FEDERAL RESERVE BANK
OF DALLAS

HELEN E. HOLCOMB
FIRST VICE PRESIDENT AND
CHIEF OPERATING OFFICER

DALLAS, TEXAS
75265-5906

June 20, 1997

Notice 97-55

TO: The Chief Operating Officer or Branch Manager of each financial institution in the Eleventh Federal Reserve District

SUBJECT

1996 Series $50 Note Issuance

DETAILS

The Treasury Department, in conjunction with the Secret Service and the Federal Reserve System, has prepared a flier titled *New Designs For Your Money*. The brochure introduces cash handlers to the new 1996 series $50 notes, which will be distributed in the fall of 1997.

The new $50 note has several important security features, including a larger, off-center portrait and watermark of Ulysses S. Grant, special polymer threads embedded in the paper and color shifting ink to prevent counterfeiting. The back side of the new note will also have a large dark numeral 50 which is easier to read for people with low vision and in low-light circumstances.

ENCLOSURES

The enclosed brochure, which includes illustrations depicting the new currency, is suitable for duplication in either black and white or in color. Please copy and distribute it to cash handlers and other staff. Also, quantities of the brochure are available by filling out the enclosed order form and mailing or faxing it to the Federal Reserve Bank of Kansas City—Omaha Branch.

This publication was digitized and made available by the Federal Reserve Bank of Dallas' Historical Library (FedHistory@dal.frb.org)

MORE INFORMATION

For more information, please contact Cami McKillop at (214) 922-5253. For small quantities of the brochure (10 or less), please call your business development representative or the Dallas Fed Public Affairs Department at (214) 922–5254. The brochure is also available in Spanish.

Sincerely,

Helen E. Holcomb

FEDERAL RESERVE BANK
OF DALLAS

UZZIAH ANDERSON
VICE PRESIDENT

P.O. BOX 655906
DALLAS, TEXAS 75265-5906

June 20, 1997

TO THE CHIEF EXECUTIVE OFFICER ADDRESSED

SUBJECT: APPLICATION OF MARKET RISK CAPITAL REQUIREMENTS TO CREDIT DERIVATIVES

Attached is a supervisory letter regarding the application of the market risk capital requirements to credit derivatives held in the trading account. The guidance in this letter describes the three risk elements of credit derivatives against which banking organizations should maintain capital. The capital requirements are based upon three defined types of positions, which include open positions, matched positions, and offsetting positions.

If you have any questions about this guidance, please contact Ms. Dorsey Davis at (214) 922-6051 at this Reserve Bank.

Very truly yours,

Uzziah Anderson

Attachment

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 97-18 (GEN)

June 13, 1997

TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK

SUBJECT: Application of Market Risk Capital Requirements to Credit Derivatives

In December 1995, the Basle Supervisors Committee approved an amendment to the Basle Accord that sets forth capital requirements for exposure to general market risk for all positions held in an institution's trading account and for foreign exchange and commodity positions wherever located, as well as for specific risk of debt and equity positions held in the trading account.[1] In addition, this amendment requires capital to cover counterparty credit exposure associated with over-the-counter (OTC) derivative positions in accordance with the credit risk capital requirements set forth in the Basle Accord and implemented in the Federal Reserve's risk-based capital guidelines (12 CFR Parts 208 and 225, Appendix A). The requirements of the U.S. rules implementing the market risk amendment, contained in 12 CFR Parts 208 and 225, Appendix E,[2] were effective on an optional basis beginning January 1, 1997, with mandatory compliance for certain banking organizations with significant market risk exposure required as of January 1, 1998.[3]

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[1]General market risk refers to changes in the market value of on-balance sheet assets and liabilities, and off-balance sheet items resulting from broad market movements, such as changes in the general level of interest rates, equity prices, foreign exchange rates, and commodity prices. Specific risk refers to changes in the market value of individual positions due to factors other than broad market movements and includes such risks as the credit risk of an instrument's issuer.

[2]See "Risk-Based Capital Standards: Market Risk," 61 Federal Register 47,358 (1996).

