



FEDERATION  
BANCAIRE  
FRANCAISE

*Banking supervision  
And Accounting issues Unit  
The Director*

Paris, June 20<sup>th</sup> 2013

**French Banking Federation comments on the BCBS Consultative Document on  
Recognising the cost of credit protection purchased BCBS 245**

Dear Sir,

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The French Banking Federation appreciates the opportunity to offer its views on the consultative document issue by the Basel Committee on Recognising the cost of credit protection purchased. We understand that this consultative document aims at shutting down potential regulatory capital arbitrage related to some specific credit protection transactions.

However, we draw your attention to the scope of application of this consultative document, which would discourage or burden a large number and amount of legitimate and desirable risk management transactions, and thus distort completely risk management decisions. We would also like to express our deepest concerns regarding the inconsistency of the proposed methodology with the Basel capital framework.

You will find in the annex attached our general comments and our responses to the questions raised in the consultative document.

We thank you for your consideration and remain at your disposal for any questions or additional information you might have.

Yours sincerely,

Jean-Paul Caudal

**Mr Wayne BYRES  
General Secretary  
Secretariat of the Basel Committee  
on Banking Supervision  
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## **French Banking Federation comments on the BCBS Consultative Document on Recognising the cost of credit protection purchased BCBS 245**

### **Introduction:**

We appreciate the opportunity to comment on the consultative paper (CP) “Recognising the cost of credit protection purchased” published by the Basel Committee. We understand that this consultative document aims at shutting down potential regulatory capital arbitrage related to some credit protection transactions.

However, we draw your attention to the scope of application of this CP, which would discourage or burden a large number and amount of legitimate and desirable risk management transactions, and thus completely distort their risk management decisions; we would also like to express our deepest concerns regarding the inconsistency of the proposed methodology with the Basel capital framework.

**Scope:** We believe that “capital arbitrage” transactions are the exception rather than the norm with regards to the banks’ usage of Credit Risk Mitigation techniques. On the other hand, the proposed rules are very far-reaching and could have potentially highly damaging consequences on all CRM transactions. It is essential that the Committee narrows the application of proposed rules to clearly defined areas of concern.

**Pillar 2 supervision rather than Pillar 1 capital rules:** We believe that the correct approach to discourage capital arbitrage is to refine the Significant Risk Transfer (SRT) criteria already present in the Basel framework to disallow certain transactions, rather than impose further complex calculations under Pillar 1.

**Upfront Recognition of Cost of Protection :** The justification for this proposal is hard to understand. Why should it apply when income on the underlying assets is deferred? How could it be compatible with the marked-to-market methodology already used on some assets and many risk mitigation instruments (CDS)? How would existing provisioning rules and new expected accounting rules (IFRS 9) be taken into account? Such a methodology would discourage numerous legitimate risk management transactions and be **highly pro-cyclical** by worsening the cost of hedging during crises.

**Cost and Income :** If any new methodology were adopted, Option 1 for treating the spread income<sup>1</sup> should be the only option available to the regulators and should be part of the core proposal, not the Technical guidance. The current framework adds to the uncertainty and the potential divergence amongst jurisdictions which seems in contradiction with the stated goal of international convergence on RWA calculations.

**Consistency of Risk Weighted Asset methodology:** Adding the cost of protection (whether gross, or net of income) to the Risk Weighted Assets (RWA) of a transaction is not in line with the Basel methodology. RWA should primarily reflect unexpected loss.

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<sup>1</sup> Page 12 in the consultative paper, option 1 being the full recognition of the assets’ spread income to offset the protection costs

## **I- Keys points**

### **1-Scope:**

The proposed regulation potentially impacts all traditional credit risk mitigation techniques, including the use by banks of guarantees, insurance, sub-participations as well as single-name CDS, cash securitisation as well as synthetic securitisation.

The potential disruption to the economy would be very damaging, because (EU regulated) banks would be forced either to avoid loans when a CRM is contemplated or necessary, or to significantly increase their pricing on the underlying loans to cover the additional capital due to the CRM. In other cases many legitimate or prudent CRM techniques used to reduce and distribute risks would be prevented due to their regulatory cost.

The operational burden for banks as well as regulators would also be sizable, and might lead to un-economical delays.

On the other hand, we do not understand why the Committee could have issues with more than a small number of CRM transactions. It therefore seems of the highest importance that the Committee defines much more narrowly the scope of potential changes in the regulations.

We would suggest for example that all CRM techniques that are embedded in the original credit transaction be excluded from its scope, to avoid reducing the availability or increasing the cost of finance for many borrowers. Instruments that are already marked-to-market should also be out of scope, for reasons that are developed further in the next sections and Annex 1 to this letter.

