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Mr Paul Hawkins and Ms Joanne Bouwens
Financial Services Authority
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9th April 2010

Dear Paul and Joanne

Re: Tranche protection Trades

The Association for Financial Markets in Europe (%AFME+), the British BankersqAssociation (%BBA+) and the International Swaps and Derivatives Association (%ISDA+) are writing to you in relation to Paul Sharmaqs letter of 26 February 2010 outlining the FSAqs views on the treatment of tranche protection trades. In light of that letter, the FSA hosted an ad-hoc meeting of the Securitisation Standing Group to provide greater clarity on regulatory concerns and the factors that might influence a more conservative risk transfer approach to tranche protection trades. While we appreciate the additional time that the FSA has devoted to this area and recognise that there are aspects where we have achieved greater clarity, the industry still has a significant number of questions and issues. This letter is in two sections: key messages and response to the detail of the letter.

1 Key messages

Although we recognise that it is appropriate to review and address issues where there are regulatory concerns, we reiterate our confusion as to the FSAqs intent in respect of tranche protection trades. We are concerned that discussions are progressing internationally on this issue on the basis of analysis that may not have fully taken account of all the relevant issues.

Regulatory objective: Firms appreciate the need to consider significant risk transfer (SRT) when determining the amount of capital relief retained from traditional and synthetic securitisation transactions. However, we do not understand the regulatory concern that the letter seeks to address. As stated in the letter and in our discussions, the current framework, as set out in BIPRU, allows firms to take capital relief commensurate to the risk transferred in line with the economic substance of the transaction, and we agree that approach is appropriate. This allows firms to take even very modest amounts of capital relief where risk is transferred.

The letter suggests that premiums paid should be netted against risk transferred. We do not agree that SRT is a function of premium levels, these are two separate economic events and

should be analysed separately. The premium for a synthetic transaction will depend on a number of factors, the expected loss on the tranche protected, a premium for the protection seller and market conditions. In adverse conditions, or where a credit is perceived as particularly risky, the premium is likely to be high. It does not mean that the risk has not been transferred; merely that, at that point in time for that credit, the cost of transferring that risk is relatively high. The value of that transaction to the purchaser, and the acceptability of the premium charged, will depend on the position of the firm and will be a commercial decision for that firm. There is no one right price for risk, as that would require complete foresight of events. Risk and uncertainty are inherent in trading markets. The letter would seem to suggest that the amount of risk transferred will depend on the state of the market at a given point in time, i.e. less risk can be transferred in adverse market conditions, when premiums are higher, than in more benign times, when premiums are generally lower. That approach would imply that protection can only be recognised when it is ±out of the moneyq and not when it is ±at the moneyq We think that this result is an inappropriate outcome.

Unclear scope of the securitisation framework: We are unclear as to the scope of BIPRU 9 as a result of this letter, which appears to suggest a change in approach by the FSA as to basis of determining securitisation transactions. Section B, for example, indicates that untranched transactions may be regarded as securitisation transactions. Section E also identifies the potential to bring similar credit protection arrangements and trading book transactions within that scope. Previously it had been our understanding that the FSA were taking a pragmatic approach and not specifically looking for transactions to bring within BIPRU 9, i.e. that firms could make a sensible determination in line with the definition in the BIPRU glossary. On the basis of the letter it is now increasingly unclear where the FSA intends to draw the boundary. For example, purchased receivables often include an element of seller retained risk. However, since they have a specific treatment under the capital framework they have not been assumed to be securitisation transactions. Taken to the extreme, any corporate that issues both senior and subordinated debt, or both debt and equity (i.e. anything with a capital structure), could be potentially regarded as within the securitisation framework and subject to the analysis outlined. We would like to discuss further the FSAqs views on what distinguishes a securitisation from other exposures.

Unclear parameters: While we appreciate that there is a tension between providing clarity and establishing principles based requirements to avoid arbitrage. We found the examples of issues in the letter difficult to interpret; in particular in sections B, on the impact of premiums, and section C, relating to incentive for the protection buyer to call the transaction. We appreciate that some of the issues outlined were discussed in the meeting of 30th March and some further clarity gained. It will be important that the information disseminated at that meeting is made more broadly available to firms to ensure that all are working from the same understanding. However, we still have residual issues in some areas, which we would like to discuss further.

