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The Director General delegate

Paris, March 13th 2009

Response to the consultations on the Revision to the Basel II market risk framework and on the Guidelines for computing capital for incremental risk in the trading book

Dear Sirs,

We would like to thank you for inviting us to comment on the Basel Committee on Banking Supervision's consultative documents Revision to the Basel II market risk framework and on the Guidelines for computing capital for incremental risk in the trading book (BCBS 148 and 149) published in January 2009.

Whereas we understand the desire in the current climate to increase the regulatory capital requirements against exposures in the trading book, some of the proposed requirements would have undesirable penalising impacts without increasing the soundness of the risk assessment framework underpinning Basel II. The total market risk capital charges (general specific and IRC) should never be higher than the banking charges for an identical exposure. In that regard the quantitative study is critical and its outcome will have to play a central role in the establishment of the final rules. In addition, we are afraid that the consultative paper does not provide the necessary flexible framework able to capture the actual and ever changing nature of market risk.

While our detailed comments are made in the attached appendix, we would like to underscore a few main concerns for the Industry.

1- The request for a more flexible and comprehensive framework

While more capital for the trading book in some circumstances may be the appropriate outcome, and whilst we understand the need for having a pragmatic and simple solution to address main shortcomings of the current framework in a timely fashion, it is also very important that the increase remain proportionate to the actual risks incurred, and that we leave the door open for model amendments. Institutions should be allowed and even incentivized to improve the current framework so as to really address the weaknesses that were highlighted in the first place.

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We strongly favour regulatory guidelines that are high level and principles-based and appreciate that reintroducing the necessary flexibility for firms to develop more comprehensive and advanced solutions would help restore the balance between conceptual soundness on the one hand and operational practicality on the other. This particularly applies to the addition of the "Stressed" VaR element along with the possibility for institutions to evolve towards a fully integrated model, including the incremental risk charge in the long run.

As well, full IRC modelling should be made available to firms who can prove to their regulators that they can adequately capture risks associated with certain types of structured products, such as securitisations, tranching exposures or n-th loss positions. The proposed measure should be understood as temporary and fall back solutions.

2- Two sets of rules are jeopardizing the banks' ability to support the economy

A)The consultative papers introduce a new category of exposures: re-securitization. But its definition is too extensive in two broad cases:

- where the underlying pool of assets comprises immaterial and/or temporary quantities of securitisation exposures. In that case a 5% materiality threshold would be appropriate;
- transactions where different vehicles are used for technical reasons: one vehicle is used to transform a pool of assets into a security, another one is used to refinance the bond, which typically is the case for ABCP conduits. Economically each bond is refinanced independently and covered by a liquidity line from the bank; therefore the scheme does not correspond to a re-securitization. ABCP conduits and re-securitisations do not use the same assessment model and do not hold the same kind of assets; therefore the definition of re-securitization should not encompass that kind of operations.

ABCP conduits refinance the real economy and it would be a mistake to penalize these transactions when credit is scarce.

B) Correlation trading refers to synthetic CDOs, i.e. synthetic tranches of portfolios of corporate entities. This activity would be severely affected by its new status. We are extremely concerned that this activity, which provides liquidity, helps transfer risk and plays a key secondary role in banks ability to provide credit, would be unreasonably penalised by the proposed changes, leading many institutions to abandon the business definitively. A survey of leading correlation dealers has indicated the increase of regulatory capital solely caused by the application of the proposed standardised approach to bespoke and index tranches to be at least 10 times the overall regulatory capital that is required under the current rule for the correlation trading activity.

We therefore firmly request that the Basel Committee reconsider its deletion of the exemption from the securitization scope currently in place for certain exposures (paragraph 718 xcv) provided that the underlying assets are genuinely liquid, which can be demonstrated.

3- Accounting and prudential valuations should be unique

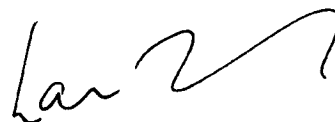
The changes to the "prudent valuation framework" proposed by the Basel Committee are widening further the gap between financial reporting based on accounting standards and reporting for regulatory capital purposes. This would unduly create confusion, market uncertainties and complicate communication to internal and external parties. This will also increase the complexity and therefore the costs of reporting and monitoring processes.

