

**ISDA®**

International Swaps and Derivatives  
Association, Inc.  
One Bishops Square  
London E1 6AO  
Tel: 44 (0) 20 3088 3550  
Fax: 44 (0) 20 3088 3555  
Email: [isdaeuropa@isda.org](mailto:isdaeuropa@isda.org)  
Website: [www.isda.org](http://www.isda.org)

**IIF**

Institute of International Finance, Inc.  
1333 H Street, N.W., Suite 800E  
Washington, DC 20005-4770  
Tel: (202) 857-3312  
Fax: (202) 463-0993  
Email: [aportilla@iif.com](mailto:aportilla@iif.com)  
Website: [www.iif.com](http://www.iif.com)

**LIBA**

London Investment  
Banking Association  
6 Frederick's Place  
London, EC2R 8BT  
Tel: 44 (0) 20 7796 3606  
Fax: 44 (0) 20 7796 4345  
Email: [liba@liba.org.uk](mailto:liba@liba.org.uk)  
Website: [www.liba.org.uk](http://www.liba.org.uk)

**ibfed** International  
Banking Federation

Pinners Hall  
105-108 Old Broad Street  
London EC2N1EX  
United Kingdom

Basel Committee on Banking Supervision  
Bank for International Settlements  
Centralbahnplatz 2  
CH-4002 Basel  
Switzerland  
e-mail to [baselcommittee@bis.org](mailto:baselcommittee@bis.org).

Friday, 24th October 2008

Re: **"Proposed revisions to the Basel II market risk framework"** and  
**"Guidelines for Computing Capital for Incremental Risk in the Trading  
Book"**

The International Swaps and Derivatives Association (ISDA), the Institute of International Finance (IIF), the London Investment Banking Association (LIBA), and the International Banking Federation (IBFed), are pleased to have this opportunity to comment on the Basel Committee on Banking Supervision's Consultative Documents entitled "Proposed revisions to the Basel II market risk framework" and "Guidelines for Computing Capital for Incremental Risk in the Trading Book".

In responding to the consultation papers we have set out our core concerns in our letter which prefaces the appendix where we present our more detailed comments and answers to the questions from the papers.

The recent market turmoil has been a catalyst for much regulatory soul-searching, and it is clear that the events in the market place have been a significant driver of many of the changes put forward in these consultation papers. While this is going on, it is important to recognise that our member firms have also gone through extensive internal reviews, with many risk departments, risk management procedures, and risk modelling processes subjected to wide scale investigation. In many institutions extensive change in risk management practices has already been effected, often with new leadership at the helm. We hope that many of these developments will result in a stronger more prevalent risk culture across the financial services industry.

While we understand the desire on the part of regulators to raise additional regulatory capital against exposures in the trading book, we continue to believe that any double counting be avoided so that these risks are only captured in regulatory capital calculations once. Equally important, the resulting minimum regulatory capital requirement should be commensurate with the risks identified at each individual firm.

The first paper proposes changes to the Market Risk framework following the decision to capture not only defaults but a wider range of incremental risks in the incremental risk capital charge (“IRC”). Many of the changes proposed reflect improvements to the VaR framework already embraced by our member firms, and therefore we welcome the changes and support their inclusion within the Basel 2 framework. Specific examples of improvements underway include the capturing of non-linearities beyond those inherent in options, as well as the incorporation of more correlation and basis risks.

The second paper identifies perceived shortcomings in the current 99% 10 day VaR framework, and proposes a new trading book capital charge covering risks incremental to the market risk charge, the “IRC”. We agree with many of the weaknesses identified, and once again industry has already looked to strengthen their risk management processes to better capture the risks of the trading book in many of the areas identified. We also agree with the Basel Committee that the proposed IRC goes well beyond the current state of risk modelling at most banks, and we would like to highlight this fact in our key messages.

## **Key Messages**

### *Market Risk amendments*

We agree with the proposed changes to the market risk framework. We understand and support the additional clarity the amendments to the market risk framework provide (BCBS 140). Many of the improvements being put forward have already been implemented by our member firms. In particular, we welcome the fact that there is no requirement in the Basel Committee paper to bifurcate the trading book, as previously proposed under the US NPR. This would be both difficult to implement and costly to maintain.

It is important to note that the contribution of the current market risk capital charge based on 3 times 10-day, 99% confidence level VaR to the total capital charge will significantly drop (perhaps to less than a third) as a result of introducing the IRC. This will almost undoubtedly result in weakening the importance of the short horizon VaR risk measures for regulatory capital purposes. This seems to be a concern raised in the second paper (BCBS 141) but we continue to believe VaR will play an important role in both internal and external risk measurement and management, and that we should not be too concerned about its on going status relative to the IRC.