[3]The market risk amendment applies to banking organizations whose trading activity (on a worldwide, consolidated basis) equals 1) 10 percent or more of total assets or 2) $1 billion or more. Trading activity means the gross sum of trading assets and liabilities as reported in the bank's most recent quarterly Consolidated Report of Condition and Income (Call Report). Banking supervisors may require an institution to comply with the market risk capital requirements if deemed necessary for safety and soundness purposes. An institution that does not meet the applicability criteria may, subject to supervisory approval, comply voluntarily with the amendment.

This SR letter provides guidance on how credit derivatives held in the trading account should be treated under the market risk capital requirements by state member banks and bank holding companies. Specifically, the SR letter defines the risks to which credit derivative transactions are exposed and sets forth the risk-based capital requirements for each type of risk. In addition, the SR letter supplements SR letter 96-17 (GEN), dated August 12, 1996, which provides a detailed discussion of the more prevalent credit derivative structures,[4] and provides guidance on a number of supervisory issues pertaining to the use of credit derivatives, including the appropriate risk-based capital treatment for credit derivatives held in the banking book. The risk-based capital guidance set forth in SR letter 96-17 will continue to apply to credit derivatives held in the trading book of banks that have not implemented the market risk capital rule.

Credit derivatives are financial instruments used to assume or mitigate the credit risk of loans and other assets through off-balance sheet transactions. Banking organizations may employ these off-balance sheet instruments either as end-users, purchasing credit protection or acquiring credit exposure from third parties, or as dealers intermediating such activity. End-user banking organizations may use credit derivatives to reduce credit concentrations, improve portfolio diversification, or manage overall credit risk exposure. Although the market for these instruments is relatively small, banking organizations are entering into credit derivative transactions with increasing frequency.

U.S. banking supervisors, together with banking supervisors abroad, have been assessing the use and development of credit derivatives, as well as risk management practices and risk modeling at major banks for some time. U.S. and international supervisors intend to continue studying credit derivatives in the marketplace, which may result in additional or revised guidance on regulatory issues, including the appropriate banking book and trading book capital treatment.

Definitions

Credit derivative transactions held in the trading account are exposed to counterparty credit risk and general market risk. In addition, they are exposed to the specific risk of the underlying reference asset. This specific risk is the same as that associated with a cash position in a loan or bond. Table 1 defines each of the three risks as they relate to derivatives.

This SR letter describes the three risk elements of credit derivatives against which banking organizations should hold risk-based capital, based upon three defined types of positions. These three position types are 1) open positions, 2) matched positions, and 3) offsetting positions. Matched positions encompass long

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[4]These include total rate of return swaps, credit default swaps and credit-linked notes.

Definitions

o Counterparty Credit Risk - The risk arising from the possibility that the counterparty may default on amounts owed on a derivative transaction.

o General Market Risk - The risk arising from changes in the reference asset's value due to broad market movements such as changes in the general level of interest rates.

o Specific Risk - The risk arising from changes in the reference asset's value due to factors other than broad market movements, including changes in the reference asset's credit risk.

Table 1

and short positions in *identical* credit derivative structures over *identical* maturities referencing *identical* assets.[5] Offsetting positions encompass long and short credit derivative positions in reference assets of the same obligor with the same level of seniority in bankruptcy. Offsetting positions include positions that would otherwise be matched except that the long and short credit derivative positions have different maturities or one leg is a total return product and the other is purely a default product (i.e., credit default swap). Positions that do not qualify as matched or offsetting are open positions. Table 2 identifies which of the three risk elements is present for each of the three defined position types.

[5]Position structures are matched only if both legs are either total rate of return products or credit default products. Matching treatment also requires that default definitions include the same credit events, and that materiality thresholds and other relevant contract terms in the matched positions are not substantially different. For purposes of this letter, cash instruments are considered total return products. Hence, a long position in a bond and a short total return swap of identical maturity referencing that bond is a matched position. If the maturities do not match, or if the swap is a credit default swap, the position is offsetting (as long as the reference asset has the same obligor and level of seniority as the bond).

