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## **Industry response to BCBS Consultative document "Guidelines for Computing Capital for Incremental Default Risk in the Trading Book"**

The International Swaps and Derivatives Association (ISDA), the Institute of International Finance (IIF), the London Investment Banking Association (LIBA), and the International Banking Federation (IbFed) are pleased to have this opportunity to comment on the Basel Committee on Banking Supervision's Consultative Document entitled "Guidelines for Computing Capital for Incremental Default Risk- in the Trading Book" (published on 12th October 2007). The joint association working group represents many of the firms invited and intending to participate, and others who are not participating in, the Basel trading book impact study. These firms are all large internationally active financial institutions with significant trading book operations.

We view this consultation as a final chance to improve guidelines that may shape the industry's trading book regulatory capital models for many years to come. We recognise and support the goals and objectives set out in "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects" (published in July 2005) as to align regulatory capital requirements more closely to the underlying risks, and to promote a more forward looking approach to capital supervision. Particularly relevant to these proposals is the intention to provide a more flexible framework that can better evolve with advances in markets and risk management practices. We feel it is crucial that the guidelines do not prioritise short term regulatory objectives over and above promoting sound risk management practices.

In responding to the consultation we have set out our core concerns in our letter which prefaces the appendix where we present our more detailed comments and answers to the questions from the paper. We feel it is important to reiterate many key concerns that may

be familiar to the Committee, particularly in light of the latest version of the guidelines, so that they can be understood in context. We hope the Committee will agree that maintaining an open dialogue on these issues will be essential as understanding and modelling techniques develop.

## **Key Messages**

Our key concern with these proposals is that they will likely result in a rigid framework that could constrain the development of industry practices precisely in an area characterized by rapid and constant evolution. It is important to bear in mind that there is presently no industry consensus on the correct way of modelling default risk in the trading book, even in principle. In particular, the “constant risk horizon” framework remains highly controversial with many leading commentators preferring alternative approaches, such as the use of a “one-period” model with a shorter time horizon. As internal practices evolve and modelling techniques develop the detail provided in these proposals will become less relevant and therefore more likely to diverge from industry practice over time. The major consequence of having this much detail in the proposed guidelines we believe, is an Incremental Default Risk Charge (IDRC) which will be unable to adapt to our better understanding of the risks in the trading book over time.

Without adequate consideration of the economic risks in firms’ trading book portfolios, the resulting increase in capital cannot be entirely justified. A study conducted by ISDA in July last year involving the trading books at seven large firms showed that if IDRC is implemented as proposed in the guidelines, market risk regulatory capital can be expected to almost treble relative to the current VaR-based regime, something that in our view does not correspond to the risk embedded in banks’ trading book portfolios. As a result we believe firms required to comply with these guidelines will be incentivised to spend more time and resources on modelling default risk rather than market risk, which the industry considers to be the more significant risk in the trading book. Even over the last two quarters where there has been significant turbulence in the market place, the market risks significantly outweigh default risks for trading book exposures. Setting rules for IDRC which lead to a materially higher level of capital for default risk than for other trading risks may also create the incentive for firms to engage in ‘regulatory arbitrage’ by structuring assets so that they are not considered ‘defaultable’, and hence not subject to IDRC. We therefore eagerly anticipate the outcome of the Basel trading book impact study to see whether the results of the industry’s own study are replicated and whether the regulatory study demonstrates satisfactorily that the level of capital corresponds to the level of risk in firms’ trading books.

Related to this is the need to ensure robust dialogue between the industry and the regulatory community on the results of the impact study, in the same manner the QIS exercises were conducted and analyzed during the Basel II process. In our view, the policy-making process currently underway needs to be informed by the results of the impact study and the active discussion of its implications between firms and supervisors. We therefore would very much appreciate the opportunity for a further exchange of views with the regulatory community once the results of the impact study are produced.

