June 2\textsuperscript{nd}, 2015

Basel Committee on Banking Supervision  
Centralbahnplatz 2  
CH-4002 Basel, Switzerland  
Via upload to www.bis.org/bcbs/commentupload.htm

International Organization of Securities Commissions  
C/ Oquendo 12  
28006 Madrid, Spain  
Via email to: Consultation-2014-10@iosco.org

Re: D304 – Clarification on Tranche Cover Transactions

To the Members of the Basel Committee and the International Organization of Securities Commissions:

On February 13, 2015 the International Association of Credit Portfolio Managers\(^1\) (the “IACPM”) had the opportunity to comment on the consultative document, “Criteria for identifying simple, transparent and comparable securitisations” (the “CD”). The IACPM remains concerned however that synthetic tranched protection on a portfolio of banking exposures, or (Tranched Covers\(^1\) as it can be called from a prudential bank regulatory parlance) which may be commonly used by Credit Portfolio Managers as a tool for prudent credit risk management of their banks’ loan exposures may be misunderstood as complex and opaque by the regulatory community just due to their “synthetic” feature. We are surprised that the simple, transparent and comparable securitisations framework (“STC”) was designed solely for cash securitisations and we strongly believe that high quality retained exposures resulting from a Tranched Cover should meet a STC designation with appropriate criteria. This short letter seeks to clarify the nature of Tranche Cover used by Credit Portfolio Managers and differentiate them from other synthetic securitisations that are different.

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.

\(^{1}\) The Basel II framework defines “tranchied cover” on page 63 of the BCBS128 paper [http://www.bis.org/publ/bcbs128.pdf](http://www.bis.org/publ/bcbs128.pdf).
In a Tranched Cover, banks seek to transfer the significant risk of a pool of their assets that they have originated and underwritten and retain some of the risk, typically through a senior tranche. It is this retained risk that could be subject to a “simple, transparent, comparable” analysis should it meet appropriately defined criteria. From a prudential bank regulation perspective, the transferred risk is subject to significant risk transfer tests. In addition, the retained risk resides with the originating bank who (1) acts as protection buyer in a Tranched Cover (2) owns the underlying assets (3) is closest to the elements of the credit risk assessment including financial statements, knowing the local economy, competition and quality of management and (4) will engage in the timely review and monitoring process of the underlying assets in the normal course of its relationship lending business.

A Tranched Cover is exclusively used for direct hedging of credits that already reside within a banking book, i.e. commitments that directly result from the bank’s lending business. It is not a generic credit index hedge and does not involve sourcing exposures in the secondary market for the purpose of originating and trading tranches. A Tranched Cover is not a correlation trading business seeking to arbitrage differences in modeled tranche valuations. A Tranched Cover is not a market arbitrage CLO that is designed to capture cash flow differences between what investors might receive from the underlying assets compared to the cost of financing the assets (in such CLOs the assets or “collateral” are only purchased by the vehicle because it is expected that they will be fully refinanced via the issuance of Notes by the vehicle); rather it is the risk mitigation that is sought to manage exposures and increase capacity to lend to the real economy especially where alternative risk management tools are limited or unavailable.

The Tranched Cover is a very important risk management tool used by bank Credit Portfolio Managers since it is extremely challenging to transfer ownership of the assets in the underlying portfolio for relationship and operational reasons (due to the nature of undrawn commitments) and poor liquidity of, for example, middle market, SME and emerging market commitments and loans. With genuine risk transferred to a growing community of non-bank investors, which includes credit funds as well as prudentially regulated insurance, or pension funds and multilateral banks. A Tranched Cover mitigates significant credit risk and frees risk capacity for banks, allowing them to extend new credit to the real economy.

To summarize our views, the IACPM strongly believes that retained risk from a Tranched Cover should not automatically be scoped out of a STC designation because of its synthetic form or that it is allegedly opaque and complex. The banking supervisors have full transparency on these portfolios as they are included in general supervisory reviews that they exert on banks. In case the STC criteria defined for true sale ABS gives rise to a differentiated prudential capital treatment, especially for senior tranches, then if prudential banking supervisors are satisfied with the significant risk transfer, retained exposures should be allowed to qualify for that differentiated treatment based upon similar but distinct criteria defining best practice in that area.

We are keen to help define a set of STC criteria that would be specific to a Tranched Cover and be complimentary but distinct from the criteria that apply to ABS cash transactions. We would be happy to suggest suitable criteria along the lines of comments already circulated including: the German Banking Industry Committee http://www.bis.org/bcbs/publ/comments/d304/gbic.pdf which also goes into further detail in their response to the European Commission on the EU Framework for Simple Transparent and Standardised Securitisations, the French Banking Federation http://www.bis.org/bcbs/publ/comments/d304/frenchbankingfe.pdf, as well as comments by other individual banks.
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 BCBS and IOSCO.

Sincerely,

Som-lok Leung
Executive Director
IACPM

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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 members to exchange ideas on topics of common interest. Membership in 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 in the US and internationally, 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 over 100 financial institutions worldwide that are members of the IACPM. These institutions are based in 17 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.iacpm.org.