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By e-mail

28th January, 2005

Mr Darryll Hendricks
c/o Basel Committee on Banking Supervision

Ref: CDMPC (EU-1001)

Dear Darryll,

Joint Forum Paper on 'Credit Risk Transfer'

Please find attached ISDA's response to the October 2004 paper on the above.

Naturally, if you or your colleagues have any questions or comments on the letter, I would be very happy to address them.

We look forward to any future possibility of working with the Joint Forum on this or other issues of mutual interest.

Yours sincerely,



Richard Metcalfe
Senior Policy Director

Overview

ISDA¹ welcomes the Joint Forum paper ‘Credit Risk Transfer’, which brings into a single, clearly written document a large amount of useful information, as well as raising issues of relevance to this important but still developing area of finance. The paper takes a balanced view as to the benefits that credit risk transfer (CRT) techniques bring to the financial markets – and to the financial system (and by implication the economy) more broadly. At the same time, it highlights a number of aspects of the market on which managers, supervisors and shareholders may legitimately wish to reassure themselves.

In particular, the paper provides a detailed explanation of the main instruments that have evolved in recent years as investors, hedgers and intermediaries have sought more flexible and efficient means of positioning themselves with regards to credit risk as part of their business activities. In describing these instruments, it also provides a considered analysis of the risks that are managed through and in relation to their use, including market and operational risk as well as credit risk and its components.

Credit risk transfer is not in itself a new phenomenon, as the paper makes clear. It has, however, developed considerably in the past decade, with the addition of derivative instruments to a range of techniques that already included securitisation and guarantees. The pattern has been similar to that applying in relation to other asset classes, where the introduction of ‘over-the-counter’ derivatives has allowed a degree of flexibility in relation to the underlying risks that was not previously available. Derivatives achieve this by allowing entities to go long or short of credit risk, without necessarily having any position in the underlying via more traditional instruments.

There is every sign that the credit derivatives market will continue to grow, with deepening interbank liquidity helping to support a still broadening array of financial products, giving rise not only to greater volumes but also a larger number of participants across a broader range of entities. In due course, the product array may include listed derivatives. For the moment, it includes a number of structured instruments that are built up from the essential ‘building block’ of credit default swaps covering both ‘single-names’ and indices.

As has happened with other derivatives markets, while a rapid growth phase has caught the eye of many commentators, this only came about after a period of methodical early development, with major effort in terms of adapting instruments to market needs, documenting transactions, and managing the risks. ISDA believes that the current state of the market is healthy, in that risk is relatively freely transferable among major intermediaries and a form of symbiosis exists between trading on the one hand and, on the other, net transfers of risk. Not only is this healthy

¹ The International Swaps and Derivatives Association (ISDA) is the trade association representing leading participants in the privately negotiated (or over-the-counter, ‘OTC’) derivatives industry. Its membership comprises more than 600 firms, including the world’s largest commercial, investment and universal banks, corporations, government entities and other interested parties. ISDA was chartered in 1985 and today represents institutions from 47 countries around the world. OTC derivatives include swaps, options, and forwards on interest rates, currencies, commodities, equity and credit.

for the CRT market, but for the economy more broadly: it allows not only for the transfer of individual risk positions, but for confidence among those with credit positions to manage that they will be able to do so efficiently and effectively, as and when the need arises. For this reason, ISDA strongly supports the paper's rather positive tone on the market overall.

In the paper, the Joint Forum addresses three overarching questions about the development of the CRT market, relating to:

- 1) effectiveness of risk transfer;
- 2) participants' understanding of the risks involved – both underlying and related to the instruments used to transfer that credit risk;
- 3) the possibility of undue concentrations of risk.

ISDA believes that these are important issues to address at this stage of the development of the market and notes the Joint Forum confirmation that, on all three counts, the answer is essentially positive. This in turn supports the inclusion of market participants' comments to the effect that the system is well served by CRT. Such a position is consistent with the experience of modern forms of risk transfer in relation to other categories of risk.

Joint Forum recommendations

As regards the 17 specific recommendations that the Joint Forum makes in the paper, ISDA broadly welcomes these. ISDA's own mission includes a commitment to promote efficient, well understood markets and the paper highlights issues that will generally be quite familiar to participants but which are nonetheless worth reinforcing and, for the sake of any newer entrants, highlighting.

We have focused mainly on the 13 recommendations that identify and characterise management issues which participants should assess and monitor in engaging in CRT business (as distinct from the four recommendations aimed primarily at supervisors). Without commenting exhaustively on these, ISDA believes the following issues (taken mostly in the order in which they are discussed in the paper) merit some comment.

Role of senior management and Operational risk (recommendations 1, 11)

As stressed in certain other documents (most notably the G30 report 'Derivatives: Practices and Principles' of July 1993) the role of senior management is the natural starting point for any approach to risk management. This remains true, whether an entity is new to the use of a particular risk-transfer technique or is a longstanding, active user. Taken together with the involvement of suitably qualified professionals, backed up by appropriate management information systems, firms will have a strong foundation for managing risks, including operational risk.

