FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N.Y. 10045-0001

AREA CODE 212-720-1830

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AT-10868

August 21, 1996

To the Chief Executive Officer of Each Second District State Member Bank, Holding Company, and U.S. Branch and Agency of a Foreign Banking Organization

Supervisory Guidance for Credit Derivatives

Attached is a supervisory letter and appendix regarding recently developed guidance on credit derivatives, which are relatively new financial instruments used to assume or lay off credit risk on loans and other assets. Credit derivatives may be used for such purposes as risk management, yield enhancement, reduction of credit concentrations, or diversification of overall risk. The appendix includes a description of the most common types of credit derivatives.

The supervisory guidance notes that it is essential that banks, bank holding companies, and U.S. branches and agencies of foreign banks using credit derivatives establish sound risk management policies and procedures and effective internal controls. The guidance also outlines the appropriate treatment of credit derivatives for purposes of regulatory capital and other supervisory purposes, such as credit exposure, asset classifications, allowance for loan and lease losses, and transactions involving affiliates. The appropriate accounting and regulatory reporting treatment for credit derivatives is also discussed.

U.S. banking supervisors, as well as banking supervisors abroad, intend to continue assessing the use and development of credit derivatives in the marketplace. This assessment process may result in revised or additional guidance on the appropriate supervisory treatment of these instruments.

The sound practices for management of trading and nontrading derivatives activities outlined in SR Letter 93-69 ("Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations") and SR Letter 95-17 ("Evaluating the Risk Management and Internal Controls of Securities and Derivatives Used in Nontrading Activities") also apply to credit derivatives. These supervisory letters provide guidance on such additional relevant topics as the importance of new product reviews and an independent valuation process, and SR Letter 93-69 provides general guidance on sales practice considerations.

The Federal Reserve Bank of New York is interested in your comments and questions on the attached letter or on other supervisory matters related to credit derivatives activities. If you have any questions or comments, please contact me, Brian Peters, Examining Officer (212-720-2715), or Daniel Staehle, Senior Financial Specialist (212-720-2040).

Sincerely,

Christine M. Cumming

Christine M. Cumming
Senior Vice President

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

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 96-17 (GEN)

August 12, 1996

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

SUBJECT: Supervisory Guidance for Credit Derivatives

Overview

In recent months, examiners have encountered credit derivative transactions at several dealer and end-user banking organizations. Credit derivatives are financial instruments used to assume or lay off credit risk on loans and other assets, sometimes to only a limited extent. Banking organizations are increasingly employing these off-balance sheet instruments either as end-users, purchasing credit protection from -- or providing credit protection to -- third parties, or as dealers intermediating such protection. Banking organizations use credit derivatives to reduce credit concentrations and manage overall credit risk exposure. Although the market for these instruments is still quite small, banking organizations are entering into credit derivative transactions with increasing frequency. Questions have been raised about how credit derivatives should be treated in light of existing supervisory capital and reporting rules and prudential guidance.

This SR letter provides guidance on supervisory issues pertaining to the use of credit derivatives for such purposes as risk management, yield enhancement, reduction of credit concentrations, or diversification of overall risk. It is essential that banks, bank holding companies, and U.S. branches and agencies of foreign banks that use credit derivatives establish sound risk management policies and procedures and effective internal controls. Federal Reserve staff will continue to review credit derivatives as their use and structure evolve in the marketplace.

The analytical techniques used to manage credit derivatives may provide new insights into credit risk and its management. For this reason, U.S. banking supervisors, as well as banking supervisors abroad, intend to continue assessing the use and development of credit derivatives in the marketplace. Discussions with the other U.S. and international banking supervisors may result in revised or additional guidance on the appropriate supervisory treatment of credit derivatives. This is particularly true with respect to the treatment of dealer banking organizations' positions in credit derivatives and how such transactions, if held in banks' trading books, would be treated as market-risk instruments for

capital purposes once the proposed market risk capital rules become effective.[1]

Background

Credit derivatives are off-balance sheet arrangements that allow one party (the "beneficiary") to transfer the credit risk of a "reference asset," which it often actually owns, to another party (the "guarantor").[2] This arrangement allows the guarantor to assume the credit risk associated with the reference asset without directly purchasing it. Unlike traditional guarantee arrangements, credit derivatives transactions often are documented using master agreements developed by the International Swaps and Derivatives Association (ISDA) similar to those governing swaps or options.

