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24 February 2005

Dear Norah and Tom

Unsettled Transactions

Thank you very much for sharing with us an early version of your thoughts prior to the release of the Consultative Paper on the Trading Book Review in the Spring. Although there is little time left before publication, we hope that a preliminary reaction will be useful.

General Approach

Regulators have made it laudably clear that they wish to encourage industry into the greater use of DVP and DVD systems and to encourage short settlement periods. We welcome the clarity of these objectives, and we understand their attraction: other things being equal, these objectives contribute to risk reduction.

However, we believe that the costs of the proposals very significantly outweigh the prudential benefits. Our concerns are, broadly, threefold. First, there is no evidence that the prudential benefits have been even qualitatively compared with the likely costs, which include systems costs and capital requirements. Secondly, firms are already subject to prudential requirements for free deliveries and delayed settlement. Since any change to these requirements generates implementation costs, regulators must demonstrate that existing requirements are inadequate. While the objectives have been set out, the prudential benefits have not been analysed. Thirdly, even ignoring transition costs, there is no evidence that the proposed capital requirements are proportionate to the risks, for example that a capital deduction for a five-day delay in settlement is in any way justified by loss experience.

We believe it is urgently necessary for the regulators to articulate clearly what deficiencies in existing prudential regimes they are attempting to remedy, and the magnitude of the risks not presently captured, so that the net benefit of changes can be properly assessed. Many national regulators would be legally required to undertake such due diligence if they were to launch such a project in their own jurisdiction. It is just as imperative that regulators, when acting in coordinated fashion on an international basis meet the same standards.

Systems implications

The systems implications of the proposed changes are at least as significant as the likely increased regulatory capital requirements. We ask the regulators to bear in mind the accumulation of major initiatives that firms are having to prepare for at present – not only Basel 2, but IAS changes and Sarbanes-Oxley, not to mention the Financial Services Action Plan in Europe. Since the supply of necessary skills is limited, the costs of implementing these proposals at the same time as these other projects is greatly in excess of the costs of implementing them at a time when resources are not overstretched. Some firms have estimated that a further two years would be required to deliver the necessary systems changes. We do not believe that the regulators have yet taken into account either the systems costs or the potential business impact of the proposals.

Distinction between DVP and non DVP trades; normal and extended settlement

The draft proposals differentiate between DVP and non DVP trades. In each of these categories the regulators further distinguish between “normal” and extended periods of settlement. The regulatory treatment sharply penalises trades that fall outside the norm of “DVP normal settlement period.”

Although we understand the desire to create an incentive structure, in particular the desire to reduce the occurrence of free deliveries, we believe that this analysis is too simplistic and draws the false conclusion that a considerable range of existing market practice is by definition too risky. This is an example of where the regulators have stated their objectives, but have been unable to identify, provide evidence for or quantify the risks that they believe are attached to transactions which are not DVP and/or outside a “normal” settlement period.

It is necessary to draw greater distinction between the transactions attracting regulatory disapproval. Indeed we see ambiguity in the regulators’ use of “non-DVP” which we would like to see clarified. The risk on a free delivery is both quantitatively and qualitatively different from a delayed settlement. An unplanned delay in settlement is primarily an operational risk. A free delivery is more of a credit risk. Moreover, a free delivery is an unsecured credit. A settlement failure is the failure of two offsetting transfers; the risks of two days’ delay are therefore in comparison secondary.

Turning to abnormal settlement, there are a variety of standard settlement periods in different markets and for different products. Regulators have assumed that there is a single acceptable “normal” settlement period. If a discontinuity between “normal” and abnormal settlement periods is to be justified, two pieces of empirical work are required. First there needs to be a survey of what constitutes “normal” in different markets. Secondly there needs to be an assessment of the risk associated with standard periods in excess of T plus 5, so that an informed decision can be made as to when (taking account of the costs of transition and of capital) the risks on an extended standard settlement period become unacceptably high. Once again, we believe that this risk analysis is currently lacking.

