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13th March, 2009

Re: **"Revisions to the Basel II market risk framework" (BCBS 148) and
"Guidelines for computing capital for incremental risk in the trading
book" (BCBS 149)**

Dear Norah, dear Tom

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 provide additional feedback on the Basel Committee on Banking Supervision's (BCBS) consultative documents "Proposed Revisions to the Market Risk Framework" and the "Guidelines for Computing Capital for Incremental Risk in the Trading Book". We appreciate the time and effort the BCBS has gone through to arrive at these proposals, and we fully support their efforts to consult key stakeholders and to maintain a high level of transparency in the process.

We agree that the Basel II capital framework, once implemented, is the appropriate global framework for capturing and assessing risk. It is a vast improvement on Basel I, and, subject to the adjustments to the proposed revisions set out in this letter, we believe it should provide the right incentives for firms to improve not just their risk management procedures, but also their governance and systems and controls infrastructure. Most importantly in the current market turmoil, Basel II promotes a better understanding of firm-wide risks and risk management. We continue to believe that the Basel II capital requirements should be commensurate with the risks identified at each individual firm, and proper incentives should be incorporated into the rules to encourage firms to fully capture, understand and manage all the relevant risks.

The joint associations understand the desire in the current climate to increase the regulatory capital requirements against exposures in the trading book. A number of banking organisations have experienced large losses in their trading books, which were not captured in their VaR models. Since many of these losses were not caused by defaults, rather by a loss of liquidity and a decline in values, we support the new proposals' additional focus on the market risk framework. Raising additional regulatory capital purely via an incremental risk charge would have been inconsistent with the risks identified by some of these firms. Many of the firms who experienced large losses in their trading books were quick to recognise gaps in the coverage of their market risk models and faults in the VaR models themselves. Many of these have now been addressed and VaR modelling over the last 12 - 18 months has contributed significantly more capital to the overall regulatory capital requirements for trading book exposures. Specific examples of improvements include the capturing of non-linearities beyond those inherent in options, as well as the incorporation of more correlation and basis risks. Therefore, although we welcome the decision to revise the market risk framework, we have set out in this letter the industry views as to how the framework could be improved to take into account the recent and any future improvements in VaR modelling.

As a result of the additional focus on amendments to the market risk framework, the revised incremental risk charge (IRC) proposal is more clearly defined and likely to be easier to implement and regulate consistently across firms. We strongly favour regulatory guidelines that are soundly based on clear principles and appreciate the flexibility given to firms to develop their own IRC models.

We agree with the BCBS that there are significant challenges in modelling IRC for more complex securitised credit products, and that not all firms are currently able to model the incremental risks for certain types of products. However, the complexity involved in these products varies enormously and some are clearly more suited to IRC models than others, as we highlight in our key messages below. For a full set of industry comments please refer to the appendices attached, containing detailed comments on the two papers.

Key Messages

- We are pleased to support the move to a more practical and more effective solution to raising additional capital in the short term with more emphasis on amending the market risk framework. We believe higher capital requirements should still result in the "right" level of capital requirements for the portfolio of risks in question. The amended capital requirement should attempt to discriminate between those classes of assets where the market risk charge has been found to be lacking and those where it has not.
- We think there could still be room in the proposals to accommodate firms seeking to adopt full scope IRC modelling. Reintroducing the flexibility for firms to develop more comprehensive and advanced solutions would help restore an important balance between conceptual soundness on the one hand and operational practicality on the other. This balance would succeed by firstly placing greater emphasis on increasing the representation of risks within VaR and, secondly, by

responding appropriately to tail and liquidity risks outside of VaR. The use test would remain a powerful overriding Basel II principle, with capital aligned to firms' measurement of the material risks in the portfolio, subject to close ongoing supervisory scrutiny.

