BNP PARIBAS

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Secretariat of the Basel Committee on Banking Supervision
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Submitted via email: baselcommittee@bis.org

BNP Paribas' Response to Consultative Document on Recognising the cost of the credit protection purchased

To the Members of the Basel Committee:

BNP Paribas appreciates the opportunity to comment on the Basel Committee's Consultative Document, "Recognizing the cost of the credit protection purchased". BNP Paribas is providing hereby a response to the consultation but also fully supports the response provided by the French Banking Federation, to which BNP Paribas contributed.

BNP Paribas recognizes the importance of a sound credit risk mitigation (CRM) regulatory framework for correctly addressing risk management processes and adequately supervising the significance of the risk transfer. Effective credit risk management is critically important because of its role in supporting financial institutions' ability to lend. CRM techniques enable banks to manage their loan books (vanilla and structured finance) dynamically and to continue their lending activity while managing their cost of risk.

Therefore, due consideration should be given in addressing these issues from a regulatory standpoint. While BNP Paribas supports the goal of the BCBS's Consultative Document for ensuring that all CRM techniques are sound and represent effective risk management tools, we would like to express below several important concerns regarding the approach proposed in the Consultative Document.

1. SUMMARY OF KEY POINTS

BNP Paribas believes that the Committee's initial focus was to tighten the Significant Risk Transfer (SRT) criteria on synthetic securitisations, and that it has evolved into a much broader proposal threatening the banks' entire risk management operations, as well as a large part of their financing businesses. The Consultation Document proposes to capture most banking transactions from retail to corporate and investment banking activities, where a bank seeks to hedge day in, day out, the borrower's credit risk or the associated counterparty risk, with guarantees and credit derivatives.

PRINCIPLES

The proposal to take into account the present value of credit protection costs in the assessment of the regulatory capital, regardless of accounting rules, is a major shift from the current Basel Regulatory Capital framework. BNP Paribas considers that it is inappropriate as RWAs are assumed to cover unexpected credit losses, not future costs or income. This change in the principles and objectives of regulatory capital that is implied by the Proposal has potential ramifications that go far beyond the specific issue addressed on the (CRM) framework .

BNP Paribas expects the rules to be unambiguous in the scope of the credit protections concerned by the Proposal, as well as their implementation by national regulators. It seems contradictory with the Consultative Document. The core proposal of modifying articles 189, 554, and 555 is to create an additional capital charge on all guarantees and credit derivatives where the underlying asset's risk weight is greater than 150% in the absence of credit protection. The technical guidance waters down the Proposal with a great level of flexibility given to national regulators leading to potential divergence of application: the possibility, on an optional basis, of full recognition of the underlying asset's spread income may fully offset the capital charge defined in the Proposal.

BCBS proposes to strip the different components of individual financial transactions on both the assets (gross income net of funding and other relevant costs) and the protection (costs without benefits). This principle is new and seems contradictory with basic accounting and reporting principles It will require significant system developments and operational burden, while resulting in increasing the gap between the accounting and the regulatory framework.

SCOPE

BNP Paribas strongly believes that the scope of application is too wide:

- On synthetic securitisation, the specific issue of SRT on some abusive transactions has been addressed on BCBS NL 16 "High cost credit protection"[1]. While BNP Paribas supports the exposed provisions, they might be completed and their implementation by national regulators should be harmonized through detailed guidelines under Pillar 2
- Traditional securitisation should be out of scope (no point in amending article 554)
- Loans where the credit protection is bought at origination should be explicitly outside the scope as the protection is embedded in the transaction and the protection costs are taken into account in the initial pricing of the asset (even though the future costs are not recognized in earnings). It will avoid potential dramatic impact on bank's core financing businesses such as trade finance, export finance, SME lending, project finance, etc.
- With regards to guarantees and credit derivatives that are not synthetic securitisations (i.e. single asset credit protection contracted during the life of the asset), it appeared during the consultation period that the industry participants had different interpretations about the applicable perimeter and struggled to identify the targeted abusive transactions. The technical guidance introduces more uncertainty than it

[1] BCBS newsletter No 16 – "High cost credit protection", December 2011

adds clarification to the Proposal[2]. Should BCBS intended to address CRM techniques, BNP Paribas recommends to open a dedicated consultation with a clarification on the types of transactions that are raising concerns and that should fall in the scope of the Proposal.