Table 2

Credit Derivatives

Market Risk Capital Framework

	Counterparty Credit Risk	General Market risk	Specific Risk
Open Position	Y	Y	Y
Matched Position	Y	N	N
Offsetting Position	Y	Y(Some)	Y(Some)

Y - Risk is present; capital charge is indicated.
N - Risk is not present; no capital charge is indicated.

In summarizing Table 2, it is clear that all credit derivative positions create exposures to counterparties and, thus, have counterparty risk.[6] In the case of matched positions, counterparty risk is the only risk present. The matched nature of the position eliminates the general market and specific risk of the reference asset. Both open and offsetting positions have all three risk elements, but general market and specific risk are present to a significantly lesser degree in offsetting positions than in open positions.

Market Risk Capital Approach for Credit Derivatives in the Trading Account

General Market Risk

Beginning January 1, 1998, a banking organization subject to the market risk amendment must use internal models to measure its daily value-at-risk (VAR) for covered positions located in its trading account and for foreign exchange and commodity positions wherever located.[7] General market risk capital charges for

[6] An exception involves written options where the seller receives the premium at origination. In such instances, risk-based capital is not required since there is no counterparty risk to the banking organization writing the option.

[7] An institution's VAR is the estimate of the maximum amount that the value of covered positions could decline during a fixed holding period within a stated confidence level. Covered positions encompass all positions in a banking organization's trading account, as well as all foreign exchange and commodity positions, whether or not in the trading account. Positions include on-balance-sheet assets and liabilities and off-balance sheet items. See 12 CFR Parts 208 and 225,

credit derivatives are to be calculated using internal models in the same manner as for cash market debt instruments.

Specific Risk

As set out in the market risk capital rule, if a banking organization can demonstrate to the Federal Reserve that its internal model measures the specific risk of its debt and equity positions in the trading account, and this measure is included in its VAR-based capital charge, then the bank may reduce or eliminate its specific risk capital charges, subject to the minimum specific risk charges prescribed in the amendment.[8] This SR letter applies the same treatment to credit derivatives. The Federal Reserve intends to continue discussions with the banking industry on the measurement and management of specific risk.

Alternatively, standard specific risk charges for credit derivatives may be calculated using the specific risk weighting factors that apply to the referenced asset. As set forth in the market risk amendment, matched positions do not incur specific risk charges. For offsetting positions, standard specific risk charges are to be applied only against the largest leg of the offsetting credit derivative and cash positions.[9] That is, standard specific risk charges are not to be applied to each leg separately. Open positions attract the same standard specific risk charges that a cash position in the reference asset would incur.

Counterparty Risk

Counterparty risk is calculated by summing the mark-to-market value of the credit derivative and an "add-on" factor representing potential future credit exposure. Under the Basle Accord and the Federal Reserve's risk-based capital guidelines, the add-on factor is a specified percentage of notional amount, depending on the type and maturity of the derivative transaction. In order to calculate a capital charge for counterparty risk for credit derivatives, an appropriate add-on factor is needed. However, the current matrix of add-on factors in the Basle Accord and the Federal Reserve's guidelines does not include a specific factor for credit or other derivatives for which the underlying transaction is a debt instrument.

Based on an analysis of typical debt instruments underlying credit

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Appendix E.

[8]The amount of capital held to cover specific risk must be equal to at least 50 percent of the specific risk charge that would result from the standardized calculation.

[9]Exposure is measured by notional amount for credit derivatives or by market value for cash instruments.

derivative transactions, the Federal Reserve has determined that the following add-on factors will apply to credit derivative transactions. The equity add-on factors are to be used when the reference asset is an investment grade instrument (or its bank-internal equivalent), or where the reference asset is unrated but well-secured by high-quality collateral. The commodity add-on factor is to be used when the reference asset is either below investment grade (or its bank-internal equivalent) or is unrated and unsecured.

If you have questions on the supervisory or capital issues related to credit derivatives, please contact Roger Cole, Deputy Associate Director (202/452-2618), Norah Barger, Manager (202/452-2402), or Tom Boemio, Supervisory Financial Analyst (202/452-2982).

Richard Spillenkothen
Director

Attachment

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