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21<sup>st</sup> June 2013

Basel Committee for Banking Supervision  
c/o Bank for International Settlements  
CH-4002  
Basel, Switzerland

Submitted via email: [baselcommittee@bis.org](mailto:baselcommittee@bis.org)

## **GFMA and ISDA Response to Consultative Document on Recognising Cost of Credit Protection Purchased**

### **1. INTRODUCTION**

The Global Financial Markets Association (GFMA)<sup>1</sup> and International Swaps and Derivatives Association, Inc. (ISDA)<sup>2</sup> welcome the opportunity to comment on the proposal (Proposal) set out in the consultative document "Recognising cost of credit protection purchased" published by the Basel Committee on Banking Supervision (BCBS or Committee) on 22 March 2013 (Consultative Document or CD).

We would be pleased to discuss any of our comments in further detail, or to provide any other assistance or data that would help facilitate your review and analysis.

### **2. SUMMARY OF KEY POINTS**

Our main comments are as follows:

- We understand that the Committee's concerns relate to certain transactions that, if not addressed, could enable banks to reduce credit risk capital requirements on risky assets while deferring recognition of expected losses and without effectively transferring credit risk to

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<sup>1</sup> The Global Financial Markets Association brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, please visit <http://www.gfma.org>.

<sup>2</sup> Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 840 member institutions from 59 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).

third parties. We are concerned that, while capturing a small number of transactions deemed abusive by the regulators, the proposed rule would have a disproportionate effect on a wide range of banks' financing activities (both in corporate and investment banking), wherever banks seek to hedge borrower credit risk or associated counterparty risk. We believe the Committee's concern can and should be addressed by regulatory supervision, and may also be partly addressed by proposed changes to relevant accounting standards, without amendments to existing Pillar 1 capital rules.

- For synthetic securitisation transactions, we believe that this is essentially a question of whether there has been a significant risk transfer (SRT) for purposes of the securitisation framework, and that any potentially abusive transactions can and should be dealt with under existing Pillar 1 standards supported by Pillar 2 supervision. In this regard, additional Pillar 2 guidance may help to bring greater consistency in practice between jurisdictions.
- For non-securitisation transactions (such as a single-name credit default swap (CDS) on a corporate borrower), the SRT issue is not relevant and the question is whether the Basel framework's CRM operational conditions are met. If the Committee finds that some non-securitisation transactions are problematic and not addressed by existing Pillar 2 supervision, it may consider adding to the CRM operational conditions or issuing further supervisory guidance about potentially abusive transactions.
- The Committee should consider further the effect of its proposed Revisions to the Basel Securitisation Framework for synthetic securitizations, as well as the potential impact of changes to the accounting standards affecting loan loss reserves proposed in recent exposure drafts of the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) (current expected credit loss model). The proposed accounting changes may prevent banks from taking purchased CDS protection into consideration when calculating their impairment charges and are expected to mandate recognition of some level of expected losses, rather than incurred losses. The combination of these factors may remove any need for the Committee to address accounting-related effects by changing the risk-based capital rules.
- We believe the proposed rule would discourage and burden a large number and amount of legitimate and desirable risk management transactions, affecting a large part of banks' financing business. By increasing the cost of hedging credit risk in loan portfolios, it would lead to higher costs and less availability of credit for businesses and consumers.
- If the Committee adopts a rule along the lines proposed, it should confirm that the rule will not apply to trading book exposures or to banking book assets that are marked to market. It should also clarify that this issue does not apply to traditional securitisations that do not involve purchase of third party credit protection. In this regard, there should be no need to amend the operational conditions for traditional securitisations (as opposed to those for CRM and synthetic securitisation).
- To avoid burdening a wide range of ordinary financing transactions and raising the cost of funding for corporate borrowers, the rule should expressly exclude certain transactions where CRM is part of the terms of the original credit granting transaction, for example, in the form of a parental or affiliate guarantee. If not otherwise excluded, we also support exemptions for government-guaranteed credits, trade finance and small and medium-sized enterprises (SMEs).
- The proposed rule, if adopted, should not apply to any purchase of credit protection on exposures with pre-protection risk weight not greater than 150%, and should not apply automatically to transactions where the pre-protection risk weight is greater than 150%. It should only apply to transactions where both (1) the underlying exposures have risk weights

greater than 150% and (2) the transaction includes other features justifying this unusual treatment.

