



March 9, 2011

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SUBJECT: IACPM Response to Exposure Draft ED/2010/13

The IACPM (International Association of Credit Portfolio Managers) is an industry association established in 2001 to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest. Currently, there are over 90 financial institutions worldwide that are members of the IACPM. These institutions are based in 14 countries and include many of the world's largest commercial wholesale banks, investment banks and insurance companies, as well as a number of asset managers.

Exposure Draft Response

In our initial submission on June 28, 2010, the IACPM outlined some of the issues raised by attempting to apply current accounting standards to the business practises banks use regarding the Credit Portfolio Management (CPM) of their corporate loan books. We believe that much of that earlier commentary remains pertinent and we refer you to that letter for background to the current submission. We've attached a copy of that letter as an appendix to this submission.

On December 13, 2010, the IASB released an Exposure Draft on Hedge Accounting which included several questions to which the board was seeking comment. This submission intends to address the following of those questions:

ED Question 1:

Do you agree with the proposed objective of hedge accounting? Why or why not?
If not, what changes do you recommend?

ED Question 4:

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

ED Question 6:

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you

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think the requirements should be?

ED Question 7:

- (a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?

ED Question 15:

- (a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?
- (b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?

In addition, during various subsequent communications between the IACPM and IASB staff and board members, we have been asked to address the following more detailed points:

IACPM Question 1:

Does alternative 3 create risks of “earnings management” by banks?

IACPM Question 2:

Why is hedge accounting generally seen as an impractical solution for credit hedges of floating rate corporate loans? More specifically,

- (a) Why is it difficult to measure the credit risk component of loans to the standards of the current hedge accounting requirements?
- (b) Are there ways to streamline the measurement of the credit risk component of loans to facilitate greater use of the hedge accounting framework?
- (c) Are there ways to change the hedge accounting requirements to more readily adapt them to CPM business practises?

IACPM Question 3:

What is the motivation for CPM teams hedging loan books?

- (a) How are risk limits determined? Are limit decisions based only on risk considerations?
- (b) Does hedging strategy change as credit conditions change? Or as credit market spreads change?
- (c) Is hedging behaviour constrained by the current accounting framework – either hedge accounting or the fair value option?

IACPM Responses

1. Objective of Hedge Accounting (response to ED Question 1)

As stated in paragraph 1 of the ED, “*The objective of hedge accounting is to represent in the financial statements the effect of an entity’s risk management activities that use*

financial instruments to manage exposures arising from particular risks that could affect profit or loss. This approach aims to convey the context of hedging instruments in order to allow insight into their purpose and effect.”

We agree completely that accounting standards should seek to fairly represent the effect of risk management activities. If risks have been hedged and such hedges reduce the potential for loss in high risk scenarios, financial statements should reflect the impact of the lower net risk position. When hedges are imperfect, the associated gains or losses due to hedge inefficiency should be also presented in financial statements.

With regard to the hedging of credit risk by CPM teams, however, the current standards almost completely fail to meet the IASB’s proposed objective. Under current standards, the financial results of a bank which prudently hedges excess credit risk concentrations will appear significantly more volatile and riskier than those of a bank which takes the same gross exposure without any such hedge.

The Exposure Draft, per se, proposes no changes that would help CPM teams meet this objective. We believe that Alternative 3 (as outlined in paragraphs BC 219-246 of the “Basis for Conclusions” document) should be adopted with the modifications we propose. Failure to do so will preserve an approach which not only fails to represent the effect of credit risk management activities but actually seriously distorts the reported results of our members.

2. Hedging of Risk Components (response to ED Question 4)

In principle we agree that hedge accounting should be available for risk components as well as for the entire fair value of a hedged item. Our members hold various assets, many of which may contain more than one significant risk component. For example, a non-prepayable fixed rate corporate bond contains both interest rate risk and credit risk. As currently drafted (BC225), members may choose to hedge the interest rate risk and leave the credit risk unhedged but not the reverse. We believe that the same flexibility could be applied to credit as a risk component.

We note, as well, that the exposure draft continues the ability to apply hedge accounting on a proportional basis (paragraphs B19-B20 and BC 64) for exposures which are partially hedged. We support this approach as it mirrors the business practises of our members who generally hedge portions of each individual credit risk.