UNINTENTED CONSEQUENCES OF PROPOSED RULES

- The objective of international convergence is not achieved: for example, the 3 options for recognising spread income lead to very different outcomes, ranging from full deduction of the present value of credit protection costs discounted at the risk-free rate to no deduction at all.[3]

- Applying a Pillar 1 capital charge based on premiums' present value for CRM related transactions could cause major disruptions to the financing of the real economy as the regulatory cost of all CRM techniques will increase; moreover:

    - The proposed rules introduce cliff effects when having a RWA threshold;

    - A large number of legitimate and desirable risk management transactions that are truly intended to mitigate unexpected losses would be discouraged;

    - It may prevent banks from making sound risk management decisions;

- It may have a pro-cyclical effect as it will discourage banks from hedging assets whose credit quality has deteriorated. The operational burden for banks as well as regulators would be huge as new parameters that are not part of the existing risk architecture would have to be factored into the computation of regulatory capital and an on-going monitoring should be implemented with no value-added. As the concepts proposed by BCBS are new, they are not computed so far within the banks, and will require significant system developments and generate operational burdens for the banks: the overall costs and burden seem disproportionate compared to the amounts at stake.

[2] Page 12: "credit protection costs may be taken as zero. This may arise, for example, where a bank purchases credit protection for a loan at origination and the cost of protection is less than the spread income on the loan".

[3] These options are not included in the core proposal as they only appear in the Technical guidance.

2. CONCERNS ABOUT THE CONSULTATIVE DOCUMENT

BNP Paribas provides below an in-depth analysis that underpins the aforementioned key points as well as BNP Paribas's final conclusion.

2.1. Up-front recognition of the present value of credit protection costs as a Pillar 1 component: a dangerous shift from the Basel's regulatory framework

2.1.1. Considering the delay in recognizing credit protection costs into the risk-based capital framework – a consistent approach?

First and foremost, BNP Paribas strongly believes that taking into account the present value of credit protection costs assessment of a bank's solvability would be inadequate and inconsistent with the overall regulatory framework.

Such an approach would constitute a major shift from the current Basel III framework. Regulatory capital requirements - either through assets risk weighting or through prudential deductions from accounting own funds – are indeed designed to absorb unexpected losses, whereas expected losses are taken into account in the balance sheet through provisioning, when an asset becomes impaired.

In BNP Paribas' view, credit protection costs do not constitute unexpected losses and should therefore not result in an adjustment of capital requirements at the time the transaction is booked.

The Consultative Document's main concern is linked with a situation when "(i) there is a delay in recognizing the cost of protection in earnings while (ii) the bank receives an immediate regulatory capital benefit…" BNP Paribas does not see the incoherence with such a concept. For example, when a bank issues a subordinated debt, it gets an immediate upfront capital benefit in the form of higher level of capital to support its businesses, when the associated costs are recognized through the life of the subordinated debt. The same situation can happen when a bank purchases a credit protection. Its cost paid through time merely reflects the compensation to the protection seller for the risk taken continuously over the life of the protection.

2.1.2. The key concern is to assess when there is a lack of SRT or an ineffective CRM

In BNP Paribas's view, the cornerstone issue is whether a transaction achieves effective SRT (in the case of synthetic securitisations) or credit risk transfer (in the case of single names corporate exposure). Therefore, the primary issue consists in appropriately defining SRT's evaluation criteria (for synthetic securitisation transactions) and effective credit risk transfer criteria for all the others CRM transactions. The regulatory recognition of the effectiveness of a credit protection is not strictly limited nor closely linked to the question of valuation of credit protection costs.

