

# ZENTRALER KREDITAUSSCHUSS

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## Comments

**of the Zentraler Kreditausschuss<sup>1</sup>  
on the Consultation Papers**

**of the European Commission,  
the Basel Committee on Banking Supervision and the  
International Organisation of Securities Commissions**

**on “The Application of Basel II to Trading Activities and  
the Treatment of Double Default Effects”**

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<sup>1</sup> The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Hypothekbanken (VdH), for the mortgage banks. Collectively, they represent more than 2,300 banks.

Dear Madam, dear Sir,

Many thanks for the opportunity to comment on your consultation documents *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects* and *Trading Activities related Issues and the Treatment of Double Default Effects*. We should like to point out, however, that our comments are subject to final approval by the relevant committees of the member associations of the ZKA.

We warmly welcome the fact that the working groups set up by the Basel Committee and IOSCO on counterparty credit risk and double default and on short-term maturity were able to complete their work in time for their findings to be incorporated into the Basel Revised Framework and the corresponding European directives. The conclusions of the third working group on trading book issues (particularly in the area of specific risk) and settlement risk, on the other hand, are not acceptable in their present form. The proposals need to be discussed in detail with the banking industry, but it will not be possible to complete such a discussion within the tight timeframe of the current Basel consultation process. We suggest entering into a dialogue with the banking industry to agree on a suitable timetable for the consultations needed to together develop suitable solutions. Furthermore we should like to point out that we do not consider the current rules on maturity adjustments for exposures of less than one year to be appropriate.

Our comments make reference as follows to the documents mentioned below:

- (EU Annex ... Part ...) refers to the working document of 8 April 2005 on recasting Directives 2000/12/EC and 1993/6/EEC,
- (Basel (TB) para. ) refers to the Basel Document on *The Application of Basel II to Trading Activities and the Treatment of Double Default Effect*,
- (Basel (RF), para. ) refers to the Basel Revised Framework of 2004.

## **I. The Treatment of Counterparty Credit Risk**

We welcome the proposal to allow two new risk-sensitive methods of measuring counterparty credit risk (CCR). Nevertheless, it is equally important that it should continue to be possible to apply the existing methods of measuring the CCR of derivatives (current exposure/original

exposure method) and securities financing transactions (SFTs)<sup>2</sup>. The range of eligible methods will then reflect the heterogeneous structure of banks with respect to their business activity and level of risk management. The introduction of two new methods only makes good sense, however, if there is an incentive to move to a more complex method because it will reduce capital requirements. This depends on a suitable calibration of the  $\alpha$  and  $\beta$  parameters. If  $\alpha$  and  $\beta$  are set too high, the banks will balk at the investment needed to change from the existing to the two more risk-sensitive methods.

We have the following comment on the methods' scope of application. Derivative contracts traded on exchanges where the clearing house serves as the counterparty and where there is daily margining may be excluded from the CCR calculation and the "exposure value" set at zero (EU Annex III, Part 2, para. 4 Directive 2000/12/EC, Basel (TB) para. 93).

The zero exposure value for transactions traded on an exchange should also apply to trades by third parties which the bank route to the exchange provided that the bank demands the same level of collateral as the exchange, there is daily settlement of gains and losses and it is possible to unwind the positions at any time in the event of failure to perform. In the case of derivatives traded on an exchange, the CCR is eliminated by the provision of collateral, daily settlement of gains and losses and the possibility of compulsory termination in the event of failure to perform. This applies not only to trades where the exchange is the direct counterparty of the reporting bank, but also to trades with third parties which the bank routes to the exchange. As long as the client has to provide the same level of security as the exchanges require from their clearing houses, the exclusion should also be applicable to transactions with third parties.

## **A. The Internal Models Method**

### **1. Concept and Computation of Effective Expected Positive Exposure**

Of the various concepts for considering roll-over effects that were discussed when preparing the consultation document, the effective expected positive exposure method (EEPE) is one of the most conservative. Nevertheless, it has several advantages. First, it allows consistent

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<sup>2</sup> EU Annex Part 2(1) Directive 2000/12/EC makes clear that the banks must, with the approval of supervisors, use one of the approaches described in Parts 4 to 6 for **derivatives** (original exposure method, SM, IMM). We assume it is due to an editorial oversight that the current exposure method (Part 3) is not mentioned.

treatment of SFTs and OTC derivatives. Second, it is easy to implement for banks that already measure and manage risk internally on the basis of expected exposure (EE) and thus does not entail significant additional IT expenditure. It is also relatively easy to calculate EEPE, which makes it a simple answer to a difficult problem. But this applies only as long as banks are not able to take account of roll-over effects when calculating effective positive exposure (EPE). If industry practice evolves in this respect and EPE starts to reflect roll-over, the appropriate basis for calculating this additional exposures should be EPE, not EEPE.

