Nederlandse Vereniging van Banken

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Subject: NVB Reaction to bcbs 245 on recognising the cost of credit protection purchased

Dear Sir, Madam,

On behalf of the Dutch Banking Association[1] (NVB), I would like to thank you for giving us the opportunity to react to Consultation Paper bcbs 245 on recognising the cost of credit protection purchased. As is mentioned in the background section of the consultation paper, credit protection has become an important risk management tool, which is being used by banks to manage and mitigate credit-, concentration- and single name risks. Credit protection also plays an important role for securitisations. The paper focusses on areas where possibilities for regulatory arbitrage exist. We support the removal of such areas, as long as incentives to hedge actual risks are not reduced.

Incentives to hedge
When looking at incentives to hedge, we found a number of areas where the suggested approach of the Basel Committee will reduce those incentives. This is especially the case in areas where the perceived risk has increased since the moment of origination. In such cases, the focus on the level of premiums based on the current market perception of risk, relative to the original spreads that are based on the historic risk perception, could lead to such a hedge being regarded as capital arbitrage, even though the hedge itself is a prudent conduct of business. During periods where the market becomes more risk averse, regulatory incentives should be supportive of hedging. Creating a regime that goes against this fundamental principle could end up increasing risks.

The suggested risk-weight threshold is low
The 150% risk weight appears to be (quite/very/too) low. As the proposal currently stands, even AAA notes would be in scope.

Section 554a is not clear
It is not clear if the section 554a "*Significant credit risk associated with the securitised exposures has been transferred to third parties. Banks must incorporate in this assessment the cost of credit protection purchased in the form of a guarantee or credit derivative that is considered material and therefore a retained position under paragraph 189(a). For transactions where a bank has not transferred significant credit risk through the purchase of credit protection, paragraph 189(a) with regard to the present value of the cost of protection will not apply.*" also pertains to the sale of first

[1] The Dutch Banking Association (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

loss or mezzanine tranches of true sale securitisations. The current text suggests only guarantees and CDS-es on a securitisation position are in scope.

Inconsistency in the capital treatment
There is an inconsistency in the capital treatment. For Tier 2 subordinated capital instruments, the present value of future costs of those instruments are not deducted from the regulatory capital position, which is not consistent with the general treatment of such costs.

Reflection of the differences between purchasing credit protection and the sale of an asset
The consultation paper assumes that:

a. a purchase of credit protection against a premium, is equivalent to;
b. a sale of an asset at a price that is determined by using a margin over the base rate equal to the available margin income of the asset on which protection was purchased, plus the premium as a percentage of the asset.

The key difference between a. and b. is that option a will normally entail a premium that is payable over the protected amount less protection payments already made. This means that the present value of the protection payments under a stress scenario in relation to the asset will reduce. This effect is not taken on board.

Example:
Suppose that a bank has a credit risky asset with value 100 paying Euribor + 100 bps and a tenor of 5 years and has the choice between:
1. Selling the asset for 95, and;
2. Buying protection for the full principal for 5 years against a premium of 1% per annum, payable at the end of a one year period of the contract over the outstanding amount at the beginning of the period.

The discount rate is zero. The draft regulation produces the same capital impact for both contracts. Now, let's assume the asset defaults in year one and there is no recovery.

The pay-off for scenario (1) is as follows:

T=0: Loss of 5%.
No further results

The pay-off for scenario (2) is as follows:

T=0: No result
T=1: Premium expense = 1%
No further results.

In this example, scenario 2 leads to better results from the bank's perspective, but this effect is not reflected in the proposed methodology.

Next to this, the buyer of protection retains the benefit of a potential upside of the asset, which is not the case if the asset is sold.

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Treatment of tranched credit protection
Looking at tranched credit protection, under Basel II banks have to retain an amount of capital against an asset equal to the calculated one year unexpected loss, determined as the loss in a stress event that can statistically occur with a one in one hundred years probability using a one year time horizon (Basel II capital formula). In order to be able to claim capital relief, fundamentally speaking, the unexpected loss needs to be protected for the next 365 days on an on-going basis. Existing rules require that capital relief can only be fully claimed if the protection is at least as long as the shorter of the asset tenor and five years.
Offsetting the capital relief by the present value of the protection premium (less asset income) over the full tenor of the contract overstates the cost of the unexpected loss protection. The assumption underlying the capital formula is that the occurrence of the unexpected loss for the coming year is a remote enough event to conclude that the bank is fundamentally sound. Hedging of the one year unexpected loss by buying protection is secured by holding the protection against the unexpected loss amount for the next 12 months. If the unexpected loss materialises, the premium is normally no longer payable. This means that the maximum amount that should be subtracted from capital (relief) should be the premium for the next twelve months. The requirement that the protection arrangement should be long enough to cover the shorter of the coming 5 years or the life of the asset already secures the continuity of the protection arrangement, which in our view is a reasonable requirement.

Significant penalisation of an economically sound hedging arrangement via the capital requirements takes away some alternatives from banks to manage credit risk. This would not be a desirable outcome. Looking at the above, for regular CDS or guarantee agreements, the maximum time horizon over which the premium should be treated as a discount margin is one year.

This concludes our remarks to the consultation paper. Should you have any questions or remarks, please feel free to contact me at your convenience.

Kind regards,

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