Under some credit derivative arrangements, the beneficiary may pay the total return on a reference asset, including any appreciation in the asset's price, to a guarantor in exchange for a spread over funding costs plus any depreciation in the value of the reference asset (a "total rate-of-return swap"). Alternatively, a beneficiary may pay a fee to the guarantor in exchange for a guarantee against any loss that may occur if the reference asset defaults (a "credit default swap"). These two structures are the most prevalent types of credit derivatives and are described in greater detail in the Appendix.[3]

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[1]Once the proposed market risk capital rules are effective, credit derivatives that are held in a bank's trading book would be subject to those rules. These rules are scheduled to be effective by January 1, 1998, although supervisors will have the discretion to permit institutions to adopt the rules early. Under the market risk rules for derivatives, the risk of the reference asset generally is included in the calculation of general market risk and specific risk. In addition, capital is required to cover the counterparty credit exposure on the transaction. The assumptions that were used in the development of the specific risk factors included in the proposed market risk capital rules and the potential future exposure conversion factors under the credit risk capital rules, however, did not take into account credit derivatives and may need to be reviewed if the market risk capital treatment is applied to these instruments.

[2]For purposes of this supervisory letter, where the beneficiary owns the reference asset it will be referred to as the "underlying" asset. However, in some cases, the reference asset and the underlying asset are not the same. For example, the credit derivative contract may reference the performance of an ABC Company bond, while the beneficiary bank may actually own an ABC Company loan.

[3]The Appendix provides a detailed discussion on the mechanics and cash flows of the two most prevalent types of credit derivatives; guidance on how credit derivatives are to be treated for purposes of regulatory capital and other supervisory purposes, such as credit exposure, asset classification, allowance for loan and lease losses, and transactions involving

(continued...)

The credit derivative market has been evolving rapidly, and credit derivative structures are likely to take on new forms. For example, very recently a market has developed for put options on specific corporate bonds or loans. While the payoffs of these puts are expressed in terms of a strike price, rather than a default event, if the strike price is sufficiently high, credit risk effectively could be transferred from the buyer of the put to the writer of the put.

Overview of Guidance

In reviewing credit derivatives, examiners should consider the credit risk associated with the reference asset as the primary risk, as they do for loan participations or guarantees. A banking organization providing credit protection through a credit derivative can become as exposed to the credit risk of the reference asset as it would if the asset were on its own balance sheet. Thus, for supervisory purposes, the exposure generally should be treated as if it were a letter of credit or other off-balance sheet guarantee.[4] This treatment would apply, for example, in determining an institution's overall credit exposure to a borrower for purposes of evaluating concentrations of credit. The institution's overall exposure should include exposure it assumes by acting as a guarantor in a credit derivative transaction where the borrower is the obligor of the reference asset.[5]

In addition, banking organizations providing credit protection through a credit derivative should hold capital and reserves against their exposure to the reference asset. This broad principle holds for all credit derivatives, except for credit derivative contracts that incorporate periodic payments for depreciation or appreciation, including most total rate of return swaps. For these transactions, the guarantor can deduct the amount of depreciation paid to the beneficiary from the notional amount of the contract in determining the amount of reference exposure subject to a capital charge.

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[3](...continued)
affiliates; and guidance on the appropriate accounting and regulatory reporting treatment for credit derivatives.

[4]Credit derivatives that are based on a broad based index, such as the Lehman Brothers Bond Index or the S&P 500 stock index, could be treated for capital and other supervisory purposes as a derivative contract. This determination should be made on a case-by-case basis.