Annex III; Part 6, para. 6 Directive 2000/12/EC of the draft Directive and Basel (TB) para. 117 state that for contracts with a maturity of less than one year, EPE is defined as the “average of expected exposure until all contracts in the netting set mature”. We recommend clarification that it is also possible to limit the timeframe by exercising a termination clause.

We would like to point out with respect to Basel (TB) para. 126 that methodological consistency with the IRB approach requires that EEPE, not EPE, must be used when calculating M for an original maturity of less than one year.

The requirement to calculate EE on a daily basis is inappropriate, in our view. The same applies to the requirement for an assignment to time buckets when calculating EPE and to the required calculation frequency (EU Annex III Directive 2000/12/EC Part 6, para. 13n/Basel (TB), para. 141). The proposed calculation frequency and granularity with respect to time are out of touch with industry practices and would create an excessive operational burden with little added value in terms of risk management. We consider it sufficient to calculate EE on a monthly basis. The frequency of calculating the individual time buckets could be as follows, for example: on a weekly basis for the first three months, then on a monthly basis up to one year and on a semi-annual basis up to five years.

We consider the requirement to calculate current exposure both gross and net of collateral to be excessively onerous. To calculate gross exposure for an SFT, the transaction would have to be separated into its two components, i.e. legs of trade (EU Annex III Part 6, para. 13g and m Directive 2000/12/EC, Basel (TB) para. 140). This is at odds with the underlying definition of the instrument, however, and with Basel II’s approach to calculating exposure, namely before including an LGD. The required division would offer no additional information about the instrument’s risk potential and is therefore to be rejected. We would, moreover, point out that neither the draft Directive nor the 2004 Revised Framework require such a division into the two legs in their proposed methodology for SFTs.

We support permission to use a simplified method of calculating margin agreements in modelling EPE (EU Annex III Part 6, para. 12/Basel (TB), para. 129). We would like to draw your attention to an inconsistency in the rules, however. The simple method for margined counterparties uses a minimum margin period of risk of ten days. In the draft Directive and the 2004 Revised Framework, on the other hand, the calculation of supervisory haircuts is based on a minimum period of five days (EU Annex III Part 3, para. 38/Basel (RF), para. 167). In the interests of consistency, a margin period of five days should be used throughout.

## 2. Approval of Methods

We welcome the approach adopted by the EU, the Basel Committee and IOSCO of recognising parallel use of the various available methods (EU Annex III Part 2, paras. 1-2 Directive 2000/12/EC, Basel (TB) paras. 106-110). It must be emphasised, however, that the banks will not be in a position to simulate the entire portfolio using the EEPE method. This is because, first, there are transactions for which simulation is too complex from a technical point of view. Second, it makes good sense where new products and business segments or acquired units are concerned to begin by using a more conservative method such as the CEM until enough experience with the simulation has been gained. Against this background, we believe the phrase “immaterial in size and risk” regarding exposures that may be excluded from the selected method is too restrictive.

In our view, the proposed new standardised method is a method whose input parameters are either prescribed or approved by supervisors (“instrument models that are recognised under the rules on market risk”). This method should therefore not need separate supervisory approval; the accuracy of the calculations should be examined in the course of normal supervisory solvency monitoring.

## 3. Supervisory $\alpha$ and Internal Estimates of $\alpha$

An analysis by the ISDA has shown that an  $\alpha$  set at 1.4 is too conservative (EU Annex III, Part 6, para. 4 Directive 2000/12/EC, Basel (TB), para. 119) since this value results only if the number of counterparties and relevant market factors in the simulation is very small (one market factor and less than 50 counterparties). For the average market participant, this situation does not apply. We therefore suggest significantly lowering  $\alpha$  in order to increase the incentive for using the internal models method (IMM).

We welcome the possibility of using internal estimates for  $\alpha$  (EU Annex III, Part 6, paras. 9-11 Directive 2000/12/EC, Basel (TB), paras. 122-125). We consider the requirement to calculate  $\alpha$  every three months to be excessive, however. The major elements influencing the value of  $\alpha$  are the number of counterparties and market factors. In view of the fact that these will not change significantly over a period of less than one year, making these calculations every three months will not produce any great variation in the results. We therefore suggest an annual estimate. We do not understand the need to take account of an economic downturn scenario in estimating  $\alpha$  and would ask for urgent clarification of how this is to be done. The requirement to take account of model or estimation errors makes little sense and is to be rejected. Such errors should become apparent when backtesting or stress testing the exposure profile, since these tests enable fat tails to be identified.

Finally, we believe a floor of 1.2 for an internal  $\alpha$  estimate is inappropriately high. The costly and time-consuming internal estimation process would only succeed in lowering the multiplier by 0.2. This does not offer sufficient incentive. We also wonder why the results of a model for estimating  $\alpha$  which has been approved by supervisors cannot be trusted. We therefore advocate dispensing with the floor.