In the detailed content of the response attached to this letter below, we highlight our only concern with regards to these amendments and this relates to the section on illiquid positions, where guidance on prudent valuations attempts to align more closely with existing accounting guidance.

### *IRC framework*

We believe that there are significant weaknesses in the Incremental Risk Charge ("IRC") framework currently being proposed, and that until these are addressed an

alternative more plausible approach, both simpler and cheaper to implement, should be considered and made available to those firms who wish to adopt it.

There are several basic issues with the IRC framework as currently proposed. Firstly the definitions of the more material incremental risks to be covered are mere generalisations of the risks covered in the current market risk framework. This would result in both credit spread risk and equity price risks being counted twice for regulatory capital purposes. The double counting of risks would undermine how useful any IRC model can be for the business, and would almost certainly fail the Basel II "use test". Secondly, simulating either market spread risk or market equity risk for a full year completely ignores the liquidity of basic equity and credit index products. As a result, the capital charge for the trading book assets subject to IRC will not be comparable to banking book assets under Basel II. It is possible the charge will be much higher, with more capital set aside for trading assets that can be liquidated more easily than for assets with an otherwise similar risk profile held to maturity. This could discourage firms from holding risks in a mark-to-market environment, with the appropriate level of controls and where the prudent valuation framework would apply.

Thirdly, the constant level of risk assumption that was considered appropriate for the incremental default risk charge, is a more challenging proposition when considering the broader scope and wider risks to be captured under the incremental risk charge. Under the usual assumption of uncorrelated returns over non-overlapping time periods, a shorter liquidity horizon only delivers minor (if any) capital reductions. The universal application of a 1-year capital horizon and constant level of risk assumption ignores the principal difference in risk management between liquid positions and illiquid positions. For liquid positions, risk mitigation measures such as substantially reducing your position and/or adopting more stringent hedging strategies are often initiated at the onset of a market shock. For illiquid positions, these kinds of risk mitigating measures are often not possible or cost-effective. For this reason, the IRC definition of a 1-year capital horizon with a constant level of risk assumption is unrealistic, especially for equities, and somewhat extreme for liquid products in particular. If, as expected, the IRC turns out to be a big component of the total regulatory capital charge, an artificially high IRC will prevent convergence between regulatory capital and internal capital allocation, which is in itself a goal of the Basel II framework.

We believe these basic flaws in the proposed IRC framework, when considered alongside an overly ambitious implementation timeframe, make it imperative that an alternative fallback approach, generating the desired amount of additional regulatory capital, should be offered to the industry. Currently the framework includes two "fallback" positions for firms unable to calculate the IRC through internal modelling: (i) the specific risk capital charges under the standardised method (p718(XCiii) of BCBS140) and (ii) a charge based on F-IRB or A-IRB banking book comparable charges, with conditions, but this is only available for one year. The first option would be a step back for many firms who already have aspects of their specific risk modelling approved, and the second option could involve a significant amount of work for just 12 months regulatory recognition, without providing a firm with the suitable IRC platform to build on. The timeframe set out in the paper leaves no time for an effective quantitative impact study (QIS), following which a further review of the proposed framework would be necessary. Before such a necessary step can be

taken, the technical uncertainties need to be addressed, the models need to be designed and tested, and an alternative validation framework to back testing would need to be devised. We ask you to consider making an alternative fallback approach available, consistent with the objectives and principles of the IRC, but more accessible to more firms in the immediate future.

Developing, implementing, validating, and having regulatory approval for a fully compliant IRC model by 2011 is, for the majority of our member firms, an extremely challenging proposition. Instead we suggest a revised implementation schedule of 1 Jan 2010 for default risks on non-structured products, and 1 Jan 2011 for default risk on structured products, and then 1 Jan 2012 for the other IRC risks.

The very high degree of model error in estimating trading losses at the 99.9% 1-year percentile level has been recognised by many firms, and has led to a search for a more tractable alternative approach to computing incremental risk-based trading book capital.

We consider that appropriate methodologies to calculating the IRC should share the following key features: firstly the need to arrive at a higher regulatory capital number for the trading book; secondly, avoid creating perverse incentives and therefore encourage the right kind of behaviour; thirdly, to ensure an element of looking through to the relevant risk factors and; fourth, and finally, to avoid the double counting of risks, and in doing so building a risk process that can be of use for internal purposes (passes the "use test").

