Saudi Banks Comments on BCBS Consultative Document on Recognizing the Cost of Credit Protection Purchased

Bank # 1

Regarding the first query contained in the Consultative Document, Bank is of the view that exposures guaranteed by governmental entities (including sovereigns and public sector entities) should be exempted from the stipulation of recognizing the weighted cost of Credit Protection as exposure. In respect of exemption of trade finance transactions, we would prefer to distinguish between type and nature of guarantees. In particular bank guarantees would have a risk profile materially different to corporate / parental guarantees. Hence, trade finance transactions supported by guarantees of third party banks, the recognition of exposure on the guaranteeing banks would be appropriate. Those transactions guaranteed by corporate entities and/or supported by parental guarantees would need to be recognized in the normal course as exposures on the respective borrowers.

We are in agreement with the items brought out in the supplementary technical guidance and do not have any suggestions on this.

Bank # 2

1. The new rule text should exclusively focus on (securitization/re-securitization) transactions where high premiums and fee are structured to gain capital relief in short term and defer recognition of losses over the extended period i.e. the real source of regulatory concerns.

2. The existing para 189 (operational requirements common to guarantees and credit derivatives) of Basel rule text already ensures that "risk transfer" is not nominal.

3. Setting a threshold for protected exposures not qualifying for securitization framework and carrying greater than 150% risk weight, and where the intent is not to defer recognition of losses over extended period, could potentially be counterproductive to the development of debt capital markets in emerging/developing economies.

4. Assigning Risk Weight (RWA) of 1250% to the Net Present Value (NPV) of unpaid/unamortized premiums may significantly negate the capital relief which would otherwise accrue on account of a hedge. In the examples provided in the Annex, premium of only 100bps (1%) has been assumed for an asset which has RW of 200%. The asset with a RW of 200%, may attract higher premiums. For example, if the annual premium is 400bps (4%), it would completely offset the capital relief i.e. RWA before and after

the hedge would be the same, and in fact may turn out to be other way around. In which case, RWA may need to be capped. As such, Risk Weight of 1250% looks prohibitive and could discourage hedging activity.

5. The proposal to use the Risk Free rate to discount unpaid/unamortized premium appears overly conservative. Bank's funding curve could be used to discount the outstanding premiums or in absence of which the inter-bank curve can be applied.

6. Some countries do not have an active government bond issuance program. Thus, usage of government bond yields as risk free rates would be a practical challenge.

7. At the least, exposures guaranteed by government entities (including sovereign and public sector entities), and trade finance transactions with guarantees should be exempted.

Bank # 3

- The focus of the document is on the securitizations, which had been a cause of concern is the last financial crisis. We, therefore, understand that these guidelines are not applicable to other type of guarantees provided as collateral in the normal commercial lending. Kindly confirm our understanding.

- Keeping in view the low-risk associated with sovereigns, we suggest that exposures guaranteed by Government entities, including Public Sector Entities (PSEs), should be exempted from the proposed 150% risk-weighted threshold.

Bank # 4

1. **In addition to the 150% risk-weighted 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.**

Bank's Response: We acknowledge BCBS concerns about regulatory arbitrage that are mentioned in the related consultative document, however due considerations should be given to credit risk mitigation transactions that are truly hedging transactions and are not used for capital arbitrage purposes. Therefore, Bank believes that exposures guaranteed by governmental entities and trade finance transaction with guarantees should be exempted from this treatment.

2. **The committee welcomes feedback on all aspects of the proposed changes to the rules text and the supplementary technical guidance.**

Bank's Response:

- Considering that calculating additional capital charge shall be required for all transactions with 150% risk-weight we have concerns about potentially operational burden introduced.

- The proposed national discretions in determining the materiality threshold and in calculating the present value of the cost protection might lead to variations in the implementation of this proposal in different jurisdictions. Therefore, potentially resulting in level playing field issues.

- Bank would like to observe that requiring additional capital charge to address concerns about potential capital arbitrage might not be aligned with the intended use of risk-based capital that is to cover unexpected losses arising from credit exposure.

<u>Bank # 5</u>

1. Banks in some countries may not have so far originated securitization in their credit portfolio and have also not used CDS to cover their credit risk exposure to counterparties with a view to seek relief in regulatory capital.

2. The recently issued Basel III guidelines have stricter capital regulations for securitization exposures. However, there is a possibility of capital arbitrage in case of equity (first loss) tranche of the securitization exposures by way of obtaining CDS protection from a highly rated counterparty. This enables the protection purchasing bank to replace a 1250% risk weight with the risk weight of the CDS seller (which could typically lower than 100% depending on its credit rating. This gives rise to substantial capital relief immediately while protection premium is paid over the years or not recognized fully as an expense. The premium paid for such CDS could be very high, and could almost equal the amount of exposure or the estimated losses in tranches.

3. The new proposals in the consultative document seeks to identify such transactions and calculate a capital charge on cost of credit protection (premium paid) so that regulatory capital arbitrage could be controlled. Such arbitrage opportunities can also exist where credit risk mitigation techniques have been used and the difference in the risk weight for exposure before and after is substantial.

4. The new proposals are based on the idea that banks can continue to use CDS to hedge their losses but they must reflect the cost of the protection upfront and take an appropriate capital charge for it.

5. The proposals from BCBS are intended to make the financial sector safer and to ensure that the costs, and not just the benefits, of purchased credit protection are appropriately recognized in regulatory capital.

The bank agrees with the following proposals contained in the consultative document as conceptually sound:

- The proposal to add provisions to paragraph 189 of Basel Accord that, under certain circumstances, banks would be required to calculate the present value of premia for credit protection purchased that has not yet been recognized in earnings.

- Premia will be considered material (a) in the case where exposures that would otherwise receive, at the time the credit protection is purchased, a risk weight of greater than 150% and (b) where the risk weight is less than 150% but there are significant rebate mechanism or where the market values of the securitized asset is significantly lower than book value.

- Proposed methodologies for present value calculation of premia.

- In all circumstances, where spread income would exceed credit protection costs, supervisors may determine that is not necessary to undertake any calculations and that the present value of material credit protection costs may be taken as zero.

- Cases where credit protection costs have already been recognized in earnings and as a result there maybe no need for them to be treated as a retained position.

In respect of regulatory authorities may consider the following:

- Specify appropriate risk free discount rates for various tenors or curves to be used for discounting CDS premium and may not initially give the option of a “risk discount rate” to ensure ease of implementation.
- For contingent premium calculation of non-securitization products, option “1” where the risk free rate used for all circumstances is preferable as it is conservative and easy to implement.
- Under the treatment of the maturity mismatch, we support approach “2” as it is the most conservative, reduces incentives for banks to buy credit protection with a maturity mismatch, and extends the time of credit protection to the maturity of the exposure.