Our comments also apply to the proposed rule in EU Annex VIII, Part 3, para. 21 Directive 2000/12/EC, under which the  $\alpha$  for the IMM would be used as the multiplier to be included in a VaR approach approved for netting purposes.

#### 4. Recognition of Financial Collateral

Only financial collateral as defined in the draft Directive and in the 2004 Revised Framework (EU Annex VIII, Part 1, paras. 7-11 Directive 2000/12/EC, Basel, (RF) para. 146) may be included in the computation of EPE (EU Annex III, Part 6, para. 3 Directive 2000/12/EC, Basel (TB) para. 111). This restriction on the eligibility of collateral is not appropriate for trading activities, in our view. On the one hand, it prevents the recognition of sub-investment grade debt as a valid form of collateral or as underlying instrument of Reverse Repos/Security Borrowing etc., even though such collateral is eligible against trading book repo-style transactions under para. 703 of the Revised Framework. This introduces inconsistency in EAD calculation between VaR-based and EPE-based counterparty credit risk charges. Furthermore, it leads to the de facto exclusion of commodity collateral although such collateral is an effective means of hedging commodity position risk. Firms actively trading commodity derivatives often rely heavily on physical collateral. We therefore suggest that all collateral

should be eligible for calculating EEPE that meets the requirements of EU Annex VIII, Part 2, para. 8 Directive 2000/12/EC and para. 509 of the 2004 Revised Framework.

## 5. Validation and Stress Testing

For similar reasons to those outlined under section I.A.1, we consider it inappropriate to require stress tests to be conducted gross and net of collateral (EU Annex III, Part 6, para. 13q Directive 2000/12/EC, Basel (TB), para. 144). Even in a scenario where market factors are unfavourable, it may be assumed that the underlying agreements will be legally enforceable. There is therefore no reason to estimate exposure on the assumption that the portfolio is unsecured.

In addition, we would appreciate clarification of what is to be understood by “a bank must measure its solvency target over the life of all contracts in each netting set” (EU Annex III, Part 6, para. 13p Directive 2000/12/EC, Basel (TB), para. 143). We would categorically reject a requirement always to comply with the 8% solvency ratio even in a stress scenario since it would be tantamount to raising the minimum capital ratio. Furthermore, we consider the monitoring of compliance with the regulatory solvency ratio to be a Pillar II element, which should be analysed for the entire portfolio in the context of Pillar II. It makes little sense to discuss monitoring one part of the portfolio in the context of Pillar I.

## 6. Operational Requirements

The requirement to use historical data going back at least three years or a full business cycle for the purpose of estimating correlations is excessive, in our view (Basel (TB), para. 149). It raises both the general question of how to pinpoint the beginning and end of a business cycle and, what is more, the issue of how much influence cyclical fluctuations actually have on risk from trading activities.

We consider the requirement for the CCR measurement to include measuring overnight and intra-day usage of credit lines and economic capital allocation totally unacceptable (EU Annex III, Part 6, para. 13g Directive 2000/12/EC, Basel (TB), par. 198). It is not normal practice in the banking industry to measure economic capital requirements daily for internal risk management purposes. Current best practice – and perfectly adequate from a risk perspective – is measurement of economic capital requirements on a monthly and the usage of

credit lines on a daily basis. We therefore advocate amending the prescribed periods accordingly.

## **B. Standardised Method**

The standardised method is based on allocating modified duration for debt instruments and delta to transactions in order to calculate risk positions. As under the standardised method of calculating market risk for OTC derivatives, transactions have to be divided into their two legs of trade in order to allocate the corresponding standardised method delta to each leg (EU Annex III, Part 5, paras. 3-5 Directive 2000/12/EC, Basel (TB), paras. 69, 161 and 167). There are no economic grounds, in our view, for splitting the transaction into two legs of trade. We therefore suggest simplifying the envisaged method of calculating the risk position so that it is only necessary to calculate a single delta for the whole transaction. We also consider it unnecessary to assign time buckets for the hedging sets in the standardised method (Basel (TB) para. 171, EU Annex III, Part 5, No. 13 Directive 2000/12/EC). A parallel shift of the interest rate curves already depicts interest rate risk very precisely.

Furthermore, we believe there is a need for clarification regarding the recognition of collateralised transactions. We assume that it is permitted to recognise collateral when calculating EAD under the standardised method and that the reference to non-recognition is an editorial error (Basel (TB) para. 58).

In addition, we consider the current calibration of  $\beta = 2$  to be too conservative. The argument that the standardised method does not adequately capture basis risk can be countered by pointing out that this is already taken into account by restricting the recognition of offsets for positions of opposite sign (Basel (TB) para. 71). We therefore welcome statements by both the European Commission and the Basel Committee / IOSCO that they intend to adjust the calibration of  $\beta$  in the course of future consultations.