Traditional floating rate, prepayable loans embed a variety of difficult to value options. The IACPM is of the view that the credit risk component of fixed-rate, non-prepayable loans can generally be measured – either directly or as a residual of its other components – and this approach should be adopted by the IASB. Traditional corporate bank loans and loan commitments generally cannot use this approach without substantially greater modifications to the proposed standards. See point 7 below for an elaboration of these points.

3. Hedge Effectiveness Requirements (response to ED Questions 6 and 7)

We welcome the proposal to move towards an objective-based assessment of hedge effectiveness. In particular, we agree with the decision to abandon the 80/125 rule or any variation of this formula.

From a risk management standpoint, most banks would consider that a hedge is effective

based on simple objective criteria. Paragraph BC227 identifies the main qualification criteria. We would encourage the IASB to accept these criteria as objective evidence of hedge effectiveness and as the qualification criteria for Alternative 3 – namely:

- (a) Is the obligor identical in both the hedge and the hedged item?
- (b) Does the hedge protect obligations of the same seniority as the hedged item?

However, the focus on the hedge ratio outlined in paragraphs B33-B39 emphasizes points that may be inappropriate for CPM hedging activities and which may run contrary to basic risk management principles. The explanation for this lies in the different market reaction of credit risk measures in normal times and in times of credit distress.

When an obligor's credit quality is strong, changes in the fair value of the obligor's credit risk will be primarily driven by variations in market credit spreads. The fair value of most credit obligations is measured by the discounted value of the future stream of coupon payments minus the current market spread for that credit risk. So, when market spreads rise or fall in relation to coupon rates, obligations with longer maturities will generally have significantly more volatility than shorter term obligations. This largely reflects the fact that a longer stream of coupon payment differentials is being discounted.

As a result, the fair value of a five-year credit derivative will be roughly 5 times more volatile than a one-year credit derivative, other things equal¹. In this circumstance, the proposals to require measurement and adjustment of the hedge ratio could lead to the interpretation that a hedge ratio of 20% should be used if a five-year credit derivative is hedging the credit risk of a one-year loan. As long as the obligor retains a low risk of default, regular testing would tend to confirm this hedge ratio.

However, most debt obligations – either bonds or loans – are subject to acceleration in the event of default. Acceleration advances the maturities of equally-ranked obligations to the default date and, consequently, all pari-passu creditors are entitled to a pro-rata share of the recoveries from the defaulted obligor regardless of the original maturity of the obligation. In market value or fair value terms, this implies that when credit quality deteriorates significantly and an obligor approaches default, the value of a five-year obligation should converge on the value of a one-year obligation. In most cases, credit markets do exhibit this behaviour.

For this reason, CPM teams and the banks for which they work will normally consider that a credit derivative of 10 million hedges a loan of 10 million, as long as the maturity of the hedge equals or exceeds that of the hedged item. For most hold-to-maturity credit risk exposures, risk management considerations would normally focus mainly on whether a hedge can recover any loss of principle incurred in a default, not on whether the hedge offsets short-term changes in market value.

There are many sound and practical reasons why banks hedge credit risk with derivatives that have longer maturity dates than the underlying loans. The CDS market is most liquid at the five-year maturity. Loans are frequently refinanced and extended in

¹ In most cases, a different credit spread will apply for different maturity points. Bid / Offer spreads will also vary with differential liquidity for different maturity points. Both effects will also contribute to different fair value volatility for obligations of differing maturities.

maturity. The bid/offer costs of unwinding an old CDS to extend its maturity can be substantial – particularly if the remaining maturity of the old CDS has dropped well below the five-year mark. So, short term loans will often be hedged with five-year or longer CDS hedges and banks will cope with the accounting ineffectiveness that results rather than incur the cash costs of more continuously matching hedge maturities to those of the underlying loans. For regulatory and prudential reasons, most of our members would require that hedge maturities always equal or exceed the maturity of the hedged item.

This creates an inherent conflict between different sections of the Exposure Draft. The objective of hedge accounting (1, BC16) is “*to represent in the financial statements the effect of an entity’s risk management activities*”. However, “*the objective of hedge effectiveness assessment is to ensure that the hedging relationship will produce and unbiased result ... and shall not reflect a deliberate mismatch between the weightings of the hedged item and the hedging instrument*” (B29).

We recommend that these objectives be better aligned. Hedges based on sound risk management principles should be recognised as effective even if they do not strictly minimize ineffectiveness or completely reduce bias. If this were done hedge designations would reflect the effects of risk management activity with all ineffectiveness arising from a mismatch in the terms of the hedging instrument and the hedged item being reported in P&L with suitable disclosures.