From a regulatory capital perspective, a more efficient solution, with no unintended consequences on the consistency of the RWA Basel framework would be the disallowance of the SRT or the non-recognition of the CRM effect in the case of an arbitrage transaction.

BNP Paribas shares the objectives of the Consultative Document of properly addressing concerns about regulatory arbitrage.

The Consultative Document follows the newsletter issued by BCBS in December 2011 on “High-cost credit protection” that aimed at shutting down arbitrage opportunity, with a perimeter focused on synthetic securitisations. This initial paper aimed at addressing a specific issue on some synthetic securitisations where the relevance of SRT could be questionable. It is worth noting that these cases have been limited compared to the overall securitisation market. However, for avoiding any potentially abusive securitisation transactions, BNP Paribas supports the view of the BCBS that the SRT test on synthetic securitisation should be strengthened and the analysis should incorporate credit protection costs, among the other criteria mentioned in the December 2011 Statement. BNP Paribas believes that a case-by-case transaction analysis is the best way to conduct a meaningful assessment of the SRT. **If the analysis concludes that the transaction enables a significant risk transfer, BNP Paribas considers that the credit protection costs should not affect the regulatory capital requirements.**
Symmetrically, for securitisation transactions having little or no transfer of credit risk due to “high cost credit protection” issues, the disallowance of the SRT appears to be a firm and consistent approach for tackling abusive practices.

2.2. Scope of the proposal

The BCBS states in the consultative paper that “despite the current Pillar 2 provisions in the Basel framework to address the appropriateness of protection recognized against certain exposure […] there exists potential for capital arbitrage within the CRM framework.” This statement needs clarification.

Following BCBS NL 16, the Consultation Document **extends the scope** beyond **(i)** the **securitisation perimeter** based on the same principle (upfront recognition of the cost of the protection) and **(ii)** beyond the “**high-cost** credit protection issue” (ie recognizing the **cost** of credit protection)

The proposed regulation potentially covers all traditional CRM techniques, including the use by banks of guarantees, public or private credit insurance, single-name CDS as well as synthetic securitisation. Thus, the Proposal potentially applies to a number of structured finance transactions having an important role in financing the real economy (e.g. trade finance, export finance, SME lending, project finance) with a risk weight (RW) greater than 150% in the absence of credit protection. For some of these transactions involving the markets for insurance products or other guarantees, credit protection is a component of a transaction (e.g. for export finance transactions): underlying risk is generally high and loans are granted by the bank subject to confirmation of a guarantee by the relevant Export Credit Agency and credit protection costs are deducted from the revenues).

BNP Paribas believes that the proposed enlarged scope is **too wide** and the industry participants have different interpretations about the applicable perimeter. The Technical guidance introduces more uncertainty than it adds clarification to the proposal[4]. We urge the committee to reconsider the level of discretion left to the national supervisors[5]. Several examples in the Technical guidance do not seem realistic which makes it unclear what types of transactions seen in the market have actually raised or continue to raise regulatory concerns**.** The aim of the Proposal is to capture "arbitrage" transactions: however, they are not clearly defined, and the BCBS 245 only provides a single potential abusive transaction on credit risk transfer through CRM techniques.

Also, the 150% RW criterion can trigger the application of the Proposal for covered financing transactions for many counterparties located in risky countries. Under a downturn economic environment, these counterparties are more sensitive to market conditions 'deterioration whilst the additional regulatory capital charges related to credit protection costs would negatively impact the bank's ability to provide them financing solutions. Consequently, the proposed rules would have a highly pro-cyclical effect, worsening the economic downturn. They potentially create an incentive for banks to finance only the best rated borrowers whose risk weight is likely to remain below 150%.

This example clearly shows that the 150% RW criterion fails to provide clear evidence of no risk transfer whilst the extension of scope of the Proposal beyond the synthetic securitisation perimeter leads to negative and unintended consequences.