EU Annex III, Part 5, para. 18 Directive 2000/12/EC sets out the CCR multipliers (CCRM)s for the hedging set categories. It is not possible at this stage to make a definitive assessment of the appropriateness of the values or their relative differentiation. We would therefore suggest introducing a clause whereby these rules will be reviewed and if necessary adjusted two years, for example, after the method enters into force.

## II. Cross-Product Netting

We do not share the assumption that the legal enforceability of netting SFTs against OTC derivatives is not sufficiently certain at present to justify supervisory recognition of cross-product netting agreements (EU Explanatory Document 2.1.5, Basel (TB), paras. 22-29). Furthermore, the assertion that national competent authorities believe that the operational and legal criteria for recognising cross-product netting are not satisfied at present is too broad and ignores important new developments in documentation practices. It is stated, for example, that a legally enforceable agreement has yet to be developed. Since the claim that the legal enforceability of cross-product netting is not assured does not reflect the facts, it is mistaken to conclude that supervisory recognition for cross-product netting should therefore be withheld for the time being.

The legal enforceability of cross-product netting is evidenced by legal opinions, a number of which have now been issued on the European Master Agreement (EMA) in various jurisdictions<sup>3</sup>. They are proof of legal enforceability, even if SFTs and OTC derivatives are concluded in parallel under one master agreement. The EMA is widely used – not at least because of the advantages of cross-product netting. The European Central Bank (ECB), for example, announced its own use of the EMA in general for risk-management purposes as early as 2001<sup>4</sup>. Recently, in connection with the extended use of the Agreement, it issued a publication on the additional legal documentation offered by the EMA<sup>5</sup>. This states that, from 15 June 2005 at the latest, the ECB will use this type of agreement also for OTC derivatives

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<sup>3</sup> See the overview on the FBE website (<http://www.fbe.be/content/Default.asp?PageID=91>) of the jurisdictions on which legal opinions have been issued: Austria, Belgium, Denmark, Finland, France, Germany, Great Britain, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Spain, and Switzerland. The current opinions cover transactions which since 2004 have been able to be documented with the Derivatives Annex. The ZKA would be happy to supply copies of these legal opinions on request.

<sup>4</sup> *European Central Bank*: “Guideline of the European Central Bank of 16 November 2001 amending Guideline ECB/2000/1 on the management of the foreign reserve assets of the European Central Bank by the national central banks and the legal documentation for operations involving foreign reserve of the European Central Bank (ECB/2001/12)/(2001/833/EC)”, OJ L 310, of 28 November 2001, pp. 31ff.

<sup>5</sup> *European Central Bank*: “Guideline of the European Central Bank of 11 March 2005 amending Guideline ECB/2000/1 on the management of the foreign reserve assets of the European Central Bank by the national central banks and the legal documentation for operations involving foreign reserve of the European Central Bank (ECB/2005/6)/(2005/328/EC)”, OJ L 109 of 29 April 2004, pp. 107ff. May be viewed at [http://www.ecb.de/ecb/legal/pdf/1\\_10920050429en01070109.pdf](http://www.ecb.de/ecb/legal/pdf/1_10920050429en01070109.pdf).

and deposits, and thus on a cross-product basis, in its dealings with all counterparties in Austria, Belgium, Denmark, Finland, France, Germany, Great Britain, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Spain and Switzerland. The legal opinions were previously subjected to detailed analysis.

Should doubts about the legal certainty of enforceability remain because the cross-product netting documentation available up to now has mainly consisted of a combination of several agreements, these would also no longer be justified<sup>6</sup>. Unlike the Cross Product Master Agreements (*CPMA 1 & 2*) developed by The Bond Market Association (TBMA) or the *Bridges* of the International Swaps and Derivatives Association (ISDA), in which individual product groups are first documented in separate master agreements and then consolidated or included in a single umbrella agreement only on termination (or for collateralisation purposes), the EMA does, in fact, consist of only one agreement. It has uniform termination grounds and is subject to one contract law.

Due to the conclusions of legal opinions, we consider cross-product netting solutions based on the above master agreements legally enforceable even if certain particularities have to be taken into account in individual jurisdictions.<sup>7</sup> Particularities relating to individual jurisdictions are nothing new in international agreements, however. In our view, therefore, the rules in Directive 2000/12/EC Part 7 and Basel (TP), paras. 94-102 are met. Even possible exceptions in a few jurisdictions do nothing to change the overall positive experience already gained concerning the agreements' legal enforceability. We therefore advocate recognising cross-product netting for OTC derivatives and SFTs.

We also believe clarification is needed of the criterion in Directive 2000/12/ EC Part 7b(ii) and Basel (TB), para. 97, whereby a legal opinion must be recognised by the legal community or by a memorandum of law addressing all relevant issues. It cannot be the intention to require a legal opinion to be issued on a legal opinion. We would therefore suggest deleting this bullet point, or at least the final sentence.

