IIF
Institute of International Finance
1333 H Street, N.W., Suite 800E
Washington, DC 20005-4770
Tel: (202) 857-3312
Fax: (202) 463-0993

ISDA
International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
Tel: 1 (212) 901-6000
Fax: 1 (212) 901-6001

LIBA
London Investment Banking Association
6 Frederick's Place
London, EC2R 8BT
Tel: 44 (0) 20 7796 3606
Fax: 44 (0) 20 7796 4345

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, D.C. 20219
ATTN: Docket No. 06-09

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-1261

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
RIN 1550-AB56

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
ATTN: No. 2006-33

March 26, 2007

Ladies and gentlemen:

The Institute of International Finance (IIF), the International Swaps and Derivatives Association (ISDA), and the London Investment Banking Association (LIBA) (collectively, the Associations) are pleased to comment on the Agencies' Joint Notice of Proposed Rulemaking (NPR), "Risk Based Capital Standards: Advanced Capital Adequacy Framework."[1] The Associations represent a wide spectrum of internationally

[1] *Federal Register* 71, no. 185 (September 25, 2006): 55830.

active financial firms, including the major US banks as well as the leading banks across the world.

The Associations are commenting on the proposals given their significance and potential effects, not only for US banks, but for a number of international banks with significant operations in the US. And indeed the US proposals are of great significance for the entire global financial-services sector, as the secondary effects will be felt in other markets and by firms that do not have a direct US presence.

Our main objective, as repeatedly stated during the several years of consultation with the Basel Committee on Banking Supervision (BCBS) that led to the Basel II international framework, is to promote the development of a consistent regulatory framework across jurisdictions. For the reasons detailed in our response, the Associations strongly encourage the Agencies to avoid diverging from the international framework as defined by the BCBS in the November 2005 document *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Basel II or the international framework) when drawing up rules for banks operating in the US.

We believe that regulatory consistency across jurisdictions is vitally important not only for the industry and, in particular, internationally active groups, but also for national, regional and international regulators. The benefits of consistent regulation will be reflected in both more efficient banking operations and in smoother and more effective supervision of cross-border banks.

We also observe that some of the difficulties the industry has with the NPR stem from its deviation from what we consider to be good principles of regulatory practice, as defined in the *Proposal for a Strategic Dialogue on Effective Regulation* recently published by the IIF. While the Agencies deserve credit for the consultative approach they have taken, we regret that the NPR does not put sufficient priority on consistency with the international framework as defined by the international supervisory community (with active participation by the US banking Agencies), not providing convincing evidence of a compelling economic need or of market failure for deviations from the international norm, and not focusing on an assessment of the impact of the changes relative to whatever benefits are expected from them.

This comment letter is the result of a careful and detailed review of the proposals[2] undertaken by working groups made up of experts from the member-firms of the Associations and contains a number of recommendations and proposals intended constructively to further the purposes of the NPR. The Associations hope that the Agencies give careful consideration to their recommendations before any final rules are adopted.

We note that we do not intend to comment upon all the proposals contained in the NPR. Rather, we have selected the issues on which we would like to focus our attention based

[2] Please note, however, that, owing to time constraints, this discussion does not reflect the Proposed Supervisory Guidance published in the *Federal Register* on February 28, 2007.

on the following criteria: a) issues that have international/cross-border relevance, as opposed to pure US-domestic issues; b) issues that refer to cases in which the NPR proposals diverge from the Basel II international framework; and c) issues in regard to aspects of the NPR that are ambiguous or that require clarification. The fact that we do not comment on a certain issue does not mean that we believe the issue is not of importance nor that we necessarily agree with the proposal (an example is the retail definition of default, on which certain member firms may elect to comment individually). Rather, we have felt it is necessary to focus our attention on those issues of most relevance to the group of internationally active banks than the Associations represent. Finally, we also note that this comment letter will not address in any detail the Basel 1A proposals as they are intended for a constituency different that that represented by the Associations. However, we note our desire for all Basel II implementation efforts (including those related to the less-sophisticated approaches), to be as consistent as possible with the international framework.

The Associations look forward to discussing their recommendations with the Agencies should you consider it necessary. Let us reiterate on this occasion our commitment to collaborative work with the US Agencies in their implementation of the international framework.

I. OVERALL APPROACH AND SPECIFIC TECHNICAL ISSUES

In reviewing the Agencies' proposals, the Associations have noted two sets of issues on which they would like to comment. The first set of issues relates to the core, general elements of the new capital framework and encompasses the "overall approach" to the international framework in the US. As we indicate below, in our view there are a number of proposals that fundamentally depart from the international framework and which should urgently be revised by the Agencies. The second set of issues encompasses a number of specific technical aspects of the proposals which also diverge from what has been established under the international framework. Although those issues are not as fundamental as the ones in the first set, they do create particular burdens and costs for US banks and international banks with operations in the US and would, if not addressed, impede an adequate implementation of the Basel II framework in the US.

We must also note that the NPR poses questions that appear to point to further divergence from the international framework on issues that do not relate to areas of national discretion as defined by Basel II. Examples of such issues are: questions 1 and 2 on asset-value correlations; question 3 on the allocation of excess reserves to Tier 2 capital; question 14 on the definition of default; question 19 on the definition of operational loss; and question 27 on the boundary between operational and credit risk, as well as others noted herein. On certain of these questions, further refinement of the international framework may be appropriate upon due consideration and consultation. The Associations suggest, however, that the Agencies refrain from adopting unilateral decisions on such important issues without previous discussion and agreement with their international peers through the BCBS. A unilateral revision of such elements by an individual BCBS member country could not only jeopardize the international character of the international framework but also create greater regulatory inconsistencies across jurisdictions.

A. OVERALL APPROACH

Banks have communicated with the BCBS over several years as the Committee has developed a more risk-sensitive capital framework, culminating in the June 2004 revised capital framework. In the Introduction to the November 2005 Basel II document the BCBS stated: "*The Committee has sought to arrive at significantly more risk-sensitive capital requirements that are conceptually sound and at the same time pay due regard to particular features of present supervisory and accounting systems in individual member countries.*"[3]

The Associations have long supported the need for a more appropriate risk-based approach, including increases in capital requirements in certain areas. However, in the NPR the Agencies have proposed a number of significant changes to the international framework that represent substantive revisions to, and divergences from, an approach which was agreed by the BCBS and is being implemented without such significant deviations by the other members of the Committee, as well as many other jurisdictions around the world. These changes, which would apply to both US banks and international banks with subsidiaries in the US, have the following undesirable consequences: They

- reduce risk sensitivity;
- place banks subject to these regulations at a competitive disadvantage compared to other international banks;
- significantly increase the cost of implementation;
- undermine the comparability of regulatory capital requirements across different jurisdictions;
- risk interfering with sound business practices;
- undermine the use test; and
- encourage regulators who have yet to finalize their rules for the introduction of Basel II to diverge from the international framework in their local regulations, further reducing comparability and increasing implementation costs.

We also believe that the changes introduced are unnecessary because supervisors have the authority either to compel banks not adhering to standards to modify their risk-measurement techniques or to make other adjustments through the mechanisms of Pillar 2, and could do so consistently with Basel II as interpreted internationally.

[3] BCBS, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Basel, November 2005): par. 5, 2.

1. Permit US Banking Organizations to Choose among all Basel II Credit and Operational-Risk Approaches (NPR Questions 6 and 7).

A critical departure from the international framework is that large, internationally active US banks (and international banks with significant operations in the US) are required to adopt the advanced approaches. In contrast, the international framework permits the choice of the Standardized, Foundation, and advanced IRB (A-IRB) approaches for credit risk and the Basic Indicator, Standardized, and Advanced (AMA) approaches for operational risk. In addition, the Standardized approach for credit risk is generally being introduced without a 12-month parallel reporting requirement.

As a general principle, we urge that every effort be made to align the US rules with the international framework. The Associations are of the view that consistency across national jurisdictions is a key objective not only for the industry but also for the international regulatory community as it works to ensure that the new framework will protect the stability of the financial system and the adequate provision of financial services. Specifically, and in line with this reasoning, we believe that harmonization with the international framework requires that substantially the same menu of approaches offered under the international framework (including at least Standardized) be offered by the Agencies to all Basel II mandatory and opt-in banking organizations.

In regard to operational-risk approaches, we also believe that harmonization is necessary and that the Basic Indicator and Standardized approaches should be offered in the menu of options available for Basel II banks.

Providing banks with at least the Standardized approach to risk-based capital (including that for operational risk) as an alternative would have these important benefits:

- Banks, irrespective of size, could, after an assessment of their risk-management and business needs, select alternative methodologies that are most appropriate for them.
- This would tend to improve the level playing field, both by giving US banks options available internationally and by giving non-US banks active in the US options that may mesh better with their international Basel II implementation planning.
- Adequate minimum capital requirements would be preserved.

The Associations believe there are no significant drawbacks to making alternative approaches available in the US.[4] The results from QIS 5 published by the BCBS indicate

[4] We note that the OCC, in fulfilling its requirement to evaluate regulatory alternatives under Executive Order 12866, provided in the NPR a summary of the costs and benefits of permitting all Basel II approaches and noted that the only drawback of such action would be "the increased cost of applying a new set of capital rules to all U.S. banking organizations." The simple remedy for this sole drawback is to permit institutions below the mandatory thresholds for Basel II to remain on the current or modified Basel I rules, which is a choice the Agencies have always expressed their intention to offer. Furthermore, the benefits of allowing the full menu of approaches clearly outweigh the drawback upon which we have just commented.

that the less-advanced approaches provide acceptable trade-offs between reduced complexity and increased capital requirements in comparison to the international advanced approaches. In addition, the Agencies should note that most US international banks and international banks with operations in the US are already implementing the Standardized approach in other host jurisdictions. The Agencies, therefore, via home-host agreements, already have access to very relevant information as to how banks are operating under this approach, information that can serve as basis for its expedited implementation in the US.

Allowing banks the option to adopt the alternative approaches would have two dimensions. First, there are some substantial practical reasons why banks may need to adopt the alternative options for certain of their portfolios. Second, the option should be available to adopt at least the Standardized approaches across the board.

Allowing banks to adopt the Standardized approach for certain portfolios would be consistent with emerging international practice, pursuant to which banks may adopt the Standardized approach in certain circumstances (subject to supervisory review to avoid cherry-picking), for example where a portfolio is running off, where a business is planned to be sold or a bank plans to leave a given market, where a portfolio is so immaterial as not to warrant investment in the advanced approaches, or where data issues make it impractical to adopt the advanced approaches.

Moreover, banks should have the option to adopt the Standardized approach for operational risk while proceeding with the advanced approaches for credit risk and market risk. This is a course adopted by certain non-US banks across the board, and by other banks for their overseas operations. It is, among other things, a way for banks to conserve resources and achieve better change management during the implementation period. In some cases, banks may feel more comfortable deferring the decision to go advanced on operational risk for a number of reasons, including accumulation of data and proceeding at a deliberate pace on methodological developments.

The sort of optionality just described will be especially important for international banks, to keep their group-wide Basel II implementation efforts consistent and manageable in accordance with their implementation strategies as approved by their home regulators.

More broadly, and consistently with the international framework, the Standardized options should be available to banks that, after due consideration, conclude it is the most appropriate approach for their circumstances and needs. Among other things, a bank could conclude that it wishes to take more time to implement the advanced approaches, and the Standardized option would make more sense than the de facto current binary choice of advanced Basel II or staying on Basel I. More importantly, if the NPR requires divergence from the bank's own methodologies based on the Basel II Framework, while the Associations' member firms are fully committed to continuous improvement of robust internal risk-management techniques, some may conclude that their resources are better used focusing on their own economic risk-management processes (which, of course, will remain a subject of review by and discussion with their primary regulators), rather than on the advanced regulatory capital approaches as set out in the NPR. As the industry has often argued, advanced risk-management cannot be just a compliance exercise; if regulatory requirements appear to be sliding into a mere compliance exercise, less than satisfactorily congruent with internal risk management, then a bank ought to have the ability to opt for the Standardized approach, accepting of course its likely less-than-favorable minimum-capital results.

