IACPM

INTERNATIONAL ASSOCIATION OF CREDIT PORTFOLIO MANAGERS

360 MADISON AVENUE
17TH FLOOR
NEW YORK, NY 10017
tel (646) 289-5430
fax (646) 289-5429
ADMIN@IACPM.ORG

WWW.IACPM.ORG

April 16, 2010

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
By email to baselcommittee@bis.org

To the Members of the Basel Committee:

I write to you in regard to the Basel Committee consultative documents "Strengthening the Resilience of the Banking Sector" and "International Framework for Liquidity Risk Measurement, Standards and Monitoring", issued on December 17, 2009.

Background

I am the Executive Director of the International Association of Credit Portfolio Managers (IACPM). The IACPM is an industry association established in 2001 to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas and act collectively. The Association represents its members before legislative and administrative bodies in the United States and internationally, holds conferences and regional meetings, conducts research in the credit portfolio management field, and engages in other activities relating to the measurement and management of credit portfolio risk.

Currently there are 83 financial institutions, in 12 countries, who are members of the IACPM. These members include many of the world's largest commercial and investment banks, as well as insurance companies and a number of asset managers. I attach a short document that provides additional information about the association, its members, and its board of directors. (More information about the IACPM may be found on our website: www.iacpm.org.)

While the IACPM's member firms comprise the world's largest financial institutions, the IACPM represents a very specific constituency within those

firms. Our members are the teams within those firms who have responsibility for managing credit portfolios. At a bank, for example, our members would be the group responsible for managing the bank's loan portfolio – actively controlling concentrations, adding diversification, and managing the return of the portfolio relative to the risk. At many institutions, our members also manage counterparty risk related to derivatives exposure.

In carrying out these responsibilities successfully, credit portfolio managers contribute to maintaining the safety and soundness of their respective financial institutions. Importantly, this also allows them to make credit more available to their clients, which is so vitally important in the current environment. In these ways, the objectives of credit portfolio managers are often well aligned with those of regulators. As such, our membership supports the overall effort to provide more robust capital and liquidity standards in the banking sector.

There are, however, several issues the IACPM would like to highlight in regard to the new Basel proposals. These proposals are very expansive in scope, and it is clear that many of our member firms will comment on every aspect of the documents. The IACPM will comment in this letter specifically on two issues important to credit portfolio managers that may not be covered by others: 1) The additive effects of the new capital and liquidity proposals on the cost of corporate credit, and 2) conflict between central counterparty structures and Basel II capital regulations.

Additive effects of capital and liquidity proposals on the cost of corporate credit

The individual elements of the new proposals will each impact bank capitalization and liquidity, but also will have clear impact on the cost of providing credit. The additive effects of all the proposals, and the interdependent way they relate to each other, can potentially have an enormous impact on credit costs, perhaps to a level not intended.

One of the IACPM's member firms provided an analysis, summarized in the table below, comparing the costs of providing an undrawn, committed line under both the current capital regime and under the new proposals. The analysis combines the effects of:

- The countercyclical adjustment to use higher PDs
- The narrower definition of Tier 1 capital
- Inclusion of undrawn amounts in the leverage ratio
- Including high quality assets from the liquidity ratio in the leverage ratio
- 100% liquidity reserve for undrawn commitments

The summary analysis shows that the total capital costs of providing such a liquidity facility (measured in basis points), increases more than seven-fold from 37bp under the current capital regime to over 271bp under the new proposal.