[5]Legal lending limits are established by the individual states for state-chartered banks and by the Office of the Comptroller of the Currency (OCC) for national banks. The determination of whether credit derivatives are guarantees to be included in the legal lending limits are the purview of the state banking regulators and the OCC.

In some cases, such as total rate of return swaps, the guarantor also is exposed to the credit risk of the counterparty, which for derivative contracts generally is measured as the replacement cost of the credit derivative transaction plus an add-on for the potential future exposure of the derivative to market price changes. For banks acting as dealers that have matching offsetting positions, the counterparty risk stemming from credit derivative transactions could be the principal risk to which the dealer banks are exposed.

In reviewing a credit derivative entered into by a beneficiary banking organization the examiner should review the organization's credit exposure to the guarantor, as well as to the reference asset -- if the asset is actually owned by the beneficiary. The degree to which a credit derivative, unlike most other credit guarantee arrangements, transfers the credit risk of an underlying asset from the beneficiary to the guarantor may be uncertain or limited. The degree of risk transference depends upon the terms of the transaction. For example, some credit derivatives are structured so that a payout only occurs when a pre-defined event of default or a downgrade below a pre-specified credit rating occurs. Others may require a payment only when a defined default event occurs and a pre-determined materiality (or loss) threshold is exceeded. Default payments themselves may be based upon an average of dealer prices for the reference asset during some period of time after default using a pre-specified sampling procedure or may be specified in advance as a set percentage of the notional amount of the reference asset. Finally, the term of many credit derivative transactions is shorter than the maturity of the underlying asset and, thus, provides only temporary credit protection to the beneficiary.

Examiners must ascertain whether the amount of credit protection a beneficiary receives by entering into a credit derivative is sufficient to warrant treatment of the derivative as a guarantee for regulatory capital and other supervisory purposes. Those arrangements that provide virtually complete credit protection to the underlying asset will be considered effective guarantees for purposes of asset classification and risk-based capital calculations. On the other hand, if the amount of credit risk transferred by the beneficiary is severely limited or uncertain, then the limited credit protection provided by the derivative should not be taken into account for these purposes.

In this regard, examiners should carefully review credit derivative transactions in which the reference asset is not identical to the asset actually owned by the beneficiary banking organization. In order to determine that the derivative contract provides effective credit protection, the examiner must be satisfied that the reference asset is an appropriate proxy for the loan or other asset whose credit exposure the banking organization intends to offset. In making this determination, examiners should consider, among other factors, whether the reference asset and owned asset have the same obligor and seniority in bankruptcy and whether both contain mutual cross-default provisions.

The supervisory and regulatory treatment that is currently outlined will continue to be reviewed to ensure the appropriate treatment for credit derivatives transactions. Such a review will take into consideration the potential offsetting of credit exposures within the portfolio and how the proposed market risk capital rules would be applied to credit derivative transactions once they become effective.

An institution should not enter into credit derivative transactions unless its management has the ability to understand and manage the credit and other risks associated with these instruments in a safe and sound manner. Accordingly, examiners should determine the appropriateness of these instruments on an institution-by-institution basis. Such a determination should take into account management's expertise in evaluating such instruments; the adequacy of relevant policies, including position limits; and the quality of the institution's relevant information systems and internal controls.[6]

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[6]Further guidance on examining the risk management practices of banking organizations, including guidance on derivatives, which examiners may find helpful in reviewing an organization's management of its credit derivative activity, is contained in the Commercial Bank Examination Manual; Bank Holding Company Supervision Manual; Trading Activities Manual; SR Letter 93-69 (12/20/93), "Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations;" SR Letter 94-45 (8/5/94), "Supervisory Policies Relating to Structured Notes;" SR Letter 95-17 (3/28/95), "Evaluating the Risk Management and Internal Controls of Securities and Derivatives Contracts Used in Nontrading Activities;" and SR Letter 95-51 (11/14/95), "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies."

