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Dear Barry

Credit derivatives

I am writing on behalf of LIBA, ISDA and the BBA to set out our collective views on the draft Integrated Prudential Sourcebook chapter on credit derivatives. Whilst these comments are made in that particular context, the majority of the policy issues - most importantly those covered in sections 1 and 2 below - apply equally to the existing FSA/SFA approach and the Interim Prudential Sourcebook and we would hope, therefore, that amendments can be made sooner rather than later.

I should preface our comments by stating that we are, of course, at this stage working within the constraints of the existing international frameworks. We are all hoping for significant developments from the Basel reform process and corresponding revisions to the Directives, particularly in respect of credit risk mitigation, extending the amount of risk offset that can be acknowledged in both the trading and non-trading/banking books. In particular, we look forward to a new, and more balanced, approach to the treatment of the maturity mismatches for all products including credit derivatives.

1. Step-ups and calls

The FSA currently regards the existence of a step-up/call in purchased credit protection as creating a maturity mismatch, an approach which assumes certain exercise of the call. The resulting capital charge is particularly onerous, considering that a stepped-up credit derivative provides better protection than a mismatched hedge: if the credit quality of the underlying asset decreases between the inception of the contract and step-up date, leading to fears that the underlying issuer might default, the protection buyer is likely to keep the contract, resulting in protection covering the full maturity of the underlying. If the same protection buyer were to acquire mismatched protection, of a term equal to step-up date, he might find it impossible to renew the cover at expiry on a potentially distressed underlying. Stepped-up protection therefore ought to attract a lower capital charge than a maturity mismatched hedge.

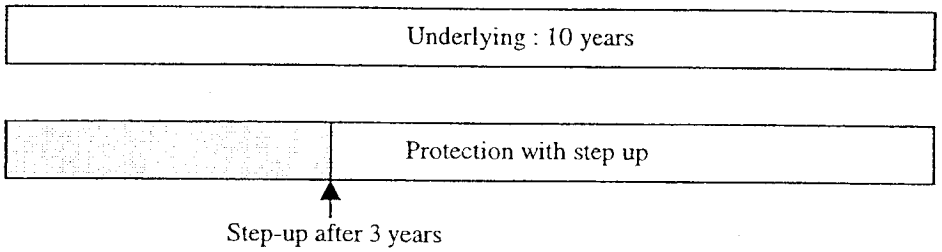
It is worth noting that if the underlying asset's credit quality improves, the protection buyer has the possibility to call the initial contract and buy new protection at a lower price, which in turn benefits its capital levels.

Our understanding from the last Prudential Sourcebook Standing Group meeting on this subject is that the FSA does not object in principle to the use of steps ups and calls; the issue is simply one of establishing appropriate tests in order to distinguish those cases which are undertaken on commercial/economic grounds from those which are not. We would suggest that the FSA differentiates between three states, described below, where determining the capital charge applied on step-ups/calls.

(a) Residual risk is fully hedged: no spread widening risk

Where residual risk is fully hedged, a step-up/call should not entail an additional charge. Residual risk can be seen as fully hedged in the following instances :

- where, at inception, the protection buyer gives a commitment that, in the event that the call is exercised, it will re-adjust its position in order for residual risk to be treated as fully hedged under the capital rules prevailing at the date of the call;
- where the stepped-up fee can be demonstrated to be in the money at inception. A simple test may be used to evaluate "in-the-moneyness":
  - for externally rated underlying assets (or unrated assets of a seniority equal to that of rated assets issued by the same originator), by contrasting the stepped-up fee against forward market spreads on these assets. Using market indicators of credit quality is not prevented under the current EU directives (regulators already largely rely on the banks' pricing of their own positions for setting VaR based capital requirements in the trading book).
  - for unrated assets, by comparing the stepped-up fee with the fee required for protection on the full maturity of the asset, and that required before the step-up arises. Taking a concrete example:



The stepped–up fee is out of the money if higher than the forward spread (or forward price of credit risk) expressed as :

$$\left(\frac{(1+10yrprotectionfee)^{10}}{(1+3yrprotectionfee)^{3}}\right)^{1/7}-1$$

[assuming fee is annualised]

The protection buyer would need to perform the calculations and gather the information necessary for the FSA to apply the tests above.

(b) Residual risk is partially hedged: limited spread widening risk

Where the stepped-up fee is out the money at inception, but no more than 3 times higher than the forward spread (or price of credit risk, as defined above), residual risk is partially hedged. This is because the contract will not be called, should a downgrade in the underlying issuer's credit quality bring the stepped-up fee in the money close to exercise date. A cap is imposed on the forward spread multiplier to avoid situations where the fee is so far out of the money that in effect only default on the underlying could bring it into the money.

Partial hedging of residual risk justifies a lower capital charge than that applied to maturity mismatched hedges. We would suggest that the FSA retains a 20% risk weight, in accordance with the options listed under Annex 1 of the Solvency Ratio Directive.