Basel Capital Proposal
Quantitative Example

$100M A-rated Undrawn Corporate Commitment
Summary of implied costs

	Current	Proposed	Description
Tier 1 Capital			
Total Capital $	$4.52	$6.18	Increased PD per Procyclicality proposal
Capital Cost %	8%	12%	Narrowing definition of Tier 1 Capital
Tier 1 Capital Cost bps	**36.2**	**74.1**	
Leverage Ratio			
Add'l Capital for Undrawn Portion	0.00	3.82	Undrawn amounts included in leverage ratio
Add'l Capital for HQ Assets	0.00	8.87	HQ Assets from liquidity ratio hit leverage ratio
Total Add'l Capital $ (above Tier 1)	0.00	12.69	
Capital Cost %	8%	12%	
Leverage Ratio Capital Cost bps	**0.0**	**152.3**	
Liquidity Ratio			
Liquidity Reserve above Tier 1 $	$2.48	$88.51	High Quality Assets required for 100% reserve
Cost of 1 yr Debt	0.50%	0.50%	
Liquidity Ratio Debt Cost bps	**1.2**	**44.3**	
Total Regulatory Cost of Lending	**37**	**271**	

The assumptions behind the analysis, and the calculations used, are detailed in the attached spreadsheet. We invite you to repeat these calculations with your own assumptions, to test the range of impact. We believe you'll find that, within a broad range of reasonable assumptions, the potential increase in capital cost for providing credit will be very significant.

This increase in cost will likely be passed on to corporate clients, in whole or in part, dramatically increasing their cost to borrow. Of special note is the potential impact to related funding markets, especially the commercial paper market, which relies on bank provided committed liquidity. We hope the Committee will explore and fully understand this possibly unintended consequence of the new proposals.

The IACPM suggests two possible ways to mitigate this impact. One way would be to recognize the additive impact and to recalibrate the combined proposals to mitigate the size of their effect. Another would be to reduce the 100% treatment of undrawn commitments from both a liquidity and a leverage perspective. The experience of portfolio managers would indicate that actual usage of these commitments by corporate borrowers is less that 100% (both from the view of typical utilization, but more importantly under stress conditions and even default by the borrower). We would be happy to discuss these views and experiences with the committee.

Conflict between central counterparty structures and Basel II capital regulations

In general, the IACPM strongly supports the creation and use of clearinghouses for CDS and other derivatives, which have the potential to greatly reduce risk for all market participants. The

new proposals encourage their use, and the IACPM believes this is a generally positive outcome. However, there is a clear conflict between standards developed for the clearinghouses, and the current capital regulations for banks under the Basel II Capital Framework.

The IACPM represents credit portfolio managers who are mitigating risks for their firms, rather than the dealer desks who are trading credit risk. When credit portfolio managers use CDS to hedge a portfolio, they reduce economic risk to the firm and should, appropriately, receive a reduction in regulatory capital requirements related to the portfolio. Under Basel II, a CDS hedge only provides full regulatory capital relief if the documentation underlying the CDS recognizes restructuring as a credit event. (Restructuring occurs when a company renegotiates its debts while in distress as an alternative to default or bankruptcy. Under Basel II, there is a 40% reduction in capital relief for CDS hedges without restructuring language.) While standardized CDS contracts have included restructuring language for many years, the current North American clearinghouse mechanisms have removed them.

The problem is clear, as the new proposals aim to force trading volume through clearinghouses, yet Basel II rules penalize these same transactions. Our understanding is that some firms have used custom CDS contracts with restructuring language that will *not* clear through clearinghouses, in order to get full regulatory capital relief. While this is a rational response to the current environment, it is clearly not the type of behavior that the new proposals aim to encourage.

Assuming that there will not be a change to the current structure of the clearinghouse contract in North America, then an appropriate solution would be to modify regulations to allow capital relief for CDS without restructuring. We note that, in the original Basel guidelines from June 2006 on this issue, a footnote states that the current penalty "is provided as an interim treatment, which the Committee intends to refine prior to implementation after considering additional data". With the implementation of CCPs and strong consensus to encourage their use, now would appear to be an opportune time to revisit this issue.

* * * * *

I thank you for your attention to our thoughts and concerns. The IACPM's Board of Directors and I would welcome the opportunity to discuss these issues with the Basel Committee.

Sincerely,

Som-lok Leung
Executive Director
International Association of Credit Portfolio Managers

Guide to Quantitative Examples of Basel Consultative Document Proposals, March 2010

HighLevelSummary

The high level summary sheet provides a simplifed tabulation of the costs associated with the Tier 1 Capital, Leverage and Liquidity rules under the current and proposed Basel regimes.