Besides, we do not understand how the proposal could possibly apply to traditional securitisation, where the securitised assets are sold to a special purpose vehicle and the assets' cash flows are allocated to noteholders according to rules documented in the "waterfall". There is no CRM instrument used, no protection costs, no rationale we can think of about the proposed amendment of article 554.

We would hope that the Committee much more explicitly describes the types of transactions and situations which are deemed not adequately covered by the current regulations, and addresses only these situations. It is unclear why the simple fact of paying for a CRM transaction would justify taking an additional capital charge, with no consideration whatsoever given to the benefit or effectiveness of the CRM which covers principal notional loss (among other things), or to the income derived from the underlying asset (which is usually accrued in banking books).

### **2-Pillar 2 supervision rather than Pillar 1 capital rules**

If the goal of the regulation is to identify and penalize abusive transactions, this would be better achieved by refining the criteria under Pillar 2 and extending restrictions for CRM recognition when the capital relief is not justified because there is insufficient risk transfer.

Additional criteria could be envisaged to define the scope of transactions to be reviewed by local supervisors and more precisely defined rules used to exclude transactions that fail to satisfy adequate Significant Risk Transfer tests.

We would comment that the riskiness of a transaction ( $RWA > 150\%$ ) is not an adequate test, even if high RWA transactions potentially present a more attractive target for abusive transactions than low RWA transactions (please refer to the example developed in Appendix 2 for further discussion). Discouraging legitimate CRM transactions on riskier assets would be highly counterproductive for the banking system as a whole. It is essential that banks be allowed to rapidly execute legitimate CRM transactions on riskier assets without being subject to potential reviews or automatic additional capital rules.

The amount of premiums paid is also irrelevant in determining whether a significant risk transfer has taken place, except in the most extreme cases such as one of the example selected by the Committee when the premiums equal the amount at risk. To address such a case, we would suggest for example that, among potential criteria, an SRT test should measure whether both the protection buyer has reduced its remaining risk (unexpected loss) and the protection seller(s) has assumed real risk (as opposed to the example given in BCBS 245)

This would avoid complex Pillar 1 calculations for high number of transactions which are clearly not abusive.

### 3-Upfront Recognition of Cost of Protection

The Committee seems to propose a wide application of rules taking into account immediately the future cost of protection in CRM transactions, even if significant risk transfer has effectively been achieved. It is hard to understand the justification for this change in the great majority of cases:

1): When CRM techniques are embedded in credit transactions (i.e. loans guaranteed by another entity), their cost is taken into account in the pricing of the loan. Both the income from the loan and the cost of the CRM are accrued in banking books. The pricing of the CRM also reflects the risk transferred to the CRM counterparty. The net remuneration kept by the bank reflects any remaining risks (including counterparty risk on the CRM provider) and the value provided by origination, structuring and servicing the loan. What would be achieved by upfront recognition of the CRM costs?

2): When a CRM technique is used to protect an existing banking book asset, it is in full consideration of the risk transferred to the CRM counterparty. The cost of the CRM (present value of protection costs) is embedded in the valuation of the CRM instrument, and the lower losses incurred by the protection buyer in the event of a default justifies the reduction in the amount of regulatory capital.

3): For all marked-to-market assets and CRMs, the valuation is updated periodically to reflect marked-to-market pricing, with a direct impact on banks' regulatory capital. At inception, any cost higher than the fair market cost would be reflected as a loss in the accounts.

We understand that the Committee may have an issue with situations where the cost of the CRM may exceed the income of the underlying asset, and this potential loss is not recognized upfront because the asset is booked on an accrual basis (banking book). This could happen in some cases when the market view of the fair credit spread of an asset exceeds the interest margin on that asset, so that the cost of the CRM exceeds this margin.

Before discussing this point in greater detail in the next section, we would like to point out that this issue is very wide as it is linked to the difference in philosophy between accrual and marked-to-market accounting. Why should the use of CRM in itself lead to a forced recognition of the MTM of assets booked under the accrual methodology? This would probably discourage prudent risk mitigation measures while increasing the portion of banks' assets subject to the volatility and procyclicality of MTM accounting.

#### 4-Cost and Income

If the Committee wishes to address the existence of situations where the cost of a CRM exceeds the income of the underlying asset, then it is essential to consider the income generated by the asset, as proposed by the Committee under Option 1 for the valuation of the cost of protection. It is hard to understand the logic for the other proposed methodologies, as if a high-cost protection in itself should be penalized regardless of the risk transferred and/or the income generated by an asset.

