The International Swaps and Derivatives Association ("ISDA"), and

The Association of Financial Markets in Europe ("AFME")

Response to European Banking Authority ("EBA") Consultative Papers 48 on Stressed Value at Risk ("SVaR") and Consultative Paper 49 on Incremental Default and Migration Risk Charge ("IRC").

1. Points Common to CP 48 and CP 49

Overall the ISDA and AFME ("The Associations") strongly support the objectives of the EBA set out in the Background and Rationale sections of each paper. These include:

Developing a common understanding among competent authorities across the EU in order to converge supervisory practices,

Providing guidance

Creating more transparency, and

Creating a level playing field

1.1. Consistency

The Financial Markets and OTC Derivatives Industry ("the Industry") believes that effective regulation can only derive from common regulations which are consistently applied. In Europe the EBA is charged with producing Guidelines although it remains unclear how these will be implemented at the national level. Both Consultative Papers ("CP") 48 and 49 contain provisions which differ in ways which are both sub equivalent and super equivalent to comparable guidance implemented by national regulators. It is the national guidelines to which firms have adhered in submitting IRC and SVaR models for approval.

The executive summaries to both CP's contain the wording:

"It is expected that national competent authorities around the EU will implement the Guidelines by incorporating them within their supervisory procedures within six months after publication of the final guidelines."

Furthermore, the status of the papers is not clear. While both papers are referred to as 'guidance' they are worded in their Scope and Level of Application as rules: for example, "competent authorities shall require institutions to comply with the provisions laid down in these Guidelines." While in a general sense the industry believes in consistency of treatment, there may also be instances where the guidelines do not reflect specific national circumstances. Referring to the papers as both guidance and mandatory is ambiguous and makes it difficult to assess the impact of

the papers, for example in decisions about where to allocate scarce resources to develop models required across various regulations. This ambiguity should be clarified. In any event some element of flexibility will be required where national regulations and guidelines differ from those issued by the EBA.

Finally, on December 7, 2011 in the US, a Notice of Proposed Rulemaking ("NPR") was released as an amendment to the Market Risk NPR published on January 11, 2011. This new NPR addresses alternatives to credit ratings for debt and securitization positions, as required by Section 939A of the Dodd-Frank Act, which requires Federal Agencies to remove references to and requirements of reliance on credit ratings from their regulations. This proposal relies on a framework that is inconsistent with the one adopted by the Basel Committee on Banking Supervision ("BCBS") as that framework relies on credit ratings. We urge the EBA to work together with international regulators towards the goal of consistency with international standards.

1.2. Timeline

Both CP's introduce guidelines in respect of the Basel 2.5 proposals and CRD 3 regulations which came into effect in Europe on 31 December 2011. The Guidelines are in consultative form with a comment period lasting until 15 January 2012. Firms have been required to submit models for approval throughout 2011 under existing national regimes. Where the final EBA Guidelines differ from the existing national regulations, firms will require a period of twelve months to achieve compliance with the EBA rules after they are published in final form.

The EBA must publish Guidelines, even in draft form, at the earliest opportunity and in any event in advance of the submission dates for models. Re-modelling is a significant drain on scarce resources, which would be better focussed on value-adding risk-management activities.

2. Points Relating to CP 49 on Incremental Default and Migration Risk Charge ("IRC")

2.1. Super Equivalence

Under standardised rules sovereign bonds issued in domestic currency carry a zero risk weight. Under the IRC proposals such bonds are included in scope and, since charges are derived from realised Credit Default Swap ("CDS") spreads, these can be non-zero. Although it is accepted that no sovereign provides a truly risk free rate, such instruments do not display jump to default characteristics; rather the ratings migration is somewhat steady. IRC should not produce capital charges which are inconsistent with standardised rules.

Consistency may be achieved through revision to standard rules, so that risk weights for OECD sovereigns are better differentiated on a risk sensitive basis. However, this will require credit spreads on sovereigns to be measured and this will, in turn, require a definition of an observable credit risk free rate in all relevant currencies.