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<sup>6</sup> The reference solely to the ISDA-TBMA paper *Trading Book and Credit Risk Mitigation Capital Review, 2004* gives rise to the assumption that the consultation paper's findings have not taken into account the most recent developments concerning the EMA.

<sup>7</sup> For further information on the legal enforceability of the *Bridges*, please see ISDA's comments under <https://my.isda.org/isdaforum/isdaloginframeset.asp>.

### **III. Improvements to the Current Trading Book Regime**

As we pointed out in our introductory remarks, we do not consider the third working group's proposals – the basis of our comments in this section of our response – to have been sufficiently thought through. The proposals were introduced into the Basel consultation process only at a very late stage and were developed without any input from the banks. Major aspects, especially those concerning Pillar I, do not have the support of the industry. Implementation of the rules in their present form is therefore not acceptable. The proposals need to be discussed in detail with the banking industry and it will not be possible to conclude these discussions within the tight timeframe of the current consultation process. The following are preliminary observations in anticipation of the upcoming debate.

#### **A. Minimum Capital Requirements**

##### **1. Capital charges Related to the Trading Book/Banking Book Boundary**

We reject the introduction of a list of specific instruments which are excluded from inclusion in the trading book from the outset (EU Annex VII, Part D Directive 1993/6/EEC, Basel (RF) paras. 689a to c). Positions should be allocated to the trading book or the banking book solely on the basis of the existing general allocation criteria (EU Article 11 and Annex VII, Part A, No. 1 Directive 1993/6/EEC, Basel (RF) paras. 684-689). We believe these criteria are an appropriate and suitable means of assigning all transactions to the trading or banking book in a manner that is clear and makes good sense. We consider it entirely appropriate, for example, to allocate certain equity stakes to the trading book provided that the criteria are satisfied. Calculating the capital charge under the banking book rules would be out of proportion to the risk involved in this case. The same goes for securities from securitisation transactions such as asset-backed or mortgage-backed securities which are traded on the market even if their credit rating is low, and for credit exposures earmarked for securitisation. Moreover, the “material holdings” referred to in EU Annex VII, Part IV/Art. 57(l), (m), (n) Directive 2000/12/EC, Basel (RF) para. 689(c)) can also in principle satisfy the criteria for inclusion in the trading book.

It must, in particular, be possible to allocate positions to the trading book if they closed out by opposite positions within a short space of time, thus generating short-term arbitrage profits (cf. also Basel (TB) para. 277: “The [new trading book] definition makes clear that positions held with trading intent are those held ... to lock in arbitrage profits.). The question of an instrument's tradability should at least not play a decisive role if the bank has succeeded in dealing adequately with the corresponding risk drivers. The focus should be on an

economically accurate portrayal of the risk involved, not formal arguments as to an individual instrument's ability to be resold. We would also point out in this connection that application of the banking book rules is unable in the majority of cases to take accurate account of the hedging of positions by the incoming offsetting transactions, thus resulting in an artificial exaggeration of risk.

## 2. Further Prudent Valuation Guidance

In principle, we consider it appropriate for the banks to take account of less liquid positions in their internal risk assessment. How this is done should be left to the banks themselves, however. The envisaged downward valuation adjustment is only one method of doing so and will not always be the most sensible solution (EU Annex VII, Part B, para. 11 Directive 1993/6/EEC, Basel (TB) para. 303/700). A rigid valuation system prescribed by supervisors would be unable, in contrast, to take account of bank-specific circumstances.

We also reject the envisaged direct impact on Tier 1 regulatory capital of less liquid positions. Prudent valuation of these positions is already ensured by financial accounting standards. A separate valuation system which diverged from accounting rules would be highly onerous and difficult to implement in practice.

The appropriateness of the banks' internal consideration of illiquid positions should therefore be examined only in the context of Pillar II.

## 3. Trading Book Capital Treatment for Specific Risk under the Standardised Methodology

Under the standardised approach, non-qualifying issuers are subject to the same capital charge as non-investment grade corporate borrowers (EU Annex 1, para. 14 Table 1 Directive 1993/6/EEC, Basel (TB) paras. 307/713). We consider it appropriate to accord these instruments equal treatment and see no need for a national discretion arrangement permitting higher charges.

## 4. Trading Book Capital Treatment under the Internal Models Approach

The significantly more stringent criteria for supervisory recognition of internal VaR models under discussion in Basel and in Brussels, particularly in the area of modelling specific risk,

would make it necessary for German banks to make extensive adjustments to their internal VaR models and give rise to substantial costs. Given the rule prescribing the use of longer periods of historical data for VaR estimates (at least a whole business cycle), it must be assumed that considerable time would be needed to adjust the models. What is more, it is not possible to acquire market data from data suppliers, so the banks have no alternative to collecting their own data.

At present, no German bank has a non-surcharge model eligible for recognition under the new rules (a model capable of capturing event risk pursuant to EU Annex 5, end of para. 10, Basel (TB), para 312( 2)). As far as we are aware, no non-surcharge models have yet been approved anywhere in the world that would meet the envisaged requirements.