There are two areas of current risk management practice and thinking worth considering further for possible inclusion in the IRC framework.

#### *1. VaR plus some form of scaling factor(s)*

For those firms unable to develop, implement, and validate models to compute the IRC, we recommend for further consideration a "fallback" position based on a general market risk charge and a specific risk charge (both measured using a 10-day VaR at 99%, subjected to "x3" multiplier) scaled up. This could include a charge for migration risks (subject to scaling up), or if not a separate default / migration risk charge (1 yr capital horizon, at 99.9%) could be applied. Such an approach could be simpler and easier to implement, yielding a similar capital result, and not subject to the same weaknesses we identify with the proposed IRC framework. However, because of a lack of a strict mathematical and conceptual definition, it is not possible to compare the capital impact of the IRC as defined against such an approach on a consistent basis - over time and on different exposure types. That is to say, as we do not know what the results of full IRC modelling will look like, calibrating an appropriate scaling factor to yield a similar result is not currently possible. However, we believe there is still some merit in considering further developing this as a more useful fallback approach.

Such an approach has the advantage of building on the progress some firms and regulators have already made on modelling default risks. In considering this approach, we would anticipate the scaling factor being applied to the newly improved VaR framework (BCBS140). This includes all factors that are deemed relevant for pricing,

nonlinearities beyond those inherent in options (e.g. mortgage-backed securities, tranching exposures or n-th loss positions), as well as correlation risk and basis risk (e.g. between credit default swaps and bonds). We argue that allowing some firms to fall back on an approach based on a scaled-up VaR number could effectively achieve similar results to those provided by a full IRC model. The main reason for this would be that many of the drivers of an IRC model are likely to be short term inputs scaled up. This approach would also leave market risk VaR intact for internal and reporting purposes, and would not therefore present a problem vis a vis the "use test". Firms seeking to embrace more fully an integrated modelling approach would be free to do so.

As with many scaling factors, the number is arbitrary, but would achieve the dual aims of raising additional capital and charging relatively more capital for illiquid asset classes, such as structured credit. The scaling should generate a capital number that provides firms with an incentive to implement a full IRC model, but should not result in a disproportional capital charge for those not in a position or willing to implement a full IRC model. A multiplier/s would need to be specified in advance, and different multipliers could be applied to different aspects of the trading book, perhaps determined by the liquidity of the position (this would avoid punishing very liquid positions). Scaled up VaR is a practical alternative approach to achieving the aims of raising additional regulatory capital, and charging realistic overall levels of capital for trading book activity, without the profound conceptual and implementation difficulties of the full proposals as currently written. Scaled up VaR belongs with a range of pragmatic approaches for calculating IRC while avoiding the difficulties of the current proposal. It builds usefully on firms' existing VaR infrastructures, and the IDR calculators already being developed, and could be an efficient approach to the new calculation. Indeed, in many cases firms' have implemented VaR calculations which already use most of the available market data, and after supplementing that data with forward looking adjustments where appropriate, it makes sense for firms to look to leverage those calculations for the IRC charge. Potential approaches building on the VaR technologies in use at many firms include modified historical simulation approaches with long time series, and the use of reval grid technology (suitably extended to cope with the larger market moves seen over the longer IRC horizon).

Evidence that these approaches can be viably applied comes from the fact that firms in many cases use their VaR infrastructure and calculation techniques for Economic Capital calculations, which are typically performed to a one year time horizon. Through pragmatic use of data and calculation methodologies, it is therefore feasible to adapt VaR techniques to an IDR setting. Previously developed IDR calculators or non-VAR based Economic Capital calculators (possibly based on similar principles to IDR calculators) could also be adapted for IRC, perhaps in conjunction with VAR. Hence, leveraging existing VaR and / or Economic Capital approaches could be a valuable route to implementation of the IRC regime for many banks, and we believe this should be considered for inclusion in the final framework.

## *2. VaR, stress testing, and scenario analysis*

A further approach worth considering as an appropriate methodology for calculating the IRC is partly based on systemic stress tests, and would see firms apply extreme scenarios to their trading book portfolios. This approach could be one of the few ways

in which banks and regulators ensure that statistical models do not miss some tail risk. In order to promote a consistent approach, the focus could be on having only a few, or perhaps even just one, stress scenario which is designed to simulate a systemic financial crisis of the kind supervisors are most concerned about. This scenario would focus on assets which suffer in a “flight to quality” scenario associated with financial crises; for example equities, corporate debt, consumer debt, emerging market government Eurobonds and FX rates, and derivatives which reference such assets. Under this approach output under a stress scenario should become a key output of firms’ pricing models, requiring monitoring and benchmarking by supervisors. This way firms and supervisors can build confidence in the results of their scenario analysis and stress testing.

