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Mr. Wayne Byres
Secretary General
Basel Committee on Banking Supervision
Centralbahnplatz 2
Basel, Switzerland

**Re: Recognizing the cost of credit protection purchased**

Dear Mr. Byres:

The Institute of International Finance, through its Working Group on Capital Adequacy, would like to provide comments on the proposed rules on the recognition of cost of credit protection purchased. From the outset, we underscore that our members strongly support the goal of ensuring that credit risk mitigation techniques, whether for risk-based capital or for internal risk management purposes, serve as effective risk management tools.

The industry is particularly aware of the concerns about regulatory arbitrage that are mentioned in the introductory sections of the BCBS consultative document and shares the objective of addressing effectively such concerns. We would note, however, that such concerns were precisely the subject of the guidance that was issued by the BCBS in December 2011 (*High Cost of Credit Protection, BCBS Newsletter No. 16*). We believe that given that the guidance has been in place only for year and a half, a more comprehensive assessment of the effects and changes in behavior promoted by the guidance should be undertaken. In that sense, in our view the BCBS should allow more time to monitor developments with respect to high-cost credit protection transactions and to review the effective implementation of the guidance, rather than to move forward with a Pillar 1 rule, especially as proposed.

Should the BCBS deem that a more direct policy response is needed, we believe that the proposed approach to risk weight the present value of premium on credit protection is not the right solution since it will only result in unintended consequences of (1) adding further complexity to the risk-based capital framework, and (2) unnecessarily penalizing a large number of transactions that are truly intended to mitigate unexpected losses, especially if applied based on an arbitrary criterion as proposed.

Hence, if a Pillar 1 approach is deemed preferable, we would suggest it should be based on reinforcing the eligibility criteria for credit risk mitigants to screen arbitraged transactions to the greatest extent possible. This would mean that if a hedging transaction is found to be an arbitrage transaction, outright disallowance of the recognition of protection would be the most effective solution. We believe only this kind of response will effectively shut down arbitrage opportunities without the unintended consequences mentioned above.

To do this, the criteria for judging a credit risk mitigation technique as an arbitrage transaction ineligible for recognition in the risk-based capital framework should be

transparent. Regulatory authorities already have full power to recognize or reject the risk transfer based on a number of Pillar 1 criteria for eligible credit risk mitigants. The BCBS can supplement and reinforce these existing criteria. Once a credit risk mitigant complies with the eligibility criteria, cost of credit protection should have no role to play in determining the level of capital that would be required for the hedged transaction.

We understand, however, that the nature of these arbitrage transactions (structures vary and may evolve with market developments) requires flexibility in how regulators respond. Hence, for cases that cannot be easily captured by tightening the eligibility criteria for credit risk mitigants, Pillar 2 should have a role to play.

We note with interest the statement in the consultative paper that says "*despite the current Pillar 2 provisions in the Basel framework to address the appropriateness of protection recognized against certain exposures…there exists potential for capital arbitrage within the credit risk mitigation framework…*" We are unsure whether the statement is a reflection of the effectiveness of enforcement, or the lack of appropriate and consistent application guidelines, or both (i.e., no consistent guidelines hence limiting the effectiveness of enforcement). In any case, clear and appropriate Pillar 2 guidelines, which would reinforce the BCBS December 2011 guidance, for the identification and treatment of hedging transactions that are deemed arbitrage transactions would help facilitate a consistent and effective enforcement of the rules.

This dual approach (reinforcing the Pillar 1 eligibility criteria for credit risk mitigants and allowing Pillar 2 flexibility for supervisors to respond to market developments) would be in our view much more effective in addressing the problem. Focusing only on a Pillar 1 approach, particularly the approach proposed in the consultative document that gives a lot of flexibility to national regulators in implementing the rule, would not only result in unintended consequences noted above but would certainly result in inconsistent implementation of what is supposed to be a standard Pillar 1 rule. This would lead to level playing field issues, and is also potentially inconsistent with the goal of the BCBS to narrow divergences in RWA calculation across banks and jurisdictions.

In addition to these overarching comments, below we offer some detailed comments on the proposal:

***Unintended consequence of the additional risk-based capital requirement***

Risk-based capital for credit risk is intended to cover unexpected losses arising from credit exposure to a counterparty. Imposing an arbitrarily high capital charge on the premium paid on credit protection is not fully aligned with this intent. It may be justified if the proposed rule captures only arbitrage transactions, but the way it is currently designed, it would certainly capture even legitimate hedging transactions. This would either discourage the prudent practice of hedging credit exposures, especially high-risk, low quality assets that would most likely be subject to the proposed rule, or restrain banks from lending to all but the highest quality borrowers. This in turn would have potential adverse effects not only on an individual bank's safety and soundness but also on the system as a whole. As we noted above, the more efficient solution, and one with no unintended consequences, is to simply disallow the recognition of the credit mitigating effect of arbitrage transactions, where these are clearly identified.