Furthermore, we firmly believe that the introduction of alternative approaches should not lead to material additional delays in the implementation process. The Standardized approach is sufficiently straightforward to permit its evaluation without requiring lengthy NPR consultation and also is broadly comparable to the Basel 1A approach currently under evaluation. Recognizing the potential need for public consultation, the Agencies, given their active involvement in the international framework process over the past several years, could adopt these approaches without undue additional delay and with confidence as to the capital result.

We stress that time is of the essence. The IIF Steering Committee on Regulatory Capital previously expressed its concern when the one-year delay of US implementation was announced. Any further material delay would only compound the needless cost burden and implementation inconsistencies caused for internationally active banks, issues the industry has previously discussed in detail with the Agencies. We hope that the Agencies will make every effort to assure that no further substantial delays of the implementation schedule for the international framework occur, at least for those banks that consider themselves ready to go forward beginning January 1, 2008. In any case, the delay that has already occurred in regard to the international implementation schedule makes it necessary for the Agencies to provide additional flexibility to banks implementing the new regulatory capital framework.

The Associations would further like to stress that key objectives of the industry include the promotion of a risk-sensitive regulatory capital framework and the continued improvement of risk-management practices. The request made here that less-sophisticated approaches (such as the Standardized approach) be available to banks in the US should not be misinterpreted as a departure from the industry's desire to make available the advanced approaches as provided for in the international framework or to maintain robust internal risk management or to continue to invest in refining and improving advanced risk-management methodologies. The availability of the Standardized approach is necessary given the significant departures of the US A-IRB proposals vis-à-vis the international framework.

Finally, were the Agencies to offer the Standardized option without addressing our concerns on the advanced approaches as proposed in the present NPR, we believe the result would be detrimental to the US financial-services industry in the global context. The judgments banks ultimately make about which approach to adopt would, of course, be affected by their assessment of the final rules adopted in the US.

2. Recalibration on a 10% Aggregate Fall in Regulatory Capital Requirement (NPR Question 5).

The Associations are strongly opposed to the statement by the Agencies included in the NPR, but not the actual rule text, that a 10% aggregate capital decline in regulatory capital will trigger "modifications to the supervisory risk functions or other aspects of this framework."[5]

The Agencies' reliance on this numerical benchmark ignores the principle of risk sensitivity on which the international framework was developed. This arbitrary threshold, which is defined relative to the current Basel I capital requirements and without reference to fluctuations in credit quality, will by its very definition produce comparisons that do not reflect the risk embedded in banks' portfolios, precisely the flaw that the Basel II international framework was intended to correct.[6] Moreover, it locks in a point of reference without any technical or policy justification other than the assumption that Basel I somehow produced the right level of capital requirements, despite all its acknowledged flaws and the fact that Basel I over time will become less and less relevant.[7]

It is important to note that in strong economic cycles, credit conditions will improve and a drop in minimum required regulatory capital of 10% or more may well be expected, and would not per se pose any safety and soundness concerns. In addition to being arbitrary, the 10% limit on the reduction in capital has no relationship to either US or global economic conditions, would not be applied symmetrically and would apply to a limited collection of US-based banks. It could have grossly disparate and unpredictable impacts on different firms within the US. This provision is not included in the international framework, it does not apply to non-US-based banks and, if implemented, would create competitive inequalities.

Moreover, the exact method of calculation and the statement of consequences for exceeding this limit are ambiguous and unclear. The uncertainty regarding the magnitude

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[5] NPR, 55839.

[6] One reason that minimum capital requirements might decrease under a risk-sensitive capital regime, relative to the current Basel I rules, may simply be that one or more banks included in the aggregate calculation is more actively engaged in credit-risk management and mitigation. A risk-sensitive capital regime would capture the corresponding decrease in minimum capital requirements that active credit portfolio management would appropriately cause. It would thus be contrary to the objectives of the international framework to reduce incentives for active credit-risk management by imposing an arbitrary floor based on declines relative to Basel I.

[7] As has been widely discussed, the industry does not share the Agencies' decision to set regulatory policy based on QIS 4 results. QIS 4 had a number of limitations that the Agencies themselves recognized in their January 24, 2006 Press Release (it was conducted on a best-effort basis by participating banks using limited data and without the benefit of fully articulated final rules for US implementation). In addition, QIS 4 was conducted in what is considered perhaps the most benign point ever in the economic cycle. Given Basel II risk sensitivity, it is logical that the comparison between pre-Basel II and Basel II capital levels shows an apparently substantial decrease in capital requirements on an unadjusted basis. It would be a mistake, however, to consider that the capital levels evidenced in QIS 4 would be the capital levels at which banks would operate under Basel II.

and timing of any resulting future modifications would introduce severe unpredictability into the capital-planning process, which would abridge a firm's right to make its own strategic decisions within prudential limits. The 10% aggregate limit is beyond the control of individual firms and hence will introduce significant difficulties in the capital-management process. Therefore, it will have knock-on consequences by creating hurdles to effective capital allocation and related financial decisions such as share re-purchases. Significantly, the artificial system-wide capital floor will result in market-value uncertainties as firms will no longer be able to manage their capital autonomously, based on their individual risk profiles.

A particularly undesirable outcome, if the 10% threshold were triggered, would be a supervisory decision by the Agencies to require an across-the-board upward adjustment in capital requirements. If risk weights were to be recalibrated and increased at the peak of an economic expansion, this could result in minimum capital requirements substantially in excess of current requirements during a recession, and in excess of what well-conceived risk-based requirements would produce, potentially leading to economically counterproductive overcapitalization, especially for institutions that have adopted low-risk business strategies. To illustrate further this point we note that several large US banks have internally estimated that commercial credit-risk capital requirements would have been 20-35% higher with their 2000-2001 recessionary portfolios than reported at the time of QIS 4. However, if the Agencies were to set capital requirements at that level, through the cycle, it is clear that substantial bank overcapitalization would occur, something that we believe is not the Agencies' intent. Such uneconomic excess capital would divert resources that could otherwise be allocated to credit, increasing the cost of credit and eroding the competitiveness of banks operating in the US.

We note that the 10% aggregate limit moves regulatory capital further away from risk sensitivity. A more risk-sensitive capital regime would reinforce business incentives to banks to manage their credit risk actively, through the increased use of credit derivatives, collateral and other credit-risk mitigation tools. A more risk-sensitive regime would also provide an incentive to focus on credit-risk mitigation for lower-rated obligors, whereas the current proposal could, depending on the circumstances, penalize a cautious approach given that capital requirements would not only depend on the individual firm risk profile but that of the other firms in the system. In fact, the 10% reassessment links the fate of all banks implementing the advanced approach in the US to the possible decisions of a small number of banks that choose to adopt conservative lending and investment policies. Such decisions could, via the 10% reassessment, unpredictably affect the plans of all advanced-approach banks. There would always be the danger of an arbitrary, unpredictable, and exogenous change of the rules that would affect well-managed and compliant banks unevenly. Even a decline in capital resulting from balance sheet restructuring by a few banks could trigger this reassessment. Thus a situation would be created where the actions of a few banks could dramatically affect the regulatory-capital requirements of competitors.

Finally, the Agencies should also recognize that the proposed limit is not needed for supervisory purposes, given that the Agencies have the ability to increase the required capital of an individual bank through Pillar 2, and through the use of other supervisory tools, should there be an objective need to do so. The Agencies should also recognize that fluctuations in minimum Pillar 1 capital requirements will not necessarily be reflected in similar fluctuations in actual capital. Bank capital-management policies, rating-agency requirements, and market expectations would be expected to dampen such fluctuations and maintain a buffer between regulatory and actual capital for a variety of purposes.

For these reasons, we strongly urge the Agencies not to adopt the 10% numerical benchmark as a litmus test for reconsideration of the framework.

3. Transitional Floors (NPR Questions 10 and 12).

The additional year of transitional floors, the higher floor levels and the requirement that each bank formally "graduate" from one floor to the next by another new administrative process, are all divergences from the international framework that lack any clear justification. In our view, the floors established in the international framework provide sufficient safeguards and achieve the same prudential objectives sought by the Agencies and, therefore, we question the need for adding extra requirements that were not deemed necessary when the BCBS devised the international framework.

The NPR proposals in this respect add to the complexity that banks operating in the US will face when implementing Basel II. In effect, US banks must not only start the implementation of Basel II (at least) twelve months after most other large international banks, but they would also be required to comply with more restrictive transitional arrangements over a longer period of time. The mandatory capital floors, expressed as percentages of minimum capital requirements under Basel I, are shown in the following table. It is evident that competitive differences between US-based banks and other international banks occur in every time period.

	2007	2008	2009	2010	2011
Intl. Frame-work	Parallel	90%	80%	N/A	N/A
NPR	N/A	Parallel	95%*	90%*	85%*

* *Subject to regulatory approval.*

We strongly believe that the additional requirements for the capital floors further reduce the risk sensitivity of the new framework as proposed in the US. It is clear that subjecting regulatory capital requirements to artificial floors for a longer period and at a higher level moves further away regulatory capital from banks' internal risk-management practices, a fundamental principle of the international framework. Furthermore, it creates additional difficulties for the comparison of capitalization levels across jurisdictions, one key feature of the international framework. Finally, the additional capital floors, arbitrary by definition, would further artificially interfere with the capital-management process of banks and create an additional divergence between regulatory capital minima and a business view of appropriate capital.

It is important to note, in addition, that the difference in implementation timing in the US could be extended beyond 2011 as a bank must seek the permission of its US regulator to move to the next transitional floor. This is not a feature of the transitional arrangements currently applied by other regulators and seems unnecessary in light of other supervisory tools that are available, including extension of the floors if a supervisor judges this necessary for a given institution. Moreover, it carries the danger of impeding innovation or response to competitive challenges, for no very obvious prudential gain.

Furthermore, we observe that the floor percentages are applied to different definitions of minimum capital requirements. Both risk weighted assets (RWA) and capital were redefined in the international framework such that expected credit losses were excluded from RWA and were subtracted from general provisions in the definition of Tier 2 capital.

RWA under the NPR floor calculation[8] is simply Basel I RWA times the floor percentage. RWA under the international framework floor[9] is the sum of Basel I RWA <u>less 12.5 times the amount of general provisions included in Tier 2 for Basel I</u> plus 12.5 times Basel I capital deductions. The Basel II floor-related RWA is lower than the NPR RWA due primarily to the subtraction of Tier 2 general provisions. Because the NPR lacks this adjustment, the NPR floor includes an additional constraint, namely the unadjusted Basel I RWA (which implicitly includes expected loss) as a floor on the Basel II RWA, which excludes 12.5 times expected loss. This difference can easily exceed 10% of Basel I RWA for large banks.

Based on the calculation, the NPR floor methodology does not recognize the exclusion of expected loss in the international framework and is inconsistent with this principle agreed to by the BCBS. The result is not simply a higher transitional capital requirement (before multiplying by the floor percentages in the above table), but a fundamental, conceptual departure from the agreed international framework

In sum, we particularly request the Agencies to align the transitional floors in the NPR to those established in the international framework in regard to both their duration and magnitude. We also request the removal of the requirement for a bank to seek permission from its primary federal regulator before moving to the next floor as this is both inconsistent with the international framework and unnecessary in light of the range of other supervisory tools. Finally, we encourage the Agencies to align the transitional minimum capital and ratio calculations with those used in Paragraphs 45 and 46 of the international framework.

[8] NPR, 55922.
[9] Basel II, par. 45-47, 13.

4. Leverage Ratio Review.

The Agencies have publicly indicated their intention to retain the leverage ratio in conjunction with the new international framework capital requirements. We believe that the leverage ratio should be reviewed for phase-out upon completion of the introduction of the international framework. This device not only lacks risk sensitivity but ignores fundamental principles by which modern financial institutions manage their portfolios and risks. In particular, the application of the leverage ratio is inconsistent with the fundamental Basel II principle by which banks can improve their risk profiles either by holding additional capital or by holding less risk in their portfolios. In essence, a regulatory capital tool that limits itself to a crude comparison of assets in the balance sheet against capital is inconsistent with the way financial institutions currently operate.