It is our current understanding that the European Commission proposes to amend the Capital Requirements Directive (CRD) to reflect the substance of the Basel Implementation guidelines. Given that we are conscious that the deadline to present legislative proposals for the amendment of the CRD is in October of this year, there is very little time to permit consultation on the content of the EU text following the finalisation of the Basel text. While we acknowledge that the Basel Committee process is separate from the process in the European Union, there is significant overlap of jurisdictions. These same considerations apply, of course, to any other legislative or rule-making process currently underway in any of the Basel Committee jurisdictions. Given the importance of international coordination and consistency we ask that the Committee bear in mind the fact that text it has been preparing as guidelines might be transposed into legislation and the critical importance this fact places on clarity of intent being expressed in the guidelines. We believe legislative text should reflect only the agreed Basel text that will result from this consultation and should not seek to introduce new rules, conditions, or restrictions. As has been strongly emphasized before by the industry, consistency of regulations and their implementation across jurisdictions is fundamental in order to preserve a level playing field and to permit internationally active banking groups an adequate and efficient adoption of the new Basel II framework.

## **Conceptual framework**

- Firms should be able to choose a capital horizon that is relevant to the way they manage capital for the trading book. Typically this will involve a decision making process and governance structure with at least monthly reviews (which would become more frequent in a market stress scenario). Furthermore, raising capital in the market place does not take a year as implied by a 1 year capital horizon. Although the rule is said to be comparable with standards set for the IRB charge for credit risk, we believe it sets a far higher standard for default risk (99.9%, 1 year, no diversification) than for market risk (99%, 10 days, diversification, 3 multiplier). We would also like to point out that the proposed guidelines are not always held to a standard consistent with the principles underpinning the IRB charge, as with the fallback position, where the benefits of netting are excluded.
- Requiring firms to add the existing market risk charge to the proposed IDRC is unrealistic and almost certainly fails any “use test”. This is inconsistent with what has been determined under Strand 1 of the TBR (which recognises that diversification between market and [systemic] credit risk exists, p120 of “The Application of Basel II to Trading Activities and the Treatment of Double Default Effects”) and the postulated comparability of the IDRC and IRB charge for credit risk implies the economic need for netting between trading and banking book.
- While significant concerns remain, both conceptually and below with regards to the detail, it is difficult for our members to fully support the proposals. However, we appreciate the flexibility contained in the paper allowing firms to leverage off their internal Incremental Default Risk (IDR) models to produce the regulatory capital

charge. In particular we welcome the reliance placed by the Basel Committee on the firm's own estimates of EAD, PD, LGD and default correlation.

## **Scope (structured products and equity positions)**

- We broadly accept that asset backed securities whose collateral consists of defaultable assets should in principle be included within the scope of the IDRC. This is for example relatively uncontroversial in the case of a corporate bond CDO (but please be aware there are significant modelling challenges for these instruments referred to in greater depth below). However, for many other classes of asset backed securities, such as mortgage backed securities, there is no question of modelling the behaviour of the individual underlying assets, for example in a very large pool of retail mortgages. In the case of such securities, although in principle indirect credit risk is present in the mix of risks arising from the security, there is little risk of outright default, and other market price related risks are more material than default risk itself. For example, there is more of a gap in price in these securities arising from a market event than from actual sudden default of a large part of the underlying pool. Accordingly these securities are normally modelled by regarding them as subject to various market risks rather than by attempting quantitative analysis of the behaviour of individual assets in the underlying pool. We believe these risks are all either covered in firm's current VaR model approaches, or at best treated via an event risk modelling approach. As such we believe firms should have the option of adopting these approaches rather than attempting to somehow include such assets in the IDRC.
- Likewise, the industry has debated at length the proposals to include equity positions in the IDRC. Again, the modelling challenges are significant and practice is varied. In particular where a firm considers these exposures to form an immaterial part of their trading book we feel their exclusion from the charge at least in the short term would be justified. We also strongly support the availability of the option set out in paragraph 12 to include them in the event risk provisions of the framework rather than the IDRC.
- We believe the current reference to “unleveraged” funds in paragraph 11 is too restrictive, since almost all funds have some degree of leverage. In addition, the presence of leverage does not affect the ability of these products to be handled appropriately by the event risk provisions of the Framework. We therefore suggest that the word “unleveraged” is deleted.
- As we remark above, the debate on firms' likely behaviour in the event of large trading book losses, and the appropriate time horizon for a trading book default risk charge, has not reached any definite conclusion and a range of views are held. Therefore expressing at this time an opinion on this debate in the sentence (in footnote 5) “*it is not appropriate to assume that a bank would reduce its VaR to zero at a short-term horizon in reaction to large trading losses*”, while putting forth a tenable point of view, does not give a balanced picture of the various theories and opinions presently being discussed and as such, should be removed.

