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Ms. Norah Barger
Chair, Credit Risk Mitigation Subgroup
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

October 2, 2002

Dear Norah,

It was a pleasure for our Associations to be able to meet with you in London. ISDA and LIBA (in the following, "the Associations") are pleased that we are making progress on the capital treatment of securities financing transactions and hope that you found the meeting helpful and constructive.

The purpose of this letter is to continue constructive engagement regarding the capital treatment of credit default swaps and other forms of unfunded credit protection in Basel 2. In the process of formulating this letter, we have received comments from market participants with a diverse spectrum of views, including bank portfolio managers, dealers, and end-investor sellers of credit protection. We hope this letter moves us closer to a consensus among supervisors and market participants.

As mentioned notably in ISDA's response to the Basel Committee on Banking Supervision's consultative paper on the New Capital Accord, dated May 31, 2001, the Associations recommend that supervisors not require restructuring to be included as a credit event covered by a credit derivative contract for regulatory capital purposes. We believe that protection against failure to pay and bankruptcy should be sufficient for recognition of credit derivatives in Basel 2. Restructuring should remain one of several options bank portfolio managers have at their disposal in tailoring credit protection to their needs, and the evidence suggests that many banks will continue to purchase protection with restructuring where they are able.

The Associations' primary motivation for encouraging supervisors to adopt this approach is the strong desire by all market participants, including those enjoying the benefits of protection with restructuring, to see the further development of liquidity in the credit derivatives market. We elaborate on this point below. In addition, we address what we understand are the Credit Risk Mitigation Subgroup's two main concerns: (1) the residual risk associated with hedges with maturity mismatches and (2) the possibility that a regulatory capital rule that does not require restructuring would encourage banks to force borrowers into bankruptcy, thereby increasing systemic risk.

**Relationship between Restructuring and Liquidity in the Credit Derivatives Market**
As you know, the credit derivatives market is a crucial risk distribution channel for banks. The deeper and more liquid this market is, the more efficient and effective bank portfolio managers can be in executing their hedging strategies. The continued development of a deep and liquid credit derivatives market is essential, in our view, to promoting safety and soundness in the banking system going forward. We hope you share this view. In light of the market developments discussed below, however, we strongly believe that a regulatory requirement that banks' credit derivative contracts include restructuring in order for the banks to obtain capital relief would work in the opposite direction.

As the attached letters in Appendix 1 and Appendix 2 from end-investor sellers of protection indicate, the difficulties around the restructuring definition are reducing the attractiveness of the credit derivatives market to these critical players, as well as others in the end-investor community. It is not the Associations' intention to endorse the views expressed in the attached letters, or for that matter, the position of other market participants who may disagree with those views. We are concerned, however, that end-investors will choose to pull back from the credit derivatives market, reducing liquidity. The attached letters validate that this is a legitimate risk, and there is some evidence that it is beginning to happen. The Associations are also concerned about recent evidence that, in the absence of market consensus, some market participants have been trying to negotiate their own, non-standard definitions of restructuring, which would spawn basis risk and undesirable segmentation, which, in turn, would work against the development of market liquidity.

The challenges around the restructuring provision have caused at least one major bank portfolio manager to publicly announce that it will no longer include restructuring as a standard provision in its credit derivatives contracts. Attached as Appendix 3 is the bank's announcement and supporting rationale. We also would note that the high-yield credit derivatives market already trades exclusively without restructuring, implying that the cost of including it on these riskier names – presumably on which banks and their supervisors would like to see protection -- is prohibitive.

Against this background, a subcommittee of ISDA's Credit Derivatives Market Practices Committee, representing bank portfolio managers, dealers, and end-investors, has labored to agree a single definition of restructuring that would satisfy all market participants in Europe, North America and Japan. So far, agreement on a single definition has been elusive, although the committee continues to pursue definitions that might work for participants in these regions who wish to pursue contracts with restructuring. Despite a lack of agreement to date on a restructuring definition, most representatives of the relevant market constituencies agree that a bank regulatory requirement to include restructuring would be detrimental to the market because it would interfere with its natural development based on commercial factors. Accordingly, the Associations strongly urge the Basel Committee, through the Credit Risk Mitigation Subgroup, to avoid unduly influencing evolving market practice in one direction or the other, which we believe it can only do by not requiring restructuring as a credit event for bank capital relief.