For certain banks subject to the international framework, the leverage ratio will become a binding constraint because of its lack of risk sensitivity. Banks that accumulate low credit risk assets on their balance sheets will be penalized for adopting such a strategy, because the leverage ratio is not dependent on how conservatively banks operate. This will have the counter-prudential effect of encouraging those banks that find themselves constrained by the leverage ratio to change strategy, possibly by acquiring riskier assets until their regulatory risk-based capital and leverage capital requirements are equalized, or by reducing their willingness to provide credit services vital to the health of the economy.

Even banks that have very strong capital structures, with substantial Tier 1 capital against RWA, may be caught by the rigidity of the leverage ratio. The leverage ratio requirement thus can distort market perceptions and improperly interfere with management strategy, because it is a constraint inconsistent with the objective of introducing more risk-sensitive capital requirements, as agreed through the international framework. Continuation of the leverage ratio undermines many of the purposes the regulatory community – including the US regulators – sought to accomplish when they saw the need to replace Basel I.

Moreover, to the extent that the leverage ratio results in a higher minimum capital requirement than justified by the risk presented by banks' activities, the regulatory requirement will have the effect of reducing the flow of credit to the economy. We therefore believe that the permanent retention of the leverage ratio is not appropriate from an economic perspective. It may be unavoidable to retain a leverage ratio during the capital-floor periods to manage the transition from Basel I to Basel II, but this should be a temporary expedient, subject to regulatory review within a reasonable period of time. It should be stressed that this is a comment on the lack of risk sensitivity, risk-management disincentives, and negative international competitive effects of the leverage ratio. It is not a comment on the general concept of prompt corrective action (PCA). We support the principle of prompt corrective action properly linked with the more appropriate risk-sensitive requirements of Basel II, which in turn will strengthen PCA's effectiveness.

5. Operational Risk (NPR Question 7).

The Associations have undertaken a careful review of the NPR proposals in the area of operational risk. In our view, there are a number of proposals that require further revision, given that they are likely to limit the effectiveness of the advanced measurement approach (AMA) framework established by the BCBS in the international framework.

Our first concern relates to the decision by the Agencies to limit available approaches to operational risk to the AMA only. As already mentioned, we believe banks in the US should be able to choose from the full menu of approaches established by the international framework, including the Standardized and Basic Indicator approaches. The availability of less-sophisticated approaches not only would bring the US rules in line with the international framework but also would avoid forcing banks in the US to adopt the AMA when that is not the most appropriate decision in the judgment of banks' managements. Mandating all US Basel II banks, including opt-in banks, to implement the AMA would unduly override management's business judgment in those situations where, after an evaluation of a bank's internal assessment of the nature of its business, its risk-management culture, and importantly its available data, the adoption of less-sophisticated approaches would be more advisable. Mandating the adoption of the AMA could deter many opt-in banks that otherwise would decide to move to the international framework on the credit-risk side, deferring a decision on the AMA, or maintaining an operational-risk approach consistent with the approach adopted in their home countries.

An equally important concern is the Agencies' position in regard to the hybrid AMA. The NPR proposals unduly limit the adoption of a bank's global AMA solution on the basis of allocation of capital to US subsidiaries of US and foreign banks and mandate the implementation of stand-alone AMA systems for each subsidiary, contrary to the express intent of the BCBS that the number of "significant" subsidiaries should be low. We find this particularly troublesome for two reasons: first, it goes against the international framework which expressly recognizes the possibility to develop allocation mechanisms for non-significant subsidiaries; second, it obviates the fact that subsidiaries may not have the necessary data to implement a stand-alone AMA model, making the mandate impossible to comply with. Moreover, for groups developing robust group-level AMAs, this approach undermines sound risk management and methodological development. Our recommendation therefore is for the Agencies to align their proposals with the international framework and expressly make available the allocation of capital to non-significant subsidiaries.

In addition to the two main concerns noted above we also provide comments on specific operational-risk technical issues. Those comments can be found in the Annex to this letter.

6. Disclosure Issues.

Although Pillar 3 requirements under the NPR are generally in line with those of the international framework, there are three areas that the Associations recommend be examined carefully by the Agencies:

a. Disclosure Level.

The international framework provides that all disclosures be made at the group level,[10] which the Associations believe is the appropriate level for market disclosures, in line with other reporting requirements (e.g., analysts, investors, depositors, shareholders, etc.). We observe that the NPR requires that a Bank Holding Company (BHC) (including a BHC that is owned by a foreign banking organization) "that meets the conditions in Federal Reserve SR letter 01–0122 and is a core bank" adopt the advanced approaches, compute and report its capital ratios in accordance with the advanced approaches, and make the required public and regulatory disclosures even though it would not be required to meet the minimum capital ratios in the adequacy guidelines.[11] We believe this requirement would not only be extremely onerous but also could result in unintended consequences given the potential misinterpretation of the disclosures that would result from obviating the fact that to a large extent capital transactions at the BHC level are undertaken for purely group-organizational motives. It also lacks justification that an entity be obliged to adopt the advanced approaches and make the corresponding disclosures when its capital does not need to meet the capital ratios set under the international framework. This onerous burden, in our view, is not compensated by the supervisory goals that apparently are the reason for the requirement, and therefore should be removed from the proposals.

Equally important, the Associations believe that it is not appropriate to apply Pillar 3 below the Group level or require such market disclosure for a US subsidiary, if such disclosure is being produced by the parent. The NPR appears superequivalent to the international framework and poses additional burdens on firms operating on Basel II in the US.

b. Comparability.

If Pillar 3 is to achieve the objectives of transparency and market awareness originally envisaged, then it is important that the Pillar 1 elements of the various implementations be broadly consistent. Without such consistency Pillar 3 risks misleading the market with the potential detriment to market stability and to US firms. Inconsistency of Pillar 3 requirements between the US rules and the international framework is equally troublesome. For example, the US-only requirement for calculation of RWA impact of guarantees and credit derivatives would be extremely burdensome because it would require a re-engineering of a wide range of credit-risk practices. Banking organizations would be forced to establish credit-risk ratings on entities for whom this may not be feasible, because the impact analysis requires calculation of a probability of default (PD)

[10] Basel II, par. 822, 187.
[11] NPR, 55841.

before the guarantee. This will not be available in most cases where the decision to extend credit is based solely on the strength of the guarantor and not the underlying obligor, for example a US parent company's guarantee of a non-US subsidiary.

We note that the Canadian regulators have dealt with this problem by requiring only the related exposure at default (EAD) amounts, which does not require additional processing. If the Agencies insist that this type of information is significant, then we believe they should adopt a similar approach to that of the Canadian regulators.

c. Disclosure of Supervisory Actions.

For Pillar 3 to support supervisory objectives, it needs to encourage the disclosure of market-relevant information. Issues relating to supervisory actions generally should not be disclosed publicly as this has the potential to destabilize and/or restrict supervisory actions in the future, given the link between market disclosures and public confidence.

Specifically, Section 23 of the NPR contains a provision by which a bank that has completed the parallel run, but for some reason is deemed to have failed to comply with some qualification requirements, must disclose to the public such failure. We believe such a requirement would be counterproductive and would not serve any market discipline objective. In addition, the requirement seems to obviate the fact that transition toward the international framework should be treated as a process of continuous improvement, where flexibility prevails in order to provide opportunities for correction of any bona fide errors or mishaps, or perhaps methodological disagreements with the relevant Agency, in the development of banks' systems and internal approaches. We are concerned that this provision seems to take an almost "punitive" approach, which is not congruent with the tradition of prudential supervision. In sum, the rigid requirement to publicly disclose "failure" in the qualification requirements seem to us drastic and unjustified (especially as it would likely be the result of divergences of opinion about highly technical matters), and could potentially be highly misleading to investors and to the market in general. In addition, it is inconsistent with the flexibility widely recognized as necessary during the phase-in period. Many approvals will need to be subject to refinement and improvement. Continuous improvement is the history of risk management under prudential supervision and that should remain the case under the new rule.

Our recommendation to the Agencies is to remove the disclosure requirement currently included in Section 23.

B. SPECIFIC TECHNICAL ISSUES

A more detailed discussion of a number of technical issues is set out in the Annex to this letter.

II. CONCLUSION

The consequences of a US regulatory capital regime so substantially divergent from the international framework as proposed would be troublesome: internationally active banks would face additional compliance burdens in dealing with divergent regulatory standards, group-wide model validation standards would be interfered with, and special customization for the US would create needless operational and regulatory risk. Most troubling, regulatory capital standards would further diverge from internal capital policies and processes, and the goal of an overall risk-based regulatory capital approach would be deferred indefinitely. We therefore strongly encourage the Agencies to revise their proposals and align them with the international framework.

As mentioned at the beginning of this letter, international consistency is an essential goal for US banks and international banks with significant operations in the US, from a competitive perspective, for reasons of consistency and effectiveness of internal risk management, and for efficiency reasons. Regulators would also benefit from such consistency by achieving smoother and more effective supervision of cross-border banks, with a net gain to the goals of prudential supervision as compared to a US regime based on the NPR.

The Associations fear that if the Agencies persist in imposing a regulatory framework that so fundamentally diverges from the international norm, the result would be a clearly disadvantageous competitive environment for US banks and international banks operating in the US.

The foregoing comments are intended to respond at an appropriate level of detail to the main issues arising from the NPR. The Associations and their member institutions look forward to discussing the above comments, and stand ready to respond to any questions or provide any necessary clarifications.

Very truly yours,

David Schraa	David L. Mengle	Katharine Seal
Director,	Head of Research	Director
Regulatory Affairs Department	ISDA	LIBA
IIF		

CC. Mr. Stefan Walter, Secretary General, Basel Committee on Banking Supervision.

ANNEX – SPECIFIC TECHNICAL ISSUES

In addition to the comments contained in our letter, the Associations would like to provide the Agencies with the following specific technical comments addressing credit risk (including counterparty risk) and operational risk issues.

A. SPECIFIC TECHNICAL ISSUES – CREDIT RISK

In regard to the credit-risk proposals (except counterparty risk which is addressed separately in the following section) the Associations note:

1. Wholesale Definition of Default (NPR Question 14).

The NPR definition of default diverges from that of Paragraph 452 of the international framework. As shown in the table below, the NPR proposals use different criteria for wholesale defaulted exposures:

<table>
<tr><th>International Framework</th><th>US NPR</th></tr>
<tr><td colspan="2" align="center">Definition of Default – Wholesale</td></tr>
<tr><td>Paragraphs 452 and 453</td><td>Proposed Rules, Page 55913</td></tr>
<tr><td>452. A default is considered to have occurred with regard to a particular obligor when either or both of the two following events have taken place.
• The bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full, without recourse by the bank to actions such as realizing security (if held).
• The obligor is past due more than 90 days on any material credit obligation to the banking group.
453. The elements to be taken as indications of unlikeliness to pay include:
• The bank puts the credit obligation on non-accrued status.
• The bank makes a charge-off or account-specific provision resulting from a significant perceived decline in credit quality subsequent to the bank taking on the exposure.
The bank sells the credit obligation at a material credit-related economic loss.</td><td>(i) A bank’s obligor is in default if, for any wholesale exposure of the bank to the obligor, the bank has:
(A) Placed the exposure on non-accrual status consistent with the Call Report Instructions or the Thrift Financial Report and the Thrift Financial Report Instruction Manual;
(B) Taken a full or partial charge-off or write-down on the exposure due to the distressed financial condition of the obligor; or
(C) Incurred a credit-related loss of 5 percent or more of the exposure’s initial carrying value in connection with the sale of the exposure or the transfer of the exposure to the held-for-sale, available-for-sale, trading account, or other reporting category.
(ii) An obligor in default remains in default until the bank has reasonable assurance of repayment and performance for all contractual principal and interest payments on the exposure of the bank to the obligor (other than exposures that have been fully written-down or charged-off).</td></tr>
</table>

As evident from the table above, the NPR definition mandates recognition of default in a prescribed set of circumstances, whereas the international framework definition is based on the bank's view as to whether it will receive full payment (based in part on the Paragraph 453 indicators of unlikeliness to pay) and is therefore a principles-based approach to individual circumstances of each loan and applicable market conditions. In contrast to this principles-based approach, the NPR approach appears unnecessarily rigid.