The VaR models used by German banks are already today capable of at least partially capturing event risk by techniques such as spread modelling, for example. Despite higher default rates in recent years, backtesting has shown these models to be conservative. The backtesting results indicate that it is not necessary to increase the VaR and the associated capital requirements for trading book risk in the context of Pillar I.

The third working group's proposals for modelling event and default risk contain various inconsistencies<sup>8</sup>. Furthermore, the amount of additional capital charges for trading book positions resulting from the proposals is not known at this stage, thus introducing a further element of uncertainty into calibrating Basel II capital requirements.

With this in mind, we strongly advocate postponing implementation of the third working group's proposals on Pillar I for the time being and separating further discussion of them from the current consultation process. We suggest entering into a dialogue with the banking industry to agree on a suitable timetable for the development of appropriate requirements and the introduction of non-surcharge models. Until then, the use of surcharge models should be accepted as before without imposing any additional requirements.

The following comments are to be seen against the background of these general introductory remarks. Their objective is to commence the dialogue on revising the requirements and illustrate a few areas where there is still a considerable need for further consultation.

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<sup>8</sup> We refer you in this regard to the responses from ISDA and the IIF, which go into the methodological weaknesses of the approach in more detail. We have singled out some examples in our comments below.

- a) According to the consultation paper, it must be demonstrated that default risk is captured in regulatory capital even by a non-surcharge model that adequately models event risk and that there is consistency with a one-year time horizon and 99.9 percentile confidence level in line with the IRB approach (EU Annex 5, para. 4(f), Basel (TB) para. 312(3)). We assume that, in principle, adequate **modelling of event risk** will also capture default risk as a specific event (jump to default). An additional capital charge for default risk is therefore not necessary. Furthermore, it would be at odds with Annex 5, para. 9 of Directive 1993/6/EEC, under which a surcharge can generally be dispensed with provided that the model takes full account of specific risk. We therefore assume that the capital to be set aside for default risk can be reduced to zero.
- b) The envisaged **modelling of default risk on the basis of an assumed holding period of one year** is at odds with the short-term nature of trading transactions and is therefore inappropriate. Furthermore, the proposed 99.9% confidence level for measuring default risk is not consistent with the 99% level otherwise used in VaR modelling. The use of different holding periods and confidence levels for individual risk components of a trading portfolio make a simple interpretation of aggregated VaR for the portfolio impossible (as an estimate of the potential future loss which will not be exceeded over a certain period of time and with a certain level of confidence). It is, moreover, unclear how a model using different confidence levels is to be validated in backtesting. We believe that supervisors should in principle refrain from prescribing specific parameters for modelling event risk. Instead, the rules should be sufficiently open to ensure that future developments in event risk modelling can be taken into account in the banks' internal models. As an alternative to adjusting the VaR model, future consultations should examine whether event risk which is not covered by the VaR model might be better captured by stress testing under Pillar II.
- c) It must be demonstrated that any assumptions made by the VaR model are appropriate and do not underestimate risk (EU Annex V, after para. 2, No. 15 Directive 1993/6/EEC, Basel (TB) para. 309). The appropriateness of **scaling up from a one-day to a ten-day holding period** with the square root of ten also has to be demonstrated. We recognise that the scaling-up assumption is not always conservative, i.e. not when applied to every possible portfolio level. Nevertheless, it may be assumed that scaling up will continue to produce a conservative estimate on the higher portfolio levels for which VaR estimates are made. The required demonstration is therefore unnecessary, in our view.

- d) The use of **hypothetical test portfolios** is called for to reveal weaknesses in the model (EU Annex V, after para. 2, No. 15 Directive 1993/6/EEC, Basel (TB) para. 309). We do not believe any useful purpose will be achieved by using hypothetical test portfolios that do not reflect actual trading portfolios, however. This requirement is not consistent with the basic approach of VaR modelling, which tailors aspects such as the selection of relevant risk factors to the bank's actual portfolio and makes systematic adjustments to reflect any portfolio changes. In our opinion the adequacy of the models used can be judged only on the basis of the actual bank portfolio, which will change over time, and not on the basis of hypothetical test portfolios.
- e) It is envisaged that **tests must be carried out on the basis of confidence levels other than the 99%** confidence level. We do not consider it necessary from a supervisory point of view to conduct such tests with several confidence levels that are not relevant for risk management purposes and would impose a significant additional burden on the banks' internal processes, e.g. in the context of simulations. Estimation of the 99% confidence level is adequate to ensure that capital requirements are correctly measured.
- f) The validation standards require the unit responsible for **model validation** to be operationally independent of the unit which developed the models (EU Annex V, after para. 2, No. 15 Directive 1993/6/EEC, Basel (TB) para. 309). This is *not* necessary and does not reflect international practice in the banks using the internal models approach. Allowing the market risk controlling unit to carry out both tasks simultaneously is in no way at odds with the perfectly reasonable requirement that all relevant risks must be adequately covered. What is more, the model validation standards for IRB models quite rightly demand no such independence. The requirement should be dropped or replaced with a rule that the models should be developed and validated independently of the trading units.

