Comment on New Basel Capital Accord Consultative Paper 3, April 2003

Risk-weights on Sovereign Debt under the Foundation and Advanced Internal Ratings-Based Approaches

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In general, the sovereign mandates their debt treatment. Clearly, Consultative Paper 3 provides this mandate substance for under the Standardised Approach, 28. However, this mandate is not treated specifically in either the Foundation or Advanced Internal Ratings-Based Approaches (IRB). Furthermore, the QIS Impact Study 3 - Areas of National Discretion does not provide for such discretionary choice under the IRB. i.e. http://www.federalreserve.gov/qis3/National_Discretion_Topics.pdf.

I suggest that this implicit preference be made explicit in the IRB. My specific suggestion is to add the text of section 28 to section 180:

180. .... In some cases, banks may be required to use a supervisory value as opposed to an internal estimate for one or more of the risk components. **At national discretion, supervisory values (e.g. PD, LGD, EAD and M) may be applied that lower risk weights to banks' exposures to their sovereign (or central bank) of incorporation denominated in domestic currency and funded[10] in that currency.[11] Where this discretion is exercised, other national supervisory authorities may also permit their banks to apply the same supervisory values and associated risk weights to domestic currency exposures to this sovereign (or central bank) funded in that currency.**

My particular concern with this item has arisen with regard to major international bank risk professionals' PD and LGD estimates for the U.S. sovereign. Some institutions assigned a 0.01% PD to U.S. Treasury debt. These estimates have led to more conversations about the potential for U.S. government default in the context of the Basle II definitions, 414. Though I believe this likelihood is zero, the point should be - and I believe is - moot from a bank regulatory capital perspective. Furthermore, I believe that Section 180, as written, includes the preference. Knowledgeable parties have disagreed.

The 0.01% PD estimate may have been simply misapplied to U.S. Treasury debt in interpreting the qiswk3.xls worksheet. I understand that U.S. regulators have and will set any U.S. Treasury security PD at zero. Furthermore, the reason a non-zero value was entered in the distributed worksheet arises from a programming feature of Excel.[2]

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[2] In application, any zero estimate input that induces spreadsheet error should be set to a small value that Excel supports. This value must not result in linked spreadsheet cell errors, #n/a error. I understand the smallest value is 9.99999999999999E-308. Since the IRB approach multiplies the PD and its related parameters (LGD, EAD, etc.) together and uses functions of these arguments, problematic 0% quantities (such as PD) may be entered in scientific spreadsheet cell format as 1E-25 (=0.0000000000000000000000001). At this slight round-up of zero, dependent calculations that are zero in monetary terms should be, and no linked spreadsheet errors should result.