### *Delay in recognizing cost of protection*

The consultative document takes issue with "(i) there is a delay in recognizing the cost of protection in earnings while (ii) the bank receives an immediate regulatory capital benefit…" We do not see anything inherently wrong with that. For example, when a bank issues subordinated debt, it gets an immediate capital benefit in the form of higher level of capital to support its businesses, but the associated costs are recognized through the life of the subordinated debt. The same thing can be said of credit protection. The cost of credit protection paid through time merely reflects the compensation to the protection seller for the risk taken continuously over the life of the protection.

### *Delay in recognizing losses in earnings*

Part of the regulatory concern in this area, as stated in the BCBS December 2011 guidance mentioned above, is the delay in recognizing losses in earnings. This arises from an accounting rule that does not recognize future credit loss events even if they are expected. However, it should be noted that there are now proposals from both the IASB and FASB to change this rule. While the two proposals are not exactly the same – the IASB proposes a dual-measurement approach where a lifetime expected loss approach is used if there is significant credit deterioration, and a 12-month expected loss approach otherwise; while FASB do not make such distinction and subject all to a lifetime expected loss approach – both agree that expected credit losses should be recognized for all financial instruments subject to impairment accounting. These proposed changes would limit opportunities for deferral of loss recognition and, thus, reduce arbitrage opportunities even without the proposed rule of risk-weighting the cost of credit protection.

### *Covered transactions*

We do not believe that the purpose of the proposed rule is to capture transactions that are clearly meant to hedge credit risk. In particular, we believe that should BCBS push ahead with this proposed rule, guarantees extended by governmental entities and those extended to trade finance transactions should be excluded. Government-backed guarantees are explicit expressions of public policy goals to aid important sectors that contribute to national economic development. Hence, the proposed rule should not undermine such national policy goals. In the case of trade finance guarantees, the BCBS already recognized the potential material unintended consequences of regulations on trade finance, particularly in its consultation document on *Supervisory Framework for Measuring and Controlling Large Exposures*[1] (LE consultation). We therefore believe that the BCBS should exclude these transactions.

In addition, the BCBS may consider exempting credit protection transactions with maturities of 1 year or less and credit protection transactions that are made at the same time as lending transactions. This would avoid undue burden on short-term transactions, where opportunities for arbitrage is quite limited if not non-existent, and those that are clearly meant to hedge credit risk from the start.

Furthermore, we are particularly concerned that the proposed treatment could be applied where both the hedge and the related asset are marked-to-market (MtM) and held at

[1] Note in particular paragraph 66 of the LE consultation

fair value through income. The stated intent of the proposed rule is to address transactions where "there is delay in recognizing the cost of protection in earnings."[2] This issue does not exist where the hedge and the related asset are held at fair value since any changes in the value of the hedge and the related asset have already been immediately reflected in earnings. There is no delay in the recognition of gains or losses in this case, and so the opportunity for capital arbitrage does not exist. We therefore do not believe it was the BCBS's intent to capture these transactions. Accordingly, we seek clarification that paragraphs 189(a) and (b) do not apply to hedging against assets (both asset and hedge) in the trading book as well as assets in the banking book that are carried at fair value through income.

As noted above, having a blanket application of the proposed rule would surely penalize a large number of legitimate hedging transactions. This would limit the ability of banks to manage risk and it could even provide disincentives to prudent risk management by banks. We therefore hope that the BCBS would make the requested exemptions and clarifications above.

***Application of the rule to traditional securitization***

We seek clarification on the intent of the inserted sentence in paragraph 554(a), which states that "*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...*" This paragraph refers to originating banks of traditional securitizations, which as defined by Basel II do not use guarantees or credit derivatives to transfer credit risk. It seems the inserted sentence may be out of place and should be clarified.

***Interaction with other Basel proposals***

The BCBS should consider the potential interaction of the proposed rule and the proposed revisions to the Basel securitization framework. The proposed securitization changes would likely lead to significant increases in capital requirements. Hence, if BCBS pushes ahead with the proposed rule using only the 150% risk weight criterion, certainly more securitization transactions would be covered – even relatively low credit risk transactions that would attract higher risk weights because of the conservative changes in the securitization framework.

In addition, the impact of the proposed rule on banks' large exposures limit should also be considered. The BCBS LE consultation noted above states that "the scope of the large exposures framework should include any exposure that attracts a capital requirement under the risk-based capital standards." If the present value of the premium on credit protection is going to be risk-weighted under the proposed rule, this would imply that it should also be captured by the large exposures framework. It is our view that this should not be the case since the present value of the premium does not add to the amount of losses that would arise if a single large counterparty defaults – which is what the large exposures rule aims to capture. Otherwise, it would only add to the already unduly conservative risk shifting approach for credit risk mitigants proposed under the large exposures rule. We hope the BCBS clarifies this issue.