- We understand the concerns about arbitrage between the banking book and the trading book and the existing incentives for holding credit related instruments in the trading book. Similarly, we can see how this has led to the BCBS exploring an alternative approach that removes the availability of trading book capital charges from certain exposure types. However, we do not support such proposals as we believe they would result in an inadequate treatment of risks. We believe that the proposals to strengthen the trading book capital regime are generally on the right track, and we do not believe that it would be relevant or useful to pursue the suggested alternatives raised at the end of the consultative paper. Fundamentally, the banking book framework is inappropriate for trading book assets because the framework is only concerned with credit risk and the event of default and as such only addresses one of the material risks that trading book assets, recorded at fair value, are sensitive to. The banking book rules also fail to address the off setting of long and short positions. The requirement to compute both VaR-based and banking book regulatory capital will also result in significantly greater complexity, overhead and cost to firms' Basel II infrastructure, due to the need to capture the same trades in multiple systems consistently. Furthermore, because these positions would also be included in the general market risk VaR and "stressed" VaR capital charges, under such an alternative approach, they would attract considerably more regulatory capital than similar exposures in the banking book. This creates perverse incentives and encourages banks to hold trading book exposures in the banking book. We do not believe the BCBS intends to set a higher capital charge for trading assets that can be liquidated more easily than for assets with an otherwise similar risk profile held to maturity.
- In previous discussions on amendments to the trading book capital charge we have highlighted the problems with prescribing a purely credit ratings-based approach for capturing full price risk on complex structured assets, and that such an approach would not have captured the key drivers of trading losses recorded in 2007 and 2008. It therefore seems odd at this stage to revert to prescribing an approach for such instruments entirely based on external ratings, without providing firms with an incentive to further develop their models so as to better capture the loss drivers. There is also the added logistical complication of "switching off" existing models based approaches, which have previously been granted approvals from regulators.

Carving out all securitisation positions from a trading desk's portfolio will lead to an incoherent picture of the risk, affecting capital charges for the portfolio in an unpredictable way and resulting in capital charges which are not commensurate with the risk. The use of the standardised approach for these positions counteracts the recent advancement of valuation techniques and risk modelling for such products. We believe this would be a step backward for more sophisticated firms, and will result in punitive regulatory capital treatment for many assets, which will be an impediment to recovery of the market's ability to generate credit through securitizations, while potentially under-capitalizing others, for which the credit

rating on its own may not reflect the potential unexpected loss. The appropriate response to the division of opinion on the state of modelling risk of securitizations in the trading book evident in paragraph 7 of the “Revisions to the Basel II Market Risk Framework” should lead to incentives to further methodological development, not just blanket exclusion.

- We believe that paragraph 718(xcv) provides useful language exempting certain exposures from the ratings-based securitisation framework since they result from credit derivative market-making activities based on liquid, transparent markets. Without this exemption language, firms with significant market making activity (e.g. those offering portfolio credit protection or those with correlation trading businesses) will experience multiple fold increases in capital requirements not commensurate with the risks measured. In para 718(xcv), the BCBS recognised that rating was not an appropriate risk driver of the correlation tranche business. We would suggest that, where their main risk components are actively hedged on a liquid market, securitisation positions referencing liquid single name corporate CDS that are not re-securitisations should be allowed to receive a modelled market risk charge instead of the banking book charge. The modelled charge will be conservative, as the IRC is predicated upon an increased time horizon for default risk. The demise of correlation trading activity (see appendix 1 below for details) would materially impact firms capacity to hedge their concentration and corporate portfolio risk arising from the loan book and curb significantly new corporate lending. The overall liquidity of the CDS single name and index markets is also expected to be reduced significantly, as correlation desks are key players in flow CDS.
- We welcome the introduction of “stressed” VaR in the computation of market risk capital. Including a stress measure in the formula addresses one of the shortcomings of the current approach, namely its calibration on excessively short observation periods. However, in a few years’ time, “stressed” VaR will be challenging to compute if it must be calculated by reference to a fixed historical period. We believe that firms should be given an incentive to improve their computation of VaR over time and that where a firm can eventually demonstrate that its VaR measure is sufficiently conservative that it passes a back test over stressed periods, we believe that a separate "stressed" VaR component should no longer be required.
- We understand the need for an increase in the market risk capital charge; however an approach based on simply adding “stressed” VaR to the current VaR will in many instances double count risk. We think a more conceptually correct solution would be to consider a weighted average of VaR and "stressed" VaR as an effective way of increasing the current market risk charge. The weighting scheme should be allowed to evolve over time, and to reflect the performance of firms’ VaR models. Institutions that over time can demonstrate the robustness of their VaR estimates in stressed market conditions should be able to rely on a pure VaR + IRC measure of market risk in the future. We have suggested a possible approach to such a scheme in our detailed response in Appendix 1.
- In addition, beyond the actual implementation of the “stressed” VaR, we suggest that the rationale for the stressed VaR be further clarified. Currently it is not clear

whether this new element of the trading book charge is intended to address procyclicality or deficiencies in a firm's VaR model, or both. This clarification could also address supervisory expectations around the behaviour of the "stressed" VaR component both in a downturn scenario and during more benign economic conditions. For example, should the "stressed" VaR component be allowed to fall as the economic cycle turns downward, allowing capital to be released and used in the promotion of new business activity. Overall, we would welcome further explanation on how the "stressed" VaR charge would work throughout the downturn and upturn of an economic cycle.