We suggest that the scenario(s) could be confined to those that would pose major systemic risks to the banking system (e.g., an asset price collapse). The exact magnitude of the stresses would need to be worked on together by firms and supervisors, but could be based on historical economic crises such as occurred in Japan in the late 1990s, 1998 in east Asia and 2008 in the US and western Europe, or more forward looking scenarios to be devised.

We note that using stress testing based on judgemental extreme scenarios to set capital requirements creates a number of conceptual and technical challenges for firms and regulators. In considering this alternative supervisors would need to work closely together in designing scenarios, and in monitoring their application by firms. It would be important to ensure that losses on all non linear or complex products (e.g. securitisations), are calculated using “full revaluation” given you have stressed the underlying exposures. We note that it may be beyond the current capability of many firms to perform such a revaluation on securitisations of consumer debt, but that such an approach is nevertheless essential to gain an accurate assessment of stress losses.

Whereas it is clear that stress tests are useful indicators for risk management (and mandatory for internal models), a range of views exist about the effectiveness of stress testing approaches in calculating capital requirements.

#### *Other key messages*

*Structured products* - The draft guidelines require banks to have in place a model for “credit default and migration risks for positions subject to credit risk” by 1 January 2010. It should be feasible for most large banks to implement such a model by that date for their corporate credit portfolios, where the concepts of default and migration risk are relatively well understood and where banks have been working on IDR models for some time. Firms are much less likely to be in a position to implement a model for default and migration risks on structured products by that date, as the behaviour of such assets over the economic cycle is less well understood. Moreover, recent market events have demonstrated that a default-migration-spread risk framework may not be the most appropriate for structured products. Prescribing a model incorporating "migration risk" would force banks to use credit ratings to model the risk on structured finance products. It is unlikely that such an approach would have captured the trading losses of 2007 and 2008, and firms may prefer to model the risk of such assets on a price basis. Firms should have the flexibility to model such assets as they think is appropriate (e.g. on a price risk basis, as for other derivatives),

rather than be explicitly or implicitly required to adopt a default-migration-spread approach.

*The interim treatment for re-securitisations* - the interim treatment for re-securitisations based on the current banking book charge, which we know is under review, will require firms to implement successive changes to the regulatory treatment for these types of products. This is not a desirable outcome and, in promoting further uncertainty about the treatment of re-securitisations, could delay market recovery further. Furthermore we do not believe there will be enough time to adapt the securitisation banking book approach to specific securitisation trading book positions. There are different processes and risk management principles for trading book and banking book positions that need to be considered, making any short-term adjustment particularly challenging. With many of the details yet to be decided, we suggest that the switch of the respective regulations at the beginning of 2009 be re-considered. Besides these fundamental time constraints as well as technical concerns the significant effort to implement an interim solution is, from our point of view, not justifiable. Rather than implementing such a short-term solution banks should be allowed to focus on the enhancement of the IRC for these positions. Furthermore we encourage the Basel Committee to await the upcoming results of its ongoing investigations on risk weightings for securitisation positions. We believe that in order to fully assess the quality of the proposals with regards to re-securitisations a complete picture on all of the proposed changes is needed, instead of merely discussing single pieces of the framework.

*A one year capital horizon* - as we have argued in the past, we do not think that the reference to the existing Basel II framework justifies the choice of a one year capital horizon and 99.9% confidence level. We raised concerns around the regulators' choice in capital horizon in previous submissions, including most recently in February 2008 in our response to the default risk framework (Industry response to BCBS Consultative document "Guidelines for Computing Capital for Incremental Default Risk in the Trading Book", Friday 15th February). In this response we explained why we felt that although the rule is said to be comparable with standards set for the IRB charge for credit risk, we believe it sets a far higher standard (99.9%, 1 year, no diversification) than for market risk (99%, 10 days, diversification, 3 multiplier).