- If the Committee adopts a Pillar 1 rule as proposed, it should specify the methods supervisors must use to apply the rule, to avoid uncertainty, inappropriate results and unlevel playing field effects in different jurisdictions. We set out below our views with respect to calculation of premiums' present value, including credit for future earnings, discount rates and treatment of maturity mismatches.

If possible, we would appreciate an opportunity to meet at place and time convenient to the Committee and discuss the Proposal and our comments in person.

### **3. THE ISSUE CAN BE ADDRESSED WITHOUT ADDING TO CAPITAL RULES**

In this section we discuss further the first four points listed above.

#### **3.1 Address by Pillar 2 supervision rather than Pillar 1 capital rules**

In its newsletter (no. 16) dated December 2011 on "High cost credit protection" (NL16), the Committee noted potential for capital arbitrage in synthetic securitisation and other CRM transactions, recommended consideration of various aspects of pricing and terms of such transactions, and listed a number of factors that it considered might indicate either lack of SRT or ineffective CRM. Though we would argue that certain of those factors should not be treated as suspect or inappropriate, we believe the Committee took the right approach in treating such potential arbitrage as an issue to be addressed at the supervisory level on a case-by-case basis.

The Pillar 2 approach allows the regulatory response to adapt to evolving market practices, though we accept that this may lead to some variance in application in different places and times. Taking into account the experiences and views of supervisors in its member countries, the Committee may be able to formulate additional guidance leading to a more effective and consistent application of existing rules. In order to encourage such consistent application of capital rules between different national regulators, the Committee may also wish to consider asking supervisors reviewing synthetic securitisation or other CRM transactions to consider the following additional factors:

- What approval process was used by the protection buyer for the credit protection transaction? Did the protection buyer present the proposed transaction to the appropriate internal control and governance groups within the bank? What are the key benefits and risks of the transaction?
- Are there any side agreements between the protection provider and the protection buyer? Ensure that the protection buyer has provided all relevant documents, even if entered into indirectly, rather than directly, between the parties.
- Is the protection buyer providing any form of financing or similar benefits to the protection provider in support of or exchange for its providing credit protection?
- Is the protection buyer taking any of the transferred risk back through any other provision? For example, are there any clauses that would require the protection buyer to alter the portfolio to improve its quality or would require an increase in the cost of protection in response to portfolio credit quality deterioration?
- In the case of a portfolio hedge within the banking book, has the protection buyer run appropriate models to determine the level and sufficiency of risk transference?

- Are the protected exposures credit-impaired and, if so, has the protection buyer recognised the impairment charges?

The Committee should also clarify that the factors referred to in NL16 do not by themselves make a transaction inappropriate. In particular, we disagree with the suggestion that regulatory arbitrage is likely whenever "there is a delay in recognizing the costs of the protection in earnings while ... the bank receives immediate capital benefit." For example, when a bank issues subordinated debt that qualifies as capital, it effectively gets an immediate capital benefit while the associated costs are recognised through the life of the subordinated debt. Moreover, the markets for insurance products and other guaranties rely on the presumption that the transfer of risk is consistent with the transfer of income (spread or premium paid is coherent with loss that will be supported).

Also, though we accept that "guaranteed" premiums (not linked to value of non-impaired protected assets) may subject a transaction to closer review and will be treated differently in present value calculation, they should not be seen as suspect in all circumstances. For example, market standard single-name CDS contracts typically involve an up-front payment (either by the protection buyer to protection seller or vice-versa) along with a running premium in a standard fixed percentage. Standard terms like these add to the transparency and liquidity of the market in such contracts and should not be discouraged.

If the Committee issues further supervisory guidance in relation to this issue, we ask that it take the opportunity to discuss which approaches supervisors should use in the analysis of SRT and to encourage more consistency between different jurisdictions.

