

March 11th, 2009

Subject: Comments on the consultative documents “Guidelines for Computing Capital for Incremental Risk in the Trading Book” (bcbs149) and “Revisions to the Basel II market risk framework” (bsbc148)

Dear Sirs:

We welcome the opportunity to provide our comments on the consultative documents bcbs 148 & 149 on the following matters.

BCBS 148

1. STRESSED VAR

- We agree on the fact that the current framework does not adequately take into account stressed situations, as was demonstrated by banks' losses in 2007/2008. To that extent, the 2007-2008 period appears to be a relevant reference for today's purpose. However, defining a static reference has also significant drawbacks: new risk types may arise; portfolio structures may significantly evolve over time (making the reference to the period obsolete or making it impossible to obtain daily historical data for the reference period). We are therefore concerned that today's proposition of a fixed period stressed VaR might not age very well and we would recommend some flexibility in the definition of the stressed VaR, allowing banks to choose, under the regulator's supervision, how to improve their VaR model with the effect of taking into account stressed factors.

2. TREATMENT FOR ILLIQUID POSITIONS

- The use of different valuations for regulatory purpose and for accounting should be avoided. It increases the burden of P&L reconciliation and hinders VaR back-testing. There should be only one definition of 'fair value' for both accounting and prudential regulation. Regulators should work together with standard setters and agree on one valuation standard. The Basel Committee should increase its involvement with standard setters to ensure that the regulators' needs and the constraints of banking institutions are taken into account in the drafting process of accounting standards.

BCBS 149

3. SECURITISATION / RESECURITISATION

- The new IRC framework would lead to a major increase in the capital charge of the trading book. This increase is mainly due to the asymmetric treatment between securitisation / resecuritisation (banking book charges) and their hedges (IRC charges). We understand the regulator's lack of confidence with regard to ABS models and CDO square, since for those models a significant part of the information related to the underlying risk is missing or ignored in the model. However it is not the case for securitization of corporate exposures: a large trading activity has been developed around the hedging of CDO of corporate exposure with CDS. Those positions are usually fully synthetic (both on the CDO position and on the CDS) and are based on market quotations (CDS spread, CDO index). They are thus more liquid and are hedged on a day-to-day basis even in the current crisis. The models for such CDO continue to be used by practitioners, and give a much more reliable assessment of risks (in particular for the convexity) than any internal or external rating mechanism on which the proposed IRC would be based. Investment banks sell a CDO corporate tranche to a client and replicate its Mark-to-Market with CDS. In the proposed regulation, the CDO sold to the client is a protection that will not be recognized at all. The CDS will be included in the IRC calculation but not the CDO protection, furthermore the CDO protection will have zero impact in the banking book calculation. This is very far from a sound risk management where one would rather tend to recognize hedges

in order to encourage risk reduction¹. This double effect will also lead to a gross over-estimation of real risks: the first estimates are that the charge will be more than 10 times the current charge under VaR. It will thus increase the pressure on bank's adequacy ratio and lead to radical decisions for this kind of business, with obvious consequences on the CDO liquidity and potential consequences on the level of CDS spreads and on credit spread paid by corporate to borrow. Our concern is to avoid excessive capital charges and keep incentives for improving the modelling of complex products, therefore we ask for an inclusion of corporate CDO in the IRC calculation. We understand that this inclusion cannot be done for every sort of securitization, but we believe that for corporate CDO based on reference portfolios that are themselves quoted on markets, there is no reason to refuse its inclusion in the IRC calculation. This addition could be conditioned to the ability of the bank to adequately model the underlying assets of the securitization (default/migration correlation on the underlying), and to the liquidity of the underlying CDS (i.e. existence of quotations and market activity).

- It is all the more surprising to exclude Corporate CDO from the IRC calculation that we understand that n^{th} to Default products are not excluded and are treated as options on credit derivatives. Yet n^{th} to Default are a type of CDO and a CDO tranche is roughly equivalent to a combination of n^{th} to Default. In fact, both products (CDO and n^{th} to Default) are options on a basket of CDS, and should be treated as such rather than as securitized products.
- In some cases a tranche can have a nominal of 100 but being valued at 10 because of a serious increase in spread and correlations. This valuation is already taken into account in the PNL and should not be double counted in the capital as well. Therefore in this case, we would expect that the reference exposure that is used in the IRC calculation would be 10. On the opposite, if the Mark-to-Market increases, the exposure can go above 100. This highlights the fact that being a seller of protection is not always more risky than being a buyer of protection, even though the proposed IRC calculation would be imprudently nil for purchased protections. This is clearly the case now for equity tranches. When you sell a protection in distressed times on an Equity tranche, you receive an up-front payment which is quite high, maybe 90 for a nominal of 100, generating an exposure of 10 on the CDO. In this case, the bank will take a risk far smaller than the bank counterparty who bought the protection, since this bank counterparty has paid 90 and may not receive any payment if there is no reference default, so the 'protected' bank has in fact a larger downward risk on its Mark-to-Market. In the current framework, this protected bank will put 0 IRC capital in front of a higher risk. In fact, this example re-enforces the need to include CDO in the IRC calculation with an exposure that takes into account both the hedges and the current Mark-to-Market of the operations.

4. NETTING

- The new IRC proposal states that exposure amounts are eligible for netting recognition only when long and short positions refer to the same financial instrument. For instance, the netting of a security and the CDS relying on the same security might not be recognised. The benefits from hedging would only be derived from the diversification effect into the calculation model, and not from the hedge itself. We certainly advocate that hedges be properly recognized (i.e. not a 0% or 100% rule) in the IRC model, in order to align the economic benefit of hedging and capital requirement.

5. LIQUIDITY FLOOR

- While we agree on the need for guidelines for the modelling of liquidity, the 3-month liquidity-floor does not reflect adequately the liquidity of the positions remaining in the IRC scope and seems overestimated. The most illiquid positions (securitisation / resecuritisation) have been removed from the IRC scope and the revised perimeter now mostly includes liquid or highly liquid products (e.g. CDs issued by banks, sovereign and corporate bonds and CDS, and transactions on indices).
- Besides it should be underlined that the 3-month liquidity floor does not reflect the actual trading and hedging practices (adjustments of hedging positions are usually done on a daily basis).
- We suggest that a 1-month – or even 2-week - liquidity floor should be set at least for :
 - Government bonds
 - Liquid Credit Indices (Itraxx, CDX)

¹ Cf § 35 of bcbs 149 : "The approach that a bank uses to measure the IRC is subject to the "use test". Specifically, the approach must be consistent with the bank's internal risk management methodologies for identifying, measuring, and managing trading risks."

A 2-week liquidity floor would be consistent with the 10 business day VaR horizon.

- We believe that 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.

6. CALCULATION MODEL AND PARAMETERS

- The calculation of IRC using multiple liquidity horizons may prove fairly complex. Given the short timeframe for the IRC implementation, we suggest that simplified approaches may be considered.
- In addition to that, we believe that through-the-cycle (as opposed to point-in-time) parameters are more in line with Basel II banking book parameters, as they reduce pro-cyclic impacts.

7. TRADING / BANKING BOOK

- We are in favour of measures that would lead to the reduction of arbitrage incentives between trading and banking books. We would like to underline the fact that the current proposal contains strong incentives to hold securitisation and resecuritisation positions in the banking instead of the trading book, or to hedge risks in a non-economic way by the reduction of hedges or by taking more risks on purchased protection.

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