Specifically, the main differences between the definitions are:

- The NPR specifies 5% as a threshold for materiality of credit-related loss on sale or change of reporting for an exposure;
- The NPR eliminates the words "without recourse to actions by the organization such as the realization of collateral," excluding obligor defaults where the bank has recourse to strong loss mitigants, such as cash collateral, underlying goods, letters of credit, etc., which have historically not been placed on non-accrual given the strength of the mitigants.

A crucial point is that effective risk management will be severely undermined if banks are forced to use two definitions of default for wholesale portfolios, one for the US and one elsewhere. This would not only cause many methodological problems but also increase operational and regulatory risk. Therefore, consistency with the international framework is of utmost importance. Should consistency not be possible, banks should at least have the option to use the home definition of default, which is more appropriate and compatible with group-wide system requirements.

a. The 5% Materiality Threshold.

Linking the wholesale default definition to a 5% credit-related loss is at odds with what was agreed by the BCBS. The definition of default used by most other banking regulators (as well as in the Advanced Notice of Proposed Rulemaking regarding Basel II) gives discretion to banks as to when to recognize a default based on the sale of an exposure at a material discount. In practice the discount at which banks would be willing to sell an exposure will depend on several features[12] including the risk rating of the facility, the liquidity associated with the obligor (or facility), the size of the exposure and portfolio considerations. We believe that, given there are many reasons to sell down an exposure, the individual bank is best placed to understand the reason for the sale and whether it is connected to a possible default (this is therefore a case where business judgment should

[12] As the market price for an exposure will be influenced by a range of factors both known and unknown, it is not feasible to specify precisely the impact of credit-related factors and therefore setting any pre-specified threshold is inappropriate. Even where credit risk is the sole identified factor in a change in market price, a reduction of around 5% is more realistically interpreted as indicating an increase in PD rather than reflecting default. Exercising credit judgment about obligors is the classic task of bankers, yet this provision substitutes an inflexible rule for that judgment.

not be replaced by regulatory judgment). This is what the international framework assumes and what other regulators permit.

We believe that the NPR definitional differences equate to moving away from the concept of measuring PD and loss given default (LGD) from actual default events by focusing solely on transactions that result in losses that are perhaps only transitory measurement “losses” in the case of the 5% test, whether or not there is an actual default by an obligor. As such, the NPR moves away from the concept of bifurcated ratings, which measure default at the obligor level and loss at the facility level. By eliminating recognition of defaults where there are no losses, the NPR effectively shifts the definition of default to the facility level. This creates a situation where the PDs would not reflect the actual default rates among obligors and the LGDs would not reflect the actual losses related to those obligor defaults. Moreover, the amount of “noise” in the system as a result would be compounded over time by the general move toward more marking to market of assets and fair-value accounting.

The prescribed 5% threshold lacks clear economic or prudential justification and does not seem to be supported by a rigorous analysis. Moreover, for wholesale, investment-grade (i.e., low-default) portfolios, where internal default history is extremely sparse, inclusion of these asset dispositions as defaults systematically hinders and distorts validation of a bank’s PD, LGD and EAD to all external default databases. Individual banks’ dispositions of non-defaulting assets have never been captured in the external databases.

The Associations would like to dispel any regulatory concerns about any potential abuse of the banks’ discretion to sell their loans and the related effects on regulatory capital. It is important to note that loan sales are made in an open and transparent market and are therefore subject to market controls.[13] Banks’ interest in these sales is strictly related to active portfolio management. Artificial thresholds, therefore, could have negative consequences and are likely to inhibit early active management of deteriorating exposures, or simply interfere without prudential benefit in management’s strategic and tactical decisions about how to manage its book of marketable assets.

Again, to emphasize, it will be very difficult for banks to achieve the risk-management goals of the international framework with multiple definitions of default, at least for wholesale portfolios. The definitional differences noted above between the US and other jurisdictions would have important repercussions for banks. First, there would be inconsistency in the parameters calculated by banks with cross-border operations. As a result, PD (and consequently LGD) calculated for the Agencies would not be comparable to the same metrics calculated for other regulators. Similarly, LGD estimations and models would need to be redone using the differing definitions of default. Multiple estimates would require multiple database structures, systems solutions, reporting systems, model validations and estimation processes, all of which would require additional resources and could, potentially, create high levels of confusion. Both US A-IRB banks with overseas subsidiaries and overseas banks with US A-IRB subsidiaries

[13] It is also important to note that losses in this type of sale would be evidenced in the P&L of banks, preventing any sort of gaming of the system.

would be required to have several years of default data available on two different bases and systems to support both definitions. This would be extremely impractical, would increase operational risk and cost, and would be at odds with good risk control from a group perspective.

b. Collateralized Exposures.

The exclusion of obligor defaults where banks have recourse to strong loss mitigants would have a significant impact on LGD estimations and LGD model development. The elimination of such defaults would increase LGD estimates by focusing on defaults where there are expectations of losses (facilities placed on non-accrual). While there would be a reduction in the observed default rates, the structure of the RWA formula is such that any increase in LGD would more than offset the reduction in PD. The end result would be artificially higher capital requirements by means of a change in the definition of default.

The Agencies have explained their rationale for departing from the international framework as an attempt to conform more closely to the definition of default being used by risk managers, based on comments from certain US risk managers earlier in the process. However, most international banks adopted a decision early on to align systems, policies, practices and estimation calculations to the international framework definition, given the delays foreseen in the US implementation process. Therefore, this change in such a key element of the A-IRB approach at this stage of the Basel II implementation process is unwelcome and problematic.

In conclusion, our recommendations are:

(i) Remove the reference to any specific percentage of credit loss and to an undefined "initial carrying value." Replace it with wording consistent with the international framework so that a sale at a *material* credit-related loss would be an indication of unlikeliness to pay.

(ii) Align the definition of default with the international framework by retaining the framework's primary definition and listing the conditions of the current proposal as hortatory indications of unlikeliness to pay, but not mandatory conditions triggering default.

(iii) Modify the NPR text to recognize, as the international framework text does, the recourse to collateral. This could be done by modifying the wholesale definition of default as follows: *"Placed the exposure on non-accrual status consistent with the Call Report Instructions or the TFR and the TFR Instruction Manual, or would have done so but for the opportunity for the bank to have recourse to security (if held)."*

(iv) Should the Agencies retain their proposed definition, permit internationally active banks discretion to use either the local definition of default in the US or that of the international framework as applied in their home jurisdictions to avoid the negative consequences noted above.

2. Downturn LGD, Supervisory Mapping and ELGD.

a. Evidence and Approach.

The Associations do not endorse the Agencies' approach to downturn LGDs as proposed in the NPR. In particular, a review of empirical studies of the correlation between economic downturn and LGD indicates the evidence is inconclusive. Some studies[14] associated with public bond LGDs appear to show some level of correlations. However, these bond studies cannot be directly applied to other types of lending as the bond studies measure the trading price one month after default, whereas bank-loan recoveries are measured by discounting cash flows over recovery periods that often extend over several years. In addition, some recoveries may take place during expansionary parts of the credit cycle or may be affected by relationship factors not present in the public bond market. For commercial loans, even after discounting cash flows, evidence of any relationship between LGDs and default rates is quite mixed.[15]

The discount rate for bank-loan recoveries is dependent on the correlation between LGDs and systematic default rates. To the extent that correlations do not exist, the case can be made that the discount rate should be the risk-free rate[16] plus a liquidity factor. In practice, banks apply a substantially more conservative rate for discounting purposes.

Furthermore, a linear adjustment to default-weighted average LGD (and hence RWA) as a proxy for downturn LGD is an inappropriate way to attempt to incorporate systematic correlation of LGD and PD effects. The degree to which this correlation should impact capital requirements is in part a function of portfolio composition and the degree to which downturn effects, if any, occur contemporaneously for subdivisions of the portfolio. As an alternative approach, banks can examine historical data to determine the degree to which downturn LGDs are observable for different types of facilities. For example, empirical data may show that periods of recession do have impact on unsecured LGDs but not on secured LGDs. Such effects can be quantified by measuring the correlation for these facilities. More advanced internal economic capital models might then incorporate both the systematic correlations of default rates and their effect on LGDs.

In conclusion, we believe that the impact of downturn LGDs could thus be better estimated and, subject to supervisory review, applied on a bank-specific basis to adjust the capital formula.

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[14] See E.I. Altman, B. Brady, A. Resti, and A. Sironi, "The Link between Default and Recovery Rates: Theory, Empirical Evidence, and Implications," *Journal of Business*, November 2005.

[15] M. Araten, M. Jacobs, Jr., and P. Varshney, "Measuring LGD on Commercial Loans: An 18-Year Internal Study," *RMA Journal*, May 2004.

[16] Gordy, Michael, "Portfolio Credit Risk Modelling: A Regulatory Perspective on the State of the Art," presented at Recent Advances in Credit Risk Research, NYU Stern, New York, May 2004.

b. Standards for Validation of a Bank's Internal Estimate.

If the NPR is adopted as proposed, use of the formula-based measure of downturn LGD may be mandated for a bank to ensure conservatism unless the bank's internal estimate meets undefined standards, even where the internal estimate is fit for the purpose. In these cases, additional arbitrary conservatism, not specifically risk based, will increase the capital requirement for non-defaulted exposures of US banks when compared to international framework requirements. Furthermore, we note that the discussion of Section 22(c) of the NPR (at page 55849) establishes ambiguous standards for the qualification of internal LGD estimates that seem to go beyond those established in the international framework. This is a situation where a reasonable dialogue between the supervisor and the bank as to the adequacy of the means by which it has chosen to meet the downturn LGD requirement – and the appropriate compensation for any temporary inadequacies – would be more appropriate than imposition of a rigid and arbitrary default approach.

This uncertainty is particularly concerning for portfolios that have long histories of low default experience because of the credit quality of the obligors, as statistical evidence will be very limited. In view of this fundamental fact, the implication that failure of a single, high-quality portfolio to meet unpublished regulatory standards should be the cause of a bank's not being permitted to use advanced approaches for any portfolio within broad subcategories is draconian and inconsistent with the risk-based approach.

As part of the approval process for internal estimates of LGD, we urge supervisors to take into account the conservative practices employed by banking organizations with respect to discount rates, updated collateral, and exposure reduction in order to avoid overstating the LGD percentages when applied to the non-defaulted segments of a portfolio.

c. Supervisory Mapping Formula (NPR Question 16).

The Associations appreciate the intent of the Agencies in suggesting a supervisory mapping formula[17] as a fallback option for those cases where data is scarce for the calculation of downturn LGDs. However, the Associations have strong reservations about the proposed formula. At a fundamental level, the proposed supervisory mapping function is inconsistent with accepted risk-management practices given that there is no generally accepted relationship between default-weighted average LGD (ELGD) and downturn LGD and that there is no conclusive evidence to support the presumption that LGD in downturn conditions should be greater than ELGD. Furthermore, there is a high risk that a formula created as a "fallback" option will likely evolve into the de facto approach for all banks given that as of today there is no common standard in the industry in this evolving aspect of risk management.

[17] NPR, 55848.