## Frequency of calculation

- Many firms will find calculating and reporting the IDRC on a daily basis very challenging (paragraph 49) not only due to the changing nature of the underlying portfolios but also on a conceptual basis when you consider the guidelines propose a calculation based on a 1-year capital horizon. However, even though the IDRC will undoubtedly have far higher computational requirements than the present VaR calculations, on the whole firms believe the related challenges of a daily charge are surmountable, and of course firms monitor these positions on a daily basis. The overriding concern here relates to the regulatory reporting aspects and the assumption in planning and implementation projects that the IDRC calculation will need to be embedded in a process of quality control, reporting and regulatory dialogue comparable with that currently existing for VaR. This represents a far greater burden than simply running a simulation once a day and it is with this in mind that firms are concerned that a more appropriate frequency of calculation be set. As such, we propose that a monthly reporting framework for the calculation, or whatever shorter period a firm adopts given its own risk reporting assessments and technological capabilities, is the right frequency to adopt at this time.

We would be happy to discuss any of these comments further and or hear your views on our response, and to arrange this please contact either Ed Duncan (at ISDA, 0203 088 3574), Andres Portilla (at the IIF, 202 857-3645), or Katharine Seal (at LIBA, 0207 367 5504).

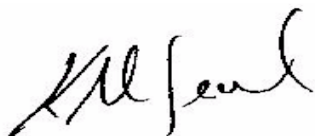
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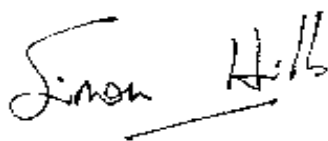
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## Appendix: Answers to the questions in the consultation paper

We have grouped the answers to the questions in to the themes being addressed.

### Flexibility of the proposed approach and Capital Adjustment Factors

1. Commenters' feedback is sought on whether the guidelines achieve an appropriate balance between providing sufficient clarity to achieve consistent implementation and allowing flexibility for banks to leverage off their internally developed models. What are commenters' views on the feasibility of implementing the overall guidelines?

4. What are commenters' views on the desirability and feasibility of applying the Capital Adjustment Factor in the guidelines?

Although we object to the level of detail in the guidelines, and we do not believe the proposals are grounded on the principles of sound risk management practice, we are pleased that the proposed approach offers some flexibility to firms to leverage off their internal models to produce the IDRC.

We welcome the reliance placed by the Basel Committee on the firms' own estimates of EAD, PD, LGD and default correlation.

The industry sees the introduction of the "Capital Adjustment Factor" (CAF) to adjust for differences between the internal model and the capital model as a positive step. However, further work is required to provide industry with more clarity on how the CAF might work in practice. For example how are regulators planning to assess the degree of conservatism in the factors produced by firms?

We also welcome the provision of a proposed fall back option for banks not wishing to develop a full IDR model (paragraph 50), but the option proposed here is unworkable because (a) it still requires an internal model and (b) it is likely to lead to an unworkable level of regulatory capital, that means in practice no real option to adopt this approach. We would welcome the opportunity to work with regulators to develop a fall back option that is proportionate but also one that can be realistically implemented, while maintaining incentives for firms to step up to a full IDR model.

### Scope and related issues

2. What are commenters' reactions to the proposed scope on instruments covered in the guidelines?

8. Commenters' views are sought on including listed common equity positions in the scope of instruments covered in the incremental default risk capital charge.