4. **Preferred Accounting Approaches** (response to ED Question 15b and IACPM Question 2)

- (a) As mentioned in our earlier submission, we believe that accrual accounting of CDS hedges of loans and loan commitments should be permitted. If accompanied by suitable qualification criteria, appropriate provisioning procedures and, possibly, footnoted disclosure of CDS fair value changes, such an approach would best reflect the IASB’s proposed objectives for hedge accounting, particularly when the portfolio is managed primarily on a hold-to-maturity basis. Hedges of investment grade credit risk primarily seek to protect against the infrequent, but potentially costly, impact of an obligor’s default. They are not focussed on managing the day-to-day volatility of traded credit spreads. Accrual accounting would seem to best match the business practises and risk management activities of IACPM members. We would strongly encourage you to consider this alternative.
- (b) However, we understand that the IASB is philosophically opposed to accrual accounting for derivatives of any description. Given this circumstance, the current asymmetric approach can only be improved by modifying either the current hedge accounting standards or the fair value option. For a variety of reasons, we believe that the best choice is to adopt changes to the fair value option largely along the lines of Alternative 3, but with one important change.
- (c) Alternative 3 as currently drafted (paragraph BC240) would introduce a subtle difference in the accounting for loans and loan commitments. In the event that hedging occurs after the origination date of the loan, the initial fair value gain/loss would be recognized on the day the hedge is purchased as a measurement change adjustment. For loans, this amount would be amortized into P&L over the remaining life of the loan. For loan commitments, amortization would be deferred until:
 - i. the loan commitment is drawn and therefore becomes a loan,

- ii. the hedge is discontinued,
 - iii. a provision is taken on the loan or
 - iv. the loan commitment marks back to par.
- (d) As noted in our 2010 submission, most of the risk hedged with credit derivatives is in the form of undrawn loan commitments. While such commitments generally remain largely undrawn, loan commitments are designed to provide our clients financial flexibility and, as such, are drawn occasionally. This can be either for very short-term or seasonal financing requirements or because of changes in a borrower's financial position or credit quality. Whatever the reason, the administrative burden of linking accounting approaches to the daily draw behaviour of our borrowers would undermine much of the benefit of Alternative 3.
- (e) We therefore propose that Alternative 3 be amended such that the recognition of the original fair value gain/loss is treated consistently for both loans and loan commitments. In other words, it should either be amortized in both cases or deferred in both cases but not a mixture of the two. We recommend the amortization approach as it is simpler than the deferral approach.
- (f) To echo the comments on hedge accounting outlined in point 7(f) below, we recommend that fair value measurement be accepted even if it is primarily based on CDS spread levels. Some of the more important sources of the fair value of loans and loan commitment include prepayment options and the cheapest-to-deliver option implicit in CDS can be modelled via statistical approaches. But we do not believe it is relevant or material to require detailed modelling of most other theoretical components of fair value.

5. Complexity of the Proposed Options (Response to ED Question 15a)

- (a) As noted above, we believe that the complexity of Alternative 3 can be reduced by harmonizing the treatment of Loans and Loan Commitments.
- (b) We recognize that even with our proposed revision the approach cannot be described as a simple one. Nevertheless, in reviewing other available options, we do not see feasible alternatives that appear less complex.
- (c) The main alternatives that we see are:
- i. **Accrual accounting** – much less complex but not feasible from an IASB policy standpoint
 - ii. **Current Hedge Accounting approach** – much more complex, less transparent and very difficult to meet old hedge effectiveness requirements
 - iii. **Modified Hedge Accounting approach** (see point 7f. below) – would facilitate the use of hedge accounting, particularly if the hedge effectiveness requirements could also be relaxed somewhat. In our view, however, such an approach would not be materially less complex than Alternative 3.
 - iv. **Doing nothing** – has the advantage of introducing no additional complexity but at the price of retaining accounting standards which distort the performance of CPM hedging activities. This approach would not meet the

IASB's proposed objectives for hedge accounting.

