



Association for Financial
Markets in Europe

St Michael's House
1 George Yard
London EC3V 9DH
Telephone: 44 (0)20 7743 9300
Email: info@afme.eu
Website: www.afme.eu



The voice of banking
& financial services

British Bankers' Association
Pinners Hall 105-108 Old Broad
Street London
EC2N1EX
T +44(0)20 7216 8800
F +44(0)20 7216 8811
Email info@bba.org.uk
Web www.bba.org.uk



International Swaps and
Derivatives Association, Inc.

One Bishops Square
London, E1 6AD
Telephone: 44 (0)20 3088 3550
Facsimile: 44 (0)20 3088 3555
website: www.isda.org

Dr. David Jones
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland
by email: djones@frb.gov

31 March 2010

Ref.: consultation document: proposed stress tests for the correlation trading portfolio (TBG/10/05 from 15th March 2010)

The International Swaps and Derivatives Association (ISDA), the Association of Financial Market in Europe (AFME) and the British Bankers Association (BBA) are pleased to provide initial analysis and feedback to the Basel Committee on Banking Supervision's (BCBS) consultation document 'TBG/10/05 from 15th March 2010' - with restricted circulation.

The July 2009 revision to the Basel II market risk framework requires banks to meet certain conditions to calculate specific capital risk charges for the correlation trading portfolio using a the Comprehensive Risks Measure (CRM).

One of these conditions is that banks using the CRM approach must conduct, at least weekly, a set of predetermined stress-tests for the "correlation trading portfolio" resulting from shocks to market parameters related to credit: recovery rates (RR), credit spreads (or default rates), credit correlations, etc.

In the referenced consultation document, the Trading Book Group (TBG) of the Basel Committee on Banking Supervision proposed a set of tests for the correlation trading portfolio. The consultation document requires certain historical 'large credit related shocks' to estimate the mark-to-market (MTM) changes that would be experienced by the correlation trading portfolio.

In this letter, ISDA, BBA and AFME provide initial analysis and feedback on the consultation document, which complement the discussions held in a conference call between the TBG officials and financial institutions practitioners on the 24th March 2010.

First we include some key messages and then we structure our initial comments into three categories: (i) general issues, (ii) stress scenarios and (iii) general guidelines, which correspond to the way the consultation document is framed.

Key messages:

- After reading of the consultation document, banks require a confirmation from the TBG that only market parameters will be shocked.
- Banks remark that recovery rates are not generally observable in the market: they have no history
- The consultation document proposes perhaps more than 30 different stress tests but the industry expects that only a few would be used and anticipates that these will be agreed between the banks and their supervisors / regulators.
- The industry also requires further clarity on how to shock 'individual spreads' with some index based on the current rating of each individual name.
- The period (1 month / 3 months) should be the same for the whole industry and agreed with the regulator.
- Shocks and correlations should be further clarified.

1. General Issues:

a) Banks would require a confirmation, that the "credit risk factors" at stake are all market parameters (such as the ones mentioned: spreads, recoveries, credit correlations, etc.) and that they exclude the factors driving migrations (transition matrices, etc.). Although this seems obvious, a confirmation would be required to avoid uncertainty. The industry also has important remarks:

- Typically, the market parameters shocked will be spreads, recovery rates and credit correlations. However, this will depend on the framework chosen by each institution – e.g. some banks will store default rates instead credit spreads, index tranche prices rather than base correlations, etc.
- In contrast to actual recoveries from defaults, recovery rates for non-defaulted credits are generally not observable in the market. The market for recovery locks mostly trades for distressed credits and is still at a relatively early stage of its development in terms of depth and liquidity. Dealers generally make their own best judgements on appropriate recovery rates for CDS and CDO pricing, these tend to be sticky unless there is strong market evidence for adjustment. It seems evident that the behaviour of implied recovery rates differs substantially between distressed and non-distressed credits. We believe the appropriate methodology for stressing recovery rates in a stress framework needs more discussion.

b) Banks questioned how would these stress tests be used in practice? The 1-month tests are identical to the 3-month tests, except by the magnitude. This would imply that only a fraction of these tests will be used in practice, once the regulator identifies which ones are relevant, and which ones were not.

- The regulator would first require to consider the consultation document stress tests 3.(a) and 3.(b), with 6-months intervals.
- These stresses will essentially be used to assess the size of a correlation book in a normalized fashion. Regulators would be then able to compare the stability of ratios CRM / Stress Tests: (i) across banks, (ii) along time, etc.

c) In general, firms' exposure to the iTraxx Asia will be much smaller than to CDX.NA or iTraxx Europe. Therefore, it is possible to suggest that the guidelines could be simplified by specifying only two regions, without materially affecting the results.

It is important to remark that there is not an established market for tranches of iTraxx Asia, and therefore the industry is asking for an exclusion of iTraxx Asia from the list of indices to be considered.

d) The consultation document seems to ignore the ability to delta rebalance a stress within the stress interval - currently 1 month and 3 months - but potentially 6 months or longer. During the conference call, the TBG officials highlighted that stress tests are considered on a period **without** hedge rebalancing (just like a liquidity horizon).

However, the key point remains regarding active risk management: should not the stress testing framework allow for **rebalancing / hedging**? We believe that due to the liquidity of hedging instruments, active risk management is possible and therefore stress testing framework should allow for position **rebalancing and hedging**.

e) It is also important to remark that defaults have not been considered but they can be approximated by spread movements.

f) The consultation document general guideline 4.(c) requires to apply on the current spread (or current default rate) the move that would have been observed on the spread of a similar name and with a rating equal to the **current** rating. One solution would be to consider the average spread for issuers with a given rating (and same geography? and same sector?).