(c) *Residual risk is not hedged: substantial spread widening risk*

In all cases not covered under (a) and (b) above, the residual risk may be viewed as unhedged and the maturity mismatch treatment is appropriate.

We would urge the FSA to adopt a more risk sensitive approach to the treatment of step-ups/calls. Not only is the current position unduly onerous, it is also in its inspiration irreconcilable with other pieces of regulation, in particular the acceptance of step-ups/calls on hybrid debt.

2. Credit derivatives referenced to "obligations"

As you will know, it is now common practice, particularly following the introduction of the ISDA 1999 Credit Derivative Definitions, for the "obligations" which determine whether a credit event has occurred to be more widely defined than one particular bond. There may be a particular "reference obligation" specified, but credit events and physical settlement are frequently based on any obligation of the issuer which ranks pari passu with that reference obligation. Furthermore, it is likely that none of the range of obligations will have the maturity of the credit derivative, which is what determines the maturity of the specific risk of the notional position in the "reference asset". So the concept of a particular "reference asset" does not work and we have now had an opportunity to consider in some detail how this is best tackled. We therefore propose that a purchased/written credit derivative referenced to obligations should be treated for market risk purposes as a long/short position in a notional FRN (ie an instrument with the specific risk of the issuer but no general market risk) with the maturity of the credit derivative.

On a related matter, the FSA has already agreed to review the operation of the specific risk offset rules in the context of credit derivative products which carry only specific risk and not general market risk. We believe it is clear that the normal rule that offset is only permitted between positions in "identical" instruments needs to be varied in such cases so that offset is permitted where the specific risk profile is identical. This is particularly necessary given the approach advocated above for credit derivatives referenced to "obligations".

3. Parity of regulatory capital treatment vis -à-vis securitisation

Where credit derivatives emulate securitisation (eg: CLO/CBOs), the relaxations given with respect to securitisation should be extended to them: in particular, clean-up clauses and specific allowances made for step-ups in the field of mortgage securitisation should apply equally where risk is mitigated by using credit derivatives.

4. Other comments on the draft chapter

We set out below various other observations on the draft chapter of the Integrated Prudential Sourcebook, some of which have already been discussed by the Standing Group.

- Para 7.2.1 would benefit from some clarification at the end: "... and offer protection in tranches, first loss, second loss etc.".
- Para 7.2.3(4): it is not correct to say that credit default products are treated as swaps because sold protection where a premium has been paid up front attracts no counterparty risk. We think therefore that it is more helpful to continue to refer to them as "credit default products/transactions" and to state the rules specifically.

- Para 7.4.17 and others: is there the possibility of confusion between "first (second etc) name to default" and "first (second etc) loss" up to a specified amount? If so, the difference could usefully be explained in section 7.2.
- Para 7.4.19: the FSA has already agreed to clarify the contents of this table in order to specify more clearly the market risk positions to be included.
- Para 7.4.20: it would be helpful to add an additional point here clarifying that specific risk offset is permitted where there is a currency mismatch, provided that the mark to market value is included in the calculation of the foreign exchange requirement, as described in para 7.4.33.
- Para 7.4.24(3) should be expanded to clarify that the matched position can be created using several sequential or tranched transactions against a single position or transaction.
- Paras 7.4.27 and 28 should specify the counterparty risk treatment to be adopted in each case. In addition, this section needs to include material on the use of credit derivatives for counterparty risk hedging, including an explanation of the capital treatment.
- Para 7.4.33 would be clearer if it began "A firm must feed the *mark to market values of* ...".
- Para 7.5.11 contains an arithmetical inaccuracy. The protection required to achieve full hedging recognition for regulatory capital purposes is $1.5m ÷ 92% = $1.63043m (not $1.5m x 108% = $1.62m).
- Para 7.5.19: we assume that the intention here is to achieve the same treatment as for other forms of credit enhancement. This will not always result in a deduction from capital so this paragraph needs to be clarified; perhaps a cross-reference to the relevant part of the securitisation chapter (once it is drafted) would help.
- Paras 7.5.26(2) and (3) are, we think incorrect. The risk weightings should be applied to the lower of: the maximum payout (or, in (3), the relevant proportion thereof); and the actual exposure for each of the assets. (The examples in 7.5.27 are consequentially incorrect.)
- Section 7.7: the Standing Group has already raised numerous queries on this part of the text, which requires considerable re-drafting. In particular, we believe that the very prescriptive rules need to be reduced to a small number of "purposive", high level rules thus leaving firms to determine precisely how they comply.

We would like to discuss these issues with you at the Standing Group meeting on 29th August. We have not, at this stage, provided suggested drafting amendments to the text of the chapter but would be happy to do so if that would be helpful.

Yours sincerely

Deborah Chesworth
Director