But we would like to point out a series of difficulties and facts not necessarily taken into account by the Committee for the application of this methodology.

The first one, already mentioned above is that this methodology should not be applied to assets and CRMs accounted in MTM.

The incompatibility of the MTM methodology with the proposed calculation also raises the question of how to address the cases where an accrued asset is hedged by a CRM which is booked under MTM, such as most or all single-name CDS. When a CDS is purchased, its cost could potentially be compared with the income of an underlying asset and the proposed calculation under option 1 made. However:

- The CDS price will then fluctuate and such fluctuations will be taken into account in banks' regulatory capital. Should the proposed methodology also give rise to updated calculations and how?
- CDS prices are expressed in the market in the form of upfront premiums and spread income. How will this be made compatible with the proposed methodology?
- CDS are not attached to any single asset and can be used to cover one asset and then another (for example when a loan is sold or repaid). How will this be taken into account?

We would also like to understand how various existing and future accounting norms with direct impact on banks' regulatory capital will be taken into account:

- For example, when an asset experiences a significant deterioration, it is subject to the same level of provisions whether it is hedged by a CDS or not. Will the cost of the CDS (either existing or newly purchased) be added to the RWA of the asset, independently of the provisions already taken?

- What about the newly contemplated IFRS 9 and FASB rules regarding recognition of estimated losses?

We would also like to underline the very complex questions which will need to be addressed if calculations under option 1 need to be made in the future and the myriad consequences that each possible answer will entail:

- Will such calculations need to be updated for each regulatory date?
- How will the margin from an asset be determined, with questions for example on the determination of cost of funds for each bank (updated ?), ancillary income obtained linked to the asset (arrangement fees , swap fees...) or from the same client, thanks to the loan granted ?
- How will the cost of tranching protection be compared to the income of the assets ?

The proposed methodology raises considerable technical issues, the potential for a huge workload and multiple possibilities of arbitrage between jurisdictions if such questions are not addressed consistently.

## 5-Consistency of RWA methodology

The proposal to take into account the present value of credit protection costs in the assessment of the regulatory capital, regardless of accounting rules, is a major shift from the current Basel Regulatory Capital framework. We view this as fundamentally inappropriate as Risk Weighted Assets are assumed to cover unexpected credit losses, not future costs or income. This change in the principles and objectives of regulatory capital that is implied by the CP has potential ramifications that go far beyond the specific issue addressed on the CRM framework.

What the Committee proposes implicitly means stripping the various components and taking into account only one component of (i) the assets (gross income net of funding and other relevant costs) and (ii) the CRM instrument (costs without benefits). This goes against existing principles, and seems contradictory with basic accounting and reporting principles. It would require significant system developments and operational burden, while resulting in increased gaps between the accounting and the regulatory frameworks.

## **II- Unintended consequences of proposed rules**

- The proposed rules are highly pro-cyclical: when the credit risk is high (and so is the cost of protection), banks must be able to hedge without being penalised on top of that in capital. The proposed deduction of the PV of the premium from capital will make it virtually impossible for banks to manage the risk in a period of crisis (when cost of hedging increases in the market as well as banks' cost of funding, banks can not be penalised by additional reduction of capital). Different layers for significant capital buffers have already been incorporated in Basel III framework.
- Under proposed rules, the regulatory cost of CRM techniques will be increased. This would prevent banks from financing real economic activity. Companies will be constrained to obtain funds from the shadow banking system, whose activities are fully or partially outside the regular banking system.

- The proposed rules will create level playing field issues, for example:
  - The CP is ambiguous so that the market participants do not understand (i) what is in scope and (ii) how the rules will be implemented. The core proposal of modifying articles 189, 554, and 555 is to create an additional capital charge on all guarantees and credit derivatives where the underlying asset's risk weight is greater than 150% in the absence of credit protection.
  - The technical guidance waters down the proposal with a great level of flexibility with regards to the actual implementation by national supervisors. On page 12 especially, the possibility is given to the supervisor, on an optional basis, to factor the spread income of the asset being hedged in the calculation. Thus “**material credit protection costs may be taken as zero**”, e.g. “where a bank purchases credit protection for a loan at origination (...)”. The colossal difference between using this possibility or not only adds uncertainty. The risk of divergence across jurisdictions would be increased by applying the CP in its current form.
  - The funding cost is a component, which depends on the credit spread of the bank (buyer of the credit protection) and de facto varies over time. Thus, not only the determination of the funding costs is difficult (it is difficult to track down on an individual transaction basis), but also, the deduction of the funding costs is not consistent with the need for a level playing field within the industry. Under proposed rules, for a same transaction, according to the credit quality of the protection buyer, the present value may vary.