The deviation from a truly risk-based approach reflected in the proposed ELGD/LGD dichotomy would be further exacerbated by the particular functional form of the mapping function (a linear scaling factor to ELGD and hence RWA) proposed by the Agencies,[18] which would have a greater proportional effect on low LGDs – precisely those where there will be the greatest difficulty obtaining statistical evidence to support internal estimates, but where a risk assessment would show the least need for added conservatism in the calculation, and where the cost of extra capital would be least justified. We note that there is no apparent impact assessment that would justify the burdens of this change of practices on individual institutions relative to the incremental prudential benefit that might accrue to the system.

Use of a supervisory mapping formula, in place of supervisory approval of internal estimates for broad subcategories of exposures, was suggested by the BCBS as an interim fallback solution for banks that are temporarily unable to comply with a principles-based approach to produce internal estimates of downturn LGD. However, there is a risk of imposing the supervisory mapping in circumstances inconsistent with the broader guidance of the BCBS on standards for own-LGD estimates: "*The Committee has determined that a principles-based approach to elaborating on the requirements of paragraph 468 is most appropriate at this time. This approach is intended to ensure that banks have systems in place for identifying downturn conditions and for incorporating these conditions into LGD estimates where appropriate. The principles articulated in this document are designed to be flexible enough to allow for a range of sound practices and to encourage continued work in this area, while also clarifying the Committee's expectations****. These principles are not intended to amend the Revised Framework or to introduce any new rules*** (emphasis added)."[19]

More generally, we oppose the use of any supervisory mapping function that would result in substituting a formula for a bank's sound judgment. The formulaic approach also has the effect of discouraging improvement of internal data and methodologies if used as a rigid benchmark by supervisors. Furthermore, the proposed NPR mapping function is inconsistent with the approach taken in other jurisdictions and would therefore create an additional calculation and reporting burden for banks reporting under advanced approaches both in the US and overseas, and would constitute a competitive disadvantage for banks whose capital requirements are determined by the NPR rules.

If the Agencies do adopt a supervisory formula as a fallback, it should not become a de facto standard factored negatively into the approval process for internal LGD models.

d. Use of both ELGD and LGD in RWA calculations.

The concept of distinguishing ELGD from LGD as an additional input to the capital calculation for non-defaulted exposures is an innovation of the NPR and is not present in the international framework. The international framework utilizes a single LGD parameter (downturn LGD). The NPR capital formulas, however, utilize both downturn

[18] LGD = 0.08 + 0.92 x ELGD, where ELGD is the default-weighted average LGD.
[19] BCBS, "Guidance on Paragraph 468 of the Framework Document," July 2005.

LGD and ELGD (defined as the estimated default-weighted average economic loss per dollar of EAD). This adds a great deal of extra complication for little or no evident improvement from a prudential or risk-management viewpoint.

We oppose a new formal requirement to calculate ELGD as an additional IRB parameter, as this would result in capital calculations for non-defaulted exposures and expected credit loss that are incompatible with figures calculated under the international framework. Banks reporting under advanced approaches in the US will suffer an additional procedural burden compared with other banks not subject to the NPR, and the late introduction of this requirement creates a systems challenge for banks in meeting the qualification requirements.[20]

e. Granularity and sub-portfolio level LGD calculation (NPR Question 15).

The NPR establishes the requirement for banks to estimate individual sub-portfolio LGDs (segmented by industry or geography, for example). In our view this requirement is unnecessary given that LGD for a given portfolio will already reflect significantly increased loss rates within sub-portfolios weighted according to the materiality of each sub-portfolio.

We believe that banks instead should be encouraged to analyze their portfolios, to examine the evidence pertaining to downturn conditions, and to adjust LGD internally based on their findings for relevant categories of exposures. Such an approach would reflect each bank's mix of business and portfolio-specific findings, consistent with the principles-based approach recommended by the BCBS.[21]

Although additional granularity will have the mathematical effect of increasing the aggregate of capital requirements by eliminating the diversification effect arising from the timing of downturns in different subdivisions, the effect is unlikely to be significant and the subdivision LGD estimates would be less reliable owing to being based on a smaller amount of data. Any increase in aggregate capital requirements resulting from such a granular approach to LGDs would primarily be the result of assuming 100% correlation in the timing of downturns across all subdivisions. Contemporaneous downturns across all categories of assets are not evident from historical data and requiring use of a 100% correlation assumption would be unreasonably conservative.

Requiring banks to provide downturn LGD estimates for subdivisions of entire rating categories, such as industries or regions, would create both estimation and implementation problems and further distance regulatory capital from economic capital practices. Assuming that systematic downturn conditions affect LGDs, it would be unusual for these to affect all subdivision levels over the same time period. For example, while there may be peak LGD periods for both the telecommunications and retailing industries, these could occur years apart. Selecting the worst of the LGDs for each of

[20] As described in Section 22 of the NPR relating to the quantification of risk parameters.
[21] BCBS, "Guidance on Paragraph 468 of the Framework Document," July 2005.

these subdivisions in an ASRF capital formula violates basic portfolio theory and the recognition of diversification effects.

In addition, the appropriate extra level of granularity is not addressed in the NPR and this could lead to onerous, unproductive and inconsistent requirements' being applied to banks, depending on the eventual interpretation of the language either in the final rules or by individual bank examiners.

3. Definition of EAD.

The NPR introduces a definition of EAD materially different from that in the international framework. The NPR diverges from the international framework in these main respects: 1) treatment of partial write-offs and specific reserves; 2) treatment of future drawings; and 3) inclusion of future interest and fees.

International Framework	**US NPR**
Treatment of partial write-offs and specific reserves	
Paragraph 308	Proposed Rules, Page 55916
308. The following sections apply to both on- and off-balance sheet positions. All exposures are measured gross of specific provisions or partial write-offs. The EAD on drawn amounts should not be less than the sum of (i) the amount by which a bank's regulatory capital would be reduced if the exposure were written-off fully, and (ii) any specific provisions and partial write-offs.	(1) For the on-balance sheet component of a wholesale or retail exposure (other than an OTC derivative contract, repo-style transaction, or eligible margin loan), EAD means: (i) If the exposure is held-to-maturity or for trading, the [bank]'s carrying value (including net accrued but unpaid interest and fees) for the exposure less any allocated transfer risk reserve for the exposure; or (ii) If the exposure is available-for-sale, the [bank]'s carrying value (including net accrued but unpaid interest and fees) for the exposure less any unrealized gains on the exposure plus any unrealized losses on the exposure.
Treatment of future drawings and inclusion of interest and fees	
Wholesale exposures	Proposed Rules, Page 55916
310. For off-balance sheet items, exposure is calculated as the committed but undrawn amount multiplied by a CCF. There are two approaches for the estimation of CCFs: a foundation approach and an advanced approach.	(2) For the off-balance sheet component of a wholesale or retail exposure (other than an OTC derivative contract, repo-style transaction, or eligible margin loan) in the form of a loan commitment or line of credit, EAD means the [bank]'s best estimate of net additions to the outstanding amount owed the [bank], including estimated future additional draws of principal
EAD under the advanced approach	

316. Banks which meet the minimum requirements for use of own estimates of EAD…will be allowed to use their own internal estimates of CCFs across different product types provided the exposure is not subject to a CCF of 100% in the foundation approach...	and accrued but unpaid interest and fees, that are likely to occur over the remaining life of the exposure assuming the exposure were to go into default. This estimate of net additions must reflect what would be expected during economic downturn conditions.
Retail exposures	
336. For retail exposures with uncertain future drawdown such as credit cards, banks must take into account their history and/or expectation of additional drawings prior to default in their overall calibration of loss estimates. In particular, where a bank does not reflect conversion factors for undrawn lines in its EAD estimates, it must reflect in its LGD estimates the likelihood of additional drawings prior to default. Conversely, if the bank does not incorporate the possibility of additional drawings in its LGD estimates, it must do so in its EAD estimates.	

a. Treatment of partial write-offs and specific reserves.

The international framework (Paragraph 308) requires that specific reserves and partial write-offs are included in EAD but the proposed rules define EAD as carrying value, which is net of specific reserves and partial write-offs. In terms of the calculation of capital requirements, the proposed rules (page 55927) make an adjustment to align more closely with the international framework for wholesale exposures – but not for retail exposures – by adding the amount of charge-offs or write-downs to EAD. For banks which have already designed or built systems based on the international framework, this departure leads to additional cost and delay (and ongoing costs for banks with international framework-compliant regulatory reporting obligations) to no clear prudential benefit. It will also hamper cross-border validation.

b. Treatment of future drawings for retail exposures.

The international framework (Paragraph 336) explicitly allows future drawings on retail exposures to be reflected in either EAD or LGD. By contrast, the NPR requires a bank to include estimated future drawings over the remaining life of the exposure in EAD. Where banks have developed their EAD/LGD approach using the international framework option of reflecting further drawings in LGD, the NPR proposal would require them to change their systems and restate statistics (or face an inadequate data history) for no prudential benefit.

c. Inclusion of future interest and fees.

The NPR requires future interest and fees, which have not yet been recognized in capital resources, to be treated as exposures for which current capital cover is required. The international framework clearly requires only additional drawings to be reflected (in either EAD or LGD) for such exposures. The inclusion of unbooked income in EAD would be felt most in portfolios such as cards, where there tends to be a higher rate of interest/fees, resulting in higher regulatory capital requirements. Requiring capital to support future interest and fees results in a mismatch with the definition of regulatory capital, which takes no account of the future net interest income which will augment capital as at the date of default.

4. SME Loans (NPR Question 25).

The Associations believe the treatment of SME portfolios under the international framework is a valid and robust one. In fact, the risk weighting proposed under the international framework is commensurate with risk levels in large and diversified portfolios such as those of banks implementing Basel II in the US.

Although there might be technical reasons for which a revised approach to SMEs could be conceived, we believe that this is another area where consistency with the international framework is necessary. In the absence of a strong prudential reason for which it would be necessary to establish a new and revised approach to SME loans (as proposed in the NPR) we strongly encourage the Agencies to refrain from establishing additional departures from the international framework. These divergences would result in inconsistent capital requirements and duplicative reporting systems for banks using advanced approaches both in the US and overseas, something that seems clearly unjustified.

5. Treatment of Equity Exposures.

a. Definition of Equity Exposures (NPR Question 59).

The international framework defines equity exposures on the basis of the economic substance of the instrument. This definition encompasses indirect equity interests, defined to include "holdings of derivative instruments tied to equity interests, and holdings in corporations, partnerships, limited liability companies or other types of enterprises that issue ownership interests and are engaged principally in the business of investing in equity instruments."[22] Given this all-encompassing definition, we believe that the equity rules should be comprehensive. In particular, there is no basis to exclude investment funds with material liabilities from the equity rules.

Under the definition of investment fund in the NPR, investment funds "with material liabilities" that are held in the banking book would be excluded from investment fund

[22] Basel II, par. 235, fn. 59, 53.

treatment. Consequently, our interpretation of the rule text is that these exposures would then be included under the equity rule (as non-publicly traded equity), but we find the NPR is not fully clear on this point.[23]

In industry discussion, some in the regulatory community suggested that such funds are equivalent to the lower tranche in a two-tranche synthetic securitization, junior to the fund's liabilities, resulting in a capital deduction for an unrated fund. Although we find no such interpretation in the actual NPR text, we are nevertheless concerned that this could be included in the final rule.

We find such a securitization treatment to be artificial and inappropriate for investment funds with liabilities. In the extreme, this interpretation could be extended to a publicly traded equity, which typically has materially liabilities, and by this line of reasoning is a first-loss tranche. This securitization interpretation also creates inconsistent risk weighting by requiring a capital deduction for investment funds with liabilities while non-publicly traded equity is subject to a maximum 400% risk weight. There is no apparent rationale to conclude categorically such funds are a multiple riskier than non-publicly traded equity. We consider a securitization interpretation inconsistent with the intent of the international framework to define equity exposures broadly based on the economic substance of both direct and indirect holdings.

The treatment of hedge funds is a specific example of investment funds with material liabilities. As such, hedge funds in the banking book should also explicitly be treated as non-publicly traded equity under the rules for equity exposures. Furthermore, hedge funds in the trading book should remain in the trading book, as covered positions subject to market-risk rules, and not excluded from trading-book treatment based on an alternative interpretation as securitization exposures subject to capital deduction.