**Maturity Mismatches and Residual Risks**
In the event that a bank is hedged using a credit derivative matching the maturity of the underlying loan, and a restructuring occurs, the bank may deny the restructuring, force a failure to pay and collect on its hedge. Alternatively, the bank could accept the restructuring if it believes the overall commercial benefits of that decision outweigh the cost.

Importantly, the Associations do not believe that excluding restructuring events from the scope of credit risk protection will systematically result in residual credit risk being left unhedged, although in some instances this might be the case. We understand that the Subgroup might be concerned that if the Basel Committee were to grant capital relief for a hedge without restructuring it would leave the bank facing residual risks, particularly if the hedge had a shorter maturity than the reference asset. In this regard, we note that the maturity dimension of the internal ratings-based risk weight formula should address this concern because required capital tends to increase with tenor. In fact, accommodating credit hedging is why many commentators on Basel 2, including ISDA, have been advocates of a maturity adjustment. As we understand it, if a bank had a five-year loan and bought protection with a three-year credit derivative, it would not obtain full capital relief. Essentially, at the outset the capital on the five-year loan would be offset by the amount of capital required for a three-year asset with the credit rating of the protection seller (the substitution approach). We believe that this partial offset, when combined with the substitution approach, which gives no credit for the reduced likelihood that both the underlying and counterparty default, is already a conservative treatment of credit hedging. To not allow any capital relief for credit hedges without restructuring on top of that conservative treatment would be a dramatic overstatement of the risk. We would welcome the Sub-group's views on this particular point.

We understand further that the Subgroup might be concerned that if a bank restructured a loan on which it had a maturity mismatched hedge with no restructuring provision, it could open up a new exposure for which it might have insufficient regulatory capital to meet the Capital Accord's minimum standards. In this regard, we believe that it is inappropriate with respect to credit derivatives, as it would be for any other product subject to the Capital Accord, to require banks to hold capital in anticipation of the possibility that they might need capital. In fact, banks open up new exposures daily in their credit books and virtually hourly, if not more frequently, in their trading books. Well-managed banks anticipate these potential changes in their risk profiles and set their economic and regulatory capital policies accordingly. This is an issue the supervisors might wish to address as part of Pillar 2.

It is possible that the supervisors also wish to see banks hold regulatory capital against the loss of economic value that could result from an adverse restructuring of a loan. On this point we would observe that neither a credit default swap nor a guarantee is a complete hedge against all degrees of economic loss. The economic value of an unsecured loan will fall, for example, if general credit spreads widen. The Basel Committee has quite rightly not insisted that credit default swaps cover such losses or that banks otherwise capitalize such a possibility unless the asset is in the trading account. Similarly, the Basel Committee does not require the inclusion of provisioning decisions made internally by the protection buyer before an objective default event has occurred even though the provisioning acknowledges that an economic loss has effectively occurred.

**Systemic Risk**

Bank supervisors and central banks are naturally concerned about the availability of credit and liquidity to companies that drive the real economy. We understand that supervisors might fear that excluding restructuring from the list of regulatory credit events will encourage banks to push borrowers into bankruptcy rather than encourage them to work with borrowers to avoid that stage. We wish to assure supervisors that the banks represented through the Associations are generally pre-disposed to work with clients through their difficulties, however severe, because of the relationship orientation of their business models and because of their need to defend the interests of other syndicate members as part of their distribution franchise. Moreover, in any given situation a lender might agree to a restructuring – even if it holds credit protection without a restructuring provision – if it is in its commercial interest to do so. Such an evaluation needs to be made on a case-by-case basis. It is worth noting that, while a bank may not be able to recoup 100% of its losses, a credit derivative hedge that excludes restructuring would generally have increased in value as a result of the credit deterioration that necessitated the restructuring. Such increased value, which would likely be significant, could be realized by the bank requesting an early termination of the hedge. In principle, we do not believe the capital rules are an appropriate mechanism to influence banks' behavior in these situations. We do, of course, recognize that supervisors might wish to intervene, if appropriate, in specific instances.

