

March 11, 2016

Mr. Frank Pierschel and Mr. Ong Chong Tee
Co-Chairs, Task Force on the Standardised Approach
Basel Committee on Banking Supervision
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Dear Messrs. Pierschel and Ong,

The International Association of Credit Portfolio Managers¹ (IACPM) appreciates the opportunity to comment on the "Revisions to the standardised approach for credit risk – second consultative document" (the "Consultative Document"). We have joined a group of other industry associations, including the Institute of International Finance ("IIF"), the Global Financial Markets Association ("GFMA") and the International Swaps and Derivatives Association ("ISDA") to provide comments on the broader issues covered in the Consultative Document in a separate letter. The purpose of this letter is to follow up the previously submitted IACPM letter², dated 27 March 2015, which addresses the sole topic of credit risk mitigation with credit default swaps that do not specify Restructuring as a Credit Event ("No-R CDS").³

Overview

We greatly appreciate the working group's consideration of our earlier letter and the inclusion of supportive language in footnote 21 of the Consultative Document. While we support the removal of the 100% penalty (no regulatory capital relief) for use of No-R CDS in the latest draft of the Consultative Document, we believe that the continued use of the Basel II 40% penalty (60% recognition for regulatory capital relief when using No-R CDS, in paragraphs 171 and 172) is inappropriate for U.S. corporate CDS.

We note that the 40% penalty was an "interim treatment which the Committee intends to refine prior to implementation after considering additional data"⁴. We now have over 10 years of CDS data and experience from the modern CDS market (see section 3 and Appendix 1 of the previous letter, summarizing corporate Credit Events from 2005 to March 2015). With this empirical evidence and given the legal framework for restructuring in the US is based on Chapter 11, we believe that refinement is now in order, that the 40% penalty can be removed, and that full regulatory capital relief can be recognized for credit exposures hedged with No-R CDS, provided certain conditions are met.

Negative Impact of 40% Regulatory Capital Penalty

A bank's credit portfolio managers focus on managing risk in a way that is consistent with prudential regulatory goals. In particular, credit portfolio managers hedge the tail risk of the bank in a way that maintains solvency and reduces risk of

¹ 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 of 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 97 financial institutions worldwide that are members of the IACPM. These institutions are based in 19 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.iapcm.org.

² <http://iacpm.org/dotAsset/65087.pdf>

³ For purposes of this letter, the terms "Restructuring", "Bankruptcy", "Failure to Pay", "Reference Entity", "Transaction Type" and "Credit Event" have the respective meanings specified in the relevant Credit Derivatives Definitions published by the International Swaps and Derivatives Association, Inc. ("ISDA").

⁴ Basel Committee on Banking Supervision, Second consultative document "Revisions to the Standardised Approach for credit risk" p. 60 Footnote 79

failure. To manage these risks, credit portfolio managers use a variety of tools, and one of the most important for managing large corporate credit risk is hedging with CDS.

For corporate exposures in Europe, Asia and other jurisdictions where the standard CDS contract includes the Restructuring Credit Event, risk reduction is incentivized by full recognition of the regulatory capital relief provided by the CDS hedge. However, for exposures to U.S. corporates (widely held by both U.S. and non-U.S. financial institutions), No-R CDS is the standard, and the most widely available, CDS contract. For these entities, the 40% capital penalty serves to artificially increase the cost of hedging, and thus can discourage the prudent management of credit risk. In effect, this creates a different set of criteria for how U.S. corporate credit risk is managed, relative to the rest of the world. Removing the 40% penalty would provide more uniform global treatment, and provide the same incentives to manage risk using CDS as in other jurisdictions.

The above argument assumes use of the standard No-R CDS contract, which is widely preferred because it is the most liquid and most widely available product. Less commonly, some portfolio managers who need greater capital relief under current rules will negotiate bilateral, bespoke CDS contracts that contain Restructuring as a Credit Event. However, these contracts are not widely offered, typically cost more, are far less liquid, and most importantly, are not traded on regulated exchanges or trading facilities or centrally cleared. The only reason they are sometimes bilaterally negotiated is to avoid the 40% penalty. Also, based on feedback from market dealers, there is no guarantee these contracts will be available in the future due to capital cost and basis risk. While global regulators have done much work to drive as much CDS volume through transparent trade execution facilities and central clearinghouses as possible in order to enhance price transparency and reduce systemic and counterparty risk, in accordance with the G-20 commitments, it is evident that the 40% penalty can obstruct these regulatory goals, and create a pool of CDS contracts that will not be subject to trade execution or clearing mandates. Removing the 40% penalty should cause this pool of bespoke contracts to roll off and disappear, as the only reason for their existence is the penalty.

The U.S. corporate CDS Market – Size, Global Usage of the Market, and Risk Mitigation

As we are highlighting a problem in the treatment of U.S. corporate CDS, it may appear that the 40% penalty is a problem faced only by U.S. banks. However, this is not case, as most large international banks headquartered outside the U.S. have significant exposure to U.S. corporates, and hence use the standard U.S. No-R CDS contract to hedge those risks.

According to recent DTCC data, looking at the top 1000 corporate Reference Entities that are cleared, 49% of the corporate Reference Entities are based in the U.S., while 37% are located in Europe and the remaining 14% in other jurisdictions (see attached table).

