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Via Electronic Mail (baselcommittee@bis.org)

Wayne Byres
Secretary General
Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Re: Consultative Document on Revised Basel III leverage ratio framework and disclosure requirements

Dear Mr. Byres:

TF Market Advisors[1] appreciates the opportunity to provide comments on the consultative document issued by the Basel Committee on Banking Supervision describing the revised Basel III leverage ratio framework and disclosure requirements.

We applaud your efforts to address issues that have been persistent problems in the financial crisis. One of our views over time has been that banks in particular get in trouble when a formerly "low risk" asset becomes "high risk". That transition from low risk to high risk causes forced selling into an already declining market. By focusing on leverage in addition to risk, banks should become "safer". Banks will have to control both their risk weighted capital exposure and their leverage ratio capital exposure. That two pronged approach should reduce risk in the banking system overall.

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[1] TF Market Advisors ("TFMA") is an independent financial research provider with deep expertise in fixed income and credit products. TFMA has a global macro and thematic approach to markets, focusing on near term trading strategies along with longer term tactical risk positioning. TFMA's team of 3 people have a combined 40 years in the markets and have traded over $1 trillion of bonds, loans, and credit derivatives, ranging from sovereign debt to distressed loans.

Disclosure Requirements

We are particularly pleased with the disclosure requirements. The concept of periodic reporting based on the average of each month end within the reporting period is a step forward. It will limit the ability of banks to readjust their balance sheet solely to meet a specific target on a specific date. The standardized nature of the disclosures is also an important step forward. Too often it is difficult to evaluate the impact of any rule on banks because they each disclose it differently. The standardized disclosure enables investors to immediately isolate the drivers of the leverage ratio for each bank and to more easily compare them to each other.

Credit Derivatives For Pools of Reference Entities

As we examined the rules regarding credit derivative “tranche” or “correlation” trading, we believe that more clarity is necessary, even with the elaborating footnote 17 in paragraph 31. We believe the following rules would be consistent with the overall framework of the leverage ratio while providing much greater clarity.

- Any tranche or basket of structured credit that is bought and sold (i.e., back to back) should be treated the same as a single name CDS and be given the benefit of netting. The rules on single name CDS allow for netting when the CDS that is purchased matches (or is longer) than the CDS that is sold. Treating any back to back trade similarly would be consistent with that approach.
- Whenever a “full capital” structure is bought on one side, it can offset all of the single names on the other side. For example if a bank buys 1st to default on a 2 name basket and 2nd to default on that same basket, then it can get offset on both of those names. The same would occur for tranches. It doesn’t rely on models to create “effective” notionals. It is a simpler approach, but one that is fair and consistent as it lets banks get netting when they have really bought and sold the same risk, just in different formats.
- If a bank sells structured risk that is not matched, the bank will have to use the greater of effective notional and actual notional. This makes sense relative to the other rules in the document. We think, however, if a bank buys protection on a structured basis it would be consistent that they can only get protection on the LESSER of the effective notional and the actual notional. For example, if a bank buys $10 million 1st loss protection on a 2 name basket, the “correlation” or “basket” model might determine that the effective notional is $15 million, or $7.5 million per name. We think the bank should be allowed to net up to $10 million (the amount purchased) and it should be allocated between the two names. The language in the current document is just too

unclear, and could be interpreted 2 ways, neither of which seem consistent with the rest of the rules. An aggressive interpretation would be that the bank could net that $15 million of effective notional against single name CDS that was sold on each of those names. That would be using the greater of effective and actual notional approach. Another, more conservative approach would be that buying "first" loss protection is not the same seniority as single name risk so no offset is given. That seems too strict of an interpretation. So we think for the application to structured credit should be clarified as it is unclear. We believe that limiting non-matched tranches where protection is bought to the LESSER of the effective and the actual notional is the correct methodology.

By adopting our clarifications, Basel would encourage banks to run matched books (which seems to be the intent with single name CDS) and would treat mismatched trades in a way that is entirely consistent with other rules set out in the document.

Rules Pertaining to "Basis Packages" and Collateral

Finally, we have some concerns that the leverage ratio framework goes too far in providing no benefit for "basis packages" or for receiving collateral to secure trades.

While the document allows for netting CDS contracts, there is no provision that allows a bank to reduce leverage on bonds or loans held by purchasing CDS. While not a perfect hedge, this dichotomy of treatment seems too great. There are benefits from buying CDS against bonds or loans held. By eliminating any ability to reduce the leverage ratio by hedging across products, the Basel Committee runs the risk of pushing banks too far away from prudent risk management.

Banks might be more hesitant to hedge risk when the leverage ratio is not impacted or, worse yet, negatively affected through their efforts. Since reducing their hedges would impact their risk weighted capital measures, the two prong approach (of risk weighted asset tests and leverage ratio tests) helps, but does not eliminate the risk that banks will become riskier over time. Banks should be incentivized to manage their risk and providing no benefit for owning CDS against assets seems to have gone too far.

The other issue with the current rule is that it can encourage banks to sell CDS rather than lend. Over time banks may decide that, when it comes to leverage ratio, selling protection is more efficient than buying bonds or loans because they will be able to manage CDS risk but will not be able to manage loan or bond risk. If a bank makes a loan the only way to reduce their leverage ratio is to sell that loan. For investment grade revolvers, this might not be easy to do. The bank that sells CDS to gain their exposure has the option to buy CDS in the future

and reduce their leverage (so long as they buy to a longer date than they sold). This could cause banks to adopt behavior that may be a complete contradiction to the goals of the committee.

The committee provides netting for CDS versus CDS, so it would seem appropriate to give some netting for cash instruments versus CDS. Otherwise banks may shift to a more synthetic balance sheet, hurting lending to corporations and may simply run more risk than they would if some benefit for hedging cash instruments with CDS was given. Providing some relief for holding bonds and loans versus CDS should be considered as it is still prudent and encourages banks to lend rather than write CDS protection.

Similarly, collateral is treated too harshly by these rules. While collateral is not foolproof, especially in an environment where hypothecation is the norm, it is certainly not harmful for risk management of trades. In order to obtain collateral, banks often engage in tough negotiations with their clients. With the new treatment where collateral results in charges against the leverage ratio, banks are less likely to demand high levels of collateral from clients. The rules as proposed run the risk that banks will reduce the amount of collateral they require from their counterparties in an effort to appease clients and improve leverage ratio, which in general seems to be the wrong sort of behavior to encourage. Banks should be encouraged to get collateral from clients and manage it well.

In summary, we are pleased with the attempt to reduce overall balance sheet risk with the leverage ratio, find the disclosure requirements extremely well done, but think clarification on structured CDS needs to be provided, and that the exclusion of any netting on cash instruments versus CDS and the proposed treatment of collateral on derivative trades runs the risk of encouraging banks to behave in ways that runs contrary to the stated goals of the Basel Committee.

If you have any questions on our comment letter, please feel free to contact the undersigned.

Sincerely,

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Peter Tchir
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