If you have any questions on the supervisory or capital issues related to credit derivatives, please contact Norah Barger, Manager (202/452-2402), or Tom Boemio, Supervisory Financial Analyst (202/452-2982). Questions concerning the accounting treatment for these products may be addressed to Charles Holm, Project Manager (202/452-3502), or Greg Eller, Supervisory Financial Analyst (202/452-5277).

Richard Spillenkothen
Director

Attachment

Appendix

Supervisory and Accounting Guidance Relating to Credit Derivatives

I. Description of Credit Derivatives

The most widely used types of credit derivatives to date are credit default swaps and total rate-of-return (TROR) swaps.[1] While the timing and structure of the cash flows associated with credit default and TROR swaps differ, the economic substance of both arrangements is that they seek to transfer the credit risk on the asset(s) referenced in the transaction.

The use of credit derivatives may allow a banking organization to mitigate its concentration to a particular borrower or industry without severing the customer relationship. In addition, organizations that are approaching established in-house limits on counterparty credit exposure could continue to originate loans to a particular industry and use credit derivatives to transfer the credit risk to a third party. Furthermore, institutions may use credit derivatives to diversify their portfolios by assuming credit exposures to different borrowers or industries without actually purchasing the underlying assets. Nonbank institutions may serve as counterparties to credit derivative transactions with banks in order to gain access

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[1]Another less common form of credit derivative is the credit linked note which is an obligation that is based on a reference asset. Credit linked notes are similar to structured notes with embedded credit derivatives. The payment of interest and principal are influenced by credit indicators rather than market price factors. If there is a credit event, the repayment of the bond's principal is based on the price of the reference asset. When reviewing these transactions, examiners should consider the purchasing bank's exposure to the underlying reference asset as well as the exposure to the issuing entity.

to the commercial bank loan market. These institutions either do not lend or do not have the ability to administer a loan portfolio.

Credit Default Swaps

The purpose of a credit default swap, as its name suggests, is to provide protection against credit losses associated with a default on a specified reference asset. The swap purchaser, i.e., the beneficiary, "swaps" the credit risk with the provider of the swap, i.e., the guarantor. While the transaction is called a "swap," it is very similar to a guarantee or financial standby letter of credit.

In a credit default swap, illustrated in Figure 1, the beneficiary (Bank A) agrees to pay to the guarantor (Bank B) a fee typically amounting to a certain number of basis points on the par value of the reference asset either quarterly or annually. In return, the guarantor agrees to pay the beneficiary an agreed upon, market-based, post-default amount or a predetermined fixed percentage of the value of the reference asset if there is a default. The guarantor makes no payment until there is a default. A default is strictly defined in the contract to include, for example, bankruptcy, insolvency, or payment default, and the event of default itself must be publicly verifiable. In some instances, the guarantor is not obliged to make any payments to the beneficiary until a pre-established amount of loss has been exceeded in conjunction with a default event; this is often referred to as a materiality threshold.

The swap is terminated if the reference asset defaults prior to the maturity of the swap. The amount owed by the guarantor is the difference