- In regard to the proposed treatment for illiquid positions, and specifically regarding valuation adjustments, we continue to believe the BCBS is potentially widening further the gap between financial reporting based on accounting standards (such as those proposed by the International Accounting Standards Board, IASB) and reporting for regulatory capital purposes. In particular, we are concerned that if differing valuation requirements are applied at a transaction level this will result in firms being required to carry two different sets of books for the related positions. Instead, we argue that concerns about liquidity be dealt with in the risk models themselves, avoiding the need for dual valuations. We strongly encourage the use of only one definition of 'fair value' for both accounting and prudential regulation. Regulators should continue working together with standard setters and develop an approach that avoids two different pricing mechanisms: one to meet the valuations used for regulatory purposes and another one to meet the valuations used for the profit and loss account.
- We continue to believe that imposing a floor of three months (p20) for the calculation of IRC is unnecessarily prescriptive and inconsistent with the objectives to provide high level principles (p4). 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.
- Finally, we support the forthcoming Quantitative Impact Study aimed at measuring the impact of the proposals. We hope that there will be adequate time and resources available to understand the results and implications of the QIS before the rules are finalised. While more capital for the trading book in some circumstances may be the appropriate outcome, any increase should be proportionate to the actual risks and include appropriate recognition of the differences between the trading and banking books. Therefore, we would advocate that final calibration of the new charges be the subject of further discussions in the light of the results of the QIS.

We are keen to continue to participate in an on-going dialogue between regulators and firms during the final stages of policy determination and throughout the implementation period. 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, Katharine Seal at LIBA, or Sally Scutt at IbFed.

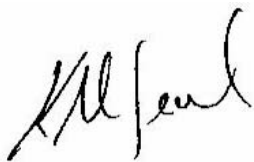
Yours sincerely,

A handwritten signature in black ink, appearing to read 'Ed Duncan', with a long horizontal flourish extending to the right.

Ed Duncan
Head of Risk and Reporting
(ISDA)

A handwritten signature in black ink, appearing to read 'Andres Portilla', with a stylized, cursive script.

Andres Portilla
Director, Regulatory Affairs
(IIF)

A handwritten signature in black ink, appearing to read 'Katharine Seal', with a stylized, cursive script.

Katharine Seal
Director
(LIBA)

A handwritten signature in black ink, appearing to read 'Sally Scutt', with a stylized, cursive script.

Sally Scutt,
Secretary General,
(IbFed)

CC; Mr. Jörgen Holmquist, Director General, Internal Market & Services, EU Commission, Mr. David Wright Deputy Director General, Internal Market & Services, EU Commission, Mr. Patrick Pearson, Head of Unit, EU Commission, Mr. Kai Spitzer, EU Commission, Ms. Kerstin af Jochnick, Chair of CEBS, Mr. Arnoud Vossen, Secretary General CEBS, Mr. Karl-Friedrich Cordewener, BIS, and Mr. Martin Birn, BIS.

Appendix 1: "Revisions to the Basel II market risk framework" (BCBS 148)

QIS (p10)

We support the BCBS's commitment to understand the quantitative impact of these proposals and we look forward to providing feedback on the proposed questionnaire. We strongly recommend a thorough QIS covering all aspects of the three papers in the Basel II reform package. In particular, where previous data was submitted prior to the sub-prime crisis in 2007, we would be happy to submit new figures on the impact of migration and default risks for the impact of the IRC on firms' regulatory capital requirements. We think it would be worthwhile understanding the changes based on up-to-date numbers, incorporating the impact of the market turmoil. We also strongly encourage including questions on the impact on the total capital charge for all securitisation positions of all three papers (including questions on the effect of the removal of the carve-out under 718(XCV)), as this is likely to be a material and significant change.