*New liquidity horizon requirements* - one of our key concerns relates to the prescriptive nature of the new liquidity horizon provisions, and floors proposed for various transaction types (paragraph 25) which do not take into consideration the maturity of the transactions in question. At the very least, for trades whose remaining maturity is shorter than the specified minimum liquidity horizon floor, it is appropriate to consider the trades' remaining maturity as being the most relevant measure of liquidity horizon: the exposures from such trades will close down at maturity, and management can decide whether to re-open such exposures at this time. More generally, the horizon should be linked to the liquidity under stress conditions of the position being examined: as recent events have shown, one year can be either far too long or even too short, depending on the instrument. The additional capital that would result from the minimum liquidity horizon floors could be fairly significant, given the relatively long 3-month period specified for 'other IRC covered positions'. Imposing floors on broadly defined asset classes may severely distort the proper reflection of different markets (e.g. related to highly liquid equity indices or less

liquid single stocks). Inappropriate liquidity horizons may also lead to a misrepresentation of hedges (e.g. hedges with shorter maturities than the imposed liquidity horizon) and consequently lead to a capital charge not commensurate with the true risks of the positions. We believe the maturity of the instrument should be considered as a factor in determining the appropriate liquidity bucket.

*Validation* - It is unclear how the validation of the IRC model for the one year horizon at the extreme level of 99.9% should be performed. Defining a validation framework for a regulatory capital calculation still to be finalised and for models the industry has yet to build and implement is an almost impossible task. We think the guidelines should not include any detailed provisions on validating the IRC at this stage.

We hope the Committee will agree that maintaining an open dialogue on these issues will be essential as understanding and modelling techniques develop. We would be happy to discuss any of these comments further and or hear your views on our response, and to arrange this please contact either Ed Duncan at ISDA, Andrés Portilla at the IIF or Katharine Seal at LIBA,

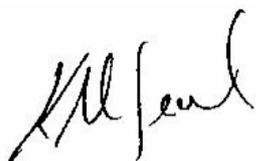
Yours sincerely,



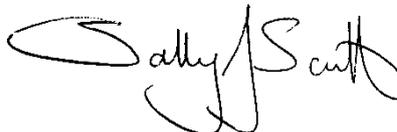
Ed Duncan  
Head of Risk and Reporting  
(ISDA)



Andres Portilla  
Director, Regulatory Affairs  
(IIF)



Katharine Seal  
Director  
(LIBA)



Sally Scutt,  
Secretary General,  
(IbFed)

## Appendix

### **“Proposed revisions to the Basel II market risk framework” (BCBS 140)**

We understand and support the additional clarity the amendments to the market risk framework provide (BCBS 140). Many of the improvements being put forward have already been implemented by our member firms.

In the section on illiquid positions, where guidance on prudent valuations is included, the Basel committee proposes to include a requirement to use actual prices or observable inputs, even when market volumes are down. Banks are expected to adjust valuations used for financial reporting (regardless of where they are in the FV hierarchy) to reflect the lack of liquidity of certain positions (including in times of stress) for market risk capital calculations. This must be reflected in Tier 1 regulatory capital.

Regulators must be aware that in proposing changes to the “prudent valuation framework”, that they are potentially widening further the gap between financial reporting based on accounting standards (such as those produced by the International Accounting Standards Board IASB) and reporting for regulatory capital purposes. The market risk charge, with the 99% confidence interval and 10 day liquidity horizon is based on model inputs, such as volatilities, which already do reflect liquidity aspects to a certain extent.

The IAS 39 accounting standards require a prudent valuation of trading book positions using mark-to-market or mark-to-model techniques. Based on a going concern assumption and an end of day portfolio, prudent valuation will in general not reflect the impact of potential trading volumes under periods of market stress or assuming certain market concentrations and will not account for the aging of positions. Therefore the requirements for valuation adjustments to less liquid positions would drive a significant wedge between the valuation for balance sheet accounting and for market risk calculation. This would unduly increase the complexity of reporting and monitoring processes and complicate communication of evaluation results to internal and external parties. Rather than dividing the processes for accounting and market risk measurement even more we would welcome a convergence of both systems.

Valuations clearly play a critical part in reporting both for accounting and capital purposes, and we strongly advise against further divergence between the two frameworks. We recommend Basel accept and recognise fair value measurement as a "prudent valuation" framework, without risking the introduction of elements which could be perceived as incompatible with IAS 39.

## **“Guidelines for Computing Capital for Incremental Risk in the Trading Book”**

### Question 1.

Under the proposal, the IRC would reflect all price risks except those directly attributable to movements in commodity prices, foreign exchange rates, or the term structure of default-free interest rates (“non-IRB market factors”).

(a) Would it be preferable for supervisors to list specific types of events that must be captured (eg defaults, migrations, and only certain types of movements in credit spreads and equity prices)? What should be the basis for determining which types of events would be included, and how could the Committee ensure that the framework was not largely backward looking?