### **3.2 Separate capital requirement from asset valuation questions**

The question of valuation of future premium obligations should be separated from the question of effectiveness of credit protection. The valuation question is driven by accounting standards, and its implications for capital treatment should be dealt with under Pillar 2, while the transfer of credit risk and effectiveness of credit protection are already included as operational conditions in the Pillar 1 securitisation and CRM frameworks. Under the securitisation framework or, as applicable, the CRM provisions, a credit protection transaction that does not effectively transfer credit risk of protected assets should not reduce those assets' capital requirement. If a credit protection transaction does meet the relevant securitisation or CRM conditions for reduction of capital requirement, the bank should not forego all or part of that capital reduction just because of higher original risk weight or other characteristics of the transaction.

The proposed rule would incorporate elements of cost reserves and expected loss provisioning in parts of the capital requirements that are designed to cover unexpected loss. This would represent a significant and, we believe, inappropriate shift in the Basel capital framework.

Part of the regulatory concern in this area stems from accounting rules that allow banks to defer recognition of losses or credit protection costs while credit protection reduces a bank's capital requirement. Proposed changes in accounting standards may reduce accounting-regulatory arbitrage opportunities without any change in capital rules, by limiting banks' ability to take purchased CDS protection into consideration when calculating their impairment charges and requiring earlier recognition of credit losses.

In International Financial Reporting Standards (IFRS), the existing IAS 39 uses an incurred loss impairment model, but proposed provisions of IFRS 9, which will replace IAS 39, would require earlier recognition of expected credit losses<sup>3</sup>. Under the proposed model, an entity should recognise a loss allowance on a financial instrument equal to a "12-month expected credit loss" or, if the credit

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<sup>3</sup> See IASB, Exposure Draft ED 2013/3, *Financial Instruments: Expected Credit Losses* (March 2013), available at: <https://inform.pwc.com/inform2/content?action=resource&id=0000000833408345.pdf>.

risk on the financial instrument has increased significantly since initial recognition, an entity should recognise a "lifetime expected credit loss".<sup>4</sup> As an exception to the model, an entity would not have to recognise "lifetime expected credit losses" for financial instruments that are equivalent to "investment grade". Expected credit losses would be determined using a probability-weighted approach and they would take into account the time value of money. Like the existing IFRS, US GAAP currently uses an incurred loss impairment model. The FASB's proposed "Current Expected Credit Loss" model<sup>5</sup>, in simple terms, would require the impairment charge to be calculated based on lifetime expected credit losses. If these proposed accounting changes are finalized and adopted, this regulation would not be necessary<sup>6</sup>.

In addition, the proposed Current Expected Credit Loss explicitly prohibits the consideration of purchased CDS protection in the calculation of impairment charges (although collateral and other credit enhancements should be taken into account), IFRS 9 may be interpreted to require the same treatment.

These proposed changes to IFRS and US GAAP, if adopted and implemented as proposed, would further limit opportunities for deferral of loss recognition.

### **3.3 Proposed rule would impede strong risk management practices and create adverse incentives**

The proposed rule would discourage banks from hedging high-risk exposures as part of prudent risk management. Among other things, we believe the proposed rule would discourage banks from hedging credit risk of lower quality assets, with potential adverse effects on banks' safety and soundness.

For some corporate credits, there is no effective secondary market for loans or CDS. Credit risk mitigation transactions that would be subject to the proposed rule are one of banks' few options to reduce their credit risk exposure in order to maintain and increase their ability to make new loans.

The proposed rule would be challenging to implement and monitor, especially in the context of a dynamically hedged portfolio. Among other things, it might steer banks to obtain credit protection based on indices rather than bespoke trades, resulting in more basis risk and less effective portfolio hedging.

This effect would be compounded by certain proposed changes to accounting standards that would make portfolio management more difficult. In US GAAP, proposed changes to FASB 825.15 would place very restrictive conditions on sales of loans from the "amortised cost" category, preventing normal credit risk management of banks' retained wholesale loan portfolios. Measures such as this and the Proposal, by making portfolio management more difficult, may drive banks to make only better quality loans, thus impeding the flow of credit to business enterprises.

