IACPM

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
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baselcommittee@bis.org

Dear Sirs,

The IACPM is a global 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.

The IACPM's institutional member firms comprise the world's largest financial institutions, and as such overlap 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, including actively controlling concentrations, adding diversification, managing the return of the portfolio relative to the risk and applying capital to new lending.

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.

Management of the portfolio often encompasses purchasing credit default protection that protects against a borrower default. The hedges of this risk mitigation activity are a hedge against banking book loans, commitments and unfunded exposures.

In the fall of 2017, IACPM submitted an FAQ seeking clarification regarding the trading book and banking book boundary (specifically page 7, paragraph 13c) found in BCBS d352 "*Minimum capital requirements for market risk",* Basel Standards, January 2016 and repeated again in the BCBS Consultative Paper (CP) d436. "*Revisions to the minimum capital requirements for market risk" (*specifically page 36, paragraph 13b and Footnote). We believe there are unintended consequences that could arise from a certain interpretation of the wording of this footnote that we describe below. We wish to highlight that the existing process is effective in meeting the objectives of the committee and with less complexity while not unnecessarily disincentivizing banking book hedging activity. In fact, we believe the proposed rules regarding the boundary in this consultative paper contradict other parts of existing regulations. Therefore, we seek clarification from the Basel Committee as we do not believe the intention of the revised market risk standards was to bring hedges used in the context of protecting against default risk in the banking book into the bank's regulatory trading book activity.

Paragraph 13 and in particular 13b prescribes that a net short credit or equity position in the banking book must be included in the regulatory trading book. The Footnote to paragraph 13b explains that "A bank will have a net short risk position for equity risk or credit risk in the banking book if the present value of the banking book increases when an equity price decreases or when a credit spread on an issuer or group of issuers of debt increases". As such, this suggests that a "net short credit position" (as defined) can arise in instances where credit default swaps (CDS) are used to hedge credit exposures (such as loans, commitments or other unfunded exposure) held in the banking book.

While CDS would be generally subject to mark- to- market (MtM) accounting, the credit risk exposure, such as a loan, may not be, and as such, may not offset an increase in the present value of the CDS when the credit spread of the issuer rises. Therefore, we are concerned that the net short credit position as described in the footnote may cause instruments, in this particular case the CDS, that are appropriately treated under banking book rules as currently described under the Basel 3 standard to move into the trading book.

We are concerned that without clarification this ambiguity could lead to an increase in capital and complexity given that the desk managing its loan portfolio may generally not be a trading desk that would be covered by the internal models approach (IMA). In a case where the flow credit desks were IMA approved, these CDSs would be capitalized under the standardized approach (SA) on a standalone basis which could lead to a substantial increase in capital requirements. This capital increase would be in addition to the impact felt by not being able to recognize the risk mitigating benefit with respect to the banking book position. While we believe that such a treatment is not intended given the risk mitigation rules in the banking book as per above, we also think it would be inconsistent with the internal risk transfer rules (IRT), in particular 34, where it is stated that under certain conditions, (none of which are related to footnote 13b), the mitigating benefits of a CDS can be recognized. It would not appear sensible to recognize CDSs as banking book hedges only through the construct of an IRT and we seek clarification that direct hedges from CDS trading desks into a banking book can continue which is currently an acceptable process. Therefore, we are seeking confirmation that the intent of footnote 13b is not to inadvertently force effective credit risk hedges into the trading book and the current practice of recognizing CDSs as risk mitigants to banking book position continues to apply regardless of the applicable valuation methodologies.

Furthermore, we are concerned about the operational complexity implied in the response to question 3 of the FAQ under section 3.1 which says that "banks should continuously manage and monitor their banking book positions". The industry proposes instead replacing continuous monitoring with an assessment at inception and subsequent periodic monitoring, to balance the operational burden and ensure adequate controls. Implementation details (definition of non-negligible, frequency of monitoring) should be left for banks to agree with supervisors. The initial assessment should determine whether the credit risk hedge is hedging a banking book position and does not constitute a non-negligible net short position.

If the previously mentioned assessment determines that a particular instrument constitutes a non-negligible net short position and would have to be scoped into the trading book, the industry would like to seek confirmation that paragraph 27 of the consultative paper would apply. Paragraph 27 states that only discretionary redesignations (outside paragraph 12-17) are restricted by governance rules per paragraphs 28-29, but given that such redesignation would not be at the discretion of the bank, paragraphs 28-29 should not apply, in particular the bank would not be required to calculate a capital surcharge. We appreciate that the intent of the specific paragraphs of 28-29 is to prohibit regulatory capital arbitrage. Therefore, the industry wants to confirm that the CP language applies in this case where there is inconsistency with the response to question 2 of the FAQ under section 3.1. This response to the question states that "the disallowance of capital benefits as a result of switching positions from one book to another applies without exceptions". It is very important that a bank can continue to effectively hedge its loan portfolio to manage its risk. For that purpose it requires certainty that this is recognized as a mitigant in capital calculation and would not increase capital costs and result in undue operational complexities.

In conclusion, we are concerned that hedging activity of the bank's loan portfolio could be disincentivized by increasing capital requirements and creating uncertainty with respect to the capital treatment of hedging. In this respect, we seek clarification as stated throughout this response letter. Credit portfolio management teams are focused on managing the risk of a portfolio within a bank. The issues highlighted above could create unintended consequences; impact risk management of credit portfolios and create operational complexities for banks.

Sincerely,

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