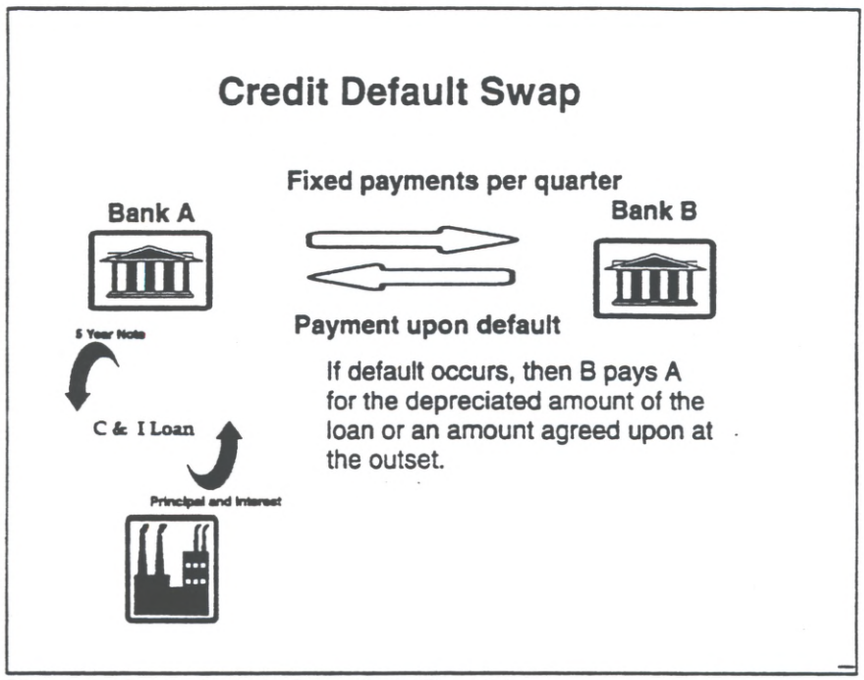

Figure 1 Credit Default Swap Cash Flow Diagram

between the reference asset's initial principal (or notional) amount and the actual market value of the defaulted, reference asset. The methodology for establishing the post-default market value of the reference asset should be set out in the contract. Often, the market value of the defaulted reference asset may be determined by sampling dealer quotes. The guarantor may have the option to purchase the defaulted, underlying asset and pursue a workout with the borrower directly, an action it may take if it believes that the "true" value of the reference asset is higher than that determined by the swap pricing mechanism. Alternatively, the swap may call for a fixed payment in the event of default, for example, 15 percent of the notional value of the reference asset.

Total Rate-of-Return Swap

In a total rate-of-return (TROR) swap, illustrated in Figure 2, the beneficiary (Bank A) agrees to pay the guarantor (Bank B) the "total return" on the reference asset, which consists of all contractual payments, as well as any appreciation in

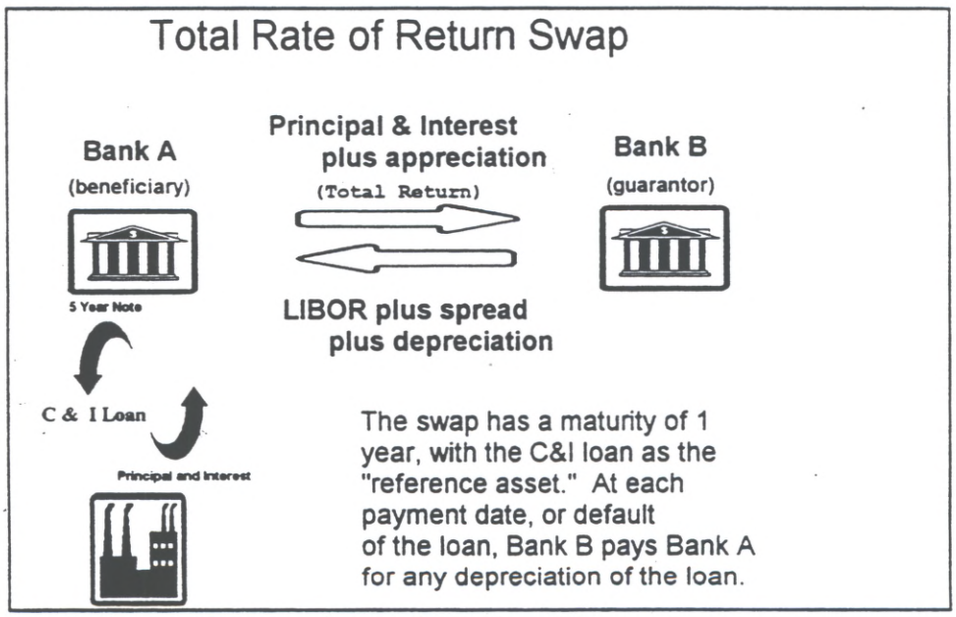

Figure 2 Total Return Swap Cash Flow Diagram

the market value of the reference asset. To complete the swap arrangement, the guarantor agrees to pay LIBOR plus a spread and any depreciation to the beneficiary.[2] The guarantor in a TROR swap could be viewed as having synthetic ownership of the reference asset since it bears the risks and rewards of ownership

[2]The reference asset is often a floating rate instrument, e.g., a prime-based loan. Thus, if both sides of a TROR swap are based on floating rates, interest rate risk is effectively eliminated with the exception of some basis risk.

over the term of the swap.