4- The level playing field must be kept even

The Basel II framework was published in 2004 by the Committee and is not yet implemented in some countries which took part in the negotiations. French banks strongly require a full application of the Basel II rules before modifying the market risk part of the framework. We cannot accept increased capital requirements for the trading book unless all institutions are required holding the same level of capital to prevent competitive distortions.

The French Banking Federation wants to see the instigation of healthy competitive conditions and believes the only way to do so is to establish appropriate regulations. The FBF remains at the Basel II Committee on Banking Supervision's disposal for any further discussion on these matters.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'Lauzun', with a stylized flourish at the end.

Pierre de Lauzun

Appendix: Detailed comments

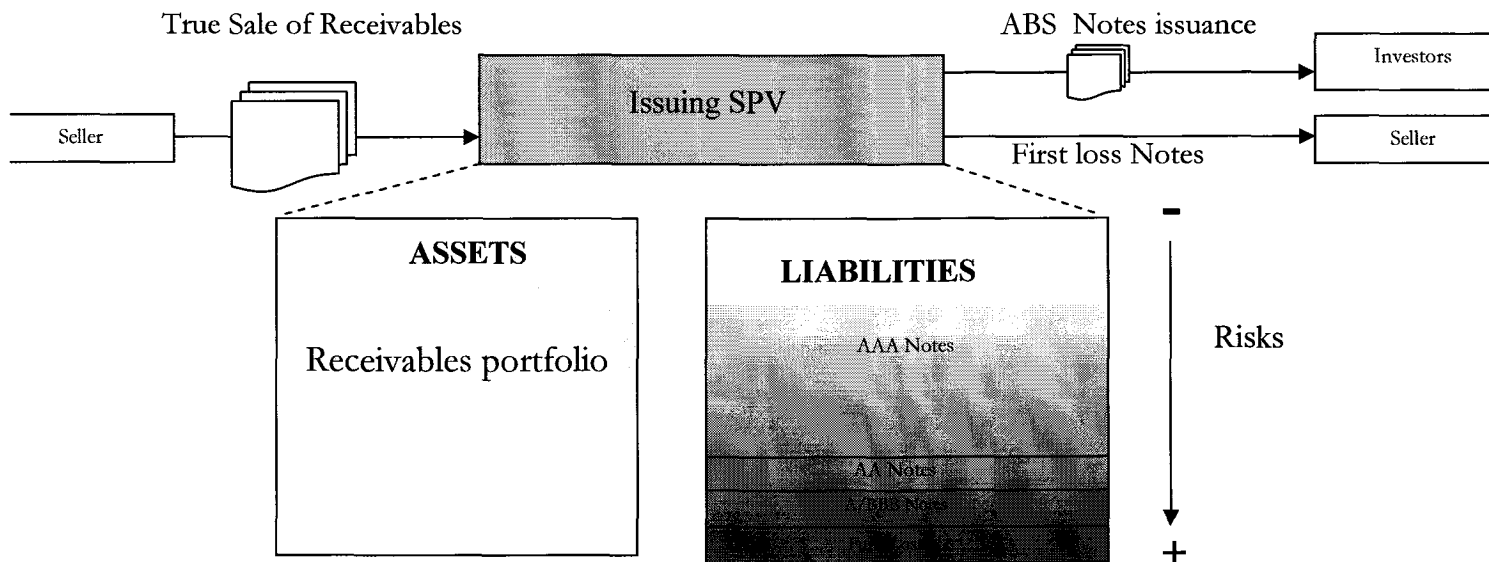
Securitisations

Multi-seller commercial conduits are not re-securitizations. Re-securitizations are CDO's of ABS/RMBS (or CDO's of CDO's), SIV's and securities arbitrage conduits.

1. Why ABCP structures are not re-securitisations

To understand the rationale for conduit structures, let's first get back on the ABS structure, as described below:

ABS structures are one-off structures, i.e. a single - and homogenous - pool of asset is purchased, the documentation is written, the bonds are issued and placed in the market and after issuance, no modification excepted those provisioned in the documentation will or can occur.