### III- Conclusion:

We understand the need to address CRM or synthetic securitisation transactions without a significant transfer of risk. This issue is better addressed under Pillar 2 as recommended in the statement issued by BCBS in December 2011 («high cost credit protection»). We don't think it is necessary or advisable to issue new rules under Pillar 1 at this stage.

We think that the mentioned statement deserves instead further clarification about SRT monitoring and about homogeneous implementation across jurisdictions. For example BCBS could propose a “score card” to review the contemplated protection characteristics:

- economics of covered exposure(s) + economics of the guarantee (funding, rebate, guaranteed amounts...) + complexity or degree of standardization of the instruments (mark-to-model? observability of the parameters and model?)
- other impacts: strategy of the bank, ...
- internal governance for protection approval + documentation review + independent analysis

While we agree with the necessity to discourage regulatory arbitrage, we believe that the proposed methodology suffers from deep flaws, over-complexity and, most of all, overreach, as it is highly unlikely in our view that the potential issues linked to the use of CRM techniques justify such wide-ranging proposal.

## **Appendix 1 – Discussion of the incompatibility of Marked-to-Market methodology with the proposed changes to the CRM framework**

At any time and for any transaction, the fair value is the sum of actualized cash flows i.e. the actualized difference between cost of protection and expected indemnification in the case of Credit Risk Mitigation transaction. The market value is the amount the bank will pay (in the case of a positive market value) or receive (in the case of a negative market value) to enter into a similar transaction. When there is limited arbitrage opportunity as in all liquid markets, the fair value is equal to the market value. Especially for CDS, the vision of the CDS mark to market (MtM) reflecting the change in market spread is just a consequence of the MtM being equal to the difference between the present value of the premium leg and the present value of the indemnification leg (see below).

Therefore, for transaction accounted for in fair value, the present value of cost of protection net of expected indemnification is always recognised in P&L or equity. As the relevant criteria to address the Committee concern about capital arbitrage is precisely the cost of protection net of expected indemnification, requesting an additional exposure for transaction accounted for in fair value will lead to a double penalty.

Moreover, it is worth noting that, though the consultation paper is vague about the implementation of the proposed framework, one can anticipate that including mark to market instruments in the scope will create incentive for bank to either unwind their protection or concentrate their protection on the less risky part of their portfolio (see exhibit 2). In addition, for liquid instrument that could be unwinded (such instruments are typically accounted for in market price), having a fixed threshold at 150% will create incentive for the bank to artificially reset their protection when a loan cross the threshold (if the RW of a loan becomes lower than 150% unwind the existing protection (which comes with a premium PV deducted from regulatory capital), and buy a new protection for the same loan, but based on the new  $RW < 150\%$  (which is not captured by the high cost protection framework). Such artificial reset of protection will likely increase the cost of protection for banks.

As a result, it must be clearly stated that all instruments accounted for in mark to market are out of the scope of the proposed framework.

**MtM of a CDS expressed as a spread difference is a consequence of such MtM**

**being equal to the fair value**

Let's note

- $R$  : recovery as anticipated by the market
- $r$  : risk free rate
- $T$  : maturity of the transaction
- $S_t$  : the current market spread
- $S_0$  : the contractual premium
- $\tau$  : time of credit event (stochastic variable)



At any given time, the present value of the indemnification leg and premium leg are determined by the following formula:

$$PVIL(t) = (1 - R).E(e^{-r(\tau-t)} 1_{\tau < T})$$

$$PVPL(t) = S_0.E(\int_t^T e^{-r(x-t)} 1_{\tau > x} dx)$$

The value of the CDS for the protection buyer is then equal to

$$MtM(t) = (1 - R).E(e^{-r\tau} 1_{\tau < T}) - S_0.E(\int_t^T e^{-r(x-t)} 1_{\tau > x} dx)$$

A CDS where the contractual premium is equal to the market spread at the time of the transaction will have an initial value of 0. We have then:  $(1 - R) * E(e^{-r(\tau-t)} 1_{\tau < T}) = S_t.E(\int_t^T e^{-r(x-t)} 1_{\tau > x} dx)$

So the MtM of a CDS can also be written as a duration multiplied by the difference between market spread and contractual spread:

$$MtM(t) = (S_t - S_0).E(\int_t^T e^{-r(x-t)} 1_{\tau > x} dx)$$

### **- Applying the high cost protection framework MtM instruments leads to absurdities**

As the proposed framework does not allow to deduce expected protection benefits from protection cost, instruments being accounted for in mark to market fall within its scope.