The grace period

The regulators propose a “grace period” that is much shorter than the EU CAD treatment, followed by an accelerated capital punishment. This implies a potentially significant proportionate increase in regulatory capital for unsettled trades for firms presently subject to the EU directives. We are concerned that the regulators have adopted a conservative position that is not founded on an assessment of the marginal risks in those days not presently captured. The requirement will not correspond to the risk, and fails to conform with the central and overriding Basel 2 principle of risk sensitivity. Furthermore it will require extremely costly systems changes for all firms.

The vast majority of trades settle during the S+5 time window provided in the CAD. Where a trade fails to settle on time, it is for operational reasons. Yet the delay in settlement will give rise to a credit risk charge. The boundary between credit and operational risk should correspond to firms' practice and experience. An S+1 window clearly does not meet this requirement, and it appears to double-count risk.

Calibration

First, the calibration appears to be set to withstand severe shock to the financial system. This is not the level at which the Basel Accord is intended to be calibrated.

Secondly, a deduction from capital implies that the risk is nearly a certainty, and that after the 5 day period, recovery will be zero. We cannot accept this. There is no supporting evidence for such a treatment.

Thirdly, the cost of compliance may far outweigh the capital requirements themselves. Firms, having prioritised systems projects according to perceived risk and reward, do not currently measure future exposure on an EPE basis for unsettled transactions, nor do they assign ratings to the vast majority of their counterparties in these trades. Hence a chief implementation issue with the regulatory proposal as it stands is that it would require IRB parameters (hence obligor and facility ratings) on all unsettled transactions. This would precipitate a very substantial exercise to implement. We recommend that Basel/IOSCO accept the use of standardised credit risk weights for these counterparties, which we believe is already feasible under the materiality carve-out provided in the 2004 Accord.

Furthermore, the Securities Industry Association recently submitted a revised proposal to the Joint Basel IOSCO Working Group discussing how a Simplified Approach could be constructed for trades with extended settlement terms and proposing a simple methodology for calculating "forward" future exposure. We support this initiative, which would substantially reduce compliance costs without sacrificing capital adequacy.

Finally, we request confirmation that an unsettled transaction would not be treated as a default (as deduction implies) for the purpose of risk weighting other exposures to the same counterparty.

Industry Recommendation

In the absence of compelling evidence that existing treatments are inadequate, the treatment proposed lacks credibility. If change is considered necessary regulators' next steps must be, as a matter of some urgency, to clarify what is inadequate about the current regime, and then to quantify the risks not captured. After that, any proposed amendments should be compared with realistic estimates of systems costs and any increased capital requirements; only then could any proposal be considered justified, reasonable or proportionate.

The next question would be what kind of convergence is desirable. Here the costs of convergence appear great and the marginal prudential benefits of convergence rather small. If international convergence in a detailed Pillar 1 framework is considered necessary after this analysis, we recommend that the Basel regulators converge on the current EU treatments. For non repo/securities lending style transactions, the EU approach has the virtue of not specifying the settlement period. It also sets a sliding scale of charges post settlement, having allowed for a grace period, which has the benefit of making the incentive more nearly continuous. For free deliveries, again we recommend the current EU legislation, which provides for a conceptually correct loan equivalent treatment and does not escalate into a deduction.

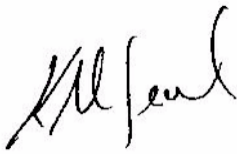
Conclusion

In conclusion, the capital consequences of the proposals lack justification on risk grounds. In addition, the operational costs exceed any benefit that we can identify. Regulators should at least rationalise the scope of application of these proposal and simplify any calculations. In particular we would recommend that regulators to hold detailed discussions with industry participants in order to understand and quantify the capital and systems implications of the proposed changes.

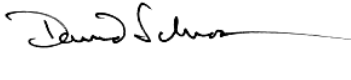
If regulators feel, after full analysis, that it is necessary to converge on a detailed Pillar 1 approach, we recommend the Capital Adequacy Directive as a template. It has the virtues of simplicity, an increased scale of capital over time, and there is no evidence that it fails to capture material risks.

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Yours sincerely,



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