ABS structures are fine for substantial volumes, but :

- they do not allow low-volume sellers (typically corporates) to get access to the capital markets as investors would have a major concern in connection with the low liquidity of their investment.
- they are less flexible in terms of adjustment of the financing, which is a key concern for corporates as their financing needs to vary across time (seasonality of commercial activity, purchase/disposal of subsidiaries), a flexibility offered by the short term CP markets.

This is where ABCP structures excel: an ABCP structure will gather all the senior tranches of different portfolios of different sellers, and refinance it globally, **on a pari-passu basis** on the financial markets; having reached a critical mass.

Therefore an ABCP is by nature a two-stage structure:

- a first stage which is dedicated to the true-sale of the receivables to a dedicated SPV, and where the tranching between the senior and junior tranches takes place (like an ABS structure). The seller keeps the first loss on his own portfolio by purchasing the junior tranche, and does not see his own risk polluted by other sellers.

- a second stage where a refinancing SPV buys all the senior notes of those different portfolios and refinances them in the markets.

It is very important to note that the refinancing is raised *pari passu* against all these senior tranches therefore there is no retransching at this second stage of the structure.

Therefore, despite this two-stage structure, ABCP conduit does not compare with re-securitisation,

2. ABCP conduits and re-securitisations do not use the same assessment model

In an **ABCP** conduit, **the model rationale is based on the analysis of the credit risk** of the underlying receivables, which are part of an homogeneous portfolio, and therefore tranching at that level, whereas the **re-securitisation model is based on the correlation** between the performance of the different tranches that are gathered together from different pools of different asset classes.

In other words, an ABCP conduit will focus on each pool with a credit analysis, and determine the risk that will be kept by the seller of the receivables, whereas the re-securitisation model will look after what can be expected in terms of revenues on the different tranches, given their ratings and the correlation between them.

3. ABCP conduits and resecuritisations do not hold the same kind of assets.

CDOs and SIVs issue debt to buy publicly-rated, registered (typically DTC or Euroclear) securities based on credit ratings, and then passively rely on the performance or the trading of these securities for repayment even as performance and/or value may deteriorate.

Multi seller conduits issue debt to finance private market transactions, through unregistered and typically unrated or not publicly rated, debt instruments (**not securities**) such as loan agreements or note purchase agreements or receivables purchase agreements, whereby the terms of the transactions are directly negotiated between the conduit sponsor and its clients. As such, multi seller conduits have the direct ability to establish the terms of such transactions and have the ongoing ability to re-negotiate, restructure, and reprice such transactions directly with the client.

Correlation trading

Correlation trading refers to synthetic CDOs, i.e. synthetic tranches of portfolios of corporate entities. What differentiates this activity from the rest of securitisation is that the first-order risk of these tranches can be hedged with liquid market products.¹

The new framework would lead to a major increase in the capital charge of the trading book. The impact of the proposed rules on credit correlation trading businesses must be strongly underscored. We are extremely concerned that this activity, which provides liquidity, allows risk transfer, and plays a key secondary role in banks ability to provide credit, would be unreasonably penalised by the proposed changes, potentially leading to many institutions abandoning the business permanently.

1. Derecognition of internal models, and application of the proposed standardised approach would create a distorted risk assessment environment: risk netting between tranche exposures, and related single name and index

¹ When the portfolio is one of the credit indices (iTraxx, CDX), the tranche is called an index tranche; otherwise it is a bespoke tranche. Each bespoke tranche can be dynamically hedged with liquid market products: corporate CDSs for the spread delta-hedge, and index tranches for the correlation delta-hedge, thus leaving only residual risk to the dealer.

hedges would no longer be possible. The impossibility to offset long and short positions in correlation books under the Standardised approach for specific risk derives from the application of para 709(iii) and 713 to 717 of the revised Basel II Framework, and may entail that a capital charge will be assessed against the full notional amount of both long and short positions.

2. A survey of the leading correlation dealers has indicated the increase of regulatory capital solely caused by the application of the proposed standardised approach to bespoke and Index tranches to be at least 10 times the overall regulatory capital that is required under the current rule for the correlation trading activity.
3. The demise of the 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.
4. In addition, as banks reduce their correlation trading activities, the ensuing lack of liquidity will create material market disruption and significant valuation losses.

