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OF
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By email: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs

Consultation on Proposals for Recognising the Cost of Credit Protection Purchased

We refer to the above consultative document published by the Basel Committee on Banking Supervision (BCBS) in March 2013.

On behalf of our members, we write to provide our views on the proposals in the consultative document as set out in the Appendix.

We hope you would find our comments useful. Should you have any questions, please do not hesitate to contact our Assistant Manager, Mr Timothy Tam, at (852) 2526 6080.

Yours faithfully

Boey Wong
Secretary

Enc.

cc. Ms. Karen Kemp, Executive Director (Banking Policy), Hong Kong Monetary Authority

HKAB's comments on BCBS consultative document on Recognising the Cost of Credit Protection Purchased

Question 1: In addition to the 150% risk-weight threshold, should additional exemptions for certain types of transactions be considered? In particular, the Committee welcomes feedback on (1) exposures guaranteed by governmental entities (including sovereigns and public sector entities) and (2) trade finance transactions with guarantees.

The purpose of the proposed rules is to capture transactions that are taking advantage of capital arbitrage, particularly when (i) there is a delay in recognizing the cost of protection in earnings while (ii) the bank receives an immediate regulatory capital benefit in the form of a lower risk weight on an exposure on which it is nominally transferring risk.

We are of the view that guarantees extended by governmental entities and those extended to trade finance transactions should be excluded from this threshold as they are usually arranged for credit risk hedging purpose and a means of incentivizing banks to provide financing to small and medium size enterprises.

Similarly, parental guarantees should also be exempted as a most common form of credit risk hedging arrangement for banks to offer direct lending to a corporate's subsidiary or affiliate that usually does not have a sound financial ground on a stand-alone basis.

We would also not expect the rules to be applied to any credit protection instruments (e.g. credit default swaps) that are classified as TRADING book activities, be it entered into for market making purpose, risk management or CVA hedging, as the instrument is already subject to mark to market (MtM) revaluation through P/L, i.e. taking credit default swaps (CDS) as example, at any point in time the MtM value for the protection buyer is the difference between the positive value of the outstanding protection (default leg) and the present value of the contractual future cost of the protection (premium leg).

Question 2: The Committee welcomes feedback on all aspects of the proposed changes to the rules text and the supplementary technical guidance.

Further comments on other areas of proposed changes -

Pillar 2 treatments on Securitization framework

Our interpretation of this consultative document includes directed focus on securitized exposures, which usually contain complex trade structures and target to achieve substantial capital savings. The Pillar 2 framework allows regulators to risk assess this type of transaction on a case by case basis, and institutions to justify the validity of the significant risk transfer, failing which the regulator may impose additional capital charges as necessary. Regulators from different jurisdictions may exercise this discretion to a different degree hence we are of doubt as to whether such application would further require an overlay of stringent Pillar 1 capital rules. Excessive capital charge on capital protection arrangements may dis-incentivize banks to offer any systematic credit protections for mitigation in the long run, and hedge effectiveness assessment becomes a huge operational burden as explained below.

Operational burden

The operational burden for banks to track down all relevant transactions with 150% RW is huge as stipulated by proposed rules and operational costs would not match with benefits. The rule perhaps intends only to capture limited arbitrage transactions but literal interpretation may take to end up capturing even legitimate hedging transactions.

The proposed rule relies only on the risk weight criterion as a determinant of a potentially arbitrage transaction. This very simple criterion likely to cover non-arbitrage transactions may end up discouraging banks to take up credit protection instruments to manage its credit risk.

Delay in recognizing cost of protection

When a bank issues a subordinated debt, it gets an immediate capital benefit in the form of higher tiered capital to support its businesses, with associated costs being recognized through the life of the subordinated debt.

Similarly, we believe the same principle should be applied to credit protection instruments whereby the cost of credit protection paid through time should merely reflect the compensation to the protection seller for the risk taken continuously over the life of the protection.

Calculating the net premium

Consideration should be given to market practices, such as the use of Standard North American Contract (SNAC) in the calculation of the net premium on single-name CDS, which is in preparation for standardization and central clearing purpose. These kinds of contracts have standardized annual running spread of CDS at 100 bps for investment grade credit and at 500 bps for non-investment grade credit irrespective of the traded credit spreads. Differences between the traded credit spread and the SNAC based running spread are settled upfront of the trade. The cash flow on the premium does not reflect the actual traded credit spread of the CDS. For the purpose of calculating the net premium over the life of the hedge, the traded credit spread should be used, not the annual running spread.