6. Earnings Management (Response to IACPM Question 1)

Regarding the concerns about potential Earnings Management we believe that these concerns are largely mitigated by the following considerations:

- (a) CPM hedging is usually based on established guidelines for the management of capital, concentration or risk levels.
- (b) CPM hedges are normally managed in a separate account from trading book hedging activity. Most CPM hedges are held until the underlying loan matures or is refinanced, unless there is a material change in the criteria that led to the original hedging decision. Turnover in most CPM hedge books is significantly lower than for trading activities.
- (c) To achieve regulatory capital or limit relief, CPM hedges must meet well-defined matching criteria. These criteria are largely mirrored in the eligibility criteria proposed for Alternative 3.
- (d) As noted above, there are substantial friction costs in actively trading off-the-run single-name CDS positions.

7. Issues with current Hedge Accounting Standards (Response to ED Questions 1, 6 & 7 and IACPM Question 2)

- (a) Our understanding of the proposed hedge accounting standards is as follows. According to ED paragraphs 13, 18 and 19, hedge accounting will be permitted if:
 - i. The hedging strategy is formally documented, specifically identifies the risk to be hedged and indicates how meeting the hedge effectiveness requirements will be assessed,
 - ii. The hedging relationship meets the (prospective) hedge effectiveness requirements,
 - iii. The hedged item can be reliably measured.
- (b) We note (ED paragraph 12) that the hedged item may be, among other choices, either:
 - i. a single recognized asset or liability or
 - ii. a portion of the cash flows or fair value of a financial asset or liability
- (c) More specifically, in the case of a fixed rate loan, a bank may chose to hedge the interest rate risk component of the loan and not hedge the credit risk component.
- (d) Once the requirements for hedge accounting are met, the offsetting changes in the hedge and the hedged item are taken into other comprehensive income (with zero net impact) and any hedge ineffectiveness is taken into profit or loss (with a positive or negative impact depending on the level and direction of the hedge effectiveness).

However, any change in the value of the asset unrelated to the hedged risk (i.e. the credit risk component of the fixed rate loan example in the previous point) is ignored. The hedged asset can remain on an accrual basis – only the change in value of a “shadow asset” related to the hedged risk component is taken into other

comprehensive income.

(e) For CPM teams, the operational difficulties of applying hedge accounting to floating rate loan books are the following:

- i. Most CPM practitioners would consider the market spread on credit derivatives as a reasonable proxy measure of credit risk. The IASB has specifically excluded direct reliance on CDS spreads as a measure of credit risk, citing concerns over the structural differences between CDS and loans or loan commitments.
- ii. These concerns relate to differences between loans or loan commitments and CDS in funding, coupon accrual, counterparty credit risk, the definition of credit events, the “cheapest to deliver” option in CDS as well as differences in liquidity and settlement conditions between the two instruments.
- iii. In the absence of a direct measure of credit risk, hedge accounting requires a bifurcation of all possible sources of risk in a loan or loan commitment. The various bifurcated components must add up to 100% of the value of loan or loan commitment taken as a whole. The bifurcation would imply the following general relationship:
 1. $\text{Credit Value} = \text{Loan/Commitment Value} - (\text{Option Value} + \text{Other Risk Components})$
- iv. Loan and loan commitments contain various embedded options. These options include:
 1. Prepayment
 2. Liquidity
 3. Term-out & Drawdown
 4. Currency
 5. Multiple Borrower
 6. Grid Pricing

Please see our June 2010 letter for more detailed description of each option.

These options generally do not trade separately from the loan or loan commitment so there is no directly available source of valuation. Attempts to value these options must be done on a modelled basis, relying on the historical statistics to estimate the theoretical relationships between option exercise and credit spreads or other market conditions.

- v. There are two major sources of material option value relevant to CPM hedging activities. The first is the “cheapest-to-deliver” option. This option, implicit in CDS, provides that CDS payments for defaulted obligors reference the bond or loan with the lowest value among the defaulted obligor’s eligible obligations.
- vi. Prepayment or term-out risk in loans a second major source of option value. As prepayable items, loans and loan commitments are rarely valued above par. An above-par value would imply that prevailing credit spreads for an

obligor were below the credit spread in the loan contract. As a floating rate instrument, however, the obligor could cancel a loan commitment or prepay a loan. It could be replaced by a new loan or loan commitment with a lower spread (and the same underlying interest rate). The obligor's ability to exercise this prepayment option means that an above market credit spread shouldn't persist and, as a result, investors will attach no sustainable value to it.