Pre-approval regime: Given our confusion over the proposed approach in the letter, firms believe that pre-approval from the FSA may result for all transactions. Section E ,for example, indicates that firms should approach the FSA at an early stage to avoid unnecessary expenditure and highlights the risk of re-characterisation of transactions where this is not the case. While the current regime relies upon firms undertaking their own assessment of significant risk transfer and for appropriate senior management approvals to be sought, uncertainties arising from this letter will mean that some firms will feel unable to sign off transactions without FSA review because the consequences of a ±wrongq determination could make a transaction uneconomic. Market opportunities can be very short, and the time required for sign off could mean that these are lost. Additional time and resource at firms will need to be factored in to accommodate the additional stage of FSA review. As noted in our response to CP 09/29 we are already concerned by the additional waiver and notification requirements that are being brought in and whether the FSA has sufficient resource to address them. This letter will put further strain on FSA resources, particularly as it is not clear as to whether the FSA expects firms to re-analyse all their extant

transactions to determine whether any of the features mentioned are included and to reassess SRT for these transactions and submit that analysis to the FSA.

Senior management sign off: We seek confirmation from the FSA that the letter is not intended to require different sign off procedures for tranche protection trades relative to other types of transactions. Sign off limits will be determined by the firm in accordance with risk appetite and materiality levels.

Status of the FSA letter and next steps: In our view the letter represents a significant reinterpretation of BIPRU, and it is unclear how it relates to the current rules and guidance, CP09/29 or ongoing international discussions, and as such the letter is of ambiguous status. Without Handbook text, material uncertainties are created for firms regarding the status of current and future transactions. Some firms will therefore feel compelled to seek pre-approval on all transactions potentially within the scope of BIPRU 9

We understand that the FSA intends to amend BIPRU in this area if international agreement for change is reached. As such we would appreciate further clarity on the status of the FSA letter. As regards international discussion, we believe that it would be helpful if the Basel Working Group addressing this issue engaged with the industry, so that practitioners are able to explain the basis for these transactions and how firms approach the question of significant risk transfer.

2 Detailed response

A Objectives of the current regulatory framework

We understand that firms must undertake a robust analysis to determine whether significant risk transfer has been achieved, and that this assessment will take account of economic substance, not just legal form. However we have a number of questions in relation to this section of the letter:

- We are confused by the reference to ±economic riskqon page 2. Should this refer to credit risk? If not, how should ±economic riskqbe determined, should this be done through economic capital models or the supervisory formula approach?

- We do not understand the footnote on page 2, please could clarification be provided.

B Regulatory capital assessment: impact of premiums

As noted in the key messages, premiums will be determined by a number of factors and will vary over the economic cycle. In our view, sensible risk management practice would suggest that it can be worth purchasing synthetic credit protection even when premiums are high because of economic conditions and because a credit is perceived to be particularly risky. Suggesting that significant risk transfer is a function of premium level will discourage credit risk mitigation on assets with higher credit risk or gives the impression that protection will only be valid in the most benign economic conditions. Principle 3 requires that ±a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systemsq The fact that a premium is paid upfront, or agreed upfront, and then spread over a period, according to accounting convention, should not undermine the basic function of the transaction, which will be to provide certainty on a particular outcome. Not recognising the function provided by these transactions disregards the fact that the timing of losses matters and that the removal of uncertainty from the balance sheet has an inherent economic value. Further, it is not aligned with BIPRU 9.3.4G, which indicates that firms should use methods for assessing SRT that are consistent with their internal processes to assess risk transfer. We do not think that this is an appropriate outcome

Further, the premium will, over time, reduce tier 1 capital as it is an expense in the profit and loss account. Essentially the letter would appear to be arguing for cash accounting of all expenses, and that accrual accounting is unacceptable. The imposition of cash accounting is at odds with GENPRU 1.3.4 and the suggested treatment of premiums departs from the valuation basis in the rest of BIPRU and GENRPU.