In closing, ISDA would like to bring to the attention of the Subgroup a point made in its response to CP2 regarding operational requirements imposed on credit derivatives, particularly in paragraphs 123 and 124 of the paper. A strict reading of these paragraphs could lead to the conclusion that a credit derivative documented under an ISDA Master Agreement would not qualify for capital relief. The reason for this is that a number of credit events (bankruptcy or default on indebtedness of the protection buyer, for example) other than "non-payment of money due in respect of the credit protection contract" would allow the protection seller to terminate the contract. Although ISDA does not believe that the Basel Committee intended this result, we recommend that the language be amended or clarified so documentation of a credit derivative under an ISDA Master Agreement does not disqualify the contract for capital relief.

The Associations appreciate the openness of the Basel Committee and the Subgroup to further discussion on this important and far-reaching subject. We would welcome the opportunity to discuss this letter with the Subgroup at its convenience and explore the best possible way forward in the most constructive way that we can. In particular, please let us know if you would like to gain a more detailed understanding of recent market developments. We would be happy to make available representatives from the full range of market constituencies.

Kind regards,

Robert Pickel
ISDA
Executive Director and Chief Executive Officer

Sir Adam Ridley
LIBA
Director General

## *APPENDIX 1*

**Open Letter to ISDA and the ISDA Credit Derivatives Market Practice Committee Co-Chairs and the G6 Working Group Representatives**

July 22, 2002

We understand that the G3 subgroup may be close to finalizing a proposal for a new Modified Restructuring definition for Europe which should represent a significant improvement over the current European standard. As end-users, we respect and fully support the work done by both the current G3 and the original G6 on the topic of restructuring. Nevertheless, it is clear from recent developments in the credit derivative market that a broader discussion of this topic must be opened. The recent groundswell of concern on the part of end-users has made it clear that this issue must be addressed for continued development and growth of the credit derivative market.

Hedgers, dealers, and end-users have acknowledged that the problem with Restructuring lies in its definition, but to date most work has focused on the Deliverable Obligations. We understand that the G3's work is also following this path and we are eager to see their proposal. However, given the current actions of certain market participants who appear to be taking positions contrary to the clear language in the current definitions, we have no choice but to tackle the difficult task of improving the definition of this Credit Event in addition to addressing the Deliverable Obligations. The current definition of Restructuring is clearly not workable if it is susceptible to the misinterpretation, as it apparently is in the minds of certain market participants, that there has been a Credit Event with respect to Xerox.

Potential Changes in Market Practice

- Explore the development of a two-tiered market, with a market including Restructuring (for European banks seeking regulatory capital relief) and one without (for all other market participants.)
- Finalize a new Restructuring Supplement, which should at minimum include a limitation of Deliverable Obligations to Restructured Bonds or Loans, that is applicable as a global market standard. (We understand this limitation on deliverables has been pursued by the G3 for application in the European market.)

Combining some or all of these and other potential steps could achieve all of our goals for the development of our market by:

- Making the credit risk transferred synthetically more consistent with the credit risk of the underlying obligations
- Improving transparency in market pricing
- Restoring the trust of end-users in the operation of the credit derivatives market

Given current market conditions and our concerns, we urge the removal of a discussion of Restructuring from the agenda of Tuesday's Market Practice Committee meeting, and propose holding a separate Market Practice Committee meeting no later than the first week in September 2002 to fully address the issue. We are eager to build on the work already done, and look forward to working with all market participants in this effort.

ACE Capital Re
Ambac Credit Products, LLC
CIFG
Chubb Financial Solutions
Financial Security Assurance, Inc.
MBIA Insurance Corporation
MSI Financial Solutions (London)
Pacific Life Insurance Company
Radian Asset Assurance Inc.
XL Capital Assurance Inc.