The consultative paper is not clear on how should be computed the cost of protection after the initial date (should it be initial premium or market premium). Hence we will study the two possibilities and in each case, show that applying the framework leads to absurd results

Case 1 : cost of protection is based on the initial premium

We consider the transaction A described in the consultative paper

- Bank holds single name corporate bond which has book value 100 and maturity of 5 years.
- Corporate bond attracts a risk weight (RW) of 200% (via an IRB approach), giving risk-weighted assets (RWA) of 200.
- Bank buys a CDS with maturity of 5 years against the bond issuer from a 0% RW counterparty.
- CDS has a running premium of 100bp per annum and no upfront premium.

- Premium payments are due annually in arrears.
- Loss Given Default (LGD) of the corporate bond is 80%.

The computation below are made under the following assumptions

- Supervisory choice is risky discount rate as per the consultative paper suggestion
- Risk free rate is constant and equal to 2%
- Internal rating of underlying assets are unchanged

The capital impact of the transaction as of transaction date is split as follow:

Item	Capital Impact
RWA Relief due to protection	+16
PV of contractual premium	-4.55
MtM	0
<b>Total</b>	<b>+11.45</b>

If we consider a scenario where the spread falls to 90bps without change in the RWA of the underlying loan asset (which is possible as the Basel II model are usually far less volatile than the CDS market), the capital impact of the transaction would be split as follow

Item	Capital Impact
RWA Relief due to protection	+16
PV of contractual premium	-4.56
MtM	-0.46
<b>Total</b>	<b>+10.98</b>

Unwinding the CDS and entering into a new CDS with an initial premium of 90bps will have the following capital impact

Item	Capital Impact
RWA Relief due to protection	+16
Impact of CDS Unwind	-0.46
PV of contractual premium	-4.11
<b>Total</b>	<b>+11.43</b>

The framework hence gives an incentive to artificially unwind CDS with a negative MtM to enter into identical CDS at market price. Such artificial reset will lead to an increased cost for the banks.

Case 2 : cost of protection is based on the market premium

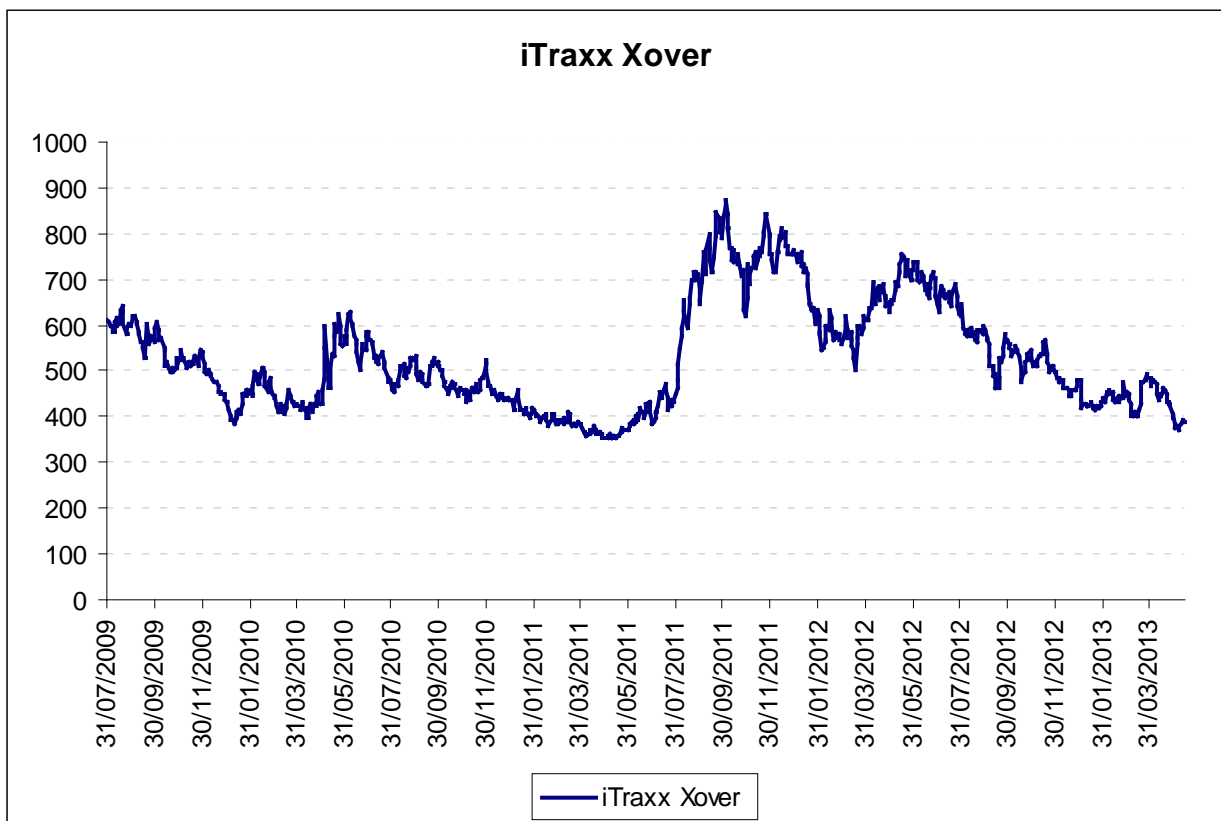
In such case, we could have scenario where the spread increases without change in the RWA of the underlying loan asset (which is possible as the Basel II model are usually far less volatile than the CDS market), we could then have situation where the PV of the premium totally offset the RWA relief of the transaction, therefore providing incentive to unwind the CDS to crystallize MtM benefit without having any capital impact.