We suggest the regulators provide some additional flexibility with regards to the scope of the guidelines. We think that a firm should be allowed to make its own choice on whether to measure event risks for its listed common equity positions or to include them in the incremental default risk calculation. For a firm with a sizable equity derivative trading portfolio, exposure to a broad market index is often a significant portion of the overall market risk of that portfolio. For this type of portfolio, an event risk model that measures various types of events is clearly preferable to a default risk model. Because a derivative portfolio is often delta-hedged, a balanced approach of measuring large jumps of both up and down side is preferable to measuring default risk alone.

Furthermore, given the modelling challenges in including both equity positions and exposures generated by structured products (as argued in the section of the letter on Key Messages), we suggest that the materiality threshold applies and firms be allowed to permanently exclude immaterial exposures arising from such instruments from the scope of the IDRC.

It would also be helpful if the regulators could clarify whether a transition period will be available for certain products, where perhaps material positions could be excluded from the scope of the IDRC on a temporary basis. In such circumstances we would expect the fallback option outlined in paragraphs 50 and 51 would apply.

In conclusion although we generally support the proposed scope of the capital charge computation, we have some doubts as to the feasibility of including all of the instruments within the scope of a firm's IDR model at the very beginning of the regulatory review process.

## **Frequency of the calculation**

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| 3. What are commenters' reactions to Paragraph 49 which requires banks to calculate the capital charge for incremental default risk with the same frequency as that required for the bank's market risk capital computation? |
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Although some firms say that they can compute the IDRC on a daily basis, many firms will struggle with this requirement. Calculating the IDRC on a daily basis is not only very challenging due to the nature of the underlying portfolios but also due to the conceptual basis of the charge and the 1-year capital horizon.

The overriding concern here relates to the assumption in planning and implementation projects that the IDRC calculation will need to be embedded in a process of quality control, reporting and regulatory dialogue comparable with that currently existing for VaR. This represents a far greater burden than simply running a simulation once a day and it is with this in mind that firms are concerned that a more appropriate frequency of calculation be set. As such, we propose that a monthly reporting framework for the calculation or, whatever shorter period a firm adopts given its own risk reporting assessments and technological capabilities, is the right frequency to adopt at this time.



## Liquidity Horizon

5. Do the guidelines sufficiently clarify supervisory expectations regarding the estimation of liquidity horizons? Would it be helpful if the guidelines articulated a number of product categories for which supervisors expect a separate estimation of the liquidity horizon, for instance investment grade corporate bonds, high yield corporate bonds and tranching products? Do commenters believe that, in light of recent market developments, the concept of liquidity in a “stressed market” needs further clarification?

The industry strongly believes that as the liquidity horizon reflects the concentration of positions at each firm, and that because this is specific to each firm, firms themselves should be responsible for defining the appropriate liquidity horizons for the positions in their trading books. We agree that market concentration could be a factor in liquidity (paragraph 25), however, firms face very considerable challenges attempting to measure accurately such concentrations on an on going basis, and do not believe it would be worthwhile to attempt to measure this except on a small subset of their very large positions.

The guidelines should provide enough flexibility with respect to the estimation of default probabilities over a liquidity horizon, provided that they can demonstrate their appropriateness. Consistency with other parameters and other internal risk models should be preferred over the exogenous and artificial restrictions of parameters. Consequently, the conditioning of PD to specific floors (e.g. 3 basis points), conditional or unconditional estimation of PD over the business cycle should be up to the firms to decide.

In conclusion, we feel the definition of liquidity horizon provided in the paper is sufficiently clear. We would not support further regulatory guidance or further differentiation criteria for defining liquidity horizons.

## Structured Products

6. Do the guidelines provide sufficient clarity as to how the Incremental Default Risk of structured products such as asset backed securities should be estimated? Do commenters believe that the transparency of structured products in the trading book is sufficient to allow banks to estimate in all cases the risk of loss from structured products triggered by defaults in the underlying assets?

