

Financial Services Alert

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Developments of Note

➤ **Basel Committee Publishes Consultative Document on Incremental Default Risk in the Trading Book**

The Basel Committee on Banking Supervision (the “Basel Committee”), along with International Organization of Securities Commissions, in July 2005 published a paper entitled “The Application of Basel II to Trading Activities and the Treatment of Double Default Effects” (see the July 26, 2005 *Alert*, the “Trading Activities Paper”). The Trading Activities Paper specified that banks must model specific risk to measure and hold capital against any default risk that is incremental to any default risk captured in the bank’s Value-at-Risk (“VaR”) model (the “Incremental Default Risk”). The Trading Activities Paper added this requirement to reflect the increasing amount of exposure in the bank’s trading book to credit risk and illiquid products.

The Basel Committee has now published a Consultative Document to provide further detail on how banks should fulfill this requirement. The Consultative Paper generally defines the Incremental Default Risk as the greater of zero or (1) the level of capital required to absorb capital that might occur to trading positions due to credit-related defaults, minus (2) any capital requirement for default losses implicit in the VaR. The Incremental Default Risk is designed to cover both direct losses due to an obligor’s default, as well as indirect losses from structured instruments such as asset backed securities (but generally would not apply to listed equities, interests in unleveraged funds, and other interests that do not typically have credit risk).

In developing an Incremental Default Risk model, banks must meet a soundness standard comparable to that in the internal-ratings based approach (*i.e.*, 99.9% confidence level over a 1 year horizon). The capital charge for Incremental Default Risk will be based on an assumption of a constant level of risk over that horizon, incorporating the effects of rebalancing as appropriate. In developing the model banks also should take into account liquidity (*i.e.*, the possibility of trading a deteriorating instrument before a default event occurs), with non-investment grade positions and positions of concentration generally implying less liquidity than others. Recognizing the effects of hedging also is permitted.

Banks are expected to validate their Incremental Default Risk model, although backtesting will not be required as it is with the standard VaR. The Consultative Document provides factors to consider in the validation process, with many elements involving validation of probability of default, and loss given default. The Consultative Document states that no specific method of computing Incremental Default Risk is prescribed, and indeed “it is anticipated that banks will develop different approaches for measuring this risk,” however the approach that the bank uses is subject to the “use test” (see the October 10, 2006 *Alert*).

Banks are expected to calculate Incremental Default Risk with the same frequency that they calculate market risk. Comments on the Consultative Paper are due to the Basel Committee by February 15, 2008. Banks that already have received specific risk model recognition under the market risk rules are expected to implement this requirement by January, 2010.

➤ **Comptroller Dugan Discusses Timing on US Basel Initiatives**

Comptroller Dugan gave a speech today whereby he stated that “forward progress” was occurring on US Basel II. Comptroller Dugan further said that “the final rule will become publicly available in early November.” As to the alternative approach for non-core banks, the Comptroller stated that the agencies

“expect this proposed standardized option to be published in the next several months with the final rule issued before the advanced approaches become operational for the first year of the transition period.”

➤ **Related Materials**

[Consultative document: Guidelines for Computing Capital for Incremental Default Risk in the Trading Book, October 12, 2007](#)