The proposed supervisory guidance introduces discrepancies between upfront payment and running premium that may create new regulatory arbitrage opportunities (due to differences with market standards on computation methods) or may incentivise portfolio managers to trade away from market

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<sup>4</sup> The "12-month expected credit loss" is defined as all cash flows not expected to be received over the life of the financial instrument as a result of defaults that are possible within 12 months after the reporting date; whereas "lifetime expected credit loss" means all cash flows not expected to be received over the life of the financial instrument as a result of defaults that are possible during the life of the instrument.

<sup>5</sup> See FASB, Proposed Accounting Standards Update — *Financial Instruments — Credit Losses (Subtopic 825-15)* (20 December 2012), available at: <http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175825477164&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs>.

<sup>6</sup> This should not be interpreted as implicit support for these accounting changes by the banks.

standards, with some other negative side effects (increasing counterparty risks and decreasing liquidity). For example, single-name CDS contracts typically include both running premiums at uniform rates and up-front premiums depending on obligor credit risk, and protection buyers who avoid paying such premiums may get contracts with higher cost and less market liquidity. Market standard contracts provide systemic benefits such as facilitating central clearing, and the rule or supervisory guidance should not penalise banks for using such contracts.

#### **4. HOW TO CHANGE THE PROPOSAL IF ADOPTED**

##### **4.1 Clarify non-application to trading book and other marked-to-market assets and to traditional securitisations**

We are concerned that the proposed treatment could be applied where both the hedge and the related asset are marked to market and held at fair value. The Proposal aims to address transactions where "there is delay in recognising the cost of protection in earnings". This issue does not exist where the asset is held at fair value, since any changes in the value of the asset have already been immediately reflected in earnings. Any further change in the value of the asset after the hedge is entered into will also be reflected immediately in earnings, as will the offsetting change in the value of the hedge. It is not possible to delay the recognition of gains or losses if the asset is measured at fair value through net income, and so the opportunity for capital arbitrage does not exist. Since future premium obligations are already taken into account in valuation of the hedge and the corresponding asset is marked to market, in line with the proposed rule's purpose, proposed paragraphs 189(a) and (b) should not apply. We note that these paragraphs require present-valuing of credit protection costs only "if such costs have not been recognised in earnings or otherwise recognised in Common Equity Tier 1". The proposed rule, if adopted, should make clear that it applies only to hedging against assets not marked to market either in the trading book or in the banking book using fair value measurement through net income or similar treatment under applicable accounting standards.

In the absence of the clarifications requested above, we believe the consultation could require higher capital requirements for bona fide hedging activity that does not pose any arbitrage concerns. This clash between regulatory capital requirements and prudent risk management would limit the ability of banks to manage risk. Furthermore, it could raise costs for financial market end-users and impose significant operational burden on banks without meeting the stated objectives of the Committee.

Also, the proposed rule should specifically exclude application to credit value adjustment (CVA) hedges. CVA is determined using a mark-to-market (MTM) accounting approach through net income (even though CVA is treated as a banking book credit exposure for regulatory capital purposes). The counterparty credit risk (CCR) exposure profile for over-the-counter (OTC) derivatives is determined using either internal models (IMM) or a standardized approach (CEM) and that CCR exposure profile is then marked to market through net income using a current CDS discount rate appropriate for each counterparty.

The Committee should also clarify that this issue does not apply to traditional securitisations that do not involve purchase of third party credit protection. In a traditional or "cash" securitisation, credit protection for senior tranches is typically provided by subordination of junior tranches. For the originator to calculate its capital requirement under the securitisation framework, that transaction will be subject to the usual requirement of SRT, but specific elements dealt with in the proposed rule, namely purchase of third party credit protection and payment of material premiums, normally would not apply. If the originator separately purchases credit enhancement in respect of a retained tranche, that transaction will be subject to the operational conditions for CRM or, if it involves further credit tranching, for synthetic securitisation, including the proposed rule if adopted. Likewise, if an investor in any tranche of the securitisation purchases credit protection with respect to that tranche, that transaction will be subject to the operational conditions for CRM or synthetic securitisation as

applicable, including the proposed rule if adopted. As to the traditional securitisation itself, however, the proposed rule would not apply. Therefore, even if the Committee adopts the proposed changes to paragraphs 189 (CRM) and 555 (synthetic securitisation) of the Basel II capital framework, there should be no need to amend paragraph 554 (traditional securitisation).