## **B. Requirements under the Supervisory Review Process**

“Sophisticated” banks are to base their assessment of internal capital adequacy for market risk from trading book and banking book activities on VaR modelling and stress testing (Basel (TB) para. 313/(RF) para. 738). We would appreciate clarification in this context that it will not be mandatory for all banks which have an approved VaR model to measure market risk from the banking book with a VaR model.

### **C. Pillar III**

“Model banks” are to be subject to an additional disclosure requirement, namely disclosure of the amount of internal capital allocated to trading portfolios (EU Annex XII, para. 9(d) Directive 1993/6/EEC, Basel (TB) para 316). This requirement is not practicable and should be deleted. The economic capital to be allocated to counterparty risk is normally calculated as a single amount covering both the banking and trading books and an amount specific to trading portfolios cannot therefore be disclosed.

### **IV. Unsettled and Failed Trades**

Losses resulting from such trades are usually due not to counterparty default, but to some kind of operational error. In our experience, the rule currently applicable in the European Union (Directive 1993/6/EEC Annex II) has proved an appropriate means of dealing with the risk involved and we reject any capital requirements over and above this as much too conservative in light of the low level of loss in this area in the past. We also consider the periods of one to four days after the settlement date far too short to be able to identify the cases for which a capital charge would have to be calculated. What is more, implementation of this rule would be extremely costly without generating any measurable benefit.

### **V. Double Default**

We welcome the fact that, in addition to the substitution approach, a further method will be permitted which is capable of dealing with the risk in an appropriate manner and reflects the low probability of a simultaneous default by both the obligor and the protection provider.

Nevertheless, we do not believe the restrictions on the scope of application, relating to either the protection providers or the obligors, are appropriate.

Eligible protection providers are limited to financial firms. There is no logical reason why recognition of the double default effect should only apply to financial firms, thus significantly restricting the range of eligible guarantors compared to the standardised and IRB approaches (cf. EU Annex VIII, Part 1, 26 Directive 2000/12/EC). The scope should therefore be extended to include, in particular, corporates and sovereigns with a credit quality assessment step 2.

Furthermore, the consultation paper extends the circle of eligible protection providers for banks using the standardised approach to financial firms with an external investment-grade rating (Basel (TB) para. 242). For banks using the IRB approach, on the other hand, eligible protection providers are limited to financial firms with an internal rating equivalent to an external A- rating (Basel (TB) para. 242). The draft Directive permits protection providers with a rating in accordance with a credit quality assessment step 2, which corresponds to an external A- rating, under both the standardised and IRB approach (EU Annex VIII, Part 1, 28a Directive 2000/12/EC). We advocate a uniform rule in both the Basel framework and the Directive opening up the circle of eligible protection providers to investment-grade ratings.

We would like to point out in this context that we regard the requirement for financial firms to be subject to supervisory oversight as met for all subsidiaries whose parent undertakings are subject to direct supervision (EU Annex VIII, Part 1, 28a, Basel (TB), para. 242).

As with protection providers, the circle of eligible obligors should be extended to include at least banks and insurance companies; it must be borne in mind that the rules on the application of guarantees envisage no restrictions on the counterparties to be hedged apart from in the double default approach. Moreover, the requirement that the obligor may not be a member of the same group as the protection provider ensures that the obligor and protection provider are not closely correlated with one another. Just because a bank, insurance company or other protection provider is guaranteeing an exposure of another bank does not mean there is a very high degree of correlation between the two. We believe the requirement that the obligor must not be one of the protection provider's suppliers is inappropriate both from a practical point of view – this would be very difficult to verify – and from a risk angle (EU Annex VIII, Part 1, 28a Directive 2000/12/EC, Basel (TB) para. 242). A supplier relationship does not necessarily result per se in a high positive correlation: this depends much more on the intensity of the relationship. The requirement should therefore be dropped.

Section 3.2.1 of the European Commission's Explanatory Document makes it clear that the double default effect can also be recognised for SMEs handled under the retail approach. The capital requirements must be calculated on the basis of the RW curve for corporates, however. This runs counter to the methodology of the IRB approach. What is more, there is no objective reason to exclude "other retail exposures" from application of the approach. They are likely to show only a low default correlation with eligible guarantors.

We also believe it would be appropriate to extend the scope of application to exposures to central sovereigns or sub-national units that are guaranteed by a financial firm. This could be important in connection with exposures to emerging market sovereigns, for example.

Under Basel (TB) para. 224 and the Explanatory Document, Part 3: The treatment of double default, the following products, among others, are excluded from recognition for double default: “synthetic securitisations and other tranching products that would fall within the scope of the securitisation framework, and covered bonds to the extent that such instruments are externally rated”.