## Appendix 2 - The 150% threshold seems disconnected from hedging market prices

In the example below, the assumptions are the following:

- A 100 MEUR loan, Maturity = 5Y, own by the bank with a 150% risk-weight which we decide to hedge.
- a. The current RWA consumption of the loan before hedging is the following:  
 $100 \text{ MEUR} \times 150\% = 150 \text{ MEUR}$  of RWA (equals to 12 MEUR regulatory capital)
- b. A 150% RW asset corresponds to a non-investment grade loan (as a comparison, it is close to a credit quality step around 6 or 7 under the Basel II Standardised Approach, depending of the type of counterparty).

The price of hedging for such a loan can be estimated over 400bps, based on the minimum of itraxx X-over 4Y



➔ Cost of the protection:  $400 \text{ bps} \times 100 \text{ MEUR (nominal of the loan)} \times 4\text{Y (wal)} = 16 \text{ MEUR}$ , to be deducted from Tier 1 capital under the new framework.

(For the sake of simplicity, the premium is not discounted here)

Conclusion:

- Without taking into account the counterparty risk of the protection seller, the cost of Tier 1 of the deducted premium is higher than the initial cost of Tier 1 of the underlying loan;
- Under the proposed framework, the hedge of 5Y loan with a 150% RW by a CDS has a breakeven point around 250 bps premium, which is disconnected with current High Yield market prices;
- This framework discourages banks to buy credit protection on underperforming / low rated loans, which seems in contradiction with the Basel framework which aims at managing credit risks efficiently especially the Pillar 2
- Discouraging hedge of under investment grade assets directly generates pro-cyclical effects

### **Annex 3 - Detailed analysis of the consultation paper**

We find that the consultation paper's objective is difficult to understand and unfortunately we find that the technical guidelines add further confusion.

The analysis below consists in discussing the definition and examples found in the paper and in pointing out the questions raised.

Operational requirements for traditional securitisations

P3: *"554. An originating bank may exclude securitised exposures from the calculation of risk-weighted assets only if all of the following conditions have been met. Banks meeting these conditions must still hold regulatory capital against any securitisation exposures they retain.*

*(a) 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."*

As defined in paragraph 539, « A traditional securitisation is a structure where the cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk.» A traditional securitisation generally does not use guarantees or credit derivatives that are defined on paragraph 189.

#### ***What kind of structure or transaction is targeted on the proposed amendment of paragraph 554?***

One of the main difference between traditional securitisations and synthetic securitisation is that all the cash flows paid under a cash securitisation derives from the underlying pool of exposures whereas the cost paid for the protection under a synthetic securitisation does not derive from the underlying pool of exposures.

P3: *"189. (b) Credit protection costs will be considered material when the risk weight on the exposure in the absence of credit protection would otherwise be greater than 150% at the time the credit protection is bought. Notwithstanding this threshold, national supervisors may determine that the cost of protection is lower than 150%. In using this discretion, national supervisors may consider a variety of factors, such as the terms and conditions of the protection contract, on a case by case basis. "*

The proposed threshold seems arbitrary and is a disincentive for banks to hedge their risky or underperforming assets.

In addition, it is not realistic that national supervisors intervene systematically for each guarantee purchased for evident deal flow volume and timeline reasons.