[2] Page 1 of the consultative document

### *Operational burden*

The proposed rule would result in huge operational burden for banks to track down all relevant transactions with 150% RW and calculate the additional capital charge for each of them. The operational cost would not be commensurate with the benefits of the proposed rule considering that the rule really intends to capture only very limited arbitrage transactions and yet would likely end up capturing even legitimate hedging transactions.

### *Arbitrage criterion*

The proposed rule relies only on the 150% risk weight criterion as a determinant of a potential arbitrage transaction. As noted, this very simple criterion would likely include many non-arbitrage transactions. It also seems very arbitrary and is only based on the idea that potential arbitrage may likely occur where potential for reduction in risk weights as a result of the credit protection is greatest, without considering other factors that may characterize arbitrage transactions.

Should the BCBS push ahead with the proposed rule, we recommend that the BCBS supplements the 150% threshold with other criteria that would provide clear evidence of non-risk transfer. In the consultative document, the BCBS recognizes that this simple criterion will not be able to capture all arbitrage transactions. On the other hand, application of this simple criterion will also likely capture legitimate hedging transactions. Hence, there is a clear need to reinforce this simple criterion in order for the proposed rule to effectively and appropriately capture the intended transactions.

It is interesting to note that while the December 2011 BCBS guidance offered several characteristics of credit protection transactions that supervisors should give more attention to because of the possibility that these transactions may be arbitrage transactions, the proposed rule focused only on one of them – i.e., transactions where the potential for reduction in risk weights or regulatory capital as a result of the transaction is greatest (hence, the proposed 150% risk weight threshold). If BCBS decides to push ahead with the proposed rule, we suggest that the BCBS uses the other characteristics it has identified in its December 2011 guidance as well as the additional factors that the GFMA comment letter on this issue has identified, to come up with supplementary criteria.

However, we would like to stress that while the existence of multiple criteria can significantly narrow and effectively target the relevant transactions, an element of judgment may still be necessary to determine an arbitrage transaction. This has been acknowledged by the BCBS in the case of the 150% threshold. Hence, this underscores the importance of Pillar 2 assessments to address this concern.

### *Recognizing spread income*

We believe that future spread income should not be disregarded in the proposed rule should the BCBS decide to push ahead with it. Disregarding spread income would distort the transaction picture and lead to excessive capital requirements. We therefore do not agree with option 3 for treating spread income presented on page 12 of the consultative document. Option 2, on the other hand, seems overly complex by requiring banks to calculate on a regular basis a valuation based on "any scenario" for a wide portfolio of

transactions. We believe that the time dependence of payments is already adequately taken into account through the use of discount factors.

We support option 1 and ask the BCBS to consider the other industry proposals (such as those outlined in the GFMA comment letter on this issue) on the standards for the calculation of premiums' present value and recognition of spread income. We are open, and encourage the BCBS, to discuss this issue further if deemed necessary.

**Concluding remarks**

In summary, we reiterate our recommendation to allow more time to monitor developments with respect to high-cost credit protection transactions and to review the implementation of the BCBS guidance issued in December 2011.

Should the BCBS deem that more should be done now, we suggest the use of a direct approach to addressing the problem of arbitrage in credit risk mitigation techniques. In particular, we recommend the dual approach of (1) reinforcing the Pillar 1 eligibility criteria for credit risk mitigants with appropriate and sensible criteria that would identify arbitrage transactions to the greatest extent possible, and (2) more importantly given the nature of these transactions which do not lend easily to Pillar 1 identification, developing clear and appropriate guidelines for Pillar 2 treatment that would allow flexibility for supervisors to respond to market developments.

In addition, we would urge the BCBS to clarify the covered transactions and be mindful of the legitimate hedging transactions that might be unnecessarily penalized by the rule. One way to limit the proposed rule's impact on legitimate hedging transactions is to expand the criteria used for determining potential arbitrage transactions to include factors that provide clear evidence of non-risk transfer.

Finally, given the importance of the issues raised by the industry in this letter as well as the complexity of the arguments, we respectfully recommend that a physical meeting between the industry and the BCBS working group on the issue be organized, along the lines of recent meetings on securitization and large exposures. The Institute stands ready to help organize such meeting.

Thank you very much for this opportunity to comment on the consultative document on *Recognizing the cost of credit protection purchased*. Should you have any questions on the issues raised in this letter, please contact the undersigned (aportilla@iif.com) or Jermy Prenio (jprenio@iif.com).

Very truly yours,