Implementation date (p12 and 13)

There remains some confusion as to the wording of these two paragraphs and what it means for outstanding model approvals. The implication of the wording is that impending or new applications for model approvals would be required to comply with the new framework, while those portfolios covered by models already with approval would not have to comply with the new requirements until 31 December 2010. This means that depending on the existing level of capital required under the standardised charge, there could be no incentive for firms to continue with any outstanding model approvals until after 2010.

There is also the added logistical complication of "switching off" existing models-based approaches, which have previously been granted approvals from regulators. This process has not been covered in the proposals and we think it would be worthwhile covering this in the final text.

Changes to the standardised measurement method for market risk (p14) - Structured products

In previous discussions on amendments to the trading book capital charge we have highlighted the problems with prescribing a purely credit ratings-based approach for capturing full price risk on complex structured assets, and that such an approach would not have captured the key drivers of trading losses recorded in 2007 and 2008. Therefore, we are surprised to see at this stage proposals prescribing an approach for such instruments entirely based on external ratings, without providing firms with an incentive to further develop their models so as to better capture the loss drivers. There is also, as stated above, the added logistical complication of "switching off" existing models based approaches, which have previously been granted approvals from regulators.

We feel that full IRC modelling should be made available to firms who can prove to their regulators that they can adequately capture the risks associated with certain types

of structured products. There is a strong feeling among our members that over time they will be better placed to more accurately capture the risks for these types of products, and that this is not a time to stifle progress and development in risk management techniques.

For example, a firm which demonstrates to the satisfaction of its regulator that it can “capture nonlinearities for options and other relevant products (e.g. mortgage-backed securities, tranch exposures or n-th loss positions)” should be permitted to calculate specific risk capital for those assets using modelled estimates. We note that it is highly unlikely that firms would be able to do this for the sorts of opaque, leveraged securitizations and re-securitizations which were the source of large trading losses in 2007/08, and that those instruments would therefore be subject to the standardised methodology for the foreseeable future. Simpler, better understood securitization products would remain eligible for a model based capital charge, reflecting the reduced riskiness of those assets.

Changes to the internal models approach to market risk - "stressed" VaR component (p718(lxxvi))

We believe these proposals are a more practical and effective solution to raising additional capital in the short term with more emphasis on amending the market risk framework. We note that the new proposals address some of the weaknesses in the IRC framework put forward last year (BCBS 141: "Guidelines for Computing Capital for Incremental Risk in the Trading Book", published in July 2008) and that we discussed in our previous response (Industry response dated 24th October, 2008). Use of “stressed” VaR is a simple short-term solution to address some of the current weaknesses of VaR but it is not a viable long-term solution in its current proposed form. Although the new proposals are easier to understand with more clearly defined boundaries, and should therefore be much simpler and cheaper to implement, we believe firms should be incentivised to develop VaR models further. Firms should be encouraged to consider ways to more appropriately capture the risks intended to be captured by the "stressed" VaR component in their overall market risk capital charge.

We understand that firms using the internal models approach under these guidelines would need to calculate a capital charge for general market risk (a specific risk charge where the firm has approval to model specific risk) calculated using 10-day VaR at the 99% confidence level and a "stressed" VaR component. The "stressed" VaR component is also to be based on the 10-day 99% VaR measure, but using model inputs calibrated to a period of relevant financial stress, such as the 12-month period from 2007-08.

We understand the regulators' concerns regarding the inadequacy of market risk VaR measures, and the perceived need for complementing them with "stressed" VaR. However, the inclusion of a "stressed" VaR component into the capital requirements as an addition to the current VaR element raises concerns about the conceptual merit of the new framework. Adding VaR and "stressed" VaR necessarily double counts risk. We would view a weighted average of VaR and “stressed” VaR as a conceptually more correct means of increasing the current market risk charge. The weighting scheme should be allowed to evolve over time, and to reflect the performance of firms' VaR models. Institutions that can demonstrate the robustness of

their VaR estimates in stressed market conditions over time should be able to rely on a pure VaR + IRC measure of market risk in due course.

The proposed market risk formula does not incentivise firms to improve their VaR models: it potentially yields higher capital charges for firms with high quality VaR models. To illustrate this point, let us consider two firms with the same market risk exposures; one of the firms passes the back test over 2007-2008 (less than 5 exceptions per year). The other firm has 15 exceptions. The first firm's VaR is 1.5 times the other firm's VaR. Even if "stressed" VaR was the same for both firms, the first one would have to hold more capital than the second one according to the BCBS proposal. In practice the discrepancy would be even greater, as "stressed" VaR is also likely to be higher for the firm with the more resilient model.