In July 2005, the BCBS stated its view that open equity stakes in hedge funds and merchant banking investments currently did not meet the definition of trading book.[24] However, it appears no action was taken on this point, since neither the Market Risk NPR nor the Risk-Based Capital Standards NPR explicitly address the treatment of hedge funds.

b. Internal Models Approach Incentives.

We are concerned that the NPR rules for the Internal Models Approach (IMA) will discourage firms from adopting this approach, due to inconsistency in the application of risk weights for non-material exposures, IMA requirements for pricing data, and inability to choose either IMA or Simple Risk Weight Approach (SRWA) on a fund-by-fund basis for investment funds.

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[23] Our interpretation is based on page 55943 of the NPR: "To calculate its risk weighted asset amounts for equity exposures that are not equity exposures to investment funds, a [bank] may apply either the Simple Risk Weight Approach (SRWA) in section 52 or, if it qualifies to do so, the Internal Models Approach (IMA) in section 53."

[24] BCBS, *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects* (Basel, July 2005): 4.

i. Materiality.

We observe that the IMA does not provide for a materiality exclusion in the same terms provided for the SRWA. In effect, under the SRWA, there is a materiality exclusion for non-significant equity investments up to 10% of total capital. Exposures below this threshold are risk weighted at 100% rather than the 300% and 400% risk weightings for public and private equity investments, respectively. This will lead to a situation where the capital assignment for most institutions under the more sophisticated IMA is guaranteed to be higher than capital calculated under the SRWA. This results in a significant disincentive for banks to invest in improving risk management for equity instruments, something which is clearly not the intent of the rules proposed by the Agencies.

ii. Required Indices.

As proposed by the Agencies, the implementation of the IMA would require daily market prices for all modeled equity exposures, either direct holdings or proxies. In the cases of private equity investments proxies are available on a monthly or quarterly basis, proxies that represent the unique risks of venture capital and other private investments. We believe that these indices, which are more relevant than public market proxies and are available for complete equity cycles, should be eligible to be used in the IMA even though they are not of daily periodicity.

iii. IMA for Investment Funds.

We believe banks should be able to choose either the SRWA or IMA based on the availability of position data for fund investments. We are concerned that standardized risk weights for assets of investment funds fail to appropriately capture portfolio concentrations across funds and exposure to specific risks. The IMA, in concert with data that allows a bank to look through a fund and reflect its proportional ownership of individual positions, should satisfy the criteria of assigning capital as though the individual assets are held directly on balance sheet.

c. Risk Weights for Investment Funds and Effectively Hedged Exposures.

The international framework provides for a look-through approach for investment funds where the investment mandate is known, but not the funds' underlying holdings.[25] In this circumstance, risk weighting proceeds from the exposure class with the highest risk weight to the maximum extent possible under the fund's mandate, then to the next class with next highest requirement, etc., until the total investment level is reached.

Under the NPR approach, there is only one risk weight available above 400%, namely 1250%, which would apply to all "exposures that ... (otherwise) receive a risk weight greater than 400% under this appendix."[26] We believe a risk weight of 1250% should not

[25] Basel II, par. 360-361, 78-79.
[26] NPR, 55946.

be applied to all exposures that would otherwise receive risk weights as low as 401%, and seek further clarification and examples of what types of exposures would attract risk weights above 400%.

At the other end of the spectrum, an exposure that is effectively hedged presents a clear case where it would be more appropriate to use a risk weight of 0% rather than 100%. Effective hedging is a risk-mitigating strategy that should be recognized and encouraged, not penalized.

B. SPECIFIC TECHNICAL ISSUES – COUNTERPARTY RISK

This section is comprised of two parts: (i) the Associations' answers to issues covered by enumerated Questions 34-40 regarding credit risk mitigation, and (ii) the Associations' additional comments about other aspects of counterparty credit risk.

1. Credit Risk Mitigation Techniques.

Note on terminology: collateral versus margin.

In answering the following questions we want to call attention to the important difference between two forms of collateral according to their effects on the measurement of risk, which both the international framework and the NPR recognize:

- The general term "collateral" refers to assets pledged by a counterparty to the party that is extending credit. Collateral tends to affect credit risk by reducing the LGD.
- The narrower term "margin" refers to assets pledged as collateral by a counterparty for OTC derivatives and Securities Financing Transactions (SFTs) when several legal conditions are met. The conditions usually include a legal conclusion with a well founded basis that no stay will be placed on the assets pledged as margin in the event of a counterparty's default (including upon an event of bankruptcy, insolvency or similar proceeding). In this context, the assets posted as margin reduce the EAD rather than the LGD.

We believe it was clear from the context that Questions 34 and 35 refer to margin as defined above, namely, assets posted as collateral which have the effect of reducing EAD instead of LGD. For Question 36, however, it was not clear to us if the question referred to collateral in the general sense (as potentially reducing LGD) or the narrow sense (as potentially reducing the EAD). Our answer to Question 36 assumes it was asking about collateral in the latter, more narrow sense.

Question 34: [27] *For purposes of determining EAD for counterparty credit risk and recognizing collateral mitigating that risk, the proposed rule allows banks to take into account only financial collateral, which, by definition, does not include debt securities*

[27] Ibid., 55868.

that have an external rating lower than one rating category below investment grade. The agencies invite comment on the extent to which lower-rated debt securities or other securities that do not meet the definition of financial collateral are used in these transactions and on the CRM value of such securities.

This is not usually an issue for the counterparty risk of OTC derivatives. The proposal is contrary to current market practice for SFTs, however. There are two issues for SFTs:

- The definition of what constitutes a "debt security" for the purpose of an SFT should be consistent with current insolvency law. For example, an SFT would currently include a contract for the purchase, sale, or loan of the following:
    - A security, a certificate of deposit, a mortgage loan or any interest in a mortgage loan;
    - A group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof); or
    - An option on any of the foregoing.

  The term financial collateral should include the same set of underlying assets.

- When an SFT is done with a non-investment grade security, it is incumbent on the bank to use an appropriately higher haircut commensurate with the risk of the security. As long as a bank can demonstrate that it assigns haircuts appropriate to the risk of the securities posted as margin there is no reason to limit collateral to securities with an external rating greater than or equal to one rating category below investment grade.

Question 35:[28] *The agencies recognize that criterion (iii) above may pose challenges for certain transactions that would not be eligible for certain exemptions from bankruptcy or receivership laws because the counterparty—for example, a sovereign entity or a pension fund—is not subject to such laws. The agencies seek comment on ways this criterion could be crafted to accommodate such transactions when justified on prudential grounds, while ensuring that the requirements in criterion (iii) are met for transactions that are eligible for those exemptions.*

As pointed out by this question, even when the law exempts, in an appropriate context, the margin posted as collateral from being subject to a stay, there may be exceptions to the exemption for specified types of obligors (e.g., ERISA funds, sovereigns, etc.).

There are several ways the exceptions to the no-stay rule can be treated. We support the approach adopted in February 2006 by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation.[29]

[28] Ibid., 55869.
[29] *Federal Register* 71, no. 35 (February 22, 2006): 8932.

Question 36*:*[30] *The agencies seek comment on the appropriateness of requiring that a bank have a perfected, first priority security interest, or the legal equivalent thereof, in the definition of financial collateral.*

As stated above in the introductory note, we assume Question 36 refers to collateral posted as margin to reduce the EAD.

The proposed requirement is more stringent than Basel II (superequivalent), where a first priority security interest is required only in relation to physical collateral. For example, Paragraph 509 of the international framework states that "in some member countries, eligible (real estate) collateral will be restricted to situations where the lender has a first charge over the property." Similarly in Paragraph 522, the international framework notes, "only first lien or charges over (other physical collateral) are permissible. As such, the bank must have priority over all other lenders to the realized proceeds of the collateral."

The international framework lists the criteria for margin for OTC derivatives in Paragraph 146 and SFTs in Paragraph 703, and does not include a requirement that such a security interest be perfected.

Although superequivalent to Basel II, the proposed requirement does not conflict with established market practice, which is to seek a perfected, first priority security interest. We question, however, the necessity or advisability of addressing through regulation a matter that is already addressed adequately by the market. As a general matter, we believe market practice should be allowed to evolve to suit market conditions, and that regulation should be imposed only in those instances when the market fails to address a risk adequately on its own.

Further, there may be some jurisdictions where US banks undertake SFTs and where the more stringent requirement of the proposal is not part of the local law.

Question 38*:*[31] *The agencies seek comment on methods banks would use to ensure enforceability of single product OTC derivative netting agreements in the absence of an explicit written legal opinion requirement.*

We understand the terminology in the NPR as follows. First, we assume that an "explicit" written legal opinion refers to one produced for and paid for by a specific firm, and that a "commissioned" legal opinion refers to one commissioned and paid for by an industry association such as ISDA for the use of member firms. Second, we interpret the question to be whether it should be sufficient for firms to rely on a commissioned legal opinion such as an ISDA Netting Opinion instead of firms' getting their own opinions.

It should normally be sufficient for firms that document OTC derivatives transactions under a master netting agreement (such as the ISDA Master Agreement) to rely on a commissioned legal opinion as to the enforceability of the contract. It should not be

[30] NPR, 55869.
[31] Ibid., 55872.

necessary, except in a few circumstances such as those mentioned below, for a firm to obtain its own legal opinion.

One of the principal missions of the International Swaps and Derivatives Association is to provide its members with written legal opinions regarding the enforceability of the termination and bilateral close-out and multi-branch netting provisions of the ISDA Master Agreements. The legal opinions are prepared by external counsel on behalf of ISDA's members. ISDA has collected these opinions since 1987 and updates them on an annual basis. ISDA has added new jurisdictions each year, and now has opinions from counsel in 52 jurisdictions.

Counsel are asked each year to provide in their written legal opinions whether the inclusion of defined transaction types, documented under an ISDA Master Agreement, would impact the legal analysis being offered. Each year, the definitions list is expanded based on the development of ISDA standard form documentation for a new product (for example, EU emissions trading or credit default swaps on asset backed securities). Given the comprehensiveness of the ISDA legal opinions, therefore, it should not normally be necessary for firms to obtain their own opinions. Reliance on such opinions is well established market practice.

It might be necessary for a firm to obtain a separate legal opinion in exceptional cases. The standard ISDA opinion might not cover a particular jurisdiction in which an institution does business, for example, so an internal (or external) legal opinion might be necessary. In addition, an existing ISDA opinion may be supplemented by an external legal opinion, for example, to provide coverage of a counterparty type not included in the ISDA instruction letter to counsel. As a general matter, however, a commissioned legal opinion should be sufficient.

***Question 39**:*[32] *The agencies request comment on all aspects of the effective EPE approach to counterparty credit risk, and in particular on the appropriateness of the monotonically increasing effective EE function, the alpha constant of 1.4, and the floor on internal estimates of alpha of 1.2.*

The Associations' response to the NPR is limited, for the most part, to those issues where the NPR materially differs from the international framework. The issues raised by Question 39 are present in both the NPR and the international framework. We will take advantage of this question to comment on the issues raised but suggest that the US regulators take our recommendations back to the BCBS to ensure consistency between the US and the international rules.

a. Floor on internal estimate of alpha of 1.2.

We do not think that a floor, equal to 1.2, should be set on the internal estimate of alpha. As the US regulators know, the origin of a floor on alpha equal to 1.2 is as follows:

[32] Ibid., 55874.

> ISDA, LIBA, and TBMA jointly did an initial study when they first proposed the use of alpha and found that alpha would have a value of about 1.1, given the characteristics of a typical, large derivative trading business. At the request of the Basel/IOSCO Working Group, a further study was done that took "general wrong way" risk into account. Alpha was then found to equal approximately 1.2.

The actual alpha applicable to a given firm can be less than 1.2 and should be based on the appropriate empirical study by that firm.