This relates to several points made in ISDA's Fundamental Review paper[1]. The framework should be practical and flexible in order to adapt to changing markets (Principles 4 and 5).

[1] See "The Market Risk Capital Framework" 3 November 2011

2.2. Probabilities of Default

Firms should be able to use risk neutral Probabilities of Default ("PD's"). PD's can be derived in a number of ways including from historic data (for example using internal models), from external ratings or from the market prices of instruments. Paragraph 12.2 states that PD's implied from market prices (i.e. risk neutral PD's) shall not be acceptable for the modelling of the rating migration or default. This guidance seems to us to be at odds with the market implied approach generally recommended for CVA and CVA VaR and also with the December 7th 2011 NPR from the US where implied PD's are listed as an alternative approach for the determination of PDs for securitization positions in the trading book.

The issue of whether to use Through The Cycle[2] or Point in Time[3] probabilities centres on an important issue around the role of capital which has been raised in the Fundamental Review feedback from industry[4] (principle 8). For wind-up capital, which we refer to as Level 1 capital, PiT probabilities are probably more appropriate. However for Level 2 capital, which we associate with going concern capital, TTC probabilities are arguably more appropriate. This remains a matter for debate however; the important point here is that consistency is needed from regulators (principle 6) and this will only be possible when fundamental principles such as the role of regulatory capital and how it fits with broader economic requirements for capital are clearly articulated.

2.3. Inclusion of equity positions in IRC

Para 6.1 only permits equities to be included in IRC if such positions "are jointly managed by an identified trading unit". Trading unit is not defined however it should be allowable to define this at levels above an individual trading desk, provided such positions are risk managed jointly e.g. at risk committee level. To clarify the guidance, the EBA could consider wording such as "are jointly managed by an identified trading unit, risk committee or other body that is empowered to manage the relevant products on a joint basis".

2.4. Constant level of risk assumption over the one-year capital horizon

Paragraph 18.5 states "Modeling a constant level of risk over the one-year capital horizon may be achieved, for example, on the basis of the approach outlined below. With respect to calculating losses over liquidity horizons, a firm may choose to assume that instantaneous shocks are applied to ratings (or spreads). This implies that, in this case, the institution does not have to integrate the time effect: positions keep their original residual maturities at the end of each liquidity horizon; in other words, there is no ageing of positions. Furthermore, there is no need to consider potential changes in market conditions when revaluating the portfolio at the time of rebalancing (in particular, credit spreads by rating can be kept constant). As a result, measurement of losses within

[2] Through the Cycle ("TTC") probabilities derive from rating agencies or internal ratings.

[3] Point in Time ("PiT") probabilities are backed out from CDS spreads. They are risk neutral and market implied.

[4] See "The Market Risk Capital Framework" November 3, 2011

IRC does not take into account the timing of each migration or default event, and the profit and loss is computed as of today."

However, an alternative approach should be permitted whereby firms may chose to take into account the time decay effect and to model the ageing of their positions.

2.5. Positions in the Institution's Own Debt

Paragraph 7.3 should be amended to make clear that only **net** long positions should be included in the scope of the IRC model for migration risk only. This should be further expanded to make clear that only net positions that give rise to a net change to income or reserves will be included (i.e. taking into account the real profit and loss effect).

2.6. Correlations between default and migration events

Paragraph 13.2 requires firms to use a time horizon for correlations between default and migration events of different obligors that is consistent with the chosen liquidity horizon (or capital horizon where an institution assumes a "one year constant position") of their positions within IRC.

We would welcome further guidance on what is meant here. Firms typically compute asset price correlations which are used in the copula models and default and migration correlations are implied by the asset price correlation. This is a standard approach and is discussed in for example Hull. We do not typically directly compute correlation of migrations and defaults.

