

# ISDA

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Mr Frederic S. Lau  
Division Head  
Hong Kong Monetary Authority  
30<sup>th</sup> Floor  
3 Garden Road  
Hong Kong

2 November 1999,

Dear Mr Lau,

The International Swaps and Derivatives Association (“ISDA”) is highly appreciative of the opportunity to comment on the Hong Kong Monetary Authority’s (“HKMA”) supervisory approach to credit derivatives. ISDA takes a keen interest in the capital treatment of credit risk mitigation instruments, and has contributed to the thinking of regulators around the world via the setting of Working Groups, gathering credit derivatives traders, lawyers and risk management experts from our 446 members.

We understand that your requirements focus principally on the capital and large exposures treatment of credit derivatives in the banking book. Although clarification of the approach is very welcome in this field, it would be equally helpful for our members to know how credit derivatives are treated where they are held in the trading book.

ISDA strongly believes that credit derivatives should be eligible for trading book treatment, where they meet the criteria set out by the Basel Committee : trading intent and marking to market, or use as hedge for trading book exposures.

A strong rationale for allowing trading book treatment for credit derivatives may be found in the close similarity between these products and interest rate swaps, notably as far as market pricing, eligibility for netting and risk management are concerned. Furthermore, active risk management often implies adjusting positions and corresponding hedges fairly regularly, making the use of credit derivatives in the trading book a very appealing risk mitigation tool. The HKMA would facilitate the development of proper risk management, by implementing a clear and public policy in relation to such products.

ISDA hopes that the Hong Kong Monetary Authority will complement the current guidelines to cover the treatment of credit derivatives in the trading book and would welcome the opportunity to comment on these rules should this be deemed useful.

Turning to the core of the proposed approach, ISDA believes that the description of credit derivatives offered in the paper would benefit from further clarification.

First, it is fundamental to the nature of credit derivatives that a buyer of protection does not need to be exposed to the obligor to which the transaction is referenced. Credit derivatives permit protection buyers to take short credit positions, a feature that does not appear clearly in the HKMA’s draft. In this respect,

protection acquired via a credit derivative contract is fundamentally distinct from that provided by a guarantee or insurance policy.

Second, ISDA has recently published Credit Derivative Definitions (attached) which attempt to codify and standardise the terms of these contracts, and the following points are of particular note.

The Reference Entity is the entity upon whose credit the contract is based.

The Floating Rate Payer (Protection Seller) may discharge its liability under the contract by taking delivery of a Deliverable Obligation of the Reference Entity from the Fixed Rate Payer (Protection Buyer) and paying the par amount of it. In practice, the vast majority of credit derivatives settle in this way i.e. by physical delivery, and Cash Settlement is usually only used as a fallback.

A Deliverable Obligation is any obligation of the Reference Entity that the contract specifies may be used in settlement of the contract as above. For example a Deliverable Obligation might be any obligation of the Reference Entity, as principle or guarantor, ranking *pari passu* with the Reference Obligation.

The Reference Obligation is a uniquely specified obligation of the Reference Entity. Its main purpose is to provide a basis for cash settlement where applicable. It may also be used to define the seniority of Deliverable Obligations.

A range of Credit Events is defined for each credit derivative contract. These are usually fairly wide ranging and are not limited to events affecting the Reference Obligation.

Finally, it is worth noting that Total Return Swaps are indeed a form of credit derivative since the total return payments include price variations due to changes in credit spread. However, these transactions are often structured with neither Credit Events nor a Credit Event Payment being included in the documentation. A TRS may be viewed as akin to an equity swap, but on a debt instrument.

It is fundamental that participants in the credit derivatives market, including the regulators, understand how these products are structured, and it would be useful if the HKMA could review its description of the main types of credit derivatives to incorporate some of the points listed above. The credit derivatives definitions provided in the HKMA guidelines should furthermore be purely indicative, to allow room for development of future generations of such products.

ISDA strongly supports the requirements set out by the HKMA with regard to risk management. Proper consideration of legal risk in particular is essential, as the offsetting effect of credit derivatives is dependent on the legal enforceability of the contract.

As far as the treatment of secondary investors in credit linked notes is concerned, ISDA believes that their exposure to the amount paid for the notes should be captured when the notes are bought at a discount, not the exposure to the underlying nominal.

Concerning the recognition of offsets in the banking book, ISDA would like to offer the three following comments:

- (i) The HKMA proposes to follow the same approach for unfunded credit derivatives as for guarantees. This implies replacing the risk weight of the underlying by that attached to the protection seller in the calculation of the capital charge. Although proceeding differently would not be consistent with the current Basel capital adequacy standards, ISDA notes that this substitution approach presupposes a perfect default correlation between the underlying issuer and the protection provider. Such high levels of correlation are not realistic in the vast majority of cases, and ISDA would hope that the Basel Committee, in its current review of the 1988 capital framework, incorporates more reasonable assumptions in the capital treatment of guarantees.

(ii) The HKMA requires that, for capital relief to be obtained, asset mismatched credit derivatives satisfy three conditions : the reference and the underlying assets must be issued by the same obligor, linked by a cross-default clause, and the reference must rank pari passu with or more junior than the asset being hedged. ISDA does not see the need for a cross default clause if both assets have the same obligor and if the reference itself is more junior than the underlying.

(iii) Finally, the HKMA does not specifically address the treatment of maturity mismatches. This is a field where ISDA believes that more clarity is required, if banks are to be able to use credit derivatives actively. It is often difficult to find derivatives the maturity of which perfectly matches that of the underlying, notably in markets where there might be an aversion on the part of investors for assuming long term credit risk.

Maturity mismatched credit derivatives do however provide some degree of protection and should warrant proportionate, if only partial, capital relief.

ISDA has recommended in various previous publications<sup>1</sup> the use of a sliding scale approach to treating maturity mismatched protection. Under this approach, a 10 year underlying hedged for 7 years would attract 3/10<sup>th</sup> of the original capital charge. A number of regulators world-wide follow a similar methodology (notably the Australian Prudential Regulation Authority). The Japanese authorities go further, recognising full offset if protection is in place for at least one year. We would find it most helpful if the HKMA could clarify its approach in this field.

Finally, it would be useful if the HKMA could specify how multiple name credit derivatives would be treated for both capital and large exposures purposes, in particular where they are structured as first-to default.

With a longer term perspective in mind, ISDA hopes that the treatment of credit derivatives and other forms of credit risk mitigation can be vastly improved as part of the on-going Basel review. The possibility of relying on the banks' internal ratings for setting their credit risk capital requirements should allow for a more accurate treatment of risk mitigation, as we would hope that the effect of hedges can be pre-processed into the banks' exposures. ISDA will endeavour to assist the regulators in the revision of the rules, notably by responding formally to the consultation.

ISDA would like to reiterate its appreciation for the opportunity to respond to the HKMA's rules. We hope that the HKMA finds our comments useful.

Yours sincerely,

Emmanuelle Septon  
Head of Risk Management

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<sup>1</sup> Including "Credit risk and regulatory capital", March 1998