***APPENDIX 2***

**Proposal from ISDA End-User (Protection Seller) Constituency**

**ADDRESSING THE PROBLEMS CREATED BY THE "RESTRUCTURING" DEFINITION**

The definition of "Restructuring" in the 1999 ISDA Credit Derivatives Definitions (the "1999 Definitions") has proven to be unworkable, and has already created conflicts and disputes. For example, although the Xerox June 2002 refinancing clearly does not (and was not intended to) come within the "Restructuring" definition, certain market participants, including a number of dealers, have mistakenly taken the position that it constitutes a Restructuring Credit Event, and at least two market participants have declared such an event to their counterparties. Moreover, we can envision refinancings by other Reference Entities under circumstances where, under the current definition, there will be substantial uncertainty and disagreement as to whether a Restructuring has occurred.

Ultimately Restructuring should be removed as a Credit Event, and in the interim the definition of Restructuring should be revised.

One of the most significant problems with the definition of Restructuring is that it includes a subjective causation test—did the event defined in Section 4.7(a), "directly or indirectly result from a deterioration in the creditworthiness or financial condition of the Reference Entity"? This subjective determination—involving (in the words of the Practice Notes and the User's Guide to the 1999 Definitions) an "analysis . . . focus[ing] on the totality of th[e] facts and circumstances"—will inevitably result in uncertainty and conflict. In order to provide market participants an acceptable level of certainty and to avoid a known source of potential conflict, this subjective causation test must be replaced by a more objective standard.

Further, the 1999 Definitions should be revised so as to leave no doubt that the Restructuring definition does not include ordinary course loan refinancings that are not caused by imminent bankruptcies or Chapter 11 reorganizations of, or imminent payment defaults by, reference entities under credit default swaps ("CDS"). We refer to a concept of Restructuring that makes the aforementioned exclusions as the "Restructuring-as-workout" model of restructuring.

*The Subjective Causation Test*

The Practice Notes set out in the 1999 Definitions (the "Practice Notes") state that the Restructuring Definition was intended to eliminate the "subjective assessment" involved in applying the Restructuring definition set forth in the Long Form Confirmation. However, the current definition, with its emphasis on causation without objective criteria, merely substitutes one set of subjective criteria for another.

The approach taken in the 1999 Definitions (according to the Practice Notes) was to identify "specific events that are typical elements of a Restructuring of indebtedness," and—recognizing that these events could occur when a Reference Entity's credit quality had improved or remained the same—provide that a Restructuring has not occurred when the event "does not directly or indirectly *result from* a deterioration in the creditworthiness or financial condition of the Reference Entity."

Even if the "specific events" identified in Section 4.7(a) were clear and objective (several are not), there is a serious problem with the definition because the "result from" test is highly fact-specific and subjective.

The phrase "result from" – like similar phrases such as "by reason of" – involves a determination of causation. Did a thing or things cause another thing to happen. Here, did the "event" covered by Section 4.7(a) "result from" a deterioration in credit value, or did it result from some other cause or causes?

There are two basic problems with the "result from" or causation test in Section 4.7(b)(iii). First, as with many events—commercial, financial or otherwise—there can be multiple causes. Second, a determination of causation frequently involves the issue of motivation; and a loan refinancing involves the motivation of at least two different entities.

This is the core problem with Section 4.7(b)(iii). It does not provide an objective standard. The Practice Notes acknowledge as much:

Whether or not the provisions of Section 4.7(b)(iii) apply will, of course, depend upon the facts and circumstances at the time of the relevant event, and the analysis in any particular case should focus on the totality of those facts and circumstances.

Unquestionably, there will be circumstances in which it is unclear whether an event identified in Section 4.7(a) did or did not result from a deterioration in creditworthiness or financial condition of a particular reference entity. The conclusion that the 1999 Definition of Restructuring is unworkable is not, however, simply based on such a hypothetical scenario. It is based on very real and significant developments, the most recent of which involves Xerox Corporation's June 21, 2002 refinancing of its revolving credit facility.