IACPM recently conducted a survey of members, and 20 international banks responded. We note that over 75% of the respondents are from banks that do not have United States headquarters. We have attached the survey results as Appendix I, which are broken out based on the region of the bank's headquarters: Europe, USA, Canada and Asia. We have summarized some of the survey highlights below:

- These 20 banks are all currently trading or have traded U.S. corporate CDS in the past, in support of their credit portfolio management functions.
- 95% of the banks indicated the importance of U.S. corporate CDS hedging as an effective product for their institution in managing portfolio risk.
- The survey shows the range of U.S. corporate loan exposure on banks books broken out by each jurisdiction.
 - It is not just the U.S. banks that have significant corporate loan exposure and wish to hedge portfolio risks and concentrations. This question provides insight into the potential size of hedging activity for all the global banks surveyed.

- While we acknowledge that hedging activity is dependent upon the credit environment as well as other factors such as corporate risk profile, these banks rely on this tool to manage risk in size if needed.
- When each global bank was asked if the current regulatory capital treatment of a 40% penalty is aligned with internal risk treatment, 100% of banks responded that the capital treatments are not coordinated. In the U.S., regulatory capital treatment is not aligned with the capital relief achieved on individual trades. However, non U.S. trades do not have this mismatch as the regulatory capital relief recognized is commiserate with internal risk treatment.
- The 20 credit portfolio respondents did note that if a 0% penalty was applied; making the treatment equal globally, then the regulatory capital and internal risk treatment would be aligned.

Recommendation

Based on the facts set out in this letter and the 27 March 2015 letter⁵, we believe there is a strong case for instituting global parity for regulatory capital relief in respect of CDS hedging, and removing the 40% penalty for No-R CDS. Importantly, however, we believe this should only be done with respect to Reference Entities like U.S. corporates, where market features and the legal framework based on Chapter 11 make the Restructuring Credit Event unnecessary.

To that end, we recommend adding the following language, or something similar, to the Consultative Document to implement this change:

"When hedging Corporate Exposures, the Restructuring Credit Event is not required if:

1. *A 100% vote is needed to amend maturity, principal, coupon, currency or seniority status of the Corporate Exposures;*
2. *The restructuring of the Corporate Exposures would generally be effected by way of an established bankruptcy or insolvency proceeding*

If these conditions are not met, then the current 40% haircut for CDS hedges without the Restructuring Credit Event applies."

We believe this statement provides a fair and balanced approach in aligning regulatory capital for U.S. corporate CDS hedges to other jurisdictions, but with the necessary restrictions if appropriate conditions are not met. The issue facing U.S. corporate CDS affects not just banks with headquarters in the United States, but also affects many other financial institutions around the world with exposure to U.S. corporates. We hope that the Basel Committee will reconsider the current position and move forward to allow 100% regulatory capital relief for these trades to align with other jurisdictions.

The IACPM appreciates your attention to our thoughts and concerns. We would be pleased to discuss any aspect of our response in further detail should it be of interest to the Basel Committee.

Sincerely,



Som-lok Leung
Executive Director
International Association of Credit Portfolio Managers

⁵ <http://iacpm.org/dotAsset/65087.pdf>

Appendix I

IACPM Member Survey 2016 - US CDS Market

1. Please indicate the amount of US loan exposure on your books that can be hedged.						
	Principal region of domicile					
Answer Options	Europe	USA	Canada	Asia	Response Percent	Total
\$ 0 - \$ 20 Billion	3	1	0	1	25.0%	5
\$20 - \$ 40 Billion	5	1	2	1	45.0%	9
\$40 - \$ 60 Billion	0	1	1	1	15.0%	3
\$60 - \$ 80 Billion	1	2	0	0	15.0%	3
\$80 - \$100 Billion	0	0	0	0	0.0%	0
Total	9	5	3	3		20

2. Do you currently and/or have you in the past used US CDS to hedge US corporate loan exposures? Please select all that apply.						
	Principal region of domicile					
Answer Options	Europe	USA	Canada	Asia	Response Percent	Total
Yes, we currently use US CDS to hedge US corporate loan exposure	8	5	3	2	90.0%	18
Yes, we have in the past used US CDS to hedge US corporate loan exposure	2	0	1	1	20.0%	4
No, we don't use US CDS to hedge US corporate loan exposure	0	0	0	0	0.0%	0

3. Do you consider the US CDS market to be an important tool for hedging your credit risk in this market?						
	Principal region of domicile					
Answer Options	Europe	USA	Canada	Asia	Response Percent	Total
Yes	9	5	3	2	95.0%	19
No	0	0	0	1	5.0%	1

4. Do you consider the current regulatory capital treatment (40% haircut) related to the adjustment for credit derivatives without restructuring as a credit event in the US market to be aligned with your firm's internal risk treatment?						
	Principal region of domicile					
Answer Options	Europe	USA	Canada	Asia	Response Percent	Total
Yes	0	0	0	0	0.0%	0
No	9	5	3	3	100.0%	20

5. Do you consider the proposed regulatory capital treatment (0% haircut) related to the adjustment for credit derivatives without restructuring as a credit event in the US market to be aligned with your firm's internal risk treatment?						
	Principal region of domicile					
Answer Options	Europe	USA	Canada	Asia	Response Percent	Total
Yes	9	5	3	3	100.0%	20
No	0	0	0	0	0.0%	0

As of 2/26/16:

Market Type CORP 

Row Labels	Values			
	Sum of Gross Notional (USD EQ)	Sum of Net Notional (USD EQ)	% Gross	% Net
Americas	2,280,301,390,123	220,306,873,210	49%	49%
Americas,Europe	9,358,065,531	788,025,940	0%	0%
Asia Ex-Japan	81,427,234,308	13,254,121,350	2%	3%
Australia NZ	104,384,092,609	9,219,306,391	2%	2%
Europe	1,988,994,102,526	165,637,630,336	43%	37%
Japan	212,238,953,953	39,086,008,329	5%	9%
Grand Total	4,676,703,839,050	448,291,965,556	100%	100%