However, whatever the approach, it is not possible to compute correlations consistent with liquidity horizons where different instruments issued by the same obligor may be assigned to different liquidity horizons. Secondly, an FSA paper OP29 showed that contemporaneous correlation may be independent of the observation period as long as autocorrelation is properly taken into account.

2.7. Expected and Unexpected Loss

The explanatory text under paragraph 18.4 recommends that the IRC should be based on unexpected losses only. We suggest that the guidance be modified to the more conservative approach of basing IRC on expected and unexpected losses as this would provide consistency with other, particularly the US, approaches. Unexpected losses are used in the IRB formula because a reserve is taken on the banking book for expected loss. No such reserve is taken on the trading book.

2.8. Systematic Factor

Paragraph 15.2 requires firms to carry the systematic factor through successive liquidity horizons. If implemented, this would contradict the notion that the portfolio is reset at the start of each liquidity horizon to the original level of risk and would, in consequence, violate the constant level of risk assumption. In any event in models we are aware of IRC looks only to the change in level of risk factors and not their absolute amounts.

2.9 Maturity Mismatches

Paragraph 19.4 requires institutions to reflect the impact within the liquidity horizon of maturity mismatches between long and short positions. This appears to replicate the requirements of paragraph 19.2 and is therefore not necessary.

3. Points Relating to CP 48 on Stressed Value at Risk ("SVaR")

3.1. The Formulaic Approach

The formulaic approach implies that the period of stress to be selected should be the period of highest VaR for the given portfolio. This is not consistent with the stated objective of calculating VaR over a period of stress and (para 6.4) "a conservative capital outcome rather than just selecting the period of highest volatility". We recommend that a judgement override be specifically introduced for the formulaic approach.

3.2. The Period of Stress

3.2.1. Determination of the period

In cases where group companies each select different periods of stress, perhaps because of differing risk sensitivities of their portfolios, the results cannot simply be added together. The resulting sum is meaningless and can only produce a sensible consolidated capital number if the underlying periods of stress are identical. Generating a consolidated stressed VaR over a particular period, while at entity level stressed VaR is computed over different periods, creates a disconnect between Group and Entity level capital requirements which is not desirable. It also creates practical issues for firms computing full revaluation VaR because of the computational time required to calculate all the revaluations collectively over such a long period of time. The requirement will lead to a degradation of VaR models. The guidance should clarify that a single group-wide period of stress is appropriate, even where that may not be appropriate for individual group entities on a solo basis.

3.2.2. Monitoring of the period

The fact that positions have been entered into in order to hedge (and hence reduce) the Stressed VaR should not be a trigger for the review of the Stressed VaR period. Banks should rather review the stressed period in case it is no longer the most appropriate one due to material changes with regard to their portfolio composition or to the emergence of a new period of greater stress. Overall, we believe this point is in contradiction with point § 15. 2 according to which "*where Stressed VaR outputs reveal particular vulnerability to a given set of circumstances, prompt steps should be taken to manage those risks appropriately*". We understand the EBA intention here is more to prevent "arbitrage" actions that are artificially reducing the SVaR and should be reformulated accordingly.

3.3 Hard limits for Stressed VaR

Stressed VaR relates to historic periods and, although the stress VaR levels are useful indicators, it is hard to see how they can effectively be incorporated as part of a hard limit structure for the current period. We suggest that the guideline should require stressed VaR numbers to be produced and reported but that they should not form part of a hard limit structure at the portfolio level. Alternatively stressed VaR limits should replace VaR limits.

3.4 Use Test

The concept of a use test for stressed VaR is difficult. The more remote in time a stress period becomes, the less relevant risk-drivers and correlations become, and the harder it becomes to demonstrate model use. Similarly, the use of the stressed VaR to validate the impact of current VaR modelling choices does not appear very relevant. We recommend removal of references to the Use Test and insertion of a requirement that regulators observe how firms use stressed VaR and provide guidance.