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Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Via email to baselcommittee@bis.org

Dear Sirs,

The IACPM welcomes the publication of BCBS227 "Capital Requirements for Bank Exposures to Central Counterparties". This is a significant piece of work which we hope will help meet the stated aims of encouraging the clearing of OTC derivatives.

Our members often use credit default swaps (CDS) for credit risk mitigation of banking book loan positions (subject to the normal Basel requirements as applied by national regulators). As CDS increasingly move from bilateral relationships to cleared relationships we are keen to ensure that we understand how credit risk mitigation may be reflected where the CDS has been cleared on an exchange.

Specifically, we believe clarification would be useful on the following issue: Can IRB banking book loan exposures hedged with cleared CDS from a qualifying central counterparty (QCCP) receive the preferential risk weight of 2% (or 4%) that are outlined in BCBS227?

This is a question because Paragraph 481 of the Basel II Accord does not appear to contemplate the use of QCCPs, which BCBS227 appears to incentivize. Paragraph 481 sets out the following:

> 481. In all cases, both the borrower and all recognised guarantors must be assigned a borrower rating at the outset and on an ongoing basis. A bank must follow all minimum requirements for assigning borrower ratings set out in this document, including the regular monitoring of the guarantor's condition and ability and willingness to honour its obligations. Consistent with the requirements in paragraphs 430 and 431, a bank must retain all

relevant information on the borrower absent the guarantee and the guarantor. In the case of retail guarantees, these requirements also apply to the assignment of an exposure to a pool, and the estimation of PD.

Consequently, as CDS move from being traded with bilateral IRB counterparties to QCCPs that would be risk weighted at 2% on a non-IRB basis, it would become less likely that CDS could be used to hedge IRB banking book credit risk without clarification on this point.

BCBS has already noted the potential impact on adoption of IRB across asset classes and BCBS227 amends paragraph 256 and adds paragraph 262 to mitigate the impact of mandatory clearing. In order to incentivize the clearing of CDS which are to be used for credit risk mitigation purposes it may be appropriate to issue an FAQ or an amendment to paragraph 481 to allow cleared CDS to be used to mitigate IRB credit exposures under the 2% risk weight (subject to all the other requirements being met).

We would propose that the treatment could be as set out below:

- Where the reporting bank is the clearing member on the CCP, the risk weighting of the exposure would be replaced with that associated with the CCP in accordance with paragraph 110 or paragraph 126 of BCBS227. Such substitution of risk weighting would be in addition to the trade exposures captured in these paragraphs.

- Where the reporting bank is a client of a clearing member on the CCP and meets the conditions set out in paragraph 114 of BCBS227, the risk weighting of the exposure would be replaced with that associated with the CCP in accordance with paragraph 110 or paragraph 126 of BCBS227. Such substitution of risk weighting would be in addition to the trade exposures captured in these paragraphs. Where paragraph 114 is not met, but the conditions in paragraph 115 are met, the risk weight applied should be that in paragraph 115 (4%). Otherwise, the reporting bank should treat the clearing member as the CDS counterparty and reflect that in any recognition of credit risk mitigation on a standardized or internal rating basis (as appropriate).

- The exposures subject to such credit risk mitigation should also be excluded from the calculation of immateriality for the purpose of IRB coverage purposes (paragraph 256 of Basel II).

- Any recognition of credit risk mitigation associated with cleared CDS should include the usual considerations of asset, maturity and currency mismatch as required in the existing Basel requirements.

The transfer of risk weighting from that of the original obligor to that of the CCP with no change in the trade exposures to the CCP may result in a minor element of double counting of risk. However, the impact should be relatively immaterial and has the following perceived benefits:

1. Not applying a risk weighting to the exposure subject to CRM but relying on capitalization of counterparty risk associated with trade exposures is akin to a trading book rather than a banking book treatment; and
2. Trying to exclude such hedging trades from the calculation of counterparty risk on trade exposures to the CCP would be operationally onerous.

If you have any comments or questions on the issues raised in this letter please do not hesitate to contact me.

Sincerely,

Som-lok Leung
Executive Director
IACPM