The guidelines do not provide much detail on how structured products should be captured in the firms’ models. These products are difficult to incorporate in IDR models, not least because of the difficulty of applying a definition of default to a tranching structure, but also when you consider the co-dependencies and correlations that need to be captured. This is further complicated in circumstances when the full details of the underlying pool of assets is not known. We therefore do not believe that further guidance in this area is necessary, particularly as calculation approaches and capabilities are likely to change over time. Furthermore, we believe that regulators should not explicitly require a daily

calculation for these products, as this is likely to result in the adoption of less sophisticated, if computationally swifter, approaches, which may not be appropriate.

We can accept (as outlined in our Key Messages) that asset backed securities whose collateral consists of defaultable assets should in principle be included within the scope of the IDRC. This is for example relatively uncontroversial in the case of a corporate bond CDO (but please be aware there are significant modelling challenges for these instruments referred to in greater depth below).

However, as we have argued above, for many other classes of asset-backed securities, such as mortgage backed securities, there is no question of modelling the behaviour of the individual underlying assets, for example in a very large pool of retail mortgages. Accurate modelling of these types of structured assets, and also those backed by small pools of defaultable assets, requires the ability to consider the underlying collateral of those structured assets and to model the non-linear transmission of loss to tranches held (paragraph 32). However such modelling is computationally and more importantly, data intensive, and this aspect of the proposals is therefore regarded as one of the most potentially problematic by the industry. In the case of such securities, although in principle indirect credit risk is present in the mix of risks arising from the security, there is little risk of outright default, and other market price related risks are more material than default risk itself. For example, there is more of a gap in price in these securities arising from a market event than from actual sudden default of some part of the underlying pool. Accordingly these securities are normally modelled by regarding them as subject to various market risks rather than by attempting quantitative analysis of the behaviour of individual assets in the underlying pool.

We believe these risks are all either covered in firm's current VaR model approaches, or at best treated via an event risk modelling approach. As such we believe firms should have the option of adopting these approaches rather than attempting to somehow include such assets in the IDRC.

## **Definition of default**

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| <p>7. The guidelines stipulate that a bank use a definition of default that is consistent with the Basel II Framework in its calculation of the incremental default risk capital charge. Commenters' reactions are sought with regard to capturing in PD estimates significant declines in market prices due to material deterioration in credit quality.</p> |
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The inclusion within the scope of default of “price declines equivalent to default losses” is problematic, as it could lead to categorising falls in prices wrongly as default event, where in practice they reflect reduced market liquidity. Price declines are normally captured in specific risk models.

<p><b>Any other comments?</b></p>
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## **Remaining conceptual issues**

There is a strong industry consensus that for clear reasons, diversification between the trading and banking books is material and can be measured. We welcome the partial acknowledgement of this fact (paragraph 41) and the call for further dialogue set out in these principles, but we remain committed to the view that this effect should be incorporated in the current proposals (see also our introduction in the covering letter).

The proposed test for sensitivity to concentration (default of largest long BBB or worse position, etc, in paragraph 43 on validation) is arbitrary and has no place in a conceptually-based framework such as the present principles being proposed. We ask for all references to it to be removed (see below on validation).

## **Correlations between Default Events**

While it is a fact that more defaults occur during economic downturn, it is unclear how to determine the joint default probability of a pair of companies in general. As an alternative way to modeling defaults as correlated events, the impact of clustering of default events can be achieved by using a higher level of default probability.

Different levels of default probability (PD) can be observed from historical data for different phases of an entire economic cycle (or multiple cycles). These different PD levels can be used in a probabilistic way in a default risk model, in which clustering of default events is one possible outcome.

We think the requirement, “Accordingly, the capital requirement for incremental default risk includes the impact of correlations between default events”, as stated in Paragraph 40 is too specific. Firms should be allowed to use other approaches to modeling the clustering of default events.

