INTERNATIONAL ASSOCIATION OF CREDIT PORTFOLIO MANAGERS

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Secretariat of the Basel Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basel
Switzerland
baselcommittee@bis.org

RE: BCBS 265 - Fundamental Review of the Trading Book

Dear Sirs,

The International Association of Credit Portfolio Managers (IACPM)[i] is pleased to have the opportunity to comment on the Basel Committee's consultative document, "Fundamental Review of the Trading Book: A Revised Market Risk Framework" (FRTB).

The IACPM's institutional member firms comprise the world's largest financial institutions, and as such overlaps the membership of several other financial industry associations. Our perspective is different, however, in that the IACPM represents the teams within those institutions who have responsibility for managing credit portfolios. IACPM members are the group responsible for managing the bank's loan portfolio, including actively controlling concentrations, adding diversification and managing the return of the portfolio relative to the risk, and managing counterparty risk related to derivatives exposure.

In carrying out these responsibilities successfully, credit portfolio managers contribute to maintaining the safety and soundness of their respective financial institutions. Effective credit portfolio management is critically important to our prudential supervisors and to policy makers more broadly because of its role in supporting financial institutions' ability to lend.

The IACPM does not represent organizations for their trading activity. Rather, we are focused on the rational management of credit risk. Consequently while our members may be impacted by the broader issues set out in FRTB our response is limited to potential impacts as a result of FRTB upon members undertaking appropriate banking book portfolio management activity. Consequently our response is limited to the boundary between the banking book and the trading book.

The trading book/banking book boundary

We are pleased that the Committee chose the trading-evidence based boundary rather than the valuation based boundary. As noted by many respondents to the original FRTB consultation, the valuation based boundary would have required significant carve outs from the trading book for hedges of banking book activity. The original consultation recognized that such carve outs might be necessary for hedges of interest rate risk but did not extend such carve outs to foreign exchange hedges or hedges of credit risk, etc.

We believe that the trading-evidence based boundary should provide portfolio managers the ability to utilize the full array of hedging instruments to mitigate the risks associated with holding a portfolio of loans (e.g., CDS for hedging credit risk, IRS and options for hedging interest rate risk, etc.). Ultimately, the most important principle that we advocate is that *loans and the instruments that hedge them should both be in the banking book*. The FRTB can best provide support for the prudent management of credit portfolios if it can clarify this to be the case.

As currently proposed, however, the FRTB does not always provide this needed clarity. For example, we note that the list of presumed banking book and trading book instruments is unhelpful and might result in additional confusion/inconsistency regarding how national authorities manage/approve the rebutting of such presumptions.

We have particular concerns with the Committee's presumption in the following cases:

- Instruments resulting from underwriting – while we agree that security underwriting would typically lead to trading book positions we would highlight that loan underwriting (e.g. syndicated loan market) could result in either trading book or banking book positions, and therefore recommend that the presumption of trading book treatment be removed.

- Embedded options – many loan products have embedded options either explicitly (such as capped interest rates, term out options, or pricing grids) or implicitly (such as the early termination/prepayment options inherent in many corporate borrowing facilities). We would not consider such positions to be trading book (there is no intention to trade) and we would expect both the loan product and any hedges of the embedded optionality to be eligible for continued banking book treatment. Furthermore, options are only one of the forms of derivatives that may be viewed as being embedded in loan instruments. We would expect the existing treatment to persist whereby the loan with embedded derivatives may stay on the banking book and the risk of those embedded derivatives may be hedged with and managed in the firm's trading book.

We believe that adding a hard coded list of product types to define the boundary between trading book and banking book adds confusion and complexity around appropriate reporting and communication of positions (and potentially results in unintended consequences resulting from separating legitimate hedges of banking book positions into a different book).

BCBS 265 provides guidance on banking book credit risk being hedged by credit derivatives and continues the Basel 2 requirement of being able to trace a hedge through the trading book to an eligible protection provider. However, BCBS 265 is silent on interest rate and FX hedges where historically it has not been required to externalize the hedge (rather the position is captured in the trading book calculation), so here clarity is needed. We are also interested in clarifying what would be required to designate a fair value derivative as a hedge of a banking book position. We would expect that any requirements reflect an appropriate balance between the need to evidence the hedging relationship and operational feasibility as hedges of banking book risk should be recognized in the banking book (rather than be capitalized as trading book positions).

If after considering industry comments, the Committee still believes it must follow an enumerated list of products that are presumed to be in the scope of the trading book, then we have concerns that this presumption may be interpreted differently by local regulators and create an uneven playing field. Rather than having a rebuttable presumption about trading book classification, the Committee should consider providing more generic guidance in this area of a less binding nature than the presumptions.

Transfers between regulatory classifications

We are pleased that the Committee has accepted feedback and moved away from its initial stance that the boundary would be impermeable. We are pleased to note that the Committee has adopted our proposal that public disclosure of material transfers would be a worthwhile control to avoid regulatory arbitrage. We concur that a competent authority should be able in certain circumstances to re-designate items between books but are surprised that the Committee is going into this level of detail – this would normally be picked up in transposing the Basel proposals into local regulations.

We are concerned, however, that the Committee is proposing to reverse any capital benefit from re-designation. Regulators always have the prerogative to impose capital filters or buffers, but it seems overly punitive when the re-designation may be perfectly justifiable and the “capital benefit” merely arises from applying the correct treatment. For example, if a loan were repaid early, any hedges of that loan would now be naked. These could either be terminated early or transferred to the trading book and hedged out. The latter approach is often the most cost effective.

A requirement to set aside any capital benefit would result in either a static number being held as a buffer, or a dynamically changing buffer. The static buffer has a benefit of relative simplicity but the cost of increasing irrelevance as the benefit will change over time. A dynamic buffer will be operationally onerous as the trading book calculations under these proposals would become so complex that running multiple parallel calculations to capture a few historic transfers will generate a disproportionate level of effort and operational risk. We

believe that the public disclosure is an adequate control against any arbitrage and consequently the reversal of benefits is unnecessary and unduly burdensome.

Pillar 1 charges for interest rate and credit spread in the banking book

We also note that the consultation paper mentions that the Committee is investigating the development of Pillar 1 charges for interest rate and credit spread risk in the banking book. We would appreciate the opportunity to comment on any proposals to further increase capital charges in this area, as there is not the perception that this was an area of concern during the credit crisis, and we believe there is sufficient conservatism built into the banking book capital charges to capture these risks.

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Please do not hesitate to contact IACPM if you have any questions or comments on any of the issues raised in this response. Furthermore, we would be happy to continue to participate in the relevant forum to discuss the issues presented in this paper in more depth.

Yours sincerely,

Som-lok Leung
Executive Director
IACPM

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[i] The IACPM is an industry association established in 2001 to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest. Membership in the IACPM is open to all financial institutions that manage portfolios of corporate loans, bonds or similar credit sensitive financial instruments. The IACPM represents its members before regulatory and administrative bodies around the world, holds conferences and regional meetings, conducts research on the credit portfolio management field, and works with other organizations on issues of mutual interest relating to the measurement and management of portfolio risk. Currently, there are 89 financial institutions worldwide that are members of the IACPM. These institutions are based in 17 countries and include many of the world's largest commercial wholesale banks, investment banks and insurance companies, as well as a number of asset managers. More information about the IACPM may be found on our website: www.iacpm.org.