital for unsettled trades in well-designed clearing houses is not warranted from a policy perspective.

Given the current appropriate treatment of failed transactions by both the SEC and EU regulators, the Associations question why it is anticipated that the Accord should need to change such treatment and require firms to measure exposure from trade date. We seek to understand better the regulatory concern that is prompting these potential changes.

Exposure determination should apply after a grace period

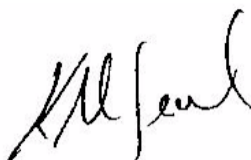
It is true, conceptually, that exposure begins from the time two counterparties enter into a trade. However, as demonstrated above, exposure resulting from unsettled transactions outstanding for a limited amount of time is not material, while the system changes that would need to be implemented at each firm to track and calculate such exposure are likely to be significant. As such, the Associations reiterate their strong recommendation that capital requirements be imposed on transactions which fail to settle on settlement date, only after a grace period has elapsed from the time of such “fail.”

The Associations sincerely appreciate the opportunity to respond to your letter, and look forward to continuing our dialogue as your review of credit risk mitigation techniques continue. If you have any questions, please do not hesitate to contact the signatories below.

Yours sincerely,



Emmanuelle Sebtou  
ISDA  
[esebtou@isda-eur.org](mailto:esebtou@isda-eur.org)



Katharine Seal  
LIBA  
[katharine.seal@liba.org.uk](mailto:katharine.seal@liba.org.uk)



Markus Sgouridis  
TBMA  
[msgouridis@bondmarkets.com](mailto:msgouridis@bondmarkets.com)

Cc: Mr Oliver Page  
Financial Services Authority, UK

Mr Mike Macchiarolli  
Securities and Exchange Commission, US

Mr Ryoza Himino  
Bank for International Settlements, Switzerland

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<sup>2</sup> For instance, ISDA’s Operations Benchmarking Survey, run on an annual basis, shows that 65% of respondents resolve payment failures on OTC derivatives trades within 5 days, while payment break resolution takes less than 5 days for 87% of firms.