To the Members of the Basel Committee:

I write to you in regard to the Basel Committee consultative documents “Strengthening the Resilience of the Banking Sector” and “International Framework for Liquidity Risk Measurement, Standards and Monitoring”, issued on December 17, 2009.

**Background**

I am the Executive Director of the International Association of Credit Portfolio Managers (IACPM). 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 and act collectively. The Association represents its members before legislative and administrative bodies in the United States and internationally, holds conferences and regional meetings, conducts research in the credit portfolio management field, and engages in other activities relating to the measurement and management of credit portfolio risk.

Currently there are 83 financial institutions, in 12 countries, who are members of the IACPM. These members include many of the world’s largest commercial and investment banks, as well as insurance companies and a number of asset managers. I attach a short document that provides additional information about the association, its members, and its board of directors. (More information about the IACPM may be found on our website: www.iacpm.org.)

While the IACPM’s member firms comprise the world’s largest financial institutions, the IACPM represents a very specific constituency within those
firms. Our members are the teams within those firms who have responsibility for managing credit portfolios. At a bank, for example, our members would be the group responsible for managing the bank’s loan portfolio – actively controlling concentrations, adding diversification, and managing the return of the portfolio relative to the risk. At many institutions, our members also manage 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. Importantly, this also allows them to make credit more available to their clients, which is so vitally important in the current environment. In these ways, the objectives of credit portfolio managers are often well aligned with those of regulators. As such, our membership supports the overall effort to provide more robust capital and liquidity standards in the banking sector.

There are, however, several issues the IACPM would like to highlight in regard to the new Basel proposals. These proposals are very expansive in scope, and it is clear that many of our member firms will comment on every aspect of the documents. The IACPM will comment in this letter specifically on two issues important to credit portfolio managers that may not be covered by others: 1) The additive effects of the new capital and liquidity proposals on the cost of corporate credit, and 2) conflict between central counterparty structures and Basel II capital regulations.

Additive effects of capital and liquidity proposals on the cost of corporate credit

The individual elements of the new proposals will each impact bank capitalization and liquidity, but also will have clear impact on the cost of providing credit. The additive effects of all the proposals, and the interdependent way they relate to each other, can potentially have an enormous impact on credit costs, perhaps to a level not intended.

One of the IACPM’s member firms provided an analysis, summarized in the table below, comparing the costs of providing an undrawn, committed line under both the current capital regime and under the new proposals. The analysis combines the effects of:

- The countercyclical adjustment to use higher PDs
- The narrower definition of Tier 1 capital
- Inclusion of undrawn amounts in the leverage ratio
- Including high quality assets from the liquidity ratio in the leverage ratio
- 100% liquidity reserve for undrawn commitments

The summary analysis shows that the total capital costs of providing such a liquidity facility (measured in basis points), increases more than seven-fold from 37bp under the current capital regime to over 271bp under the new proposal.
The assumptions behind the analysis, and the calculations used, are detailed in the attached spreadsheet. We invite you to repeat these calculations with your own assumptions, to test the range of impact. We believe you’ll find that, within a broad range of reasonable assumptions, the potential increase in capital cost for providing credit will be very significant.

This increase in cost will likely be passed on to corporate clients, in whole or in part, dramatically increasing their cost to borrow. Of special note is the potential impact to related funding markets, especially the commercial paper market, which relies on bank provided committed liquidity. We hope the Committee will explore and fully understand this possibly unintended consequence of the new proposals.

The IACPM suggests two possible ways to mitigate this impact. One way would be to recognize the additive impact and to recalibrate the combined proposals to mitigate the size of their effect. Another would be to reduce the 100% treatment of undrawn commitments from both a liquidity and a leverage perspective. The experience of portfolio managers would indicate that actual usage of these commitments by corporate borrowers is less that 100% (both from the view of typical utilization, but more importantly under stress conditions and even default by the borrower). We would be happy to discuss these views and experiences with the committee.

**Conflict between central counterparty structures and Basel II capital regulations**

In general, the IACPM strongly supports the creation and use of clearinghouses for CDS and other derivatives, which have the potential to greatly reduce risk for all market participants. The
new proposals encourage their use, and the IACPM believes this is a generally positive outcome. However, there is a clear conflict between standards developed for the clearinghouses, and the current capital regulations for banks under the Basel II Capital Framework.

The IACPM represents credit portfolio managers who are mitigating risks for their firms, rather than the dealer desks who are trading credit risk. When credit portfolio managers use CDS to hedge a portfolio, they reduce economic risk to the firm and should, appropriately, receive a reduction in regulatory capital requirements related to the portfolio. Under Basel II, a CDS hedge only provides full regulatory capital relief if the documentation underlying the CDS recognizes restructuring as a credit event. (Restructuring occurs when a company renegotiates its debts while in distress as an alternative to default or bankruptcy. Under Basel II, there is a 40% reduction in capital relief for CDS hedges without restructuring language.) While standardized CDS contracts have included restructuring language for many years, the current North American clearinghouse mechanisms have removed them.

The problem is clear, as the new proposals aim to force trading volume through clearinghouses, yet Basel II rules penalize these same transactions. Our understanding is that some firms have used custom CDS contracts with restructuring language that will not clear through clearinghouses, in order to get full regulatory capital relief. While this is a rational response to the current environment, it is clearly not the type of behavior that the new proposals aim to encourage.

Assuming that there will not be a change to the current structure of the clearinghouse contract in North America, then an appropriate solution would be to modify regulations to allow capital relief for CDS without restructuring. We note that, in the original Basel guidelines from June 2006 on this issue, a footnote states that the current penalty “is provided as an interim treatment, which the Committee intends to refine prior to implementation after considering additional data”. With the implementation of CCPs and strong consensus to encourage their use, now would appear to be an opportune time to revisit this issue.

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I thank you for your attention to our thoughts and concerns. The IACPM’s Board of Directors and I would welcome the opportunity to discuss these issues with the Basel Committee.

Sincerely,

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