Prepayment will not only complicate the problem of matching maturity between hedges and hedged items but it will introduce a disconnect between the value of loans or loan commitments and the CDS' used to hedge them, particularly in tightening spread environments. Loans and loan commitments subject to term-out options can see their maturities extend in certain conditions. Most of our members would treat the maturity of an extendible loan or loan commitment as the last date of the longest potential extension period.

- vii. Most bank credit exposure to investment grade borrowers is in the form of undrawn loan commitments. There is virtually no active market for trading of loan commitments or for investment grade loans. Consequently there is no reliable direct source of information on the value of the commitment – other than the traded CDS spread. A number of the points the IASB has identified as reasons to avoid treating CDS as a measure of credit risk (paragraphs BC 221 – 222) apply equally to other hedging instruments. Interest rate swaps, for example, have different market liquidity from government bonds and are subject to counterparty default risk. Yet, they are generally accepted as a measure of interest rate risk.
- viii. The indirect approach of separately valuing the untraded loan and its theoretical option components to arrive at an indirect measure of credit risk would require complex modelling. We understand that such a solution, although operationally intensive, could work for some instruments (potentially for fixed rate bonds) and would be similar to the current requirement in IFRSs to disclose the changes in fair value attributable to credit risk on financial liabilities designated at fair value through P&L.

We make suggestions in Point f) below on how credit hedging can be made more operational to align with risk management practices.

- (f) Potential changes to facilitate greater use of hedge accounting by CPM teams could include the following:
 - i. In the IACPM's opinion, CDS spreads should be accepted as a basis for measuring the credit component of hedged loans. Most of the differences identified by the IASB between loans or loan commitments and CDS are immaterial and should not disqualify the use of CDS spreads as a direct measure of day-to-day value of credit risk.
 - ii. Although CDS optionality may introduce a bias to using the instrument as a measure of credit risk, we believe that the value of the cheapest-to-deliver option is reasonably static over the life of a CDS. It is possible to statistically estimate the value of the option and use the statistical estimate

to extract a “loan-equivalent” credit measure from a traded CDS spread. We would propose that this method be accepted, subject to verification of the validity of the statistical estimate of option value.

- iii. Objective criteria similar to those outlined in point 3 above should be accepted as a determinant of prospective hedge effectiveness.
- iv. Adjustments to hedge ratios should not be based on short-term valuation changes for the reasons outlined above. Credit risk hedging should be considered effective when the nominal amount of the hedge matches the nominal amount of the hedged item. In instances where a bank chooses to hedge less than 100% of its loan or loan commitment, the hedge should be considered effective for a pro-rated portion of the loan or loan commitment that is being hedged.
- v. Changes in loan or loan commitment values due to the presence or exercise of prepayment options should be understood as a source of hedge ineffectiveness. Although such an approach would potentially bias the source of ineffectiveness, this short-term bias could only be addressed if hedges were shorter than the contractual lives of the hedged items. This would be counter to the hedge effectiveness measures and risk management practises normally used by our members.
- vi. The standard should recognize that other sources of loan optionality are immaterial to loan valuation and accept either that they be valued with statistical approaches or be ignored. In practise, none of the remaining options are material to loan valuations or the financial performance of our members.

8. CPM Hedging Motivation (Response to IACPM Question 3)

- (a) Our members undertake credit hedging transactions for a variety of reasons specific to the circumstances of each institution and to the evolution of its portfolio. However, the principal motivations would generally be a combination of some of the following considerations:
 - i. **Regulatory or Economic Capital Optimization** – CDS hedges are seen as reducing the credit risk in loan exposures and both bank regulators and bank internal economic capital models provide capital relief when the hedges meet defined eligibility requirements.
 - ii. **Reduction of Exposure Concentrations** – most banks have internally-defined credit limits for large individual, sector-based or geographic concentrations. CDS hedges are normally recognized as reducing net exposure and facilitate limit compliance.
 - iii. **Deteriorating Credit Risk** – CDS hedges can be purchased when a bank has a negative view on the credit outlook for an individual obligor. The aim can either be to reduce net exposure to comply with reduced exposure limits or, simply to offset potential losses should the obligor default.