In order to address the flaws of the approach highlighted above, we suggest the regulators consider a weighting scheme. This could be defined along the following lines:

$$\text{Capital charge} = (m+b)*(1-b')*\text{VaR} + m*b'*(\text{stressed VaR})$$

where m equals 3,

b is the multiplier add-on reflecting back testing experience over the previous year, and b' is a weighting factor linked to back testing experience over 2007/08.

Under such a scheme the maximum number of exceptions allowable would reflect the firms' experience (excluding securitisation) during 2007/08, assumed to be a number greater than 10. The " $m+b$ " factor would be calculated consistently with the current internal modelling framework: $m+b = m \times 2.33/\text{NORMSINV}(1 - \text{number of exceptions/number of observations})$, and not be capped at 4. The " b " factor would sit somewhere between zero, where a firm has less than 10 VaR exceptions, and one, where the number of exceptions hits an allowable maximum number.

The idea behind such a weighting scheme is that where a firm can demonstrate that its VaR model passes back testing over a stress period like 2007/08 then its absolute VaR level against a given portfolio would be higher than that of a firm failing such a test on the same portfolio. The firm's VaR number is also likely to be less volatile and thus less procyclical. Adding a "stressed" VaR component to the market risk capital charge for a firm adopting this approach would not be necessary, as the VaR itself would incorporate the appropriate level of stress.

This proposal (i) properly incentivises banks to develop their risk modelling and risk assessment, (ii) is sufficiently flexible to avoid skewed treatment of products with similar risk profiles but varying recent performance; (iii) avoids the double-counting of risks, (iv) allows the "stressed" VaR concept to be used as a short term measure to fix perceived weaknesses in the current VaR framework and (v) should eventually lead to a more realistic assessment of the level of risk capital required to be held by each firm.

Although the proposed "stressed" VaR is both easy to understand and implement, we believe it will become increasingly challenging to compute over time. As portfolios

evolve, stressed parameters referencing a particular time window will become less relevant. For example,

- (FX), pairs of currencies may have merged/pegged or unpegged;
- (EQ) any number of companies might have merged, or refocused their activity in different sectors affecting the stock behaviour;
- (IR & FX) countries leaving or joining a monetary union, new yield curves, and so on;
- (Credit) the introduction of index and tranche trading which would not have been captured by data from the previous credit crisis (1998 / 2001), etc etc.

Beyond these implementation issues, the choice of a specific reference period will necessarily entail subsidising certain business sectors or countries at the expense of others.

We suggest that further consideration is also given to the meaning of the "stressed" VaR component during a period of significant financial stress relevant to a firm's portfolio. As stated above and in our key messages there is clearly the potential for risk to be counted twice under these conditions and we continue to believe the double counting of risks to be undesirable. Risks should only be captured in regulatory capital once. A weighting scheme such as the one referred to above can also contribute to a reduction in the procyclicality of capital requirements for market risk in line with the Committee's objectives outlined in the January press release ("Revisions to the Basel II market risk framework").

Integrated modelling

There is some disappointment however that the option for a more comprehensive approach to address the perceived weaknesses in the VaR framework is no longer available. As you know, some firms were keen to explore a more integrated market and credit risk modelling framework to avoid some of the double counting issues with separate VaR, specific risk, and IRC capital calculations. These firms felt strongly that a unified modelling approach would stand a better chance of tackling risk factors such as illiquidity, large but infrequent losses, and short data windows that cut across the traditional risk types.

Integrated models may do a better job of providing vital links between P&L, risk management, and business line risk and hedging opportunities. The new proposals leave firms without a regulatory incentive to further progress their risk management techniques to more accurately capture the risks and diversification effects for exposures in the trading book. We think there could still be room in the proposals to accommodate those firms seeking to adopt more advanced solutions, and that reintroducing the flexibility for firms to develop more comprehensive approaches would help restore an important balance between conceptual soundness on the one hand and operational practicality on the other. This could also avert any future tensions applying the use test to methods used for regulatory capital calculations and more advanced methods being developed for internal risk management purposes.

Treatment of specific risk (p718(lxxxvii))

We understand that in order to be consistent with a policy imposing the standardised measurement method for calculating incremental risks for securitisation positions (p7), certain existing exceptions from the securitisation framework are removed (p718(xcv)). Some firms currently make use of this carve out for calculating the capital requirement of correlation transactions forming part of their derivative business, including, in particular, trading activity relating to standard and bespoke tranches based on market standard CDS indices (such as iTraxx and CDX).