We understand from the meeting that the FSA is concerned about upfront premiums being paid and that some element of risk adjusted pricing is sought that reflects amortisation and losses. This would seem to suggest that for risk transfer to be achieved, not only must the cost of protection not increase (BIPRU 9.5.1(4)(d)) as a result of credit deterioration but that it must actually decrease. We do not believe that this extension to the requirements is necessary. We would note, however, that the FSA did recognise at the meeting on 30th March, that rebates may serve to achieve the payment structure that the FSA is seeking.

We also do not think that linking the cost of protection to the spread achieved on the underlying assets is a good test to determine whether risk has been transferred. Credit pricing is a complex business that involves both risk assessment and relationship management. For example, certain exposures may be priced low in relation to the risk inherent in them given wider relationship issues. .

We also have a number of questions in relation to this section of the letter:

- Bullet 3 states ±where the protection buyer retains the expected loss through higher transaction costs to the counterpartyq Higher relative to what? Please explain this bullet.

- The last paragraph states ±Where the transaction has no explicit tranching, but the terms (e.g. guaranteed premium) economically result in there being an implicit retained position or economic tranching the transaction should be treated as a securitisation under BIPRU 9q Does this mean that the FSA regards all upfront premiums as first loss tranches? In which case does the FSA regard the single name credit derivative market to be within the scope of BIPRU 9, as market convention requires upfront premiums? Additionally, given that a key objective of the G20 is to reduce risk in the system, what treatment would the FSA envisage for centrally cleared credit derivatives, where upfront premium is likely to be mandatory? Would other transactions such as options, guarantees and insurance, where this practice is also common, be captured?

- If premiums are to be taken into account and these are payable over future periods, would the present value be taken into account? It would seem appropriate to take account of the time value of money. and since the transactions have loss absorbing characteristics, it would seem appropriate to discount on the basis of the firmqs cost of capital.

C Incentives for the protection buyer to call the transaction

We believe that BIPRU is already quite clear about how maturity should be defined where there is an incentive to terminate. We understand from the meeting on the 30th, that ±at market unwindsqwas intended to refer to arrangements that pre-define a formula, related to the performance of the underlying exposures, or the use of pre-determined discount rates, for determining the price rather than arrangements where a dealer poll is involved. This clarity is helpful.

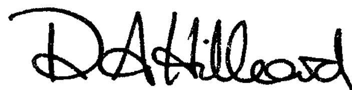
E Application to similar transactions and reporting to the FSA and the market

As noted in our key messages, and in the sections above, we are concerned that the boundary to the securitisation framework is now very unclear. We appreciate that the FSA

has identified issues in relation to particular transactions that it believes are of concern and that these issues may have broader application. We agree that when the FSA identifies issues that these should be reviewed and assessed. However, we are concerned that initial conclusions from the review are being imposed on the industry at large when the issues have not been fully ±bottomed outq thereby creating regulatory uncertainty for the industry as a whole. This lack of clarity is likely to lead to a significant increase in consultations with the FSA in relation to both new and existing transactions, as firms will not feel confident in making their own assessments given the consequences of arriving at the ±wrongqanswer. As a result there is a risk, in light of the increased requirements introduced in CP09/29, that there will be insufficient resource to deal with the demand. We therefore seek further clarity from the FSA in respect of its expectations of firms in relation to existing transactions (grandfathering etc), new transactions and assurances that it will have the resources capable to meet FSA service standards.

We look forward to further dialogue between the industry and the FSA on the issues identified in this response. If you have any comments or questions regarding this letter in the meantime, please contact Diane Hilleard at AFME (diane.hilleard@afme.eu), Irene Graham at the BBA (Irene.graham@bba.org.uk), or Antonio Corbi at ISDA (acorbi@isda.org).

Yours sincerely



Diane Hilleard
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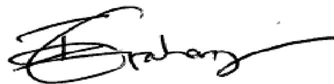

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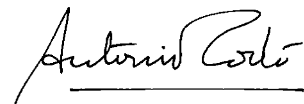

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