At each payment exchange date (including when the swap matures) -- or upon default, at which point the swap may terminate -- any depreciation or appreciation in the amortized value of the reference asset is calculated as the difference between the notional principal balance of the reference asset and the "dealer price."[3] The dealer price is generally determined either by referring to a market quotation source or by polling a group of dealers and reflects changes in the credit profile of the reference obligor and reference asset.

If the dealer price is less than the notional amount (i.e., the hypothetical original price of the reference asset) of the contract, then the guarantor must pay the difference to the beneficiary, absorbing any loss caused by a decline in the credit quality of the reference asset.[4] Thus, a TROR swap differs from a standard direct credit substitute in that the guarantor is guaranteeing not only against default of the reference obligor, but also against a deterioration in that obligor's credit quality, which can occur even if there is no default.

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[3]Depending upon contract terms, a TROR swap may not terminate upon default of the reference asset. Instead, payments would continue to be made on subsequent payment dates based on the reference asset's post-default prices until the swap's contractual maturity.

[4]As in a credit default swap, the guarantor may have the option of purchasing the underlying asset from the beneficiary at the dealer price and trying to collect from the borrower directly.

II. Supervisory Issues Relating to Credit Derivatives
Risk-Based Capital Treatment

For purposes of risk-based capital, credit derivatives generally are to be treated as off-balance sheet direct credit substitutes. The notional amount of the contract should be converted at 100 percent to determine the credit equivalent amount to be included in risk weighted assets of the guarantor.[5] A banking organization providing a guarantee through a credit derivative transaction should assign its credit exposure to the risk category appropriate to the obligor of the reference asset or any collateral. On the other hand, a banking organization that owns the underlying asset upon which effective credit protection has been acquired through a credit derivative may under certain circumstances assign the unamortized portion of the underlying asset to the risk category appropriate to the guarantor, e.g., the 20 percent risk category if the guarantor is a bank.

Whether the credit derivative is considered an eligible guarantee for purposes of risk-based capital depends upon the degree of credit protection actually provided. As explained earlier, the amount of credit protection actually provided by a credit derivative may be limited depending upon the terms of the arrangement. In this regard, for example, a relatively restrictive definition of a default event or a materiality threshold that requires a comparably high percentage of loss to occur before the guarantor is obliged to pay could effectively limit the amount of credit

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[5]Guarantor banks which have made cash payments representing depreciation on reference assets may deduct such payments from the notional amount when computing credit equivalent amounts for capital purposes. For example, if a guarantor bank makes a depreciation payment of $10 on a $100 notional total rate-of-return swap, the credit equivalent amount would be $90.

risk actually transferred in the transaction. If the terms of the credit derivative arrangement significantly limit the degree of risk transference, then the beneficiary bank cannot reduce the risk weight of the "protected" asset to that of the guarantor bank. On the other hand, even if the transfer of credit risk is limited, a banking organization providing limited credit protection through a credit derivative should hold appropriate capital against the underlying exposure while it is exposed to the credit risk of the reference asset.

Banking organizations providing a guarantee through a credit derivative may mitigate the credit risk associated with the transaction by entering into an offsetting credit derivative with another counterparty, a so-called "back-to-back" position. Organizations that have entered into such a position may treat the first credit derivative as guaranteed by the offsetting transaction for risk-based capital purposes. Accordingly, the notional amount of the first credit derivative may be assigned to the risk category appropriate to the counterparty providing credit protection through the offsetting credit derivative arrangement, e.g., the 20 percent risk category if the counterparty is an OECD bank.

