Basel Committee
Basel
Switzerland

Comments on the New Basel Capital Accord

Our response is primarily focused on paragraphs 64ff.
This is a translation of the reply in Swedish submitted to the Swedish Financial Supervisory Authority.

On PCE / add-ons

It is unfortunate that add-ons and netting are not treated in the proposal. It seems inconsequent to allow market risk expressed as VaR in many circumstances, but not when it comes to the Potential Credit Exposure of a netted derivatives portfolio.

It becomes even more unfortunate when it seems that the haircuts of collateral can be calculated in the comprehensive approach with VaR-like methods, but not the potential credit exposure. Institutions that prioritize a well-diversified netted portfolio vs. a counterparty are not given any incentives at all. That can hardly be the purpose with the Basel Accord?

Therefore, we take the liberty to propose that all institutions authorized to employ a VaR-model for market risks also will be allowed to employ it for the PCE of netted derivatives and repo-portfolios vs. a certain counterparty. This rule shall of course be applied to both trading and investment books.

The PCE model is used not only in the Market risk section of the Accord, but also in the Investment book section as a “translated” credit risk, which is why we think it appropriate to address the PCE issue in this reply.

On PCE / add-ons and collateralization

Under the comprehensive approach, we propose that the PCE is calculated as the standard deviation of the net of exposure (“E”) minus collateral (“C_A”) with 99% confidence interval and 10 days holding period.

We think the current proposal of a number of haircuts components is just not modern, nor comprehensive.

Collateralization of the PCE is not treated at all, besides being mentioned briefly in a headline (p.64).
The current rules, however, clearly states that if two large and fairly equal banks, A and B, have a common derivative portfolio between themselves, valued at 100 in favor of one of the banks, the PCE-value can be much higher – maybe 2 000. Assume that A transfers 2 000 worth of collateral (C_A) to B, which then becomes B’s asset to dispose. B then decides to transfer 2 000 worth of collateral to A. Both parties can state that their mutual PCEs are fully collateralized, which is the important risk weighted amount compared to the minor value of E. Both parties receive full capital relief and even have an incentive to move cleared derivatives out of multilateral clearinghouses into an arrangement of mutual collateralization instead. This can impossibly be the intention of the Basel committee, can it?

On collateralization and the w factor

The first reflection is that if collateralization works in practice, i.e. legally and administratively, it shall be supported all the way under all circumstances and for all countparties.
In the proposal a number of conditions must be met to allow w=0. This conveys the distinct feeling that these exception rules are constructed only to save the repo as a monetary tool, the rules have nothing to do with the risks that w=0,15 was supposed to cover. The repo market, however, is based on the collateral principles and if it works to 100 percent in some circumstances, it will work in others circumstances too.

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The argument that a w factor is necessary as an incentive to monitor the counterparty's creditworthiness is not correct. The whole collateralization agreement is always a reflection of the relative credit strength between the parties. Minimum transfer amounts, thresholds and independent amounts are always decided in a mutual negotiation that often contains rating dependent provisions, thus setting the credit worthiness in constant focus, regardless of full collateralization or not.

We don’t find the current proposal on a w factor acceptable at all. w is either zero or 1. If the legal certainty isn’t there, it isn’t to any degree at all.

Specific reflection on counterparty posting collateral

The proposal on collateral seems to focus on the situation where one counterparty is stronger than the other. In practice, that is not always the case. If two equally creditworthy counterparties start collateralizing between themselves, one could ask what happens with the counterparty that at one time or another posts “too much” collateral to an equal, or even worse, counterparty.
If the full market value of the collateral (C) is equal to E, everything is in order. But if there is over-collateralization (i.e. hair-cuts applied), things might not look so good if the receiving counterparty goes bankrupt. With the usual method of “transfer of title”, there is a risk that the receiving, bankrupt counterparty absorbs the collateral into other “assets” and it may become almost impossible for the posting counterparty to have its collateral returned. Even if the surviving counterparty starts closing deals and keeping the bankrupt party’s positive net, it could still lose more because of the surplus collateral posted. Therefore, it would be relevant to report the value of “over-collateralization” in some way, whether that stems from haircuts or PCE collateralization. We propose that this exposure is then treated as any other exposure.

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