See the detail sheets below to trace the derivations of each result.

SummaryV2

The summary sheet provides a location for high level inputs as well as bringing together the results computed on the detail sheets (individually described below). The left side of the sheet computes the cost of regulatory compliance under the currently applicable Basel rules, with the shaded area displaying the debt, equity and total costs.

The right hand side of the sheet describes the incremental costs implied by the proposals under review. There are various elements that contribute to the increases. They're broken out by Tier 1 capital, leverage ratio and liquidity coverage ratio, with the shaded area again compiling the debt, equity and total incremental costs.

See the detail sheets below to trace the derivations of each result.

Tier 1 Capital

The "Tier 1" sheet details the computation of tier 1 capital under the current regime (left column) and under the proposed rules (right column).

The first element of additional cost to identify on this sheet is the increase in PD (probability of default) which is implied by the efforts to combat procyclicality. These proposals seek to increase the probabilities of default used in the capital calculation from a projection of the next year's rate to the highest annual rate observed through economic cycles. This in turn increases the RAA attributable to the position, and therefore the amount of capital and its cost.

The second element of increased cost to identify on this sheet results from the narrowing of the definition of acceptable Tier 1 capital instruments. The proposal suggests that essentially only common stock would be counted as Tier 1 capital. As a result, the cost of generating Tier 1 capital is projected to increase significantly. Internal estimates project a 50% increase in cost, and this is reflected in the "Cost of Tier 1 Capital" cells in this sheet.

Leverage Ratio

The "Leverage" sheet details the computation of the leverage ratio under the current regime (left column) and under the proposed rules (right column).

The first element of additional cost to identify on this sheet is the inclusion of undrawn commitments to the "Exposure Measure". Under current rules, undrawn commitments are not included in the leverage ratio exposure measure. Including this value as an exposure greatly increases the amount of capital needed to meet the ratio's requirements. To complicate matters, even the requirement is as yet undefined, and as such the "Leverage Ratio Target" remains a variable input in this sheet.

The second element of increased cost to identify on this sheet is generated by the liquidity coverage ratio (see below). As a result of the need to purchase "high quality assets" to meet the liquidity coverage ratio, the exposure measure of the leverage ratio is itself greatly increased by the value of the high quality assets purchased. Again, this increases the amount of equity that must be raised and therefore the costs.

Liquidity Coverage Ratio

The "Liquidity" sheet details the computation of the liquidity coverage ratio under the current regime (left column) and under the proposed rules (right column).

The first element of additional cost to identify on this sheet is the need to purchase high quality assets to (more than) fully pre-fund undrawn commitments, such that the stock of high quality assets is at least as great as the cash outflows projected in the next 30 days. Note that for the purposes of this calculation, undrawn commitments are fully included in the cash outflows. Also note that these high quality assets impact the leverage ratio above, as previously described.

The second element of increased cost to identify on this sheet is generated by the debt issued to purchase the high quality assets. If we assume that we fund the high quality assets with 1 year debt, each month, across a portfolio of like positions, 1/12th of that debt could be projected to come due. Therefore, 1/12th of the debt amount needs to be included in the net cash outflows portion of the ratio. This further increases the amount of high quality assets needed, and the debt that needs to be raised, and so on.

Basel Capital Proposal
Quantitative Example

$100M A-rated Undrawn Corporate Commitment
Summary of implied costs

	Current	Proposed	Description
Tier 1 Capital			
Total Capital $	$4.52	$6.18	Increased PD per Procyclicality proposal
Capital Cost %	12%	18%	Narrowing definition of Tier 1 Capital
Tier 1 Capital Cost bps	**54.3**	**111.2**	
Leverage Ratio			
Add'l Capital for Undrawn Portion $	$0.00	$0.00	Undrawn amounts included in leverage ratio
Add'l Capital for HQ Assets $	$0.00	$3.90	HQ Assets from liquidity ratio hit leverage ratio
Total Add'l Capital $ (above Tier 1)	$0.00	$3.90	
Capital Cost %	12%	18%	
Leverage Ratio Capital Cost bps	**0.0**	**70.2**	
Liquidity Ratio			
Liquidity Reserve above Tier 1 $	$5.48	$98.10	High Quality Assets required for 100% reserve
Cost of 1 yr Debt	0.50%	0.50%	
Liquidity Ratio Debt Cost bps	**2.7**	**49.1**	
Total Regulatory Cost of Lending	**57**	**230**	