- For example, if a US firm is BBB today (but was AAA during the interval considered), it could be applied the relative shock of the average BBB spread during the interval considered. However, doing so we lose the idiosyncrasy of the name.
- In any case, the industry in general prefers to avoid the use either external or internal ratings mappings (mainly because of the lag and mismatch between ratings and market spreads). Banks would prefer to use a spread-related mapping (which is what the industry intends to do for the CRM). In other words, banks should be allowed to use their internal scoring methodologies to assess the riskiness.
- For consistency across banks a simple standardised approach might be appropriate.

g) It is also necessary to remark that the industry is seeking a clarification on the relevance of the ratings before using them into the stress tests. Entities would rather use a more general approach and apply shocks by e.g. spread level, sector and/ or other classification, rather than using ratings. The key issue being that firms are allowed to use their own **internal scoring methodology** to assess the riskiness and should make sure that the shocks applied to the credit risk factors address the current riskiness of the names.

2. Stress scenarios:

a) In scenario 3 (g), if other stress tests are to be defined by the regulator, it might be impossible to implement them on time, if they differ (in nature) from the stress tests 3.(a) to 3.(b)

In some occasions the banks understand that they could be considered by the regulator in special circumstances difficult to foresee. In any case, the industry really understands that they cannot be very different from the current list of stress tests.

b) Banks also remarked, that stress tests 3.(e) and 3.(f) do not appear relevant to the industry because they switch to absolute market levels - regardless of the spot market.

- 3.(e) and 3.(f) are **absolute** shocks on the credit-related market parameters: switch to their value on some past date corresponding to an historical high/low → no operational issue.
- Instead, 3.(a) to 3.(d) are **relative** shocks applied on the credit-related market parameters – this is fine for spreads, but might easily lead to arbitrage for credit correlations. Instead of looking at relative correlation shocks, one might consider shock on the distance to the extreme correlations (0% and 100%). An alternative would be to work directly on tranche spreads (or tranche expected losses) rather than correlations, but it would be operationally heavy for those banks which store correlations (and intend to shock them directly), as the shocked tranches will have to be converted into a shocked correlation smile.
- More generally, at a time when entities are heavily involved in modelling CRM it seems a waste of resources for each of them individually to do the historical analysis (and any adjustments to prevent arbitrage etc.), when theoretically they should all come up with the same stresses as far as the correlation structure is concerned. Indeed a variety of approaches will lead to different standards across entities. Even if similar stresses are to be included in routine capital calculations in the future, there is still an argument for having the dates and correlation stresses computed centrally.
- Another approach, which was supported by some entities, would be to compare the current portfolio value with the portfolio value as at the given dates, as in stress tests 3.(e) and 3.(f) of the consultation document.

c) Applying stresses based on moving inputs to the level seen on a given date -- as appears to be implied by section 3.(e) and 3.(f) of the consultation document-- is likely to create a number of practical problems:

- Banks' correlation trading models may have been heavily revised in recent years, so that it is difficult to acquire consistent model inputs using data from several years ago. It may be possible to apply some sort of transformation to generate this data, but this would require a high degree of judgment, reducing the comparability of results across the industry.
- What should be done for market inputs which did not exist as of the required date?
- Should shocks be applied on a name-by-name basis? If so, does it really make sense to set (for example) the spread on monoline insurers to a few bps, as was the case pre-2007. If not, one could bucket exposures by rating, asset class etc. But it also seems strange to assume that all issuers in a given bucket would jump immediately to have the exact same credit spread level.

For these reasons, the Industry would prefer to apply stresses based on market factor moves, as implied by 3 (a) – 3(d) as it has been addressed above.

3. General Guidelines:

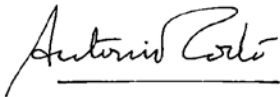
a) Based on the fourth bullet point of paragraph 4.(e) of the consultation paper, the firms understand that it is required to apply ‘relative shocks’ to credit spreads (e.g. “increase spreads by 40%” means spreads go from 100bp to 140bp) and ‘absolute shocks’ to other risk factors, such as recoveries and implied correlations (e.g. “increase implied correlation by 20 points” means implied correlations go from 35% to 55%).

- If so, we would need to floor the absolute shocks to avoid seeing recoveries or correlations outside of [0%, 100%].

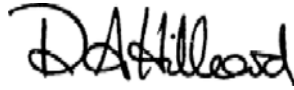
In conclusion, the key guiding principles for CRM Stress Tests should be that they result in realistic scenarios and assumptions about market movements, which will add value in both regulatory oversight as well in internal decision making and control for the participating banks (aid senior management, risk and business lines to control and assess the correlation business of the bank). For this to be achieved the CRM Stress Tests will need to consider actual market experience and reflect realistic assumptions regarding the key market variables discussed above. This is particularly important with regards to issues such as default scenarios, observed recovery rate behaviour and liquidity of hedging instruments.

We hope that you will find our comments useful. Should you have any questions or would like clarification on any of the matters raised in this letter please do not hesitate to contact the undersigned.

Yours faithfully,



Antonio Corbi
ISDA



Diane Hilleard
AFME



Irving Henry
BBA, Prudential Capital and
Risk