Several market participants are taking the position that the Xerox refinancing constitutes a Restructuring Credit Event, even though it is clear that, among other things, the refinancing did not "directly or indirectly result from" a deterioration in Xerox's creditworthiness or financial condition.

Xerox's credit facility was due to expire within a few months (in October 2002) and the company negotiated with its lenders not only in a time frame that is consistent with the refinancing of a large credit facility, but at a time when its financial position had improved significantly. The timing of Xerox's financial setback and the commencement of the negotiation of the refinancing, Xerox's allowance of a conventional and prudent amount of lead time for refinancing of its soon-to-expire revolving credit facility and Xerox's improved financial position all indicate that there was in fact no causal connection between Xerox's setback in the fourth quarter of 2000 and its second-quarter 2002 refinancing.

In a Xerox press release statement that was likely supported by its lenders, Xerox stated that its *improved* financial condition had allowed it to achieve its refinancing. As indicated by, among other factors, the prices of Xerox's long-term, senior unsecured bonds and its publicly traded stock, Xerox's financial condition had been improving for many months when Xerox commenced negotiations with its lenders for the refinancing of its revolving credit facility. The Practice Notes to the 1999 Definitions indicate that it is the reference entity's circumstances "at the time of the relevant event," including "when…negotiations [for the event] began," that are relevant to whether its refinancing resulted from a deterioration in its creditworthiness or financial condition. According to that standard, Xerox's refinancing was not a Restructuring because it was not *caused by* a deterioration.

In any event, the significant time that passed between the time of Xerox's financial setback in late 2000 and Xerox's ordinary course refinancing indicates the implausibility of any assertion that the two events are causally related. Xerox and its lenders' waiting nearly a year after Xerox's financial setback to refinance the credit facility is inconsistent with their having been motivated to refinance by that setback.

If a situation as clear as Xerox can give rise to disputes, the potential for further disputes—if the definition is not changed—is self-evident.

ISDA's Mission

ISDA should revise the definition of Restructuring so that there is no doubt that it is limited to the Restructuring-as-workout model. ISDA should do so in order to fulfill that part of ISDA's mission which is to adopt language that will support the operation and growth of the CDS market. Such support includes promoting liquidity and transparency, promoting certainty and providing definitional underpinnings that result in commercially viable and functional products and that minimize disputes.

ISDA should act to prevent the Restructuring-as-workout model from being expanded to accommodate a broader concept of Restructuring—one that would apply to non-distressed exchanges in which the restructured obligation is not a diminished obligation, the obligation holders suffer no corresponding economic loss and the Restructuring is accompanied or preceded by a credit impairment but not by an actual, imminent payment default.

Restructurings based on the Restructuring-as-workout model will provide certainty, transparency and liquidity because:

The growth of the CDS market requires that its participants can be certain of its mechanics and parameters.

The ability of end-users and other participants to model and evaluate risks included in the CDS depends upon Restructuring Credit Events conforming to characteristics for which historical risk data compiled by the ratings agencies and others are available.

An objective definition of Restructuring will minimize disputes as to whether a Restructuring has occurred and whether the Credit Event Notice and accompanying documentation is satisfactory.

An objective definition will minimize the possibility of manipulation by a reference entity's lenders—who are also buyers under CDSs with respect to that reference entity—triggering a technical Restructuring (the "moral hazard" problem).

A uniform approach by market participants, free of uncertainty, is essential to liquidity.

August 8, 2002

ACE Capital Re
Ambac Credit Products, LLC
CIFG
Chubb Financial Solutions
Financial Security Assurance, Inc.
MBIA Insurance Corporation
Radian Asset Assurance Inc.
XL Capital Assurance Inc.

***APPENDIX 3***

TO: ISDA Credit Derivatives Market Practice Committee European and US Bank Portfolio Managers.

CC: ISDA Credit Derivatives Market Practice Committee G6 Working Group

I am communicating with you in my capacity as a bank portfolio manager and not in my role as co-Chair of the ISDA Credit Derivative Market Practice Committee, nor its G6 subcommittee.

