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**Response to Commission Services Consultation Paper on Trading Activities
Related Issues and the Treatment of Double Default Effects**

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1 INTRODUCTION

EBF, ISDA and LIBA (the Associations) welcome the opportunity of responding to the latest set of proposals from the European Commission consulting on Trading Activities Related Issues and the Treatment of Double Default Effects (TBR Consultation). We appreciate and support the Commission's efforts to expedite integration of the trading book proposals into the EU Capital Requirements Directive in order to achieve the parallel implementation of trading book solutions with the rest of the Basel 2 package.

In order to provide the most efficient response to regulators, the Associations collaborated with the Institute of International Finance (IIF) and the Bond Market Association (TBMA) in preparing a submission to the joint Basel/IOSCO consultation. This response was endorsed by the International Banking Federation (IBFed), the British Bankers' Association (BBA) and the Futures and Options Association (FOA). This wide industry cooperation emphasises the significance that our memberships attach to these proposals and demonstrates a substantial degree of consensus on the issues. In keeping with the stated EU intention to maintain a parallel framework with Basel/IOSCO we attach the joint association response for your reference.

The Associations' response to the Commission Services focuses on the EU process and issues that arise specifically in the EU context and on the Working Document text, where we have sought to identify errors or drafting imprecisions. We do not comment separately on the Commission Services Explanatory Document, although we appreciated the clarity and insight that this document provided to us. We look forward to discussing the Commission draft in more detail once the review has been finalised.

2 INDUSTRY REACTION

Trading Book Review

The industry appreciates that the regulators have addressed the most important issues covered in the Trading Book Consultation particularly in the areas of counterparty risk and double default. On balance we believe that the overall package of proposals is workable – subject to the caveat that certain changes (identified clearly in our response to Basel/IOSCO) are necessary.

We have significant concerns that the elements of the “third strand” (market risk and unsettled transactions) were presented at such a late date and with such limited pre-consultation with firms that they are insufficiently developed as currently proposed to form an acceptable basis for revised regulations.

Timely implementation of fully risk sensitive trading book proposals in Europe would send a positive signal regarding the EU's capital market competitiveness and would ensure that the EU retains its vibrant growing markets in sophisticated mobile financial instruments such as repos and OTC derivatives.

European Commission Working Document

In our view the text in the Working Document succeeds in advancing the policies discussed in the Explanatory Document. We note that the amendments for the most part do not touch upon the main Articles of the CRD and this is welcome, particularly in the area where the definition of the Trading Book is touched upon. There are, however, some specific points worthy of comment, which the EC should consider amending or refining. Further detailed work will obviously be necessary when the regulators have amended the Basel/IOSCO text.

3 TRADING BOOK REVIEW ADOPTION PROCESS IN THE EU

- ❖ **On balance the industry supports the concept of the Trading Book Proposals being a package.** However, Strand 3 proposals are notably less well developed than the rest of the package. The regulatory dialogue on the complex Strand 3 proposals on market risk issues and unsettled transactions, suffered from time constraints and has thus benefited the least from the thorough discussion that the subjects would merit. It is therefore essential for particular attention to be paid to refining these elements of the proposals in order to ensure they are risk sensitive and result in an accord which is appropriately calibrated
- ❖ **The Associations firmly support the adoption of the Trading Book proposals into the Capital Requirements Directive via the European Parliamentary First Reading process** to ensure that there is a simultaneous implementation date with the wider revised capital framework. More appropriately risk sensitive trading book capital requirements are important to both banks and investment firms. Furthermore, it is vital that the EU implementation of Basel 2 reflects current risk management practices for trading book products to ensure the competitiveness of Europe's capital markets and a global level playing field.

4 ERRORS/IMPRECISIONS IN DRAFT PROPOSALS

In our commentary below we focus solely on the amendments to the draft CRD text. We do not discuss the EU Explanatory Memorandum. Comments on the substance of the trading book proposals are included in the attached response that was sent to Basel and IOSCO.

General comment

The trading book review primarily impacts on Annex III of the Capital Requirements Directive (CRD) . It does however also have a bearing on Annex VIII of this directive, since the treatment of collateral under the Internal Model Method is distinct from that outlined at Annex VIII. Article 93 (1) of the CRD should be modified accordingly:

“Where the requirements of Article 92 are met, the calculation of risk weighted exposure amounts and, as relevant, expected loss amounts, may be modified in accordance with Annex VIII, Parts 3 to 6, or Annex III, Part 6, Para. 12.”