Correlation trading books combine trading in liquid CDS Index tranches and bespoke tranches with hedging in corporate CDS Indices and liquid single name corporate CDS. Both tranche products are OTC products with an active inter-dealer market. Both have prices dealt through broker screens and Bloomberg runs. The standardised corporate CDS Index tranches, in particular, are very liquid. Bespoke tranches reference portfolios of single name corporate CDS that are variations of the corporate CDS Index portfolios. There are also standard bespoke tranches which trade in the inter dealer market (for example bespoke TOTEM / interdealer standards such as Standard 1). Bespoke tranches trades are typically traded with institutional clients. Corporate CDS index tranches are traded with funds (including regulated funds) as well as with bank trading desks.

Correlation desks typically defease the core credit risk inherent in their activity with corporate CDS index tranches, corporate CDS Indices and single name corporate CDS. The desks remain exposed to a certain level of basis risk, for example between bespoke and index tranches. At sophisticated firms, these risks are measured through VaR, which typically includes base correlation VaR and specific risk VaR. Basis risk is monitored against limits, applied to both VaR measures and single name default exposures. Correlation trading enables firms to tailor their exposure to certain portfolios of liquid corporate exposure, to perform important market-making in those, and related, products while, at the same time, hedging the risk on a liquid market. Such transactions help banks to actively manage the concentration and counterparty risk of their loan books to large global corporates. This hedging reduces risk born by banks, frees up economic capital and enables banks to engage in further lending. The distribution of tranche risk across credit investors and associated hedging activity also contributes materially to liquidity in the credit market.

Correlation trading positions are most often unrated, in line with the underlying, unrated but liquid corporate CDS names they reference and would attract an inappropriate level of capital requirements under the proposed amendments. For example, the amendments would require full deduction for equity tranches in the correlation book even where most credit risk is hedged, either with offsetting tranche positions or via the underlying single-name CDS markets. Currently, the carve out in p718(xcv) provides a useful work-around for positions to the extent that they are hedged. Upon the removal of this carve out, the main risk drivers of the actual exposure of the correlation book would be inaccurately represented and the capital charge severely distorted: both the original correlation positions and the hedges (whether in the form of CDS index trades, standard index tranche trades or single name CDS trades) would be recognised as separate, speculative positions, with no permitted offset for capital purposes. Without the ability to offset long and short positions in correlation books under the standardised approach for specific risk (para

709(iii) and paras 713-717) a capital charge will be levied against the full notional amount of both long and short positions.

The impact of the proposed revisions for the calculation of the additional regulatory capital requirements with respect to the sole specific risk on the actively managed single tranches referencing single name liquid corporate CDS is expected to render the tranche derivative business uneconomic. A survey of 8 leading correlation dealers has indicated such increase to be at least 25 times the overall regulatory capital required under the current rule for the correlation trading activity. This is in stark contrast with the approach previously adopted by the Committee, which had carved out “securitisation exposures where a two way market exists for the exposures or, in the case of synthetic securitisation, all their constituent risk components” (para 718 (xcv) of Basel II) from the scope of the deduction rule. The demise of correlation trading activity would materially impact banks’ capacity to hedge the concentration and corporate portfolio risks arising from their loan books and significantly inhibit new corporate lending. Overall liquidity of the CDS market is also expected to be severely affected as correlation credit hedging accounts for a large part of the corporate single name CDS and corporate CDS index trading volumes.

The impact of the proposed changes on credit correlation trading businesses cannot be overstated. We are extremely concerned that this business line, which provides liquidity, disperses risk and plays a key secondary role in banks ability to provide credit, would be unreasonably penalised, leading to many institutions abandoning the business permanently.

In para 718 (xcv), the BCBS recognised that rating was not an appropriate risk driver of the correlation tranche business. We suggest that, where their main risk components are actively hedged on a liquid market, securitisation positions referencing liquid single name corporate CDS that are not re-securitisations should be allowed to receive a modelled market risk charge instead of the banking book charge. The modelled charge will be conservative, as the IRC is predicated upon an increased time horizon for default risk. We also note that the use of the Supervisory Formula Approach for the numerous unrated tranches traded in the correlation business (para 712(v)) would be unduly burdensome (application of the IRB Approach to any underlying asset of the tranches) and would bring no added quality to the risk assessment of those tranches.