#### **4.2 Change effect of 150% risk weight**

Applying the proposed rule to all credit protection transactions where the underlying assets before credit protection have risk weights higher than 150% would affect very large numbers of transactions and amounts of exposures in many banks' core business lines, including loans and other credits to low-investment grade and non-investment grade corporate customers. Where the protected assets are securitisation positions, under the Committee's proposed Revisions to the Basel Securitisation Framework, which would greatly increase risk weights on higher-quality securitisation tranches, many higher-quality exposures would be over the 150% risk weight threshold.

As noted above in part 3.2 of this letter, the proposed IFRS accounting rule requiring recognition of "lifetime expected credit losses" on impaired financial instruments would not apply to financial instruments equivalent to "investment grade". Likewise, we believe the Commission's proposed rule on cost of credit protection should not apply to exposures of "investment grade" credit quality. Based on risk modelling of a hypothetical five-year unsecured bond issued by low-investment grade corporate obligor, roughly speaking, we think the Commission's proposed 150% risk weight could serve as a proxy for identifying "investment grade" exposures to which the proposed rule would not apply.

We therefore propose that the rule, if adopted, should not apply to any purchase of credit protection on exposures with pre-protection risk weight not greater than 150%, and should not apply automatically when pre-protection risk weight is greater than 150%. Instead, it should apply only to purchases of credit protection where both (1) the underlying exposures have pre-protection risk weights greater than 150% and (2) the relevant transaction exhibits an appropriate combination of other features like those listed in NC16 and in part 3.1 of this letter.

#### **4.3 Standards for calculation of premiums' present value and recognition of spread income**

The CD proposes multiple approaches to recognition of protection costs but leaves many choices to be made by supervisors. This creates a high risk of an unlevel playing field between different jurisdictions and creates high uncertainty for protection buyers. To avoid these problems we propose to choose one concrete methodology from the Proposal and to use hierarchies for the necessary parameters instead of arbitrary choices. If the Committee adopts a rule along the lines proposed in the CD, then, in order to avoid inappropriate results, increased uncertainty and unlevel playing field effects, the Committee should specify certain standards for the calculation of premiums' present value:

- Among the options described on CD page 13, the proposed rule, if adopted, should require use of only Option (i), in order to minimize differences between jurisdictions as well as to give appropriate credit to spread income in all cases, other than where the CDS premium is guaranteed regardless of default on the underlying asset (in which case only the first portion of the calculation would apply). If our other suggestions set out in part 4 of this letter are also adopted, we believe that this option, combined with the language on CD pages 8-9 of CD on "risky" discount rates for CDS premiums and CD pages 12-13 on recognising spread income where premiums are considered to be contingent, will result in appropriate amounts (cumulatively measured) and discount rates for purchased protection costs and expected portfolio spread income.
- In contrast, we believe the methods provided under the options (ii) and (iii) are not adequate since they do not capture the dynamics of spread income and premiums appropriately and are either overly complex or too simple:

- Option (ii) includes a period-wise floor which makes it impossible to cover any shortfalls of spread income in some periods with excess spread income from other periods. The timely manner of payments is already sufficiently covered by the application of discount rates. A double-counting of this effect is therefore unnecessary and would be overly conservative. Furthermore this option proposes to perform the calculation under multiple "scenarios", where it is unclear which form these scenarios should have or which scope they should cover. The option would therefore add complexity and uncertainty and might lead to different judgements between transactions and jurisdictions.
- Option (iii) does not recognise any spread income. This seems overly conservative and too simple to handle the matter appropriately, and in particular would overestimate the costs resulting from the protection purchased. The rule should require recognition of future spread income in all cases where premiums are treated as contingent.
- It is important that 'contractual income' be defined correctly. In the case of revolving credit facilities which are generally undrawn or lightly drawn, the income can be very small, but the risk and capital calculations require banks to look at the unexpected case and thus consider them as largely drawn. Banks should be able to consider the drawn spread in making the income calculation.
- In calculating the offsetting spread income, banks should be able to take into account not only the expected interest revenue on the protected position itself, but also fee income from the bank's other continuing transactions with the borrower, such as cash management and other service fees.
- The suggested criteria for treating premium as "contingent" include that "any applicable cap on credit protection costs are not expected to materially impact the credit protection costs except in highly unlikely scenarios." We think such a cap would not be common in the market and it should be made clearer that no such cap is required in order for premiums to be treated as contingent. It should also be made clear that an up-front payment of part of the credit protection cost (as in the case of a market standard single-name CDS) would not by itself prevent premiums in that transaction from being treated as contingent.
- The CD sets out an equation for determining the discount rate (CD pages 9, 12-13) but gives many options of how the parameters of the equation are to be filled. As to the parameter  $p$ , CD page 12 says it will measure the "annual contractual credit protection costs as a proportion of the position being protected", while earlier references state that that  $p$  could also be based on "parameters from the pool" or a "bank estimate or supervisory estimate of the probability of losses" (CD page 9). We propose that, in transactions with "contingent" premiums,  $p$  would be the annual contractual premium rate (ratio of contractual premium payments to amount of protected exposures). For transactions with non-contingent premiums,  $p$  would be zero in all cases.
- The conditional payment rate of the protected position ( $E(CPR_{\text{position}})$ ) should be calculated as the average annual payment rate of the protected position over its lifetime. For a securitisation, this should be the average conditional repayment and pre-payment rate of all tranches which are placed to investors. The amortisation should be based on base case assumptions for the amortisation of the pool translated to the tranches via the waterfall. For replenishing transactions, during the replenishment period the conditional payment rate would equal zero.
- For the risk-free rate ( $r^*$ ) we propose the current LIBOR or EURIBOR swap rate (based on a published index where available) over the life of the transaction and in line with the payment

frequency and currency of the protected position (e.g. for a tranche denominated in euro and with quarterly interest payments, the risk free rate would be the swap rate for three month EURIBOR).

- Treatment of maturity mismatches (CD pages 19-20) should be consistent with existing Basel II and III regulations (and all supervisors should be required to use the same approach).

#### **4.4 Drop mandate to include material credit protection cost in securitisation "significant risk transfer" determination**

In assessing whether a transaction meets the SRT requirement of the securitisation framework, supervisors will of course take into account whether a transaction includes excessive premiums or other unusual terms. However, we do not believe that mandating the inclusion of this cost whenever deemed "material" is a sensible approach.

Some jurisdictions have adopted super-equivalent modelling or calculations to justify SRT that do not appear in the Basel framework. The most important example is the EU definition based on minimum percentages of mezzanine or first loss tranches transferred to other parties, but also allowing supervisors to deny capital relief where they find that risk transfer is not "commensurate" with the resulting capital requirement reduction. This definition still allows supervisors to emphasise different factors or otherwise take different approaches in applying the SRT condition. For the Basel framework to overlay a new adjustment over these disparate national approaches will result in more inconsistent and unexpected results. In the case of jurisdictions that do not use a formula or other prescribed method, it is not at all clear how the premium position should be taken into account, and the proposed guidance gives no examples. In short, the proposed mandate to include material credit protection cost in SRT determination would serve to continue and aggravate unlevel playing fields between jurisdictions.

#### **4.5 Capital requirement for premiums' present value should not exceed that value**

If a bank is required (as under Basel III) to maintain more than 8% capital against risk-weighted assets, and if exposures such as the proposed present value of future premiums are assigned a 1250% risk weight, then the amount of capital required to be held against those exposures would exceed their present value. Besides making the bank retain incremental capital for which there is no corresponding exposure, in the securitisation framework, the rule would unfairly skew the SRT assessment. The capital requirement for any exposure should never exceed its exposure value. In the context of this rule, effective capital requirements for present value of future premiums payable should never exceed that present value.

In addition, any additional capital charge applied pursuant to this rule should be subject to an overall cap such that capital charges for the protected assets (whether in synthetic securitisation or single-name credit protection) should not exceed the capital charge that would have applied to those assets without the credit protection.

#### **4.6 Limit use of premiums' present value**

If the proposal is adopted, care should be taken to limit unintended effects under other regulations. In particular, with reference to large exposure limits and the Committee's current proposal on large exposures,<sup>7</sup> the premiums' present value should not be treated as an exposure amount given that it does not represent a credit risk to the counterparty but reflects a timing difference between regulatory and accounting treatments.