Credit risks and Market liquidity risk (recommendations 2, 3, 12)

It is particularly helpful that the paper decomposes credit risk into meaningful constituents (spread, jump-to-default and correlation risks), and highlights other relevant factors, including 'model' risk. Fundamentally, the more dynamic environment for risk transfer will tend to

contribute to the effectiveness of the allocation of credit risk. But this naturally requires that users of CRT techniques consider carefully how that use affects their exposure to any or all forms of credit risk. (See also comments on counterparty credit risk in next sub-section below.)

ISDA also agrees that market participants should assess the liquidity characteristics of CRT positions, since instruments that have been tailored to meet a particular risk profile may naturally not be so freely transferable as those that are designed to be fungible, while the term ‘CRT’ can refer to instruments of either type.

Counterparty credit risk (recommendation 6)

There are aspects of the capital of treatment of credit derivatives that remain an issue and it will be important that capital rules do not unnecessarily constrain growth, or even force that growth in a direction that it would not naturally take. Members of the Joint Forum will be aware – and in a many cases very familiar with – the continuing and helpful discussions in the context of the ‘Trading Book Review’, and we see no need to go into any detail on that evolving debate here. We simply note that the market will continue to be sensitive to capital treatment. ISDA’s guiding principles remain that the capital rules should: 1) afford due recognition of risk mitigation, including assessments of correlation effects; and 2) promote equivalence of treatment between economically equivalent means of credit risk transfer, most notably as between credit derivatives and more traditional techniques (viz, the capital treatment of restructuring risk).

Documentation and Operations (recommendations 7, 10)

The recommendations on documentation and operations are of special interest to ISDA in its role as a forum for standardisation. Not only is each area important in its own right; they are also closely inter-related disciplines. ISDA is able to report that market participants actively and continuously consider opportunities to extend the range of standardised documentation and, at the same time, are engaged in a major strategic initiative to optimise post-trade procedures, particularly in relation to more standardised transactions. This makes use of the ‘Financial Products Mark-up Language (FpML)’ that the industry has developed, through ISDA, specifically for over-the-counter derivatives, explicitly including credit default swaps.

Moreover, industry initiatives relating variously to such issues as trade confirmations, reference entities/obligations and ‘tear-ups’ demonstrate that lessons learned in the context of other financial markets are being applied relatively early in the life of the credit derivatives market, in response to its rapid growth. ISDA does, however, share the Joint Forum’s view that the process of assignment continues to merit careful attention.²

MNPI (recommendation 9)

Having worked jointly with a number of other trade associations on the use of material non-public information as it relates to the credit markets, ISDA appreciates the paper’s support of industry efforts to reinforce appropriate practices in this sphere. We believe it is an important

² Details of initiatives on operations and documentation may be found at ISDA’s web-site: www.isda.org.

signal of the health of the market that participants demonstrate their ability and commitment to directly and publicly address such issues.

Public disclosure and Supervisory reporting (recommendations 13 and 14)

Another area that has been a major industry focus in recent years is the accounting treatment of risk-transfer instruments in general. As with the capital treatment, at the time of writing ISDA is engaged in a detailed debate with the relevant authorities as to the most appropriate way forward.

As a broader point, related to the monitoring of exposures, ISDA supports continued debate on the quality and quantity of public disclosure of credit risk. In this regard, we consider the concept of 'significance' to be useful, whereby the extent of disclosure required should properly be a function of the extent to which an entity uses a particular type of financial instrument and the amount of risk shed or taken on. In order to respect this principle (and avoid unhelpful levels of detail), an entity should have a certain amount of discretion as to the information it presents in public accounts.

On this point, it is worth bearing in mind that risk disclosures are evolving and that the so-called 'third pillar' of the June 2004 revised Basel framework for capital standards constitutes a major development in the field.

As regards reporting to supervisors, while this is clearly a somewhat different issue, some care should still be taken to ensure that reporting requirements pass a similar relevance test. ISDA would expect that enhanced reporting to supervisors would complement disclosures of the type discussed above in reassuring a range of stakeholders as to the integrity of the management of CRT use within a given entity.

Other recommendations

ISDA agrees that the paper is right to draw attention to other issues that market participants should focus on as relevant: the use and meaning of external ratings (recommendation 4); dynamic management of structured transactions (recommendation 5); and the group of issues around client education and capacity and legal responsibilities (recommendation 8).

We would further note that an important dimension of legal certainty in relation to the CRT market has been the ability to characterise credit derivatives as financial instruments. ISDA members have consistently sought to promote the broadest understanding of this matter (viz, the 'Potts opinion' of 1997, dealing with the distinction under English law versus [a] insurance and [b] gaming contracts); and, to the extent that this proves necessary in future, will continue to do so. Similarly, ISDA will work to maintain and expand regulatory capital relief for legally effective netting agreements that cover credit derivatives.

Conclusion

Overall, ISDA applauds the initiative of the Joint Forum in producing its paper at this stage of the evolution of the market in credit risk transfer. ISDA believes that CRT is a market of considerable further potential, reflecting the efficiency it brings to an economically highly significant sector of finance. As such, maximising awareness among participants, supervisors

and a range of stakeholders as to the mechanics and dynamics of CRT is a truly valuable exercise.

ISDA would welcome any opportunity to contribute to further work on this subject.