We therefore firmly request that the Basel Committee reconsider its deletion of the exemption from the securitization scope currently in place for certain exposures (paragraph 718 xcv) provided that the underlying assets are genuinely liquid.

“Stressed” VaR

Regarding the “Stressed” VaR element, it is striking that although everybody will agree that the current framework could not capture some market parameters behaviours that happened in the 2007-2008 stressed period, the current proposal would in fact punish more severely the institutions with the most resilient model (as measured by the number of breaches in the backtesting). Indeed, the current proposal does not correct the discrepancies between institutions, but reinforces it by adding a “Stressed” VaR which is also likely to be higher for the most resilient models.

Beyond the many issues with “Stressed” VaR highlighted in the ISDA comment and the potential double counting of risk between VaR and “Stressed” VaR that is built in the current proposal, we would favour a weighted average between the VaR and “Stressed” VaR that could address the flaws of the approach, such as this first suggestion:

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

where :

- $m = 3$,
- m' to be defined – some institutions challenge the relevance of the multiplier m also applied to the Stressed VaR,
- b reflects the backtesting of the current/improved VaR model over the previous year,
- b' reflects the backtesting of the current/improved VaR model over the market scenarios of 2007/2008. Given the operational burden, it would be calculated by firms only when they want to demonstrate that the model has improved,

Both b and b' will naturally decrease when the breaches decrease, e.g. when a firm improves its model:

- factor $m+b$ would be calculated consistently with the current internal modelling

framework², and no longer be capped at 4;

- b' needs to reflect experience during 2007-2008. We suggest it falls to zero when a firm has less than 10 VaR exceptions, and would increase to 1 when the number of exceptions reaches a maximum (to be determined)

The intuition here is that an improved model that performs well on the backtest over 2007-2008 is likely to incorporate already some stress metric *directly* in the everyday VaR model, which is then less volatile and less procyclical. In this case, a "Stressed VaR" add-on would be redundant, and this is captured by a low factor b'.

Nevertheless, firms that do not wish to incorporate this stress element directly in their model will have a larger b' and will then still be subject to the "Stressed VaR" add-on.

Treatment for illiquid positions

In the section on the treatment for illiquid positions, the changes to the "prudent valuation framework" proposed by the Basel Committee are further widening the gap between financial reporting based on accounting standards and reporting for regulatory capital purposes.

This would unduly create confusion, market uncertainties and complicate communication to internal and external parties. This will also increase the complexity and therefore the costs of reporting and monitoring processes.

There should be only one definition of 'fair value' for both accounting and prudential regulation. Positions accounted at 'fair value' for regulatory purposes must be the same as those agreed in accordance to the standard setters' guidance on 'fair value'.

Rather than dividing the processes for accounting and market risk measurement even more we would welcome a convergence of both systems. Regulators should work together with standard setters and agree that there cannot be two pricing mechanisms: one to meet the valuations used for regulatory purposes and another one to meet the valuations used for the financial statements. In our view, any fair value calculus must encompass a liquidity premium, according to the size of the position and the depth of the instrument's market. There is no rationale for assessing this premium on a different basis for accounting and prudential purposes.

The Basel Committee should increase its involvement with standard setters to ensure that the regulators' needs and the constraints of banking institutions are considered in the drafting process of accounting standards.

Exclusion of securitisation positions from the scope of IRC

Full IRC modelling should be made available to firms who can prove to their regulators that they can adequately capture risks associated with certain types of structured products, such as securitisations, tranching exposures or n-th loss positions. It is unlikely that firms would be able to do so for the sorts of opaque, leveraged securitizations and re-securitizations that were the source of large trading losses in 2007/2008, which would therefore be subject to the Standardised approach, leaving simpler and better understood securitization product eligible for a model based capital charge.

² The formula reads : $m+b = m * 2.33 / \text{NORMSINV}(1 - E/O)$ where E is the number of exceptions (i.e. VaR breaches) and O is the number of observations (around 250 per year)