Importantly, regulators will retain the ability to derecognise a model that fails to meet the stringent quantitative and qualitative requirements defined in the Accord, and to impose the standard risk weights instead. Our proposal is not to allow modelling in every case; we would expect eligible firms to have developed sophisticated modelling tools, and, in particular, to be able to model name-specific risk and convexity.

Firms should, as a matter of principle, have the ability to reflect in their regulatory capital computation the liquidity of corporate CDS index tranches and bespoke corporate CDS tranches, and the significant amount of hedging that is accomplished in correlation trading via liquid and transparent single name corporate CDS and corporate CDS Indices. Not doing so will divorce the tranches from their hedges, and introduce a strong disconnect between the regulatory capital and the economic capital treatment of the instruments.

Treatment for illiquid positions (p20) - prudent valuations

In the section on the treatment for illiquid positions we continue to believe that in putting forward these changes to the "prudent valuation framework" that the BCBS is potentially widening further the gap between financial reporting based on accounting standards (such as those proposed by the International Accounting Standards Board, IASB) and reporting for regulatory capital purposes.

We believe concerns about liquidity and the treatment of illiquid positions are best dealt with in the risk models themselves, and we note that the market risk charge, with the 99% confidence interval and 10-day liquidity horizon is based on model inputs, such as measures of volatility, which already reflect liquidity aspects of the financial instruments. Liquidity, or illiquidity, will also be a driver in the measurement of risk and capital calculation for the new IRC. It is clear then that the new proposals will require firms to address the uncertainty around the risks associated with the liquidity of positions in the trading book in their risk modelling. Therefore there should be no need for additional measures to be taken with regards to valuations.

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 and increase the complexity in the communication of results to internal and external parties. In addition, maintaining two different measurement bases for fair value is operationally cumbersome and introduces reporting risk for preparers. Rather than encourage the separation of procedures for accounting and market risk measurement regulation should aim to bring them more closely together.

We strongly encourage the use of only one definition of 'fair value' for both accounting and prudential regulation. Regulators should continue working together with standard setters and agree that there cannot be two different pricing mechanisms: one to meet the valuations used for regulatory purposes and another one to meet the valuations used for the profit and loss account.

Model validation standards (p718 (xcix))

We understand that the back testing requirements will still apply to the old or "current" VaR, and not the "stressed" VaR component. We suggest that given that there are two new elements contributing to a higher trading book regulatory capital charge, that certain VaR back testing exceptions will inevitably be covered by the new capital charges. Currently, where the exception is caused by factors that may be covered by the new "stressed" VaR or the IRC charge (i.e. a non-general VaR event), the regulatory capital charge is subject to the "plus factors" of up to an additional 1 depending upon the number of exceptions. This means that a bank will be charged twice for the same event, once through the IRC or the "stressed" VaR and the other through the plus factor. We do not think there should be an additional charge for risks that are already accounted for elsewhere. We suggest reference should be made in the guidelines to back testing exceptions covered by capital raised via either the "stressed" VaR or IRC components.

Appendix 2: Guidelines for computing capital for incremental risk in the trading book" (BCBS 149)

Securitisation positions (p10)

We understand the motives behind the proposal to exclude securitisation positions from the IRC charge and only apply a standardised specific risk charge, even though some firms may continue to include them in their internal models based approach. However, as stated above, we believe there should be some flexibility for firms to model such assets as they think appropriate, rather than be restricted to adopting a standardised charge. We believe over time that firms will be better placed to more accurately capture the risks for these types of products, and that this is not a time to stifle progress and development in risk management techniques. Under such an approach simpler, better understood securitisation products would remain eligible for a model based capital charge, reflecting the reduced risk of those assets (this point is expanded upon in the relevant section above).

Credit migration risk (p11)

We appreciate and support the flexibility given to firms in the proposals to develop their own IRC models. In the absence of a single market practice standard, it is very important to encourage further thinking and model development. However, the IRC will be sensitive to the exact specification of the model chosen by each firm. This was highlighted as a key preliminary finding of the "Analysis of the second trading book impact study" (published in November 2008). One of the key parameter choices of the model will be the choice of what spread data to use, and we raised this in one of our last meetings with the AIG TB. The impact of the IRC could depend crucially on the type of spread data employed in the model, current spreads (or "point-in-time") may prove too volatile and may be procyclical, whereas a "through-the-cycle" data set may be overly conservative. Although we are not looking for additional prescriptive rules to be added to the proposed IRC guidelines covering what type of spreads firms use, we recommend incorporating the impact of the different choices in the forthcoming QIS exercise.