This is justified only if the double default effect is actually incorporated into the capital requirement via the external rating of the guaranteed or collateralised instrument. This does not apply to Pfandbriefe, however. In these cases, the capital requirement is based on the rating/PD of the issuer. Default can only occur if the issuing bank fails and at the same time the cash flow from the guarantee funds is insufficient to service the Pfandbriefe. We would appreciate clarification of this point.

In addition, we have reservations about the condition that the purchased credit protection must absorb all credit losses incurred on the hedged exposure (EU, Annex VIII, Part 1, 28a, Basel (TB), para. 242). Partial protection of the exposure must also be permitted, as it is under the substitution approach.

The proposed assumption of  $\rho_{gs} = 07$  as the basis for calculating the asset correlation of the guarantor is excessively conservative, in our view (Basel (TB), para. 229). We fail to understand why the asset correlation of banks should be significantly higher than the assumed asset correlation on which the actual IRB rules are based. In normal IRB calculations, the asset correlation for banks can only assume values between 12% and a maximum of 24% (EU Annex VII, Part 1, para. 3/ Basel (RF), para. 272). We would point out that this gives rise to an unequal treatment which cannot be economically justified.

In consequence, we consider the proposed highly simplified formula based on an asset correlation for financial firms which is generally over three times higher than that for other guarantors to be totally unsuitable (EU Annex VII, Part 1, para. 3a/Basel (TB), para. 231). The risk weights (EL+UL) are a monotonically increasing function of the asset correlation, which results in a clear overstatement of risk if the above assumption is applied.

With higher PDs application of the double default framework leads to higher capital requirements than under the substitution approach. The double default framework is described as an additional option available alongside the substitution approach. We therefore assume that banks can choose to apply the substitution approach or the double default framework on a transaction-by-transaction basis, depending on the capital requirement thus calculated.

The maturity adjustment must also be factored into the calculation. The consultative document states in this context: “The exemptions from the one-year floor do not apply to this calculation”. There is no such rule in the EU draft Directive. The reason for this discrepancy should be investigated.

We therefore suggest calculating the double default effect by using the exact formula<sup>9</sup> set out in the Basel Committee/IOSCO consultation document in accordance with the bivariate normal distribution function consistent with the asymptotic single risk factor (ASRF) model (Basel (TB), Annex 1, formula 2). The asset correlation of the guarantor  $\rho_{gs}$  should be computed by using the guarantor’s probability of default  $PD_G$  in the correlation term  $R$  of the IRB formula for banks (EU Annex VII, Part 1, para. 3 Directive 2000/12/EC, Basel (RF) para. 272).

We do not entirely share the view of the Basel Committee and IOSCO in Basel (TB) para. 213 on the recognition of double recovery. We believe a distinction needs to be made between guarantees and credit derivatives. In the latter case it is possible to draw up the agreement in such a way that, if a credit event occurs, the original claim on the obligor will continue to exist alongside the claim to cash payment or delivery of the reference bond. We therefore consider that double recovery can in principle be achieved in such cases. Subject to the inclusion of a suitable clause in the agreement, we consequently call for recognition of the double recovery effect for credit derivatives on the basis of a joint LGD in both the Basel Revised Framework and the European Directive.

Under Annex VIII, Part 2(21)(f) of Directive 2000/12/EC the bank is to have the right and the expectation to receive payment from the protection provider without needing to take legal action against the counterparty. The bank is also to take steps to satisfy itself as far as possible that the protection provider will be willing to make payment without delay in the event of a

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<sup>9</sup> Two typing errors have crept into the formula: the second argument should read  $\Gamma_{gs}$  instead of  $\Gamma_{os}$  under the root sign and  $PD_G$  instead of  $PD_O$ .

credit event. Both the “expectation” and the ensuring of a willingness to pay are meaningless requirements. The protection provider effects payment on the basis of the legal obligation he has entered into to do so. He also has to meet certain credit quality requirements. Rules prescribing internal expectations or declarations of intent should be dispensed with. We believe it is sufficient that the bank has a right, legally enforceable if necessary, to receive payment from the protection provider without delay and without first having to take legal action to pursue the counterparty for payment.

Annex VIII, Part 2(21)(i) of Directive 2000/12/EC requires the conditions of the credit protection arrangement between the protection provider and the bank to be legally confirmed in writing. These rules should be formulated in more abstract terms to take account of the special features of national regulations governing credit protection instruments. Under German law, for example, it is only necessary for the guarantor to sign the document; the creditor is not required to provide written evidence that he has accepted the guarantee. It should therefore be sufficient for the conditions of the credit protection arrangement to be agreed on in accordance with the applicable legal requirements.

Yours sincerely,

- on behalf of the Zentraler Kreditausschuss -  
Bundesverband deutscher Banken

von Kenne

Dr. Gaumert