For example, a firm might structurally have "general right way" risk rather than "general wrong way" risk. That could occur, as one example, if a bank tended a) to transact interest rate swaps with corporate end users for which the bank paid fixed and received floating, and b) to hedge market risk by entering into offsetting swaps in the interbank market. Counterparties in the interbank market tend to enter into bilateral margin agreements, whereas corporate end users tend not to enter into margin agreements. As a result of this structural arrangement, the bank would tend to have "right way" risk with its corporate end users (exposures will increase when interest rates rise and the systematic component of default tends to decrease) whereas there would be negligible exposure with the interbank customers in a falling-rate environment because of margin.

Floors of any kind tend to distort the measurement of risk. This is an example of where that distortion would occur.

b. Effective netting set.

We do not think that there is a good basis for specifying that Effective EPE must be calculated at the netting set level. Effective EPE can logically and coherently be measured at the counterparty level across all transactions with the counterparty, including a) transactions not covered by any netting agreement, and b) the set of transactions covered by each separate netting agreement entered into with the counterparty. The logic for doing this has been presented to the BCBS and has been published.[33] The method of simulating an exposure profile at the counterparty level fully recognizes that only transactions covered by a netting agreement can be netted together. However, a robust simulation method will take into account that for any simulated state of the market, at any future date, not every netting set has exposure; that is, there are portfolio effects across netting sets.

The requirement to compute Effective EPE at netting set level is not consistent with the level at which firms manage and measure credit exposures, which is that of the

[33] Picoult, Evan, "Calculating and Hedging Exposure, Credit Value Adjustment and Economic Capital for Counterparty Credit Risk," in *Counterparty Credit Risk Modeling: Pricing, Risk Management and Regulation*, ed. Michael Pykhtin (London: Risk Books, 2005).
Evan Picoult and David Lamb, "Economic Capital for Counterparty Credit Risk," in *Economic Capital: A Practitioner Guide* (London: Risk Books, 2004).

counterparty itself. Banks have developed sophisticated processes to simulate exposure profiles at the counterparty level in order to measure, monitor and limit credit exposure and to measure internal economic capital.

Calculating Effective EPE at netting set level will therefore require modifying systems and internal validation practices, at a significant cost for some firms, and for no clear purpose other than to abide by a regulation divorced from firms' practices. The change will cause a rift between exposures used for risk-management purposes and those calculated for regulatory-capital purposes, causing system differences and a dichotomy in user/senior management understanding. We therefore recommend that banks be allowed to compute Effective EPE at the counterparty level.

Banks have a strong incentive to enter into netting agreements with their counterparties. As we mentioned in Question 38 above, however, the legal enforceability of a netting agreement is dependent on several factors including the form of the contract, the specific product, the type of counterparty, and the applicable laws of potentially several legal jurisdictions. For this reason, a bank might have derivative transactions that are not covered by a legally enforceable netting agreement in spite of its best efforts.

For some firms the incremental processing costs of calculating Effective EPE at the netting set level will be very high. Given the points we argue above, this is an unnecessary expense which would, in many cases, be incurred only to meet a regulatory requirement rather than to improve the internal measurement and management of risk.

c. Other Issues: Calculation of EPE with and without margin.

Following Question 39, the NPR continues: "A bank's primary Federal supervisor must determine that the bank meets certain qualifying criteria before the bank may use the internal models methodology. These criteria consist of operational requirements, modeling standards, and model validation requirements."[34]

The following requirement goes beyond the criteria in Basel II: "Sixth, the bank must measure and manage current exposures gross and net of collateral held, where appropriate. The bank must estimate expected exposures for OTC derivative contracts both with and without the effect of collateral agreements."[35]

The following component of the sixth requirement is a reasonable transcription of Paragraph 190 of the BCBS Trading Book Review, which provides that: "The bank must measure current exposure gross and net of collateral held where such measures are appropriate and meaningful."[36] We have not found anything in the international framework, however, that requires banks to calculate EPE both with and without the effect of collateral.

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[34] NPR, 55874.
[35] Ibid.
[36] Trading Book, 41.

d. Other Issues: Calculation of EPE that takes into account margin agreements triggered by a change in counterparty risk credit quality.

The following appears in the discussion of "Collateral agreements under the internal models methodology" in the NPR: "If the bank has prior written approval from its primary Federal supervisor, it may capture the effect on EAD of a collateral agreement that requires receipt of collateral when exposure to the counterparty increases within its internal model. In no circumstances may the bank take into account in EAD collateral agreements triggered by deterioration of counterparty credit quality."[37]

We recommend that when simulating EPE a bank should be allowed to take into account any collateral agreements that are dependent on changes in a counterparty's external rating, provided that the bank's internal model is capable of prudently incorporating such a ratings trigger into its simulation of potential exposure and is subject to the approval by the bank's supervisor.

Although it will be difficult for banks to model the effect of ratings triggers on the calculation of EPE, the US regulations should not preclude such modeling if a bank can demonstrate that it can be performed in a sound and prudent manner.

Question 40:[38] *The agencies request comment on the appropriateness of these criteria in determining whether the risk mitigation effects of a credit derivative should be recognized for risk-based capital purposes.*

Our comments on credit derivatives are given below in the section entitled "Other Aspects of Counterparty Credit Risk: Credit Risk Mitigation Using CDS and CCDS Contracts."

2. Other Aspects of Counterparty Credit Risk: Credit Risk Mitigation Using CDS and CCDS Contracts.

In this section, we comment upon and make suggestions for improving the sections of the NPR concerning credit risk mitigation through the use of Credit Derivatives and Guarantees. This section has two parts: (i) Part 1 focuses on the traditional credit default swap (CDS), and (ii) Part 2 focuses on a new type of CDS contract, the contingent credit default swap (CCDS), which is used to hedge the market-sensitive, time-varying exposure of counterparty credit risk.

We have two types of comments:

- "Type 1" comments concern areas in which we think that the NPR has diverged from the international framework and should revert to it.
- "Type 2" comments concern areas in which we think both the international framework and the NPR need to be improved to be consistent with market

[37] NPR, 55875.
[38] Ibid., 55876.

practice. In such cases we recommend that the US regulators work with the BCBS to modify the rules internationally in a consistent way.

a. Traditional CDS.

These comments are (i) to clarify the definitions of "eligible credit derivative" and "eligible guarantee" in order to create a better fit between these definitions and how the traditional credit default swap actually works or is currently documented in the marketplace, (ii) to further harmonize these definitions with the requirements noted in international framework, and (iii) to clarify the ranking requirement in the rules of recognition regarding the credit risk mitigation benefits of eligible guarantees and eligible credit derivatives.

i. Eligible Credit Derivative.

These suggested changes to the definition of "eligible credit derivative" are to align the definition with how the traditional CDS actually works or is currently documented in the marketplace.

- The international framework does not contain the term "eligible credit derivative." This defined term is used only in the NPR. We believe the definition needs to be improved because the market generally considers an nth-to-default credit derivative and a CCDS as simply variants of a CDS. As a consequence, we suggest that the preamble be revised to read as follows:

  > "<u>Eligible credit derivative</u> means a credit derivative in the form of a credit default swap (which includes, for example, an nth-to-default credit derivative or a contingent credit default swap) or total return swap provided that:"
  > (Type 2 Comment)

- Clause (i) of the definition of "eligible credit derivative" in the NPR states:

  > "(i) The contract meets the requirements of an eligible guarantee and has been confirmed by the protection purchaser and the protection provider."[39]

  The international framework does not contain clause (i) but the intent of this clause is in the international framework.[40] The problem with the wording of clause (i), as we discuss below, is that the concept of a beneficiary (incorporated by the reference to the definition of "eligible guarantee" in this section) only exists in the context of a guarantee and not a CDS. We suggest that clause (i) be revised accordingly to read as follows:

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[39] Ibid.
[40] See Basel II, par. 307 and 488, 68-69 and 103.

> "(i) The contract meets the requirements of an eligible guarantee (where, for purposes hereof, references to the beneficiary in the definition of eligible guarantee shall be deemed to be references to the protection purchaser) and has been confirmed by the protection purchaser and the protection provider."
> (Type 2 Comment)

- The first part of clause (iii) of the definition of "eligible credit derivative" in the NPR concerns a credit event of failure to pay and states:

> "(iii) If the credit derivative is a credit default swap or nth-to-default swap, the contract includes the following credit events:
> (A) Failure to pay any amount due under the terms of the reference exposure (with a grace period that is closely in line with the grace period of the reference exposure)."[41]

The NPR is consistent with the international framework, but both documents need to be enhanced to recognize that most, if not all, plain vanilla credit default swaps have a payment threshold of USD one million or EUR one million, as the case may be. Consequently, we suggest that clause (iii)(A) be revised to read as follows:

> "(A) Failure to pay any amount due under the terms of the reference exposure subject to any relevant payment threshold (with a grace period that is closely in line with the grace period of the reference exposure)."
> (Type 2 Comment)

- Clause (vi) of the definition of "eligible credit derivative" states:

> "(vi) If the contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of the exposure provide that any required consent to transfer may not be unreasonably withheld."[42]

This differs from the wording of the analogous Paragraph 191(e) in the international framework, which states:

> "(e) If the protection purchaser's right/ability to transfer the underlying obligation to the protection provider is required for settlement, the terms of the underlying obligation must provide that any required consent to such transfer may not be unreasonably withheld."[43]

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[41] NPR, 55876.
[42] Ibid.
[43] Basel II, par. 191, 43.

Since it appears that the intent behind this clause of the international framework is to ensure that the protection buyer will be able to deliver an exposure that does not allow for any required consent to transfer to be unreasonably withheld, we suggest that clause (vi) of the definition of "eligible credit derivative" in the NPR be revised to read as follows to achieve that intent:

> "(vi) If the contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of the exposure to be transferred may not include any provision that permits any required consent to transfer to be unreasonably withheld."
> (Type 1 Comment)

ii. Eligible Guarantee.

These suggested changes to the definition of "eligible guarantee" are intended to align this definition with the requirements listed in Paragraphs 189, 307 and 484 of the international framework.

- Clause (i) of the definition of an "eligible guarantee" in the NPR states that an eligible guarantee:

  > "(i) Is written and unconditional."[44]

  Paragraph 189 of the international framework expands on the meaning of "unconditional" which is absent from clause (i) of the NPR definition. We suggest that clause (i) should be revised to read as follows to better align with the international framework:

  > "(1) Is written and unconditional, i.e., there should be no clause in the contract outside the direct control of the beneficiary that could prevent the protection provider from being obliged to pay out in a timely manner in the event that the obligor fails to make the payment(s) due."
  > (Type 1 Comment)

- Clause (ii) of the NPR definition of "eligible guarantee" states that an eligible guarantee:

  > "(ii) Covers all or a pro rata portion of all contractual payments of the obligor on the reference exposure."[45]

[44] NPR, 55876.
[45] Ibid.

The closest reference to this requirement in the international framework is the section of Paragraph 189 that states, "…the extent of the cover is clearly defined and incontrovertible."[46] With reference to this section of the international framework and in an effort to clarify and clearly define the cover as contractual payments in respect of outstanding principal balance or due and payable amount (and not *all possible* contractual payments) the obligor may have on the reference exposure, we suggest that clause (ii) be revised to read as follows:

> "(ii) Covers all or a pro rata portion of all contractual payments of the obligor in respect of outstanding principal balance or due and payable amount on the reference exposure."
> (Type 2 Comment)

- Clause (iv) of the NPR definition of "eligible guarantee" states that an eligible guarantee:

> "(iv) Is non-cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary."[47]

In contrast, Paragraph 189 of the international framework has the additional refinement of "unilaterally."[48] We suggest that clause (iv) be revised by inserting the word "unilaterally" after the words "Is non-cancelable" but before the words "by the protection provider" to read as follows:

> "(iv) Is non-cancelable unilaterally by the protection provider for reasons other than the breach of the contract by the beneficiary."
> (Type 1 Comment)

- Clause (v) of the definition of "eligible guarantee" in the NPR states:

> "(v) Is legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgment may be attached and enforced."[49]

With reference to Paragraphs 307 and 484 of the international framework, we suggest that clause (v) be revised by deleting the word "sufficient" therein.
(Type 1 Comment)

iii. Rules of recognition.