A) CRD:

Annex III, Part 1, Definitions [Page 7]: Effective Maturity : Effective Maturity, as defined here, is used only in the context of the Internal Model Method. The wording could give the misleading impression that this definition is valid across all counterparty credit risk approaches.

Annex III , Part 1, Definitions [Page 7]: Risk-Neutral and Actual Distributions : These definitions are imprecise. Since they are not used later in the text, we would recommend removing them, and adding a sentence at the end of the paragraph defining Distribution of Exposures as follows : “The distribution may be computed using market implied values, such as market implied volatilities, or historic values, such as volatilities calculated using past price or rate changes.”

Annex III, Part 5, Standardised Method, Para 1, [Page 12]: The second sentence of this paragraph contradicts the Basel/IOSCO Consultation Document, by suggesting that the Standardised Method can only be used for OTC derivatives. The Standardised Method is also available for Long Settlement Transactions.

Annex III, Part 6 Internal Models Method, Para 13(c) [Page 19]: The text notes that “ the credit institution shall not undertake business with a counterparty without assessing its creditworthiness”. It should be clarified that this does not mean there is a requirement to set an internal rating for counterparties one trades with only on a DVP basis. Annex II of the revised CAD makes clear that an external rating may be used for these counterparties if there is no other banking book exposure with the counterpart.

Annex III, Part 6, Internal Models Method, Para 13 (t) [Page 22] : Collateral thresholds and margining agreements are presented as distinct objects in this paragraph, whereas in practice the definition of a collateral threshold is a component of a margining agreement. We would recommend removing the reference to collateral thresholds.

Annex III, Part 6 Internal Models Method, Para 14(a) [Page 23]: The reference to internal VaR models is not wholly correct, for as currently drafted, a backtesting requirement would apply to the EPE models. We understand that a backtesting requirement of this nature is not intended by the Basel/IOSCO Working Group.

Annex XII part 2 4(a) [Page 28]: The reference to economic capital should be replaced by the term “internal own funds” as this is the term used elsewhere in the Directive.

Article 78 : The proposed addition to Article 78 lacks clarity. We propose amending the wording to establish clearly that derivative exposures should be treated per Annex III, whereas a choice of methods described in both Annex III (IMM) and Annex VIII exists for securities financing transactions:

“The exposure values of derivative instruments listed in Annex IV shall be determined in accordance with Annex III. The exposure value of repurchase transactions, securities and commodities lending or borrowing transactions and

margin lending transactions shall be determined, at the credit institution's discretion either in accordance with Annex III Part 6 (the Internal Model Method) or Annex VIII Part 3 (1).”

Annex VII, Part D, [Page 32]: It is proposed to apply the banking book securitisation treatment, among others, to securitisation exposures qualifying for a credit assessment step 3 or lower. This contradicts the Basel/IOSCO Consultation Document, where the credit rating threshold is set at BBB-, corresponding in the CRD terminology to step 4.

Separately, the reference to a dealer exemption for holdings of institutions own funds instruments in the trading book is welcome and consistent with Basel. However, this exemption is a de facto modification of Article 57(1),(m) and (n) of the CRD which relates to material holdings and no cross reference is made to this fact. Without further refinement, this situation could lead to significant confusion and inconsistency in implementation. Furthermore, the language of this paragraph should refer to “exemption” and not “exception.”

Annex VIII, Part 1, 28 (a) [Page 41]: . The EU text contradicts the Basel/IOSCO Consultation Document. The Basel/IOSCO Consultation Document states that financial intermediary protection providers must either be internally rated at least A- and subject to regulation equivalent to the CRD, or externally rated at least investment grade (which is normally taken to mean BBB-). However the draft Directive text states that the protection provider must be subject to regulation equivalent to the CRD and have an external rating at least credit quality step 2 (using the Basel text this is equivalent to A-), and have an internal rating equivalent to or lower than A- or above under the risk weighting rules for corporates. It is therefore not clear what the requirements actually are.

B) CAD:

Annex V, end of paragraph 2 (g): Several typos need correcting in this paragraph.

5 CONCLUSION

The Associations wish to reiterate their thanks to the Commission services for all their considerable efforts in working on these proposals. We recognise that it will be a challenging task to finalise the proposals and integrate the trading book modifications into the Capital Requirements directive and we look forward to working with the Commission and providing any support that we can over the coming months.