As for the synthetic securitization, national supervisor intervention is already in place but without any homogeneous criteria for their process. The BCBS might want to define standards for the information required, criteria, analysis grids and follow up on the Basel NL16 “High cost credit protection” from 2011..

Beyond operational issues, national discretion is likely to lead to inconsistency of implementation of the guidelines or threshold in different jurisdictions.

P 6: Transaction B

*“Note: for illustrative purposes, we assume the upfront premium in transaction B can be amortised over 5 years on a straight-line basis for accounting purposes”*

This is not realistic. A CDS is a derivative transaction and therefore has to be accounted on a mark to market basis. ***Does it mean that a protection that would be accounted on a mark to market basis would not be impacted by this paper since the cost of the protection (and the benefit) are recognized in earnings through the mark to market?***

On single name transactions (transactions A and B), market standards have developed as follows: all names trade at a fixed contractual premium (100bp on investment grade) and an upfront payment is paid or received to compensate the difference between traded spread and contractual spread. This standardisation makes all transactions fungible and enables trade compression and compensation through CCPs.

In practice, a bank would not have the choice between Transaction A or Transaction B, but will actually trade a combination of both with 100bp and upfront premium.

Note also, that in case the negotiated spread is below the contractual spread of 100bp, the protection buyer will actually receive an upfront payment. Would this upfront payment bring a capital benefit?

CDS are done at current market conditions. Any upfront premium paid or received by the protection buyer has an immediate symmetrical impact in terms of mark to market. ***The mark to market of a CDS is (almost) always collateralised through a Credit Support Annex. How would be this collateralisation taken into account?***

Market standards that are used to compute the present value of the premium leg of a CDS are different from what is suggested on page 9. The actual market practice takes into account the full interest rate term structure, the full credit spread term structure, in order to derive a probability of survival on each date of premium payment. Finally, the discount rate will depend on whether the transaction is collateralised or not, and if collateralised, will depend on the currency of the collateralisation agreement (interest rate term structure and basis swap).

As mentioned above, a negative marked-to-market under a CDS also attracts a capital charge counterparty risk exposure and therefore would attract more than 1250% RW charge in case of implementation of the proposal.

In the end, the proposed rules introduce discrepancies of between upfront payment and running premium that may either create new regulatory arbitrage opportunities (difference with market standard on computation methods), or may incentivise portfolio manager to trade away from market standards with some other negative side effects (increase counterparty risks, decrease liquidity).

P6: Transaction C

*"Protection cost (..), capped at total pool spread income after cost."*

This characteristic is unrealistic. It mixes concepts of traditional securitisation and synthetic securitisation which are fundamentally different. Protection costs on a synthetic securitization can hardly depend on the spread income on the assets. Spread income on the assets is very difficult to define contractually as the protection provider will not be in a position to check nor to anticipate the spread income on the assets.

Pool spread income per annum after cost is 5%: this high level of spread income would typically suggest assets that are well below investment grade ratings. Investors would be expected to require a higher remuneration for a first loss protection on those assets....

P7 Note 5: *"In this guidance "spread income" is defined as being the gross income net of relevant costs. The following costs and fees should be deducted from spread income: servicing fees, legal fees, funding costs, potentially also origination costs if so determined by supervisors)."*

We don't understand the rationale of deducting the funding cost in the spread income calculation. We point out that the funding cost is a component, which depends on the credit spread of the bank (buyer of the credit protection) and de facto varies over time.

Thus, not only the determination of the funding costs is difficult (it is difficult to track down on an individual transaction basis), but also, the deduction of the funding costs is not consistent with the need for a level playing field within the industry. Indeed, a same transaction, according to the credit quality of the protection buyer, the present value may vary.

Present value calculation of credit protection costs

P8: *"upfront credit protection costs are deducted, 1250% risk –weighted or recognised in earnings "*

In case of a CDS in marked-to-market, the upfront is recognised in earnings and has an immediate opposite counterpart through mark to market. How should it be treated?

Recognising spread income

P12: *"Options for treating spread income include:*

- (i) Calculating credit protection costs as "present value of contractual premiums" minus "present value of contractual spread income" when premiums are considered to be contingent, and disregarding spread income otherwise.*
- (ii) Calculating credit protection costs as maximum present value under any possible scenario of "premium" minus "spread income".*
- (iii) Disregarding spread income »*

The options entail very different outcomes. The rationale for the various options is not clear. There seems to be a confusion between the cost of credit protection and the value of the credit protection, which should take into account both the cost and the benefit of the protection. The spread income on the assets seems to be viewed in the paper as a measurement proxy of the protection benefit.

The different options proposed are very difficult to implement operationally. The determination of the spread income on the asset is in itself very difficult to assess.

