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Basel Committee on Banking Supervision

Bank for International Settlements
CH-4002 Basel
Switzerland

Department
Corporate Credit Risk Management
Location
ALP.B.03.178

Subject
Consultative Document "The non-internal model method
for capitalising counterparty credit risk exposures"

Date
September 19, 2013

Dear Members of the Basel Committee on Banking Supervision,

ING Bank welcomes the replacement of the CEM method with the NIMM method and sees potential for this measure to be used elsewhere in the regulatory framework. We recognize the fact that under the NIMM method the collateralisation of trade portfolios is better modelled than under the CEM method. Furthermore, we believe that it is a step in the right direction that overcollateralization under the NIMM method will lead to lower exposures.

However, we do have the concern that the calibration of the NIMM method is heavily over-conservative and therefore we believe that the Committee should reconsider the calibration of the entire framework. We especially have concerns in the following areas:

- The application of the 1.4 alpha multiplier (not in CEM).
- The multiplier for over-collateralization and negative MTMs has been conservatively calibrated (factor 2 in the denominator).
- The multiplication of the IR notional amount with the full maturity which is in our opinion extremely conservative as well as theoretically incorrect. There are practical ways to apply discounting for exposures over 1 year.
- The base (1Y) calibration of the IR and equity products seems to be very conservative.
- The absence of profiles in the FX and commodity asset classes.
- The absence of compensation over the different asset classes.
- The absence of compensation over the different currencies within the IR asset class.

With regard to the framework itself (not considering the calibrations of individual parameters), we see major shortcomings in the absence of profiling for the FX and commodity asset classes which could help both reducing the exposure profiles for short term exposures (< 1y) and the creation of a more meaningful effective maturity measure.

In addition, as the method is very much driven by the notional, we recommend making the definition of notional more clear/explicit. Currently, it is not clear how notional amounts should be defined for i.e. derivatives with digital payoff's, amortising notionals, callability elements or spreads.

It is also not always clear for multi asset products whether the add-on should be calculated once or multiple times.

Lastly, we would like to stress the fact that the NIMM method requires significantly more capital for corporates (with unmarginated trade portfolios) and semi-public bodies (with long-dated interest rate swaps outstanding) for which the additional costs would have to be charged to these customers.

Q1. Should the Basel Committee replace the CEM and SM with the NIMM in all areas of the capital framework? What are the benefits and drawbacks of using the NIMM in each of these areas?

We support the idea of keeping the exposure measure as uniform as possible as it avoids credit institutions having to manage different measures in different systems and for different reporting obligations. However, it should be noted that this will probably not be possible without further modifying the calculation rules for which NIMM will serve as an input.

For example: Replacing the CEM exposure by the NIMM exposure in the standardized CVA capital framework will probably have to go together with the replacement of the netting set maturity by the effective maturity in order to get a more consistent calculation.

Another example: In several places in the regulatory framework CEM is used and an explicit reference has been made that sold options for which the premium has been paid in advance can be excluded from the exposure measure. This rule however does not hold any longer under NIMM and should thus be replaced. Under NIMM both sold and bought options should be taken in the adjusted notional position.

Q2. Is the proposed approach of retaining the general structure of the CEM with respect to replacement cost and the potential future exposure add-on appropriate? Is the division of the broad asset classes appropriate?

Yes, we think it is appropriate to retain the general CEM structure (replacement costs and potential future exposure add-on). However, we have concerns regarding the proposed calibration (as further elaborated on in the introductory section). The division of asset classes generally seems to be appropriate (see Q3 however for more specific remarks).

Q3. Are there specific product types that are not adequately captured in the outlined categories?

We suggest to create a separate asset class for inflation derivatives as well as for debt derivatives (total return swaps, bond options, etc) or to include these in one of the existing categories (e.g. interest rate) explicitly to ensure a consistent interpretation across different institutions. A separate asset class could be justified for these assets as debt derivatives are sensitive to both IR and Credit movements and Inflation has an underlying risk factor that is different from nominal IR rates.

In addition, we think the treatment of straddles (in any asset class) are not sufficiently covered, as they will typically get a -0.5 and + 0.5 notional according to the NIMM definitions, which will generate a zero exposure,

where in fact there is a double exposure. We do realise though that any approximation has its limitations, and the above could be regarded as an "accepted limitation".

For FX swaps the exposure will (almost) be zero from the start, sharply increasing after the maturity date of the near leg (as the near leg will compensate the far leg until the date the near leg drops off). We prefer to see the maximum risk in such a transaction from the start. We would like to note that an approach that includes an exposure profile (see our response on Q6) would also address this potential issue.

Q4. Does the above approach reflect the replacement cost of margined transactions? Are there any other collateral mechanics that the Basel Committee should consider?

Generally, this is correct. However, we prefer to see a cap on this formula defined as the unmargined exposure, as sometimes thresholds can be set high compared to exposures which will result in overstated current replacement figures for margined sets. The representation of the maximum of the exposure as in the formula

$$RC = \max(V - C; TH + MTA - NICA; 0)$$

can in our view better be replaced by

$$RC = \max(V - C; \min(TH + MTA - NICA; \text{uncollateralised Exp}); 0)$$

Q5. Of the options under consideration for recognising offset across hedging sets, which treatment is preferred? What number of maturity buckets is appropriate to consider?

Approach 1 is preferred. Three maturity buckets seems to strike a good balance between simplicity and risk sensitiveness.

Q6. Is the proposed approach of using a different methodology for determining the add-on for each asset class appropriate? Is each proposed add-on methodology for each asset class effective at capturing the main risk driver of that asset class?

In general we think this is appropriate, however we are of the opinion that in the area of the FX and commodity asset classes, the NIMM measure could be improved by building in an exposure profile. This profile can serve different purposes:

1. It can allow for add-on reductions if i.e. FX trades are of a short term nature (1M, 3M trades).
2. It can reveal trade date exposure for FX swaps that would otherwise be hidden until the near leg drops off.
3. It can serve to build up a measure of effective maturity which can be used in e.g. CVA capital or as a maturity correction in the regulatory default capital formulae.

Q7. Are the proposed minimum time risk horizons for each transaction category (unmargined, non-centrally cleared, centrally cleared) appropriate? Should the Basel Committee consider factors other than the IMM for determining the appropriate time risk horizon for the NIMM (eg harmonising with other international or national legislation)?

In general, we think this is appropriate.

Q8. Do the suggested formula and 5% floor appropriately recognise the benefits of overcollateralisation?

We believe it is appropriate to always show some positive risk (which is what this method will guarantee). We do not have an opinion about the exact level of the floor, but the multiplier for overcollateralization and negative MTMs could have been less conservatively calibrated (especially with regard to the factor 2 in the denominator) .

Q9. Is the proposed approach to aggregate across asset classes appropriate?

We believe it is too conservative as there will always be some compensation benefit amongst asset classes. Also, both the existing CEM method (implicit through the net/gross ratio) and the IMM method allow for some level of compensation/diversification, which we think is legitimate. Therefore, we would welcome an additional PFE reduction if exposure profiles are built up over different asset classes.

Q10. Are there any risk factors that should be included in their own category or accounted for in another manner?

See our comments under Q3.

Q11. Is the proposal to introduce the multiplier in order to allow reduction of the PFE add-on in the IMM shortcut method appropriate?

We welcome the possibility to have exposure reduction under the IMM shortcut method for excess collateral, but we do not have a specific opinion on the proposed means to achieve this.

Kind regards,

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ING Bank