Basel Capital Proposal
Quantitative Example

$100M A-rated Undrawn Corporate Commitment
Sensitivity Analysis of Cost of Lending (bps)

Assumes 5% leverage ratio

	Cost of Debt			
Equity Required Return	30bps	**50bps**	100bps	150bps
8%	150	170	219	268
10%	181	200	249	298
12%	211	**230**	280	329
14%	241	261	310	359
16%	271	291	340	389

Assumes 50 bps cost of debt

	Leverage Ratio				
Equity Required Return	10%	7.5%	**5%**	2.5%	1%
8%	269	221	170	133	133
10%	325	264	200	154	154
12%	382	308	**230**	175	175
14%	438	352	261	195	195
16%	494	395	291	216	216

Basel Capital Proposal
Quantitative Example

$100M A-rated Undrawn Corporate Commitment
Summary of implied costs

	Current $	Current %
Commitment	$100.0	
Counterparty Credit Rating	A	
RAA to support commitment	$45.24	45%
Tier 1 Capital	$4.52	**10.00%**
net Tier 1 cost of equity	$0.54	**12.00%**
Current liquidity supporting commitment	$10.00	**10.00%**
Equity funding of liquidity reserve	*$4.52*	*4.5%*
Debt funding of liquidity reserve	$5.48	5.5%
1yr debt funding for bank	$0.03	**0.50%**
Leverage Ratio		
cost of equity for HQA on bal sht	$0.00	
Debt cost (bps on Commit)	$0.03	**2.7**
Equity cost (bps on Commit)	$0.54	**54.3**
Total Debt + Equity Cost	$0.57	**57.0**

	Proposal $	Proposal %
Commitment	$100.0	
RAA to support commitment	$61.76	62%
Tier 1 Capital	$6.18	10%
(1) Narrowing of Tier 1 capital definition		
cost of equity	$0.27	
(2) Increased RAA to reduce procyclicality	$1.65	
cost of equity	$0.30	18.00%
Leverage Ratio - Commitment in Numerator		
(3) Capital to support GAA	$0.00	
cost of equity	$0.00	18.00%
(4) Add'l capital if liquidity HQA included in numerator	$3.90	
cost of equity	$0.70	18.00%
Liquidity Coverage Ratio - Prefund Commitment		
(5) High Quality Assets requirement beyond liquidity rsrv	$92.63	
1yr debt funding for bank	$0.46	0.50%
Incremental debt cost (bps on Commit)	$0.46	**46.3**
Incremental equity cost (bps on Commit)	$1.27	**127.1**
Incremental total debt + equity cost	$1.73	**173.4**

If HQA are eliminated from the numerator of the Leverage Ratio, they still have an effect on Tier 1 Capital, but to a lesser degree

Tier 1 Capital		
(6) High Quality Assets in RAA	$0.65	
cost of equity	$0.12	18.00%
Incremental debt cost (bps on Commit)	$0.46	**46.3**
Incremental equity cost (bps on Commit)	$0.69	**68.5**
Incremental total debt + equity cost	$1.15	**114.9**

If HQA are eliminated from both the Leverage Ratio and Tier 1 Capital

Incremental debt cost (bps on Commit)	$0.46	**46.3**
Incremental equity cost (bps on Commit)	$0.57	**56.9**
Incremental total debt + equity cost	$1.03	**103.2**