- (b) Exposure limits are generally determined based on various parameters. Risk appetite and diversification requirements are considerations that would impact the risk limits of virtually all of our members – with exposure generally more constrained for lower quality obligors both individually and as a group. However, limits could also reflect other commercial considerations such as relative profitability of specific transactions or the growth potential of particular obligors or market segments.
- (c) Exposure limits will normally change in response to changes in credit conditions. When our members perceive deteriorating credit risk trends, they will normally reduce exposure limits for the affected risk. However, the calibration, timing and form of this decision may vary from one institution to another.
- (d) Most of our members would say that their appetite to hedge is constrained by the potential P&L volatility linked to the asymmetric accounting for credit risk hedges. The experience of the last few years has pushed the amplitude of this volatility well beyond what would have been expected prior to the credit crises. Senior management in many institutions has responded with more controls over the level of potential credit hedging.

To be sure, many other factors affect the appetite for hedging. In current market conditions, the relatively high cost of hedges and relatively slow growth in bank loan portfolios are two other important factors reducing overall hedging demand.

We appreciate this opportunity for dialogue with the IASB in order to create more transparent accounting rules. Should you have any questions about our comments, or wish to discuss, please do not hesitate to contact me.

Sincerely,



Som-Lok Leung
IACPM, Executive Director

Appendix: IACPM letter to the IASB dated June 28, 2010
Practical Issues in Managing and Accounting for
CDS Hedging of Corporate Bank Loans

The IACPM (International Association of Credit Portfolio Managers) is an industry association established in 2001 to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest. Currently, there are over 90 financial institutions worldwide that are members of the IACPM. These institutions are based in 14 countries and include many of the world's largest commercial wholesale banks, investment banks and insurance companies, as well as a number of asset managers.

At most of our member institutions, the Credit Portfolio Management (CPM) team is responsible for managing the risk and performance of portions of the bank loan portfolio. Our members may be active both in the original decision to extend loans and subsequently in decisions to sell or hedge the exposure. This responsibility almost always covers the large corporate loan portfolio, and, depending on the institution, may also include SME loans, personal loans, mortgages and other forms of credit risk exposure. Since the credit derivative market is largely limited to large corporate obligors, the comments below will relate primarily to portfolios of large corporate loans.

Credit derivatives are frequently used as means of hedging the credit risk of bank loans. These hedges allow banks to transfer the risk of loss on a loan to a third party and to reduce the regulatory capital requirements of the loan. Importantly, they also allow the bank to maintain nominal ownership of the loan and preserve its relationship with the client.

To understand the issues faced by our members, it is worth noting the following points:

1. CPM teams within our member institutions are normally managed separately from trading-book teams involved in actively trading credit. And, while CPM teams may unwind trades from time to time, the underlying loans themselves are illiquid exposures normally held until they mature or are refinanced. CDS hedges, as a result, are normally held for extended periods of time and are not actively traded and re-traded by CPM teams.
2. Organizationally, CPM hedges are normally accounted for in separate "loan book" accounts, distinct from trading book CDS positions. To obtain the regulatory capital benefit of a CDS hedge, CPM teams must be able to directly link the specific CDS hedge to individual loans of the hedged obligor. This normally requires the segregation of loan-book CDS positions into a specific internal account as well as the maintenance of a defined set of links between the CDS positions and the underlying loans.
3. Most of the obligors traded in the CDS market are investment-grade quality obligors with strong credit profiles and comparatively low leverage. Such companies normally have direct access to corporate bond markets and to short-term commercial paper markets. Consequently, bank credit is usually provided in the form of undrawn corporate revolvers rather than funded term loans. Undrawn revolvers have some unusual characteristics:
 - a. In normal circumstances, most corporate revolvers remain undrawn. On a portfolio basis, draw rates of investment grade obligors rarely exceed 5-10%

except in circumstances of temporary market disruption.

- b. On an individual basis, however, most revolvers are completely undrawn most of the time. When an obligor's credit quality deteriorates, drawings often increase and revolvers are frequently drawn 100% at the time of default. On a credit risk basis, therefore, banks normally regard such undrawn exposures as the risk-equivalent of a drawn loan.
4. Loans and loan commitments are usually managed on an accrual basis – both for accounting and for management purposes. For virtually all banks, the primary focus of most lending decisions is (a) will we be repaid on time? and (b) are we earning enough income (directly and indirectly) to justify the risk? While small segments of the loan market trade more actively, this activity is largely limited to the funded, term tranches of primarily non-investment grade obligors. There is very little trading activity in investment grade bank loans – spreads are low relative to other forms of traded credit and obligors with undrawn back-up lines normally refuse to consent to the assignment of this obligation to non-bank investors with relatively poor credit quality.
5. Bank loans usually contain various optional features including:
- a. Prepayment options – loans are normally prepayable at par without penalty at any time.
 - b. Liquidity options – undrawn loan commitments may be drawn at any time (usually with very short notice periods) at pre-agreed drawn spreads.
 - c. Term-out & drawdown options – in some cases, obligors have the right to extend the term of a loan up to a defined maximum maturity. This may either be subject to the consent of the bank or may be available as an unconstrained option to the obligor. If subject to bank consent, a refusal to extend will usually result in the loan being fully drawn with a repayment period of, say, 1 year from the expiry of the loan commitment.