We believe appropriate guidelines should provide enough flexibility with respect to the estimation of default probabilities. Firms should be allowed to take their own decisions in determining the methodology to estimate default probabilities over a liquidity horizon, provided that they can demonstrate their appropriateness. Consistency with other parameters and other internal risk models should be preferred over the exogenous and artificial restrictions of parameters. Consequently, the conditioning of PD to specific floors (e.g. 3 basis points), conditional or unconditional estimation of PD over the business cycle should be up to the banks to decide.

## **Loss Given Default**

As in the banking book, LGD should be set with due regard to the way losses actually accrue, and this, just as in the banking book, is determined by the firms’ recovery strategy. In particular, simply because an asset is in the trading book, does not mean that on default the method of recovery is automatically by sale of the defaulted asset – it is quite possible that the firm owning the asset choose instead to recover via a legal process,

as may have been the case for a banking book asset. If so then it would be incorrect to insist on an LGD “*determined from a market perspective*” (paragraph 39) and not one reflective of the bank’s practice and internal risk management.

## **Conservatism**

A degree of conservatism is essential to the successful operation of this framework. However, to avoid inadvertent distortion of the rules, for example when they are implemented into local regulatory guidance, we strongly prefer a single statement about conservatism, covering the entire application of the principles, rather than focussed conservative statements on particular aspects of the rules. For example, while it is reasonable to suppose that, in general, poor quality debt will be less liquid than higher quality debt (paragraph 23), this is not always the case and regulators should expect any well thought out modelling approach to have considered this carefully, without the need for any explicit guidance.

## **Validation**

While the existing Basel rules contain guidance on validation, it is not yet clear how to adapt these to the new framework. (Paragraph 43). Some aspects of the validation guidance are unlikely to be achievable in practice in the foreseeable future. For example, sensitivity of LGD in the case of the “surprise” defaults relevant to the IDRC, to economic circumstances, will be even more difficult to measure and validate than in the case of “plain” defaults measured in the IRB framework. Firms are anxious to ensure that such aspirational requirements do not simply translate into unnecessarily conservative assumptions having to be made in the IDR context.

Furthermore we question the vague reference made in the proposed guidelines to “The Gaussian copula model”. This implies firms will have to benchmark their IDRC against such a model, possibly requiring some firms to build and maintain two default models in the trading book. Absent a definition for the benchmark model, there is no guarantee results would be comparable across firms and therefore provide an effective validation test. We suggest the reference be removed.

We also question the justification for inclusion in the guidelines (eight bullet point of paragraph 43) the assertion that it is reasonable to assume that the IDRC should be comparable with the greater of (a) the loss on default of the largest net long position rated BBB or less, and (b) the sum of the two largest such rated BB or less. Unless the reasoning behind this can be explained some of our members question whether the two numbers would be comparable.

## **Hedging**

The proposed guidelines consider the possibility that default losses in the trading book take place before the profits are realised from the hedging of those positions where the hedging is on a systematic but not a name-for-name basis (paragraph 31). Although we

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believe this merits consideration we do not believe an additional requirement is necessary. The framework proposes an IDRC based on the estimate of aggregate losses over a one year time horizon. While constituent profits and losses may accrue at various times throughout the year, it is the net total loss at the end of the year that is measured. Furthermore, in the IDRC context, due to the fact that loss is potentially a net figure, it would be possible for the running aggregate loss, measured from the beginning of the year, to be higher than the aggregate loss measured at year end, on whose range of likely values the IDRC is based. However, this effect is outweighed by the increase in risk with time which results in much larger capital estimates toward the end of the calculation period. Were an IDRC model to calculate a “running 99.9th percentile” loss over the period (be it over 60 days as recommended by the industry, or a full year as currently proposed), this would be found to increase monotonically to a maximum at the end of the period, from which the IDRC is then taken at a level comfortably covering intermediate running losses.

It is for the same reason (although the effect is less pronounced) that the IRB approach in the banking book does not consider the risk that losses happen earlier, rather than later in the year. This key simplification is one of the reasons a successful IRB approach was able to be constructed. Similarly, to be practicable, as well as for the reason set out above, IDR models should be allowed to be based on the only basis present in any model currently proposed, namely detection of default at the end of the relevant liquidity period.