(b) Would it be worthwhile to expand the scope and coverage of the IRC to capture price risks associated with commodity prices, foreign exchange rates and the term structure of default-free interest rates?

As we discussed in the cover letter to our response, we believe that there are significant weaknesses in the Incremental Risk Charge (“IRC”) framework currently being proposed, and that we recommend for further consideration a more plausible fallback approach for firms still grappling with these issues. This would be simpler and cheaper to implement. Firms more comfortable with the conceptual underpinnings of the proposed IRC would be free to develop and implement their own internal approach to yield the appropriate capital numbers.

Many firms believe these basic flaws in the proposed IRC framework, when considered alongside an overly ambitious implementation timeframe, make it imperative that an appropriate fallback approach, generating the desired amount of additional regulatory capital, should be offered to the industry. The timeframe set out in the paper leaves no time for an effective quantitative impact study (QIS), following which a further review of the proposed framework would be necessary. Before such a necessary step can be taken, the technical uncertainties need to be addressed, the models need to be designed and tested, and an alternative validation framework to back testing would need to be devised.

We believe the guidelines were intended to incorporate enough flexibility for firms to adopt a range of different modelling approaches. It is clear from our discussions that a number of firms are keen on pursuing very different approaches to the IRC and we therefore encourage consideration of yet more flexibility in the framework to accommodate the range of evolving practices. The guidelines could be improved by focussing more on the desired outcome, and less on the detailed path and methodology to get there. It is possible that these different developing areas of risk management could be stifled by prescriptive requirements cast in stone (we note a formal process of adoption by the EU Commission has already begun). Further flexibility would also allow for those firms wishing to expand the scope and coverage of the IRC to capture price risks associated with commodity prices, foreign exchange rates and the term structure of default-free interest rates. We therefore see no reason to arbitrarily limit the scope of the IRC to just equity and credit markets.

### Question 2

For covered IRC positions, Pillar 1 charges would depend in various ways on three types of risks: general market risks and specific risks, as defined under the current MRA, and IRC covered risks. Are the differences among these types of risks clear and measurable?

The new framework as proposed fails to clearly address the relationship between the market risk and incremental risk regulatory charges, with a resulting potential for huge overlap and double counting. Risks should only be captured once. We think that any double counting built into the framework as currently proposed will undermine the credibility of the model for users, and considerably weaken the models' conceptual basis. Allowing for adjustments to the models for double counting would be theoretically correct, but less desirable than not having the double counting in the framework in the first place.

Furthermore, we believe that there is still some uncertainty around the proposed scope of the IRC and that this should be clarified. As currently drafted, the IRC could be interpreted to include a very broad range of instruments. For example, the scope currently seems to include all option products, and most interest rate and FX derivative products, since it would be difficult to argue that swap rates are default-free interest rates. Clarity around which "default-free interest rate" risks (local currency government bond? foreign currency government bond? interest rate swap/ and cross currency swap?) are excluded from IRC would be considered helpful.

Question 3

While the capital horizons and confidence levels underlying the IRC and the 10-day VaR charge would differ, the risk factors captured by these risk measures would overlap to a significant degree. However, any adjustments to offset double-counting would complicate the framework and diminish the Pillar 1 importance of the 10-day VaR calculations including incentives to estimate the 10-day VaR as accurately as possible. Is it possible to provide double-counting adjustments that do not raise such concerns? How?

While the proposed guidelines embrace the concept of "total price risks", it is not clear which component of these risks should be captured by VaR and which should be included in the IRC. For any covered position, its market risk can be decomposed into three components: system risk, idiosyncratic variations and "event risk". To avoid double-counting, each of these components should be measured either by VaR or by the IRC. If a firm measures any of these components in both VaR and the IRC, it should be allowed to calculate and deduct an amount caused by double-counting.

Our main concern with double counting is that it is likely to result in over counting, i.e. charging too much regulatory capital given the risks identified. It is possible that the IRC could end up allocating more regulatory capital to a liquid trading book position than allocated to a similar position in the less liquid banking book. If the IRC can be compared to a banking book charge for a similar position and you then factor in adding a VaR charge for the same position, then this would clearly be the case. Double counting leading to over counting should therefore be avoided.