From a risk standpoint, banks will normally manage extendible loans based on the maximum extendible maturity. For example a one-year revolving loan with a one-year term out option at the borrower's discretion will normally be treated as a 2 year risk position.

- d. Currency options – some loan commitments are available in more than one currency (eg. EUR & USD). However, banks typically take no FX risk in providing such options as individual drawings are normally repayable in the currency in which they're drawn. Typically, the facility is denominated in one principal currency with availability in other currencies limited to the equivalent amount in the principal currency.
- e. Multiple obligor options – frequently, loans are available to various obligors within a corporate group. Normally the other obligors are subsidiaries or other companies related to the principal obligor. And, generally such obligations are supported either by formal cross-guarantees of the credit risk amongst the eligible obligors or more informal “keep-well” agreements or financial covenant structures.

- f. Grid pricing options – corporate bank loans are normally on a variable rate basis and loan pricing is usually expressed as a spread over a benchmark cost-of-funds rates. The benchmark is normally Euribor or the Libor rate and different benchmarks apply depending on the term of drawn down (eg. 1 months, 3 months, etc.). A convention in the loan market is to express such pricing as Libor + [100] – the interest rate on the loan is the prevailing Libor rate + 100 basis points (1%).

Some loans contain provisions which adjust the spread over the benchmark depending on either credit rating of the obligor or reported financial ratios for the obligor.

- 6. The exercise of such options by obligors reflects both price and non-price factors. Prepayment options, for example, will often be exercised in tightening spread markets when obligors perceive an opportunity to reduce the cost of their drawn loans or loan commitments. However, loans will typically refinance well in advance of their scheduled maturity even if spreads have not tightened. Obligor typically seek to maintain long-term debt or liquidity lines on their balance sheet and will rarely allow maturities of the loan commitments to fall below 12 months. In many cases, obligors will seek to refinance 5-year loans on an annual basis in order to show a relatively constant 5-year liquidity commitment.

Similarly, obligors will usually seek to avoid drawing on their bank lines at all and, in particular, to avoid being forced to draw down as a result of a bank refusal to extend terms. Although such draw downs may be nominally attractive if bank loan spreads are below either (a) current commercial paper rates or (b) terms on offer in the banks refinancing proposal, investment-grade obligors will normally seek to avoid sending the signal that they are obliged to rely on bank financing.

- 7. Consequently, bank loans are normally managed primarily on the basis of the credit risk. The theoretical value of embedded options in a loan portfolio is not normally seen as material to lending decisions.. For example, when considering whether the risk of a specific loan is hedged, bankers and their risk management groups will normally look only to whether the credit risk has been hedged (eg. by buying CDS protection on the obligor in question) and will not focus on whether prepayment risks have been perfectly hedged. When looking to take provisions for defaulted or distressed exposures, the main calculation is with respect to the potential for recovery of principal and accrued interest.

From an accounting perspective, the hedge effectiveness framework should recognize that credit derivatives are effective hedges of corporate loan commitments and revolvers provided that any material economic mismatch that arises due to optionality embedded in the loan commitments is captured through profit and loss.

- 8. Comments on the current accounting framework
 - a. The current approach (MTM on the hedges, accrual accounting for loans) strongly distorts the economic performance of hedging. Banks that report large P&L swings due to the accounting asymmetry frequently comment to the market that these are non-recurring items that should be better viewed as an accrued expense over the life of the hedge.