Option (ii) seems overly complex to implement. It is difficult to imagine an information system that would be in position to compute on a regular basis a valuation based on “any scenario” on a wide portfolio of transactions.

P14: Example 6 – Transaction C (Securitisation, Contingent Premium)

This example is not realistic. The premium under the protection seems too low in comparison with the spread income on the assets. As a consequence the results are overly optimistic for the bank.

P15 & P17: Is example 9 a Securitisation?

The numerical example 2.2 is described as a securitisation on page 15, whereas on page 17 where the example 9 is developed, there is no mention of a tranching – it is unclear if reference is made to a securitisation or to a single name protection?

P16: Example 8 – Transaction with rebate mechanism:

First of all, this example is not realistic. Irrespective of incorporation the credit protection costs, if a bank retains the first-loss tranche, how can the significant risk be transferred by the bank?

We share the Committee’s view that a mechanism whereby the premium payments that are not needed to cover losses are rebated to the protection buyer clearly reduces the efficiency reality of the risk transfer. The exact mechanism of the rebate is not clear in the example.

P17: Example 9 – Outright protection of assets where market value is significantly less than book value:

Under IFRS:

- Financial assets, held for trading, are measured at fair value through profit or loss. In that case, there is no difference between book value and market value.
- Financial assets, held-to-maturity investments and loans and receivables, are measured at amortised cost. In which case, if the book value is different from the market value, it is rather an accounting issue. The bank shall, first of all, write the asset down to the market value.
- All other financial assets, categorized as financial assets available for sale (AFS), are measured at fair value through other comprehensive income (OCI). In which case, with the implementation of Basel 3, banks shall not make adjustments to remove from their own funds unrealised gains and losses on their assets or liabilities measured at fair value. As a result, OCI will no longer be eliminated from own funds. Besides, in case of a significant depreciation of an asset in AFS, this depreciation will impact P&L.



Example 9 looks like an attempt to resolve an accounting issue by using a regulatory route. The real issue here seems to be the capital treatment of the assets in the absence of protection. How come the bank is allowed to weigh the assets at 150% where the protection trades at such a high level? The level of protection costs (40% upfront) suggests a market consensus for a very high probability of default with a very low recovery. It is particularly high considering it not a tranching transaction.

Here the protection cost seems very high irrespective of the mark to market on the asset and the risk weight.

We would be very interested in getting more details on the contemplated transaction.

We do not see any reason to weight the present value of the premium at 1250%.

The protection buyer does not lock anything since he/she can resell the protection purchased at any time for the same premium amount if it was done at market price.

*“In cases where the difference between market value and book value is small (eg less than the premium paid) supervisors may determine that credit protection costs do not need to be considered material where the RW of the protected position is less than or equal to 150%.”*

It is not clear why the capital treatment on a credit protection should depend on the market value of an asset to which the amortised cost accounting applies.

It may be very difficult to assess the market value of the asset, which is typically not available hence the amortised cost accounting.

**This principle introduces large cliff effects depending whether (book value – market value) is above or below the present value of the premium.**

The rationale for this test is not clear at all. If there is a large difference between market value and book value, why should it be a problem for protected assets only? What is the link between this difference and the value of the protection costs?

P18: Treatment of losses already recognised in earnings
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*“The hedged assets are market valued on balance sheet and the mark to market has reduced by an amount greater than or equal to the credit protection costs, so credit protection costs are already taken into account.”*

**Why such a link should be made? What is the rationale of this point?**

If an asset is impaired, this element is already taken into account for pricing the credit protection cost.

P19: Example 11 – Treatment of maturity mismatches:

As mentioned above, the hedge decision follows banks' internal risk management assessment on a portfolio basis. It is not only driven by the protection costs. If supervisors force banks to react in the same manner, this may lead to a "flight to quality" and a disincentive for banks to finance the real economy.

Besides, the three proposed approaches are very different. If different jurisdictions adopt different approaches, this may raise "level playing field" problems.

*"supervisors may wish to consider whether banks would be inappropriately incentivised to purchase shorter maturity protection relative to the maturity of the position that is being protected"*

True. The principle of treating the cost of credit protection as a retained position introduces potentially many wrong incentives...

*"In this example credit protection costs are extrapolated on a straight line basis under Approach 2, any spread income is disregarded and a risk-free PV is shown under all approaches (supervisors could alternatively use a "risky" PV in this case)."*

What is the background? How can the Committee suggest to deduct future protection costs that will never be payable by the buyer, as they are beyond the contractual maturity of the protection contract?