For hedging transactions settled from a sound risk management perspective (that underpins on formal approval and control processes conducted by risk department and management staff), BNP Paribas would like to underscore that risk management decisions (thus hedging or purchase of credit risk protection) are not linked to historical pricing conditions. Banks have their own rules to assess credit protection costs: they usually use "break even" type of indicators which are macro, marginal and also depend on the timing of the hedging decision rather than on the historical conditions on the assets. Thus, "credit protection costs are subjective and vary through time depending on market conditions.

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[4] E.g. page 12 "*credit protection costs* ***may be taken as zero****. This may arise, for example, where a bank purchases credit protection for a loan at origination and the cost of protection is less than the spread income on the loan*".

[5] Loans where the protection is bought at origination should be explicitly outside the scope

2.3. UNINTENTED CONSEQUENCES OF PROPOSED RULES

Applying a Pillar 1 capital charge based on premiums' present value for CRM related transactions would lead to the following likely unintended consequences:

- The financing of real economy would be significantly disrupted if the regulatory cost of all CRM techniques is increased;

- The proposed rules would have a highly negative pro-cyclical effect on bank financing and capital: when credit risk is high (and likewise cost of protection), banks must be able to hedge without being penalized on top of that in capital. The proposed deduction of the present value (PV) of the premium from capital will make it impossible for banks to manage the risk in crisis times (when cost of hedging increases in the market as well as banks' the cost of funding, banks cannot be penalized by additional reduction of capital). Different layers for significant capital buffers have already been incorporated in Basel 3 framework.

- A large number of legitimate and desirable risk management transactions that are truly intended to mitigate unexpected losses would be discouraged;

- The operational burden for banks as well as regulators would be huge as new parameters that are not part of the existing risk architecture would have to be factored into the computation of regulatory capital and an on-going monitoring should be implemented with no value-added;

- Banks may have adverse incentives to discontinue hedging low-revenue assets as well as lower-quality assets, with potential adverse effects on financing. They raise operational issues: for instance, it is operationally difficult to track the revenues on the assets as (i) they may not be reported in the risk management system and (ii) they may have a very complex structure: upfront vs running margin, drawn and undrawn part have different margins, dependence on financial covenants. Furthermore the implementation of credit protection is generally under the responsibility of independent teams that do not have access to full client information due to compliance constraints.

3. BNP Paribas' proposal

BNP Paribas feels that the Proposal in its current form has major implications with regards to banks conducting their risk management and hedging policies, and creates a major change of paradigm in the way the capital is computed in the Basel framework, whilst the real concern stems from a very limited number of targeted transactions. Besides, it fails to ensure convergence across jurisdictions.

<u>In terms of scope</u>, BNP Paribas proposes that BCBS focuses on synthetic securitisations and withdraw the Proposal for all credit risk transfer transactions falling under the scope of Pillar 1/ CRM framework. Should the CRM framework for single name protection be modified, BNP Paribas recommends that BCBS should explicitly exclude specific transactions such as Export finance, trade finance, project finance, and SME's financing where (i) CRM techniques are used at inception and are a component of the transaction
If the BCBS decided to maintain the Proposal, it would be essential to see its scope of application clarified and narrowed to more precisely identified areas of concern.

Therefore, prior to implementing such a Proposal the BCBS should provide real examples of credit risk transfer transactions where the current CRM framework failed to single out "arbitrage" transactions or where the risk transfer is questionable. Clarification is required as to the accounting treatments for which the BCBS is considering to apply the Proposal:

- o Hedge and related assets marked to market and held at fair value
- o Hedges marked to market and related assets not marked to market
- o Hedges and related assets both not marked to market

In terms of the architecture of the framework, BNP Paribas's position is the following:

- **For synthetic securitisations: favor Pillar 2 supervision over more stringent formulaic Pillar 1 capital rules**

While BNP Paribas does not support the Pillar 1 approach proposed in the Consultative Document, BNP Paribas would like to point out that it provides a lot of flexibility to national regulators in implementing the rule. This would lead to inconsistent implementation across jurisdictions, with various impacts in RWA across countries, and subsequently to level playing fields issues, results that are contradictory with a Pillar 1 approach.