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<sup>7</sup> BCBS, Supervisory framework for measuring and controlling large exposures (Mar. 2013).

## **5. EXEMPTIONS FOR SOME TYPES OF TRANSACTIONS**

The Proposal is aimed at concerns that we believe are raised mainly or exclusively by certain synthetic securitisations, and possibly some single-name protection trades, involving deferral of recognition of losses on impaired assets or pools. If the proposed rule also covered all transactions that include CRM from their inception, it would cover a huge variety of transactions involving ordinary payment guarantees, credit insurance, letters of credit and other enhancements that do not raise the same concerns. We therefore propose that the proposed rule or any additional supervisory guidance, if adopted, expressly exclude transactions where the CRM forms part of the terms of the original credit granting transaction, for example, in the form of a parental or affiliate guarantee. This broad exclusion would benefit the financial markets and wider economies by avoiding undue burdens on transactions such as trade finance and SME credits and many government-guaranteed loans which should in any case be exempted.

We agree with the Committee's suggestion (Q1 on CD page 2) that certain kinds of transactions should be exempted from the proposed rule. In particular, transactions that have CRM in the form of a government-backed guarantee clearly involve a public policy favouring the bank's provision of credit, and making those transactions subject to this rule would undercut that policy. As in the Committee's October 2011 paper on "Treatment of trade finance under the Basel capital framework" (BCBS), trade finance transactions should also benefit from an exemption on policy grounds. These transactions often involve counterparties with relatively high risk weights, but also typically have short maturities, enforceable security and other risk mitigants, and are very different from the kinds of transactions the CD is meant to address.

If a broader inclusive exemption is not approved, the Committee should also consider providing exemptions for CRM or synthetic securitisation of extensions of credit to SMEs, which policy-makers in many countries and supranational bodies are trying to promote. As one example, Mr Benoit Coeure, a member of the Executive Board of the European Central Bank (ECB), said in a speech on 11 April 2013 that "there is a need for structural market innovation to improve SME financing. [T]hey have limited access to capital markets. In this context, securitisation offers an opportunity to channel resources to SMEs". Mario Draghi, the ECB's president, at a press conference in Bratislava on 2 May 2013, also identified the contraction of credit to SMEs as one of the major obstacles to the economic recovery in the EU. Unless lending to SMEs is specifically exempted, the Proposal could further constrain funding for SMEs.

## **6. CONCLUSION**

As discussed above in this letter, we understand the need to address CRM or synthetic securitisation transactions that seem designed to reduce capital requirements without a significant transfer of risk. However, we believe that such transactions can and should be addressed by supervisory mechanisms, perhaps augmented by additional supervisory guidance. We also believe that subjecting a wide class of transactions to requirements like those in the proposed rule would discourage legitimate and prudent risk management activities and thus raise the cost and limit the flow of credit to businesses and consumers. If the Committee nevertheless determines that a Pillar 1 rule change is necessary, we urge the Committee to narrow its scope to avoid burdening legitimate transactions, to clarify that this rule will not apply to trading book and other marked-to-market transactions, and to specify its application parameters to ensure appropriate results and consistent application between jurisdictions.

Thank you once again for the opportunity to provide comments on the Consultative Document. If possible, we would appreciate it if we could meet at place and time convenient to the Committee and discuss the Proposal and our comments in person.

Should you have any questions or desire additional information regarding any of the comments, please do not hesitate to contact Richard Hopkin at AFME at [richard.hopkin@afme.eu](mailto:richard.hopkin@afme.eu) or on + 44 207 743 9375 or Chris Killian at SIFMA at [ckillian@sifma.org](mailto:ckillian@sifma.org) or on + 1 212 313 1126.

Yours sincerely,

A handwritten signature in black ink that reads "Simon Lewis". The signature is written in a cursive style with a large, sweeping initial 'S'.

Simon Lewis  
CEO  
GFMA

A handwritten signature in blue ink that reads "George Handjinicolaou". The signature is written in a cursive style with a large, sweeping initial 'G'.

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