



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Press release

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The Basel Committee issues a statement on high cost credit protection

Recent transactions have raised concerns among supervisors about potential regulatory capital arbitrage related to some credit protection transactions. Given the supervisory concerns related to such transactions, this statement is intended to alert banks that supervisors will closely scrutinise such transactions in both the specific context of the evaluation of credit risk transfer within the securitisation framework, as well as within the broader context of the Basel Pillar 2 supervisory review process and assessment of capital adequacy.

Background

The Basel capital framework recognises that credit risk mitigation techniques can significantly reduce credit risk and can serve as an effective risk management tool. In particular, paragraph 140 of the framework establishes that where guarantees or credit derivatives are direct, explicit, irrevocable and unconditional, and supervisors are satisfied that banks fulfil certain minimum operational conditions relating to risk management processes, banks may take account of such credit protection in calculating capital requirements.

Nevertheless, the Committee notes that there exists potential for capital arbitrage within the credit risk mitigation framework, including the use of credit risk mitigation for securitisation exposures, particularly when (i) there is a delay in recognising losses and the costs of protection in earnings while (ii) the bank receives an immediate regulatory capital benefit in the form of a lower risk weight on an exposure on which it is nominally transferring risk. In some instances, the premiums or fees and other direct or indirect costs paid for certain credit protection, combined with other terms and conditions, call into question the degree of credit risk mitigation or credit risk transfer of the transaction. Rather than contributing to a prudent risk management strategy, the primary effect of these high-cost credit protection transactions may be to structure the premiums and fees so to receive

favourable risk-based capital treatment in the short term and defer recognition of losses over an extended period, without meaningful risk mitigation or transfer of risk.

For example, consider a bank that purchases credit protection on a first-loss retained securitisation position where the cost of protection is equal to the recorded value of the securitisation tranche on which protection is being purchased or where the terms and conditions of the contract ensure that the premiums paid throughout the life of the contract will equal the amount of the realised losses. Regulatory capital arbitrage may exist where the immediate capital relief recognised for credit protection purchased ultimately will be offset by the premiums paid and recognised in earnings over the life of the contract.

While the example above focuses on the use of credit risk mitigation in a securitisation transaction, arbitrage opportunities exist more generally under the credit risk mitigation framework. However, arbitrage opportunities are more likely to occur when credit risk mitigation techniques are used for securitisation transactions, where the difference in the risk weight before and after buying protection can be very large.

Supervisory Response and Areas of Heightened Concern

In response to these concerns, the Committee is clarifying that supervisors will consider the cost of credit protection that has not yet been recognised in earnings when assessing whether credit protection purchased should be recognised for purposes of regulatory capital, including whether a bank meets the Basel standards for significant credit risk transference within the securitisation framework contained in paragraphs 554(a) and 555(d) of the Basel comprehensive framework. In order for exposures to be de-recognised for risk-based capital purposes under the securitisation framework, significant credit risk associated with the securitised exposures must be transferred to third parties. Material costs of credit protection should be considered in this analysis.¹

More generally, banks and supervisors should consider the relevant costs of protection purchased – whether in the context of the Basel securitisation framework or within the credit risk mitigation framework – when assessing a bank’s capital adequacy. Furthermore, banks should analyse and document the economic substance of credit protection transactions that have unusually high-cost or innovative features to assess the degree of risk transference and the associated impact on the bank’s overall capital adequacy. Banks should bring to the attention of their supervisor any innovative positions which fall under this guidance to ensure they are subject to appropriate prudential treatment. The analysis also should specify how the transaction aligns with the bank’s overall risk management strategy.

In evaluating the degree of credit risk mitigation or credit risk transfer of a transaction, banks should consider, and supervisors will assess, the following factors, among others, as applicable:

¹ For example, in the assessment of significant credit risk transference under paragraphs 554(a) and 555(d), supervisors should consider these unrecognised premia as a retained position. These premia could be quantified for purposes of such an analysis in a number of ways, including through an appropriately conservative present value calculation.

- A comparison of the present value of premiums and other costs not yet recognised in capital relative to expected losses of the protected exposures over a variety of stress scenarios;
- The pricing of the transaction relative to market prices, including appropriate consideration of non-cash premium payments;
- The timing of payments under the transaction by the protection buyer, including potential timing differences between the bank's provisioning for or write downs of the protected exposures and payments by the protection seller;
- A review of applicable call dates to assess the likely duration of the credit protection relative to the potential timing of future credit losses;
- An analysis of whether certain circumstances could lead to the bank's increased reliance on the counterparty at the same time that the counterparty's ability to meet its obligations is weakened;
- An analysis of whether the bank can prudently afford the premiums given its earnings, capital, and overall financial condition; and,
- A review of any internal memos or records outlining the rationale for the transaction and the bank's analysis of the anticipated costs and benefits of the transaction.

Supervisors also should focus more attention on credit protection transactions that exhibit the characteristics noted below.

- Protection premiums are high relative to the amount of the exposures being protected - for example, when the cost of protection over the life of the protection contract approaches equals, or exceeds, the amount of the exposures for which protection is being purchased. Rebate mechanisms (ie where the protection seller agrees to refund parts of the premium to the protection buyer according to the performance/deterioration of the protected exposure) are an indication of excessive premium and, consequently, regulatory arbitrage.
- Transactions where the exposure being protected has not been fair valued and losses on the exposure have not been recognised in earnings. This situation can increase the potential for a transaction to involve regulatory capital arbitrage in the form of deferral of loss recognition.
- Transactions where the potential for reduction in risk weights or regulatory capital as a result of the transaction is greatest. This is most likely in transactions where the exposures for which protection is purchased would otherwise be assigned a high risk weight, for example, exceeding 150%. Nevertheless, the potential for arbitrage still exists for relatively lower risk-weighted reference exposures, and supervisors may also need to focus on individual transactions level that raise concerns due to unique deal features.
- Protection premiums are not proportional to the exposures being protected. This can occur, for example, when (1) premiums are guaranteed over time without respect to write-downs or default of the reference exposure (that is, the premium payments are not a proportion of the amount of still performing positions of the protected portfolio), or (2)

upfront premiums or premiums payable at termination have not been recognised in retained earnings.

- Structural features of the transaction that can increase the total cost of credit risk mitigation. These features can include: high transaction costs for the protection buyer; obligations of the protection buyer to the counterparty to post additional collateral; additional payments at maturity required of the protection buyer; and, early termination of the transaction at the option of the protection buyer. Other features that should lead to increased scrutiny include pre-agreed mechanisms, for example 'at-market unwinds', where the protection seller and protection buyer agree that the transaction can be terminated in the future at an agreed upon 'market' value where calculation of the 'market' value is pre-specified.

Conclusion

The guidance provided above is intended to ensure that the costs, as well as the benefits, of purchased credit protection are appropriately recognised in regulatory and other capital adequacy assessments. These considerations are intended to provide supervisors with the tools necessary to effectively assess the degree of risk transference of certain credit protection transactions, while also providing the flexibility to deal with the variety of transaction structures that have been observed in the market, as well as those that might appear in the future. The Basel Committee will continue to monitor developments with respect to high-cost credit protection transactions and will consider taking a more comprehensive Pillar 1 approach to these transactions.

About the Basel Committee

The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. It seeks to promote and strengthen supervisory and risk management practices globally. The Committee comprises representatives from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. Observers on the Basel Committee are: the European Banking Authority, the European Central Bank, the European Commission, the Financial Stability Institute and the International Monetary Fund.