BNP Paribas agrees that the specific SRT issue on some synthetic securitisation has been addressed by the BCBS NL 16 and its implementation by national regulators could be strengthened and harmonized through detailed guidelines under Pillar 2. In BNP Paribas's view, a more effective way to address BCBS's concerns for identifying and penalizing abusive transactions, is to reinforce and refine the criteria that might indicate either a lack of SRT (under Pillar 2) This will allow avoiding complex and arguable Pillar 1 calculations for high number of transactions which are clearly not abusive from a significant or credit risk transfer standpoint.

The banking industry could provide regulators and supervisory authorities with views on meaningful, appropriate or significant qualitative criteria, risk factors, processes, validation or control mechanisms used for risk management purposes and that could enhance CRM/SRT framework (should BCBS showed interest in this proposal).

BNP Paribas believes that prior implementing a new regulatory framework, clarification needs to be brought on whether past concerns occurred because of (i) effectiveness of enforcement or (ii) lack of consistent application guidelines or (iii) in both. In any case, due consideration should be given by the BCBS in formulating appropriate and consistent application guidelines in order to ensure the effectiveness of the enforcement across jurisdictions.

- **For non-securitisation corporate exposures: tighten the existing Pillar 1 CRM criteria, while the credit protection costs should not be taken into account in determining the level of capital for a hedged transaction**

If the BCBS has concerns on specific transactions under CRM framework other than synthetic securitisations, BNP Paribas recommends opening a dedicated consultation with a clarification on the types of transactions that are raising issues and that should fall in the scope of the proposal.

4. CONCLUSION

Considering the potential magnitude of the impact of this Consultative Document, BNP Paribas urges the Committee Members to provide the industry the opportunity to explain their position during a face to face meeting with the BCBS working group, along the lines of recent meeting on BCBS's Consultative Document "Revisions to the Basel Securitisation Framework".

Annexes

High cost issues and Spread income

While in practice, the high cost issue actually exists only on some very specific synthetic transactions, BNP Paribas does not consider that the scope should be extended to single-name protections.

BNP Paribas would like to point out that a bank has not an economic interest for buying a high cost protection. In addition, the buyer will be penalised if the cost of the protection is too high through negative impact in P&L. For instance, if a bank pays for a protection measured on fair value, the premium (upfront + PV of running coupons) shall equal to the present value of expected losses of the covered transaction. If the premium is overestimated, the Mark to Market of the transaction for the bank will be negative as of day one and will impact immediately the earning of the bank (hence the capital). At inception, hedging transactions already take into account the cost of protection, which is offset by the value of the protection benefit if the hedge is put in place at the fair market price.

Confusion seems to be made between credit protection costs and the value of the credit protection which should take into account the costs and the benefit of the protection (for the BCBS, the spread income on the asset seems to be a proxy of valuation of the benefit of the protection).

Regarding the spread income, the three options proposed in the CP are very different which raise questions about the rationale and the soundness of the approach. All three options are also very difficult to implement operationally.

Sound risk management involves assessing the pros and cons of hedging by comparing the cost and the benefit of protection (in a CDS it is the protection leg vs the default leg; the income on the asset does not enter into consideration).

150% RW criterion and arbitrage assessment

The riskiness of the transaction (RWA > 150%) is not an adequate test: we can argue that higher risk weight would correlate with higher premiums but in such case the high level of premiums would systematically be seen as regulatory arbitrage?

In addition, as already shown above, the 150% risk weight criterion fails to provide clear evidence of no risk transfer.

Accounting versus Regulatory considerations

Following the analysis of some of the examples calculations provided in the Consultative Document, BNP Paribas seeks clarification should the Proposal aims at fixing accounting issues (e.g. capturing Expected Loss?).

If the accounting framework is deemed inadequate for certain assets described in the Consultative Document numerical examples, BNP Paribas considers that it should be addressed by accounting adjustments and not changes to regulatory framework.

The impact of future accounting rules (such as IFRS 9 and equivalent US accounting rules) should be contemplated by the BCBS before considering enforcement action of this proposal.