Basel Capital Proposal
Quantitative Example

$100M A-rated Undrawn Corporate Commitment
Tier 1 Capital Ratio Analysis

	Current	Proposed	
PD	0.09%	0.17%	
EAD	**75%**	**75%**	
LGD	**60%**	**60%**	
Maturity	**5**	**5**	
R	0.235	0.230	
b	0.253	0.219	
K	0.048	0.066	
Undrawn Commitment	$100	$100	
RAA	45%	62%	
RAA $	$45.24	$61.76	
Tier 1 Capital	10%	10%	
Attributed Capital	$4.52	$6.18	
Cost of Tier 1 Capital	12%	*18%*	**approx effective hurdle rate for all-in tier 1 capital*
Total Capital Cost ($)	$0.54	$1.11	**proposal narrows definition of Tier 1 capital*
Total Capital Cost (bps)	**54.3**	**111.2**	
ALT 1: HQA not in leverage, still in Tier 1		*$92.63*	
RAA		*7%*	
Tier 1 Capital		*$0.65*	** this capital is already included in added capital for GAA*
Add'l Capital Cost (%)		*18%*	
Add'l Capital Cost ($)		*$0.12*	

Historic High Default Rates for "A" Issuers (Moody's)

1982	0.257
2001	0.168
2002	0.168

Basel Capital Proposal
Quantitative Example

$100M A-rated Undrawn Corporate Commitment
Leverage Ratio Analysis

	Target
leverage ratio = capital measure / exposure measure	**5%**

	Current	Proposed	
PD	0.09%	0.17%	
EAD	75%	75%	
LGD	60%	60%	
Maturity	5	5	
R	0.235	0.230	
b	0.253	0.219	
K	0.048	0.066	
Undrawn Commitment	$100	$100	
RAA	45%	62%	
RAA $	$45.24	$61.76	
Tier 1 Capital	10%	*10%*	
Tier 1 Capital	$4.52	$6.18	
Add'l reqrd capital for HQA and Leverage	*$0*	*$3.90*	*backsolved and max'ed with HQA Tier 1 value
Capital Measure	**$4.52**	**$10.08**	
Undrawn Commitment	$0	$100	
Additional Stock of High Quality Assets	$5	*$98*	
Exposure Measure	**$5**	**$198**	
Leverage Ratio	**82.62%**	**5.09%**	
Cost of additional required capital ($)	$0.00	$0.70	
Cost of additional required capital (bps)	**0.0**	**70.2**	

Basel Capital Proposal
Quantitative Example

$100M A-rated Undrawn Corporate Commitment
Liquidity Ratio Analysis - Interpret requirement as full funding

Assume Tier 1 capital forms the equity component of the capital structure
Assume long term debt raised to fund the remaining liquidity requirement

	Current $	Current %	Proposal $	Proposal %	
Commitment	$100.0		$100.0		
HQA Funded by Tier 1 Capital	$4.52	4.5%	$10.1	10.1%	
HQA Funded by Debt	$5.48	5.5%	$98.1	98.1%	* Long Term Debt (1Y)
Stock of High Quality Assets			**$108.2**		
Debt issuance maturing under 30 days			$8.2		*1/12 of Long Term Debt
Commitment			$100.0		
Net Cash Outflows			**$108.2**		
Liquidity ratio (HQA/Outflows)				**100.0%**	**PASS**
1yr debt cost	$0.03	0.50%	$0.49	0.50%	
Debt cost (bps on Commit)		**2.7**		**49.1**	

Basel Capital Proposal
Quantitative Example

$100M A-rated Undrawn Corporate Commitment
Leverage Ratio Analysis

		Target	
leverage ratio = capital measure / asset measure		5%	
	Current	Proposed	
PD	0.09%	0.17%	
EAD	75%	75%	
LGD	60%	60%	
Maturity	5	5	
R	0.235	0.230	
b	0.253	0.219	
K	0.048	0.066	
Undrawn Commitment	$100	$100	
RAA	45%	62%	
RAA $	$45.24	$61.76	
Tier 1 Capital	10%	*10%*	
Tier 1 Capital	$4.52	$6.18	
Additional required capital	$0	*$0*	*backsolved
Capital Measure	**$4.52**	**$6.18**	
Undrawn Commitment	$0	$100	
Additional Stock of High Quality Assets	$0	*$0*	
Exposure Measure	**$0**	**$100**	
Leverage Ratio	**infinite**	**6.18%**	
Cost of additional required capital ($)	$0.00	$0.00	
Cost of additional required capital (bps)	**0.0**	**0.0**	

IACPM
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CREDIT PORTFOLIO MANAGERS

About the IACPM

The IACPM is an industry association established in 2001 to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest.