After an extensive analysis of the issue from the perspective of our credit portfolio, and more than two years of working with market participants to arrive at an alternative solution, we have decided that JP Morgan, acting in its capacity as an end user, will drop Restructuring from its required credit events in our "standard" contract for non-sovereign credit derivatives. I am not speaking for our dealer desks who will continue to service our clients globally, including many of you, in meeting your needs for credit protection with and without Restructuring, both in accordance with standard market conventions and on a tailored basis, as applicable.

As an end user, we will also continue to make some use of contracts that include Restructuring, and as such are dedicated to continuing to work with ISDA and its members to arrive at an acceptable definition of Restructuring for use in transactions where the parties agree to include it on a negotiated basis. We also intend to continue to work with ISDA to convince bank regulators that Restructuring should not be an operational requirement for credit derivatives under Basel II.

In doing this, we are not intending to press others to follow suit nor to influence the outcome of ongoing discussions other than by "voting with our feet" in our capacity as a meaningful market participant active in both buying and selling credit protection for portfolio risk management purposes. We acknowledge that our view may not reflect that of other bank portfolio managers. However, I thought that I would share the logic behind our decision with you.

Notwithstanding the fact that we are entirely comfortable that the conduct of our own institution in this regard has been in accordance with our internal policies concerning conflicts of interest, we believe that the inclusion of Restructuring as a standard credit event is hampering the growth of the credit derivative market due to concerns about real or perceived conflicts of interest on the part of banks operating simultaneously in the lending and derivatives markets. These have been voiced repeatedly and with growing volume, culminating in the recent open letters to ISDA from a number of investors requesting a fundamental rethink of the topic. As a result, we believe that the Restructuring credit event has become the greatest source of uncertainty and potential for dispute in what is a crucially important risk distribution channel for banks.

Having been intimately involved in the process of reworking the Restructuring definition for the past few years, we believe that arriving at a definition of Restructuring which has broad enough consensus for the standard global contract and which balances the moral hazard concerns on the part of investors with intermediaries' needs to avoid unacceptable basis risk will be almost impossible. Slow progress in recent discussions has served to illustrate this point. Consequently, a standard which continues to include Restructuring, even in a modified form, will likely limit liquidity, either by keeping end investors away or by disincentivising market-makers and may not in fact truly meet the needs of bank portfolio managers seeking to hedge loan Restructuring risk comprehensively (for example, we have become increasingly concerned at the possibility of seller-triggered Restructuring events causing hedges to terminate prematurely when at low economic value to the buyer, leaving previously hedged positions open to subsequent deterioration or default). Certain investors are sufficiently sophisticated and familiar with bank lending activities to be comfortable with assuming Restructuring risk and as such we believe that contracts including Restructuring will continue to be available at a price and we are committed to ensuring that the definition of Restructuring used in these instances is one which maximizes such contracts' potential liquidity.

Our primary objective is to see the credit derivative market grow in liquidity, transparency and depth. In the long run this will significantly improve our ability to manage the risks of our lending and derivatives activities with clients, a core objective of our credit operating model. We believe that a consistent global standard for vanilla credit derivative contracts is necessary to achieving this vision. While dropping Restructuring as a standard term will reduce the economic value of the impacted credit derivative hedges, we feel comfortable that the ultimate improvement in liquidity and pricing will more than offset this. We feel that we can live without the opportunity for windfall gains and that in instances where a Restructuring occurs in conjunction with a material economic loss for us, we can realise gains on a mark to market basis on contracts which do not have Restructuring, provided we have carefully managed the maturity profile of our hedges relative to our exposures, an activity which we have successfully test-driven in recent months.

We appreciate the complications caused by the bank regulatory position on this topic and, as we have said above, will continue to work to resolve this as best we can. However, we believe that ultimately the evolution of the credit derivatives product should be driven by economic risk management objectives and not the influence of rules impacting only a portion of the product's end users. We think banks can best manage Restructuring and default risk in dynamic loan and derivative portfolios using a highly standardized and futures-like contract which enables them to buy and sell protection with minimum friction.

Best Regards
Blythe Masters