We believe that an alternative fallback approach making use of VaR-based techniques, would allow firms to better address any concerns about the possibility for double counting between VaR and IRC (for example, by using an IRC model based on VaR 99%/10 day parameters, or vice versa). In such cases, there is no legitimate argument to double count risks in VaR and IRC. Even if diversification is considered undesirable with the default component of IRC (because of concerns about estimating the joint behavior of credit and market risks), there is no reason not to allow it for the

rest of IRC. Firms should therefore be given the option of either using the multiplier and add on approach or using a unified model that captures general, specific and IRC risk drivers together and computes a total risk measure.

Question 4

The proposal stipulates that an IRC model incorporate a one-year capital horizon, a 99.9 percent confidence level, and a liquidity horizon appropriate for each trading position.

The Committee recognises that such an approach could present considerable practical challenges, including the need for data to calibrate key parameters.

(a) What alternative guidelines would achieve the Committee's objectives, but in a manner that would be less costly or difficult to implement?

(b) Given the current state of risk modelling, is it feasible to estimate the portfolio loss distribution (excluding non-IRC market factors) over a one-year capital horizon at a 99.9 percent confidence level?

(c) Would it be worthwhile to allow banks to use a single horizon for all covered positions (e.g. three months) and a lower confidence level (e.g. 99 percent), together with a supervisory scaling factor that was calibrated to achieve broad comparability with the IRB Framework for the banking book? Would such an approach be as useful for internal risk management purposes as the proposed IRC?

In the cover letter to this appendix we have outlined our preference for further consideration of alternative methodologies, both less costly and easier to implement. Such approaches should also provide more time for the regulatory community to consider a longer-term more integrated modeling approach, while providing the industry with a more realistically achievable objective. Firms seeking to embrace more fully an integrated modelling approach would be free to do so.

As stated in the key messages we do not think that the reference to the existing Basel II framework justifies the choice of a one year capital horizon and 99.9% confidence level. We raised concerns around the regulator's choice in capital horizon in previous submissions, including most recently in February 2008 in our response to the default risk framework (Industry response to BCBS Consultative document "Guidelines for Computing Capital for Incremental Default Risk in the Trading Book", Friday 15th February).

The new liquidity horizon provisions, and floors proposed for various transaction types (paragraph 25) do not take into consideration the maturity of the transactions in question. For trades whose remaining maturity is shorter than the specified minimum liquidity horizon floor, it is appropriate to consider the trades' remaining maturity as being the most relevant measure of liquidity horizon: the exposures from such trades will close down at maturity, and management can decide whether to re-open such exposures at this time. The additional capital that would result from the minimum liquidity horizon floors could be fairly significant, given the relatively long 3-month period specified for 'other IRC covered positions'. For most credit products, and for single name and index CDS, this would certainly be too long. Many of these types of instruments have remained liquid even over the last twelve months. We would consider even a one month floor as conservative. Imposing floors on broadly defined asset classes may impose severe distortions to a proper reflection of different markets (e.g. related to highly liquid equity indices or less liquid single stocks). Inappropriate liquidity horizons may also lead to a misrepresentation of hedges (e.g. hedges with

shorter maturities than the imposed liquidity horizon) and consequently lead to a capital charge not commensurate with the true risks of the positions. We believe the maturity of the instrument should be considered as a factor in determining the appropriate liquidity bucket.

We agree with the points that are made with regard to calibrating volatilities, and correlations, etc. but we are also concerned about the computational difficulty related to covering non-linear positions. The difficulty in accurately pricing derivatives in extreme stress scenarios adds to the difficulty of implementing a reliable model of market risk at 99.9% confidence and over 1 year.

*Concentration risks* (p30)- Given that at this stage the correlation dynamics under different market conditions are still not very well understood, for the introduction of the IRC model banks should be allowed to use non-stochastic correlations. Research on the modelling of correlations under different market conditions as well as their stylised facts is still very scarce. At this stage, the introduction of varying correlations into the IRC model framework would most probably have a deteriorating effect on the statistical soundness of the generated figures. This would not only weaken the soundness of the IRC in its function as regulatory risk capital measure but also the acceptance for internal risk management purposes. To capture market concentrations and critical portfolio behaviour, it might be possible and preferable to calculate the IRC charge for distinct stressed market conditions using different market data scenarios.

Question 5

Given the IRC soundness standard of a one year time horizon and 99.9th percentile loss, the Committee seeks comment on how the resulting risk measure might be validated quantitatively. For example, would it be reasonable to validate the underlying model at shorter horizons and/or at lower percentiles? If so, how might one ensure that the validation exercise is relevant for the one year 99.9th percentile standard? Also, would different aspects of the model likely require different validation approaches?