Liquidity horizons (p18 - p24)

While securitisation positions are excluded from the IRC, reference to liquidity in these markets within the proposed IRC framework (p18 and p24) should be removed to avoid any confusion.

We continue to believe that imposing a floor of three months (p20) is unnecessarily prescriptive and inconsistent with the objectives to provide high level principles (p4). 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. 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 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. Furthermore, an overly conservative liquidity horizon will not make the framework useful for internal risk management.

Correlations and concentration.

As mentioned in previous feedback, the modelling of correlations under different market conditions is still at an early stage. The clustering of defaults and migration events as well as concentrations within and across product classes under stressed conditions can be captured inherently by the model only to a very limited extent. Therefore, banks should be allowed to apply appropriate and consistent stress scenarios across the relevant model parameters to assess critical portfolio concentration behaviour under stressed market conditions.

Validation (p33)

We appreciate the changes to the proposals for the validation requirements for IRC models, and in particular we appreciate the recognition in p33 that market risk style back testing will not be possible. We support references to indirect validation methods including stress tests, sensitivity analyses and scenario analyses, and the new emphasis on assessing qualitative and quantitative reasonableness.

Alternative approach: applying the banking book treatment to positions in the trading book (p38 - p42)

We understand the concerns about arbitrage between the banking book and the trading book and the existing incentives for holding credit related instruments in the trading book. We can see how this has led to the BCBS proposing an approach that removes the availability of trading book capital charges from certain exposure types. However, we do not support such proposal as we believe it would result in an inadequate and unsound treatment of risk. In particular, the proposal would result in these positions being not only subjected to a banking book charge but would also being included in the general market risk VaR and "stressed" VaR capital charges and therefore contribute significantly more regulatory capital than a similar exposure in the banking book. This would create perverse incentives the other way and encourage banks to hold trading book exposures in the banking book. We do not believe the BCBS intends to set a higher capital charge for trading assets that can be liquidated more easily than for assets with an otherwise similar risk profile held to maturity. The requirement to compute both VaR-based and banking book regulatory capital will also result in significantly greater complexity, overhead and cost to firms' Basel II infrastructure, due to the need to capture the same trades in multiple systems consistently. This would discourage firms from holding risks in a mark to market environment, where the appropriate level of control and governance is applied.

We are also concerned as to what would actually be required of firms seeking to apply the banking book charge to such portfolios. We would recommend therefore that the

Basel working group elaborates further on this proposal and clarify how this might work in practice. For example, it would be necessary to clarify how to deal with offsetting positions, as implied by question 41. In terms of offsetting long and short positions, the existing market risk standard rules are extremely onerous and are one of the main reasons firms applied to use specific risk models for capital purposes in the first place. The banking book rules do not address long and short positions. As such, it is an inappropriate framework to apply to trading book assets.

The banking book framework is also inappropriate for trading book assets because the framework is only concerned with credit risk and the event of default and as such only addresses one of the material risks that trading book assets, recorded at fair value, are sensitive to.

Without better offsets and a framework that captures all material price risks firms cannot support a move to a banking book framework. It is important to note that given the nature of the IRC some firms may choose to give up their specific risk models as it is quite possible that under the new rules, trading book capital will be higher. We would urge the BCBS not to pursue such a proposal and potentially create such perverse incentives.

A different approach to illiquid positions in the trading book

We do not support this proposal as we do not believe that it is truly possible to define illiquid in this context. Liquidity is a function of many variables including size of position, rating, asset class and market conditions. It falls along a continuum from one day for foreign exchange to several months for some low rated structured assets. Also, willingness to take a loss is a key piece in determining whether liquidity really exists when bid-offer spreads are wide.

Furthermore there are different processes and risk management procedures in place for trading book and banking book positions that need to be considered, making short-term adjustments to capital calculation methodologies very challenging. As explained above liquidity is a characteristic of financial instruments that can come and go, and determining the approach to calculating minimum capital requirements on the liquidity of an instrument would lead to more volatile and potentially more procyclical regulatory capital requirements, an outcome that should be avoided.