- In Section 33(b) (Rules of recognition of guarantees and credit derivatives) of the NPR, clause 2(i) states:

[46] Basel II, par. 189, 41-42.
[47] NPR, 55876.
[48] Basel II, par. 189, 41-42.
[49] NPR, 55876.

> "2(i) The reference exposure ranks pari passu (that is, equally) with or is junior to the hedged exposure."[50]

This is similar to what is in the international framework. However, we believe the language needs to be edited to ensure that the ranking requirement is only with respect to priority of payment. Accordingly, we suggest that clause (2)(i) be revised by inserting the words, "in terms of priority of payment," after the word "ranks" but before the words "pari passu (that is, equally)" to read as follows:

> "2(i) The reference exposure ranks, in terms of priority of payment, pari passu (that is, equally) with or is junior to the hedged exposure."
> (Type 2 Comment)

b. Contingent Credit Default Swaps (CCDS).

The BCBS has noted that exposure to credit risk through a loan is different in several respects from exposure to counterparty credit risk (CCR) associated with OTC derivative contracts.[51] For example, unlike a loan where such exposure is unilateral in nature (i.e., only the bank as lender has the credit risk), "CCR creates a bilateral risk of loss [since depending on market conditions at the time of valuation,] the market value of the transaction can be positive or negative to either counterparty to the transaction." In addition, in the case of a loan (e.g., a term loan), the amount of exposure is fixed at inception. In contrast, the amount of exposure in the case of most OTC derivative contracts "is uncertain and can vary over time with the movement of underlying market factors."[52]

These characteristics have prompted banks to measure, manage, and mitigate their exposure to CCR associated with OTC derivative contracts differently from their exposure to credit risk through loans. The CCDS enables a bank to hedge the market-rate-dependent, time-varying nature of CCR.

The CCDS is a type of CDS that has one important feature not found in a traditional CDS: A CCDS is similar to a CDS in that upon default of the referenced obligor, the seller of the CCDS will pay the buyer the contract notional. Unlike the traditional CDS where the notional amount is fixed at inception, the notional amount of the CCDS is not fixed but changes with the movement of the underlying market factors affecting the reference derivative. The notional amount of the CCDS is the mid-market value of a referenced derivative transaction if/when the referenced obligor experiences a credit event.

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[50] Ibid., 55933.
[51] Trading Book, 208.
[52] Ibid.

From a more general perspective, just as a CDS enables the buyer to hedge against an increase in the credit risk premium of a bond or loan, a CCDS enables the buyer to hedge against an increase in the credit risk premium of an OTC derivative contract. The credit risk premium of an OTC derivative contract is its credit value adjustment (CVA). The CVA is an adjustment made to the market value of an OTC derivative contract to take into account the credit risk of the counterparty.

The derivative referenced by the CCDS contract will typically be a plain vanilla, simple OTC derivative contract. The underlying OTC derivative contract that the CCDS is hedging may be a plain vanilla, simple derivative or a derivative with more complex terms and conditions. In the former case, the change in the market value of the CCDS may fully offset the change in the CVA of the underlying OTC derivative contract. In the latter case, there may be some residual change in the CVA of the underlying OTC derivative contract that is not fully hedged by the CCDS.

The residual, unhedged exposure may arise because a) of differences between the terms and conditions of the referenced OTC derivative (usually a plain vanilla contract) and the terms and conditions of the underlying OTC derivative (which may be more complex), and/or b) the floating market rates of the referenced OTC derivative (e.g., 3 month USD LIBOR) may be highly correlated with but not identical to the floating market rate of the underlying OTC derivative being hedged (e.g., 3 month CP rate).

In this context, the OTC derivative exposure profile will need to be decomposed, as appropriate, into a component that is hedged by the CCDS and a residual component that is not hedged, in analogy to what is done for loans that are only partially hedged with a CDS.

We propose that the overall treatment of CCDS contracts used to hedge counterparty credit risk should be similar to the treatment of CDS contracts used to hedge the credit risk of loans: subject to the appropriate conditions, banks should have the option of using either the "substitution approach" or the "double-default" risk weight formula in measuring RWA for CCR.

Although the overall treatment of CCDS contracts should be similar to that of CDS contracts, some of the definitions and conditions for using these contracts should differ since, as noted above, exposure to credit risk through a loan is different in several respects from exposure to CCR associated with OTC derivative contracts.

For example:

i. Effective Notional Amount and Effective EPE.

For a CDS contract hedging a loan, the NPR defines the "effective notional amount." Unlike a loan, the EAD for counterparty credit risk is calculated, in the Internal Model Method, by the simulation of the Effective EPE of a single transaction or of multiple transactions that qualify to be treated as a netting set.

Under the “substitution approach,” the Effective EPE to a counterparty would need to be decomposed into a hedged Effective EPE and an unhedged Effective EPE. The former would be multiplied by the risk weight using the PD of the qualified seller of the CCDS; the latter would be multiplied by the risk weight using the PD of the underlying obligor. Under the “double-default” approach, the hedged Effective EPE would be multiplied by the risk weight determined by the double-default formula while the unhedged Effective EPE would be multiplied by the risk weight using the PD of the underlying obligor.

Accordingly, the concept of “effective notional amount” is not relevant to the measurement of EAD for CCR. The critical computation in the use of a CCDS is the decomposition of the EPE profile (over the life of the netting set) into a hedged EPE profile and an unhedged EPE profile. Once each of these has been simulated, the corresponding Effective EPE profiles can then be immediately derived. The decomposition will depend on how effectively the exposure of the underlying OTC derivative transaction (or netting set) is replicated by the exposure of the referenced OTC derivative. As explained above, when the underlying derivative and the referenced derivative have identical terms and conditions, there will be no unhedged residual exposure. In other cases, there may be an unhedged residual exposure, which would give rise to the unhedged EPE profile over time.

ii. No Cross-Default / Cross-Acceleration Requirement.

The cross-default/cross-acceleration requirement should not apply if the hedged exposure is an OTC derivative contract, or multiple OTC derivative contracts subject to a qualifying master netting agreement. Although some parts of the debt market (e.g., leveraged loans) have incorporated obligations from OTC derivative contracts in the cross-default/cross-acceleration clauses in the loan/bond documents, that practice is not prevalent in other parts of the market and there are a large number of loan/bond documents that do not include obligations from OTC derivative contracts in their cross-default/cross-acceleration clauses. In addition, unlike failure to pay on borrowed money such as a loan or a bond, failure to pay on an OTC derivative contract would not trigger a credit event with respect to the reference credit – another detail that indicates this requirement may not be suitable in the context of CCR.

Consequently, we suggest that clause (2)(ii) in Section 33(b) (“Rules of recognition”) on page 55933 be revised to read as follows:

> “(ii) (A) The reference exposure and the hedged exposure share the same obligor (that is, the same legal entity), and
> (B) except where the hedged exposure is an OTC derivative contract, or multiple OTC derivative contracts subject to a

qualifying master netting agreement, legally enforceable cross-default or cross-acceleration clauses are in place."

iii. No Restructuring Requirement.

A bank seeking to recognize an eligible credit derivative that does not include a restructuring as a credit event should not have to reduce its recognition of this instrument by 40% if the hedged exposure is an OTC derivative contract, or multiple OTC derivative contracts subject to a qualifying master netting agreement. The current rule basically encapsulates the idea that to the extent the hedged exposure (e.g., a term loan) is different from the reference exposure (e.g., a bond issued by the same issuer), the term loan is still considered fully hedged if, among other things, legally enforceable cross-default/cross-acceleration clauses are in place in the documents governing both the term loan and the bond. However, for reasons noted in the prior paragraph, a cross-default/cross-acceleration requirement is not appropriate if the hedged exposure is an OTC derivative contract, or multiple OTC derivative contracts subject to a qualifying master netting agreement. In addition, unlike a restructuring of a term loan, a restructuring of an OTC derivative contract would not trigger, all other things being equal, a credit event with respect to the reference credit – a detail that already renders restructuring as a credit event in an eligible credit derivative ineffective in terms of capturing a restructuring of an OTC derivative contract.

Consequently, we suggest that the phrase "Except where the hedged exposure is an OTC derivative contract, or multiple OTC derivative contracts subject to a qualifying master netting agreement," be inserted at the beginning of the preamble of Section 33(e) (Credit derivative without restructuring as a credit event) on page 55933.

C. SPECIFIC TECHNICAL ISSUES – OPERATIONAL RISK

The Associations note that the NPR proposals for operational risk include a number of specific technical provisions that depart from what is established by the international framework. The Associations strongly recommend that the Agencies revise these proposals and align them with those established by the BCBS.

The proposals that diverge from the international framework are the following:

1. Regulators' Ability to Change Banks' Parameters.

Paragraph (2) in Section 1(c) of the NPR establishes the ability for regulators to mandate changes in the parameters that were determined by firms when developing their internal models.[53] We find this provision troublesome given that it will result in regulators overriding banks' judgments in what should be purely internal models. Replacing management judgment for that of the regulator not only undermines the use test but fundamentally alters the philosophy of Basel II advanced approaches. In our view, regulators should ensure the overall adequacy of the models and their compliance with the requirements set out in the rules, but not "micro manage" the models by altering their technical components. While regulators should clearly be able to address potential capital deficiency issues at supervised banks, these issues are better addressed through Pillar 2 mechanisms that do not affect the integrity of banks' internal models.

2. Operational Loss.

The Associations recommend that, following the international framework, operational loss remain defined with flexibility in the US Basel II rules. Therefore, the Agencies' request for additional input from the industry in order to revise the definition of operational loss is unnecessary and potentially disruptive. Prescribing a particular definition would not only introduce unnecessary rigidity but would result in another divergence from the international framework.

3. Observation Period for Operational-Risk Data.

The NPR includes a proposal that would require banks' operational-risk data and assessment systems to include a minimum historical observation period of five years of internal operational losses.[54] We find this proposal not only inconsistent with the international framework (which initially requires three years of historical data) but also excessively stringent, in particular in light of the necessary flexibility that initial implementation of an AMA model requires.

4. Offsets for Expected Operational Loss.

The NPR seems to be establishing a revised framework for expected operational loss (EOL) that would go beyond what is established by the international framework. In effect, this framework not only puts into question the ability of budgeted funds to offset EOL but also limits recognition of EOL offsets to business lines and event types with highly predictable, routine losses. This limitation would unduly restrict offsetting budgeted funds that are commonly available to universal banks with sophisticated risk-management processes where predictable losses could encompass many other business lines and event types and not only securities processing and credit card fraud. We therefore recommend that in line with the international framework no prescriptiveness be introduced regarding budgeted funds as offsets to EOL.

[53] NPR, 55912.
[54] Ibid., 55852.

5. Operational-Risk Mitigants Other than Insurance.

The NPR seems to establish requirements for operational-risk mitigants other than insurance that are superequivalent to what is prescribed by the international framework. In effect, the requirement to evaluate whether a particular operational-risk mitigant covers potential operational losses in a manner equivalent to holding regulatory capital goes contrary to the international framework which does not establish any such limitation on the use of operational-risk mitigants.

6. Board of Directors' Responsibilities Regarding AMA Models.

The NPR establishes prescriptive AMA-related reporting requirements and responsibilities for banks' boards of directors that go beyond those established by the international framework. These requirements not only cover in detail what type of risk reporting boards should receive, but also mandate involvement with AMA systems that is normally only expected from expert risk managers.[55] These requirements, if interpreted strictly, would impose excessive and unrealistic involvement of senior management with the technical aspects of the AMA models. We therefore recommend that the NPR follow the international framework by requiring only adequate oversight and the establishment of effective risk-management policies and procedures by senior management.

[55] For example, see the discussion on pages 55853-55854 and 55948 of the NPR.