- b. As noted above, hedging loans is a “buy & hold” style of activity and not an active trading strategy. Loans are largely illiquid instruments which are not designed to be actively traded and can usually only be exchanged among a limited universe of authorized banks. While some loans do trade in the market, this is a very limited subset of loans that generally form a small proportion of the loans and loan commitments held on bank balance sheets.
- c. As a buyer of protection, banks contract to pay a fixed premium. The worst financial outcome is that all of the premium is paid and the obligor doesn’t default. There is no open-ended exposure to risk as there is for sellers of credit protection or for other derivatives.
- d. Our members usually manage the credit risk of loan exposures with relatively simple measures of hedge effectiveness – namely, matching of obligor, seniority and counterparty quality. When these items have been addressed appropriately, the CDS effectively mitigates the economic risk of the loan.
- e. Loans are virtually always floating rate instruments and bear virtually no interest rate risk and, moreover, are often undrawn for investment grade loan exposures.
- f. The prepayment and other options that the IASB seeks to address via the risk bifurcation approach are not generally material to the performance of the business. To resurrect an example used in our meeting, this is like worrying about the value of mining rights when valuing a house purchase – theoretically possible but economically meaningless. The mere presence of this optionality is still consistent with the hedge accounting framework provided that any material economic differences that arise from this optionality are captured through profit and loss.

Proposals

The strong preference of most IACPM members would be to allow accrual accounting for credit derivatives used to hedge loans where (a) the activity is one of pure hedging (b) a “buy & hold” approach to hedging can be suitably demonstrated and (c) hedge effectiveness can be measured through the qualitative criteria outlined above. We believe that this approach best reflects the reality of the business for high-quality obligors. Alternatively, many of the members believe that the change in mark to market for derivatives used in hedging should be booked through OCI rather than profit and loss.

We understand that the IASB feels unable to grant such exceptions and, as a second best alternative, would encourage you to think of relaxing the approach to hedge accounting and to the use of the fair-value option for hedged loans. Many of our members do not use the fair value option because it must be (a) done at inception of the loan and (b) applied to 100% of the loan balance. Many of our members hedge progressively over time and rarely hedge 100% of the loan. As a consequence, the current rules are poorly adapted to prevailing business practises.

We propose the consideration of the following measures that we believe would satisfy the IASB’s preference to keep CDS exposures on a MTM basis and would better adapt to the business practises of CPM teams. Specifically, we propose a more flexible approach to the Fair Value Option, with the following considerations:

1. The ability to qualify for hedge accounting based on qualitative criteria rather than by using the current quantitative approach based on the 80/125 rule.
2. The ability to elect fair value accounting on a proportional basis – reflecting the proportion of the loan which is hedged.
3. The ability to elect proportional fair value accounting for the loan at the time the hedge is purchased (rather than at the date the loan is originated).
4. We encourage the IASB to allow the fair value of loans to be calculated primarily on the basis of CDS spread variations.
 - a. In particular, where loans are originated as part of a wider syndicated loan involving a wide range of banks and where the syndicated loan has been fully subscribed or oversubscribed, we would encourage recognition of this as a par asset. Both the loan and any CDS purchased to hedge it should be recognized as par value instruments at origination even if there is a difference between the spread on the loan and the CDS.
 - b. Subsequent changes in value to the loan and the CDS would be calculated based on variations in the CDS spread.
 - c. Any material economic value attributable to options embedded in the loan instrument should be captured in the fair value of the loan instrument.
5. The ability to elect the Fair Value Option where a demonstrable hedging relationship exists, where something similar to the regulatory definitions of hedge effectiveness would be used to define hedging relationships, namely,
 - a. Matching of obligor and seniority
 - b. Counterparty credit quality is sufficiently high and/or counterparty risk is fully collateralized
 - c. The loan may be hedged in full or on a partial basis

6. In the absence of a full hedge accounting approach, the use of the Fair Value Option should be allowed to be “deselected” should a hedging relationship cease to exist.

If a hedge is unwound and the loan remains, the difference between book value and par value of the loan should be amortized over the remaining life of the loan. If a loan subsequently defaults after a hedge is unwound, provision amounts would be based on the difference between prevailing book value (i.e. book value at the time the hedge is unwound net of any amortization that has occurred since the unwind) and the expected value of recovered cash flows on the loan.

It should be clear that such unwinds would not be a frequent part of a loan hedging strategy and could be justified by identified criteria. Such criteria might gross obligor exposure falling below a defined exposure limit (due to refinancing or maturity of other exposures to the same obligor) and various other portfolio management considerations.

7. Where the designated hedged loan ceases to exist (for example, as a result of prepayment, maturity extension or maturity), a new hedging relationship between the hedging instrument and a new or existing loan exposure may be designated.