ISDA

INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION

NEWS RELEASE

For Immediate Release Wednesday, April 4, 2001
For More Information, Please Contact:
Ruth Ainslie, ISDA New York, (212) 332-1200; Fax (212) 332-1212; rainslie@isda.org
Emmanuelle Sebton, ISDA London, (44) 207-330-3550; Fax (44) 207-330-3555; esebton@isda-eur.org
Jennifer Iannibelli, Kennedy & Company, ISDA AGM Pressroom in Washington, D.C., (202) 756-5243

ISDA COMMENTS ON BASEL COMMITTEE'S

NEW CAPITAL ACCORD PROPOSALS

WASHINGTON, D.C., Wednesday, April 4, 2001 - At its 16th Annual General Meeting today, the International Swaps and Derivatives Association gave a preview of its comments on the Basel Committee's second Consultation Paper on the capital adequacy treatment of banks.

According to the Association, the new Consultation Paper, which was released for comment in January, meets essential objectives of regulation in defining an approach to setting banks' capital requirements that is risk sensitive, granular and flexible. The Consultation Paper also, however, raises a number of issues of concern relating to the introduction of capital floors, the imposition of new capital charges (including the W factor pertaining to credit risk mitigation tools), and the complexity of disclosure and other requirements.

Risk Sensitivity: As stressed in ISDA's response to the first Basel Committee's Consultation Document, the principal failing of the 1988 Capital Accord was its lack of sensitivity to the main risk drivers recognized by banks, particularly in the area of credit risk measurement. ISDA considers that the Basel Committee, by relying on banks' internal ratings and by disentangling the impact of the many individual risk drivers (probability of default, loss given default, exposure at default, maturity) on banks' capital, has designed a truly risk sensitive capital framework. Importantly, this framework is transparent, as regulators disclose the key parameters of the calculation, including the target loss percentile and average asset return correlation assumption retained. Risk sensitivity is also found in the eligibility of a broader variety of collateral types, itself reflective of greater regulatory reliance on banks' risk management. ISDA welcomes in particular the recognition of banks' own collateral haircut estimates.

Granularity: ISDA emphasized the need for the Basel Committee to retain a sufficient number of probability buckets in its approach to credit risk, so as to ensure that capital charges effectively reflect the true underlying credit risk. The Committee has exceeded ISDA's suggestion, by determining banks' credit risk capital as a continuous function of the risk drivers.

Flexibility: Finally, it was essential that the new Accord reflect the varying degree of precision observed in banks' risk management systems. ISDA was therefore pleased with the Committee's proposals in this area; Pillar 1 capital is effectively defined through stages from the less sophisticated to the most sophisticated institutions, leaving banks' increasing freedom to use their own risk estimates, for both credit and operational risk. Furthermore, it is possible for banks not yet fully qualified for entry into the foundation internal ratings based (IRB) approach to avail themselves of this approach from 2004 onwards, should they commit to meeting the full requirements within an appropriately defined time frame.

ISDA, however, also perceives a number of deficiencies in the current proposals, which it hopes can be corrected during and, if necessary, after the consultation period. These fall into three main categories:

Rigidity: One substantial flaw in the proposals lies in the introduction of capital floors. These are mentioned in relation to the main risk types (operational and credit) and in neither case, are suitably justified. Specifying a floor hampers flexibility, by adding significant costs onto firms, which might be sufficient to discourage evolution from one step in the regulatory spectrum to the next. ISDA maintains that the need for a floor to be applied should be subject to strict cost- benefit analysis, which does not seem to have been performed by the Committee.

Arbitrariness: The new proposals contain a number of examples of charges, or approaches, that are not satisfactorily substantiated.

One major example is the size of the operational risk charge, arbitrarily set at 20 percent of global banks' regulatory capital. The percentage retained might, as implied in the Consultation Paper, reflect the pro-rata of banks' economic capital set aside against operational risk. However, ISDA would point out that (i) only a few institutions perform these calculations; (ii) there is substantial variability around the average; and (iii) loss data available at present is insufficient to derive a meaningful industry-wide figure.

Another area of concern for ISDA is the introduction of a legal charge for credit risk mitigation instruments, in utter contradiction with the efforts made by a number of industry bodies, including ISDA itself, to ensure that collateral and credit derivatives documentation is enforceable and effective. ISDA is likewise concerned about the inequality of treatment between credit default swaps (15% W charge) and bank guarantees (exempt). It is highly unusual for the Basel Committee to lend a premium to the less standardized/less liquid side of a market, such as the market for unfunded credit risk protection, and it is difficult for ISDA to conceive of how such a decision might be justified.

Finally, the Association questions the calibration of the Internal Ratings Based function, which currently reflects adjustments assuming a systematic 50 percent under-estimation of probabilities of default, as well as lack of Tier 1 capital. ISDA would argue that such adjustments are unnecessary, as they do not reflect typical practice at well-managed institutions, and should therefore be treated under Pillar 2 of the new Basel framework, rather than being introduced in Pillar 1.

Complexity: Finally, parts of the Basel Committee's proposals are overly complex, notably the disclosure requirements listed under Pillar 3. ISDA would recommend that cost-benefit analysis be performed in order to assess the need for firms to carry out the required tasks in a manner as detailed as that prescribed in the proposals.

ISDA has identified a number of areas requiring further work in the proposals and focuses on the following in its response: Conceptual Framework, Internal Ratings, Credit Risk Mitigation, Operational Risk and Market Discipline. The full response is expected to be completed and provided to the Basel Committee on **31 May 2001**.