

ISDA

International Swaps and Derivatives Association, Inc.
One New Change
London EC4M 9QQ
United Kingdom
Telephone: 44 (20) 7330 3550
Facsimile: 44 (20) 7330 3555
email: isda@isda-eur.org
website: www.isda.org

Ms Norah Barger
Chair of the Credit Risk Mitigation Sub-group of the Basel Committee
Division of Bank Supervision and Regulation
Mail Stop 155
Federal Reserve Board
20th & C Street, NW
Washington DC 20551

12 March 2004,

Dear Norah,

Thank you for your letter dated 25 February 2004, which includes useful information on current Basel Committee thinking regarding credit risk mitigation instruments.

ISDA is particularly concerned with the treatment of restructuring risk described in your letter. The Committee, it seems, has repudiated the approach encapsulated in paragraph 162 (a) of CP3, according to which “the bank need not include restructuring in the list of credit events [covered by the CDS] when it has complete control over the decision of whether or not there will be a restructuring of the underlying obligation.” The notion of control over restructuring, which ISDA had welcomed, purely and simply disappears from the Accord. Instead, where restructuring risk is not covered by the CDS, the amount of the hedge is discounted by 40 percent for regulatory purposes.

This policy change entails far-reaching consequences for the credit derivatives market:

- (i) Bilateral loans hedged by CDS will receive the 40 percent discount factor. The reason is that protection sellers will not typically take on exposure to restructuring events that are initiated at the discretion of the buyer of protection. In markets—such as Japan—where CDS are used principally to hedge bilateral loans, the new stance adopted by the Committee might reduce the momentum for the emergence of a deep and liquid credit derivatives market.
- (ii) The value of the right of veto often present in syndicated lending documentation will be ignored for regulatory purposes. In order to receive full capital relief, protection buyers will therefore have to pay for restructuring protection, even where the syndicated lending documentation implies that restructuring risk is negligible in practice.

ISDA continues to believe that the option to control restructuring events is meaningful, and would greatly appreciate further discussion with the Credit Risk Mitigation Sub-group of the rationale for the Committee’s change of mind. We offer below preliminary thoughts on why we believe the position adopted by the Committee is unjustified. Some of these points were raised in our comment letter on the US Advance Notice of Proposed Rulemaking on the New Basel Accord, dated November 2003 (available at www.isda.org).

We understand that supervisors doubt the effectiveness of the control option in certain circumstances. Suppose, for example, that a protection buyer has 10 percent of its exposure to a counterparty covered by a syndicated loan

agreement and hedged by a CDS excluding a restructuring trigger, and the remaining 90 percent held as a bilateral exposure and unhedged. It may make economic sense in this case for the protection buyer to accept a restructuring of the totality of the exposure—and forfeit the benefit of the CDS hedge—rather than send the counterparty into bankruptcy and trigger the CDS.

ISDA accepts that circumstances similar to that described above will arise. We believe, however, that the regulatory treatment of restructuring risk should not be predicated upon worst-case examples but rather upon a broader assessment of the consistency of the capital rules.

- 1) What matters up front (i.e., at the time when the CDS is bought) is not whether the option is likely to be exercised or not. This is impossible to assess because no one can predict the structure of the exposure to the counterparty at the time of default. What matters is the existence of an option to avoid restructuring loss. There should be a difference in capital treatment between protection buyers holding the option and those who aren't.
- 2) The assumption that the option to veto is worthless contradicts common sense and documentation practice. Syndicated loan agreements generally provide the right to veto. If this option really had no value, syndicated loan agreements would not generally provide it as they do.
- 3) Banks hold many options that the regulators sensibly ignore when charging regulatory capital. For instance, any bank has the option to sell quality assets and replace them with junk bonds at any time. Regulators nevertheless charge capital based on assets held and not on possible future changes to the asset mix.
- 4) Finally, if regulators assume the option will not be exercised in the example given above, they by implication presume the occurrence of a restructuring. If a restructuring occurs, loss suffered on the 90 percent unhedged portion of the exposure will arguably be less than in bankruptcy. Unfortunately, the capital rules prevent banks from recognising this lesser degree of loss under most approaches to credit risk (standardised and foundation IRB). Even under the advanced IRB, banks might not hold sufficient data to estimate a loss given restructuring parameter. Given the lack of accuracy of the capital rules, it would be sensible for the regulators to recognise full capital relief on the CDS.

In addition, it is unclear whether financial guarantees will be subject to the same discount factor as credit default swaps. Guarantees do not normally cover restructuring losses, which are left for the creditor to bear. Inequality of treatment between credit default swaps and financial guarantees must be justified based on an in-depth analysis of both products. ISDA is concerned that absent a clear motivation of its approach by the Basel Committee, protection buyers will naturally view financial guarantees as a superior hedging instrument. This could dramatically reduce liquidity in the credit derivatives market and frustrate years of efforts by industry to optimize liquidity by means of standardizing the terms of credit derivative contracts.

On a more positive note, the size of the discount factor appears consistent with our own calculations, shared with you in the autumn of last year. We note and welcome the mention made of the possibility of re-sizing the discount as and when industry is able to provide more robust estimates of LGR/LGD and PR/PD. Still, ISDA would like to verify that banks treated under the Advanced IRB approach would be able to calculate their own restructuring discount factors. Although at present firms may not hold sufficient data to perform this calculation to the satisfaction of supervisors, we believe this will change in the future and that the Committee should encourage the collection of the necessary information. We therefore recommend including in the New Accord a reference to the possible recognition of internally estimated discount factors, subject to strict supervisory review.

We appreciate you and your colleagues' willingness to hear our concerns. Please feel free to contact me (esebton@isda-eur.org, or +44 207 330 3571) should you have any questions.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'ES' with a flourish.

Emmanuelle Sebtou
ISDA
Head of Risk Management and
Co-Head of the European Office