We do not believe the 99.9% 1 year measure can be validated via back testing. Any validation against actual results would necessarily have to be extrapolated from a much lower confidence level and shorter horizon. But even at a shorter horizon and lower confidence interval empirical validation is challenging for many traded financial products.

The daily VaR calculation now explicitly excludes certain risks which are to be included in the IRC. Outliers observed in back testing that can be attributed to IRC risks have to be excluded. It is unclear how the validation of the IRC model for the one year horizon at the extreme level of 99.9% should be performed. Validating the model at shorter time horizons and confidence levels is tantamount to using scaling.

In common with a number of the points we make, it may be that the proposed 99.9% 1-year measure is just too ambitious for the trading book.

Given the challenges of validating the IRC and the scarcity of even related data, banks should be allowed to consider other validation frameworks such as the statistical validation of the input parameters (e.g., forecasting power of default probabilities) and

the theoretical and empirical justification of the model building blocks. A possible pragmatic approach to capital modelling could require the various model components to be validated separately. However, due to the current uncertainty in how the validation of the IRC model could be performed - defining a validation framework for a regulatory capital calculation still to be finalised and for models the industry has yet to build and implement is an almost impossible task - we think the guidelines should not include any detailed provisions on validating the IRC at this stage.

Question 6

The flexibility built into the proposed IRC potentially could make Pillar 1 charges for trading positions less comparable across banks. How might the framework ensure greater comparability without unduly limiting firms modelling choices? In particular, would it be productive to require banks to calculate risk measures for standardised test decks of trading portfolios, which could be used to compare model results across banks

We are uncertain as to how beneficial a “test deck” exercise would be. However, a few of our members consider some form of benchmarking worth exploring. That said, each firm is expected to calibrate and adjust its model with respect to their own portfolios, and the comparison of model output for a standardised test deck would only allow you to analyse the differences in model output, but not to analyse the quality and/or correctness of the figures generated for each of the firm’s relevant portfolios.

Question 7

Is the proposed implementation schedule feasible? If not, which IRC guidelines, and what specific types of positions or risk factors, are most problematic?

We believe that the implementation timeframe does not allow for the weaknesses identified in the framework to be addressed. When considered alongside the essential need to better understand the impact of the final proposals, and the time required to conduct a successful Quantitative Impact Study (QIS), this makes a more realistic alternative approach / fallback position, generating the desired amount of additional regulatory capital, a vital addition to the proposed guidelines.

The timeframe set out in the paper leaves no time for an effective quantitative impact study (QIS), following which a further review of the proposed framework would be necessary. Before such a necessary step can be taken, the technical uncertainties need to be addressed, the models need to be designed and tested, and an alternative validation framework to back testing would need to be devised.

Instead we suggest a revised implementation schedule of 1 Jan 2010 for default risks on non-structured products, and 1 Jan 2011 for default risk on structured products, and then 1 Jan 2012 for the other IRC risks.

Question 8

What additional Pillar 3 disclosures related to the IRC, or the trading book more broadly, would be helpful to market participants and contribute to market discipline?

We support an appropriate level of disclosure and transparency around the regulatory capital set aside for the trading book. However, with so many outstanding questions

on the proposed framework it is difficult at this stage to opine on the relevant amendments to the Pillar 3 disclosure rules.

Question 9

Paragraph 50 requires a capital charge for re-securitisations. This would start on 1 January 2009 and last until the IRC has been implemented for these positions. Would it be worthwhile to expand the scope of these positions to all securitisations?

With regards to the interim solution proposed for re-securitisations, we believe there will not be enough time for firms to adapt the securitisation banking book approach to specific securitisation trading book positions. There are different processes and risk management principles for trading book and banking book positions that need to be considered making any short-term adjustment particularly challenging. With many of the details yet to be decided, we suggest that the switch of the respective regulations at the beginning of 2009 be re-considered. Much of the work involved will depend on the scope and the extent of positions to be included under the interim solution, and the final definition of “re-securitisation”. Besides these fundamental time constraints as well as technical concerns the significant effort to implement an interim solution is, from our point of view, not justifiable. Rather than implementing such a short-term solution banks should be allowed to focus on the enhancement of the IRC for these positions. Furthermore we encourage the Basel Committee to await the upcoming results of its ongoing investigations on risk weightings for securitisation positions. We believe that in order to fully assess the quality of the proposals with regards to re-securitisations we would require at a minimum the full picture on all of the proposed changes instead of merely discussing single pieces of the framework.