Membership in the IACPM is open to all financial institutions that manage portfolios of corporate loans, bonds or similar credit sensitive financial instruments.

The Association represents its members before legislative and administrative bodies in the US and internationally, holds annual conferences and regional meetings, conducts research on the credit portfolio management field, and works with other organizations on issues of mutual interest relating to the measurement and management of portfolio risk.

Currently, there are 83 financial institutions worldwide that are members of the IACPM. These institutions are based in 12 countries and include many of the world's largest commercial wholesale banks, investment banks and insurance companies, as well as a number of asset managers.

Today, the credit crisis is reshaping the environment for financial institutions globally. Measuring and managing credit risk is assuming ever greater importance, and credit portfolio management – across loan, bond and credit derivative markets – is increasingly complex.

As active participants in each of these markets, credit portfolio managers today are frequently facing a variety of issues for the first time. These include the challenges of structuring transactions that involve all three markets, as well as the challenges of managing less liquid or illiquid risks.

The IACPM recognizes the unique and evolving role of credit portfolio managers in today's financial markets, and offers an excellent forum through which these issues can be identified, understood and addressed.

International Association of Credit Portfolio Managers, Inc.
360 Madison Ave., 17th Floor
New York, NY 10017
Phone +1-646-289-5430
Fax +1-646-289-5429
www.iacpm.org

Som-lok Leung, Executive Director, somlok@iacpm.org
Marcia Banks, Associate Director, marcia@iacpm.org
Argie Simon, Director, Membership, argie@iacpm.org

IACPM
INTERNATIONAL ASSOCIATION OF CREDIT PORTFOLIO MANAGERS

IACPM Member Institutions

(as of April 15, 2010)

Aareal Bank
Absa Bank
Allianz
Ariel Re
Atradius
Australia & New Zealand
Banco Itau
Banco Santander
Banesto
Bank of America
Bank of Montreal
Bank of the West
Bank of Tokyo-Mitsubishi UFJ
Barclays Capital
Bluecrest Capital
BlueMountain Capital
BNP Paribas
BNP Paribas Fortis
BP
Capital One
Channel Capital Advisors
CIBC World Markets
Citigroup
Citizens Financial Group
Commercial Industrial Finance Corp.
Commerzbank
Commonwealth Bank of Australia
Credit Agricole CIB
Credit Suisse
Deutsche Bank
DZ Bank
Eurohypo A.G.
Export Development Canada
Fifth Third
FirstRand Bank
Goldman Sachs
HSBC
IKB Deutsche Industriebank
ING Group
Intesa Sanpaolo
JPMorgan Chase
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KeyCorp
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Landesbank Baden-Wurttemberg
Lloyds TSB
Manulife Financial
MetLife
Mitsubishi UFJ Trust & Banking
Mizuho Corporate Bank
Monte dei Paschi di Siena
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National Australia Bank
National Bank of Canada
Natixis
Nedbank Limited
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NRW.BANK
PNC Financial Services Group
Primus Asset Management
RaboBank
Regions Bank
Royal Bank of Canada
Royal Bank of Scotland
Shinsei Bank
Société Générale
Standard Bank of South Africa
Standard Chartered Bank
State Street Bank
Sumitomo-Mitsui
Sun Life Assurance Company of Canada
Swiss Re
TIAA-CREF
UBS AG
UniCredit Group S.p.A.
UniCredit Corporate & Investment Banking
Union Bank of California
Wells Fargo Bank
WestLB
Westpac
WGZ Bank

IACPM
INTERNATIONAL ASSOCIATION OF CREDIT PORTFOLIO MANAGERS

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