In some instances, the reference asset in the credit derivative transaction may not be identical to the underlying asset for which the beneficiary has acquired credit protection. For example, a credit derivative used to offset the credit exposure of a loan to a corporate customer may use a publicly-traded corporate bond of the customer as the reference asset, whose credit quality serves as a proxy for the on-balance sheet loan. In such a case, the underlying asset will still

generally be considered guaranteed for capital purposes as long as both the underlying asset and the reference asset are obligations of the same legal entity and have the same level of seniority in bankruptcy. In addition, banking organizations offsetting credit exposure in this manner would be obligated to demonstrate to examiners that there is a high degree of correlation between the two instruments; the reference instrument is a reasonable and sufficiently liquid proxy for the underlying asset so that the instruments can be reasonably expected to behave in a similar manner in the event of default; and, at a minimum, the reference asset and underlying asset are subject to mutual cross-default provisions. A banking organization that uses a credit derivative, which is based on a reference asset that differs from the protected underlying asset, must document the credit derivative being used to offset credit risk and must link it directly to the asset or assets whose credit risk the transaction is designed to offset. The documentation and the effectiveness of the credit derivative transaction are subject to examiner review. Banking organizations providing credit protection through such arrangements must hold capital against the risk exposures that are assumed.

Some credit derivative transactions provide credit protection for a group or basket of reference assets and call for the guarantor to absorb losses on only the first asset in the group that defaults. Once the first asset in the group defaults, the credit protection for the remaining assets covered by the credit derivative ceases. If examiners determine that the credit risk for the basket of assets has effectively been transferred to the guarantor and the beneficiary banking organization owns all

of the reference assets included in the basket, then the beneficiary may assign the asset with the smallest dollar amount in the group -- if less than or equal to the notional amount of the credit derivative -- to the risk category appropriate to the guarantor. Conversely, a banking organization extending credit protection through a credit derivative on a basket of assets must assign the contract's notional amount of credit exposure to the highest risk category appropriate to the assets in the basket.

Other Supervisory Issues

The decision to treat credit derivatives as guarantees could have significant supervisory implications for the way examiners treat concentration risk, classified assets, the adequacy of the allowance for loan and lease losses (ALLL), and transactions involving affiliates. Examples of how credit derivatives that effectively transfer credit risk could affect supervisory procedures are discussed below.

Credit Exposure

For internal credit risk management purposes, banks are encouraged to develop policies to determine how credit derivative activity will be used to manage credit exposures. For example, a bank's internal credit policies may set forth situations in which it is appropriate to reduce credit exposure to an underlying obligor through credit derivative transactions. Such policies need to address when credit exposure is effectively reduced and how all credit exposures will be monitored, including those resulting from credit derivative activities.

For supervisory purposes, a concentration of credit generally exists when a

bank's loans and other exposures -- e.g., fed funds sold, securities, and letters of credit -- to a single obligor, geographic area, or industry exceed 25 percent of the bank's Tier 1 capital and ALLL.[6] Examiners will not consider a bank's asset concentration to a particular borrower reduced because of the existence of a non-government guarantee on one of the borrower's loans because the underlying concentration to the borrower still exists. However, examiners should consider how the bank manages the concentration, which could include the use of non-governmental guarantees. Asset concentrations are to be listed in the examination report to highlight that the ultimate risk to the bank stems from these concentrations, although the associated credit risk may be mitigated by the existence of non-governmental guarantees.

Any non-government guarantee will be included with other exposures to the guarantor to determine if there is an asset concentration with respect to the guarantor. Thus, the use of credit derivatives will increase the beneficiary's concentration exposure to the guarantor without reducing concentration risk of the underlying borrower. Similarly, a guarantor bank's exposure to all reference assets will be included in its overall credit exposure to the reference obligor.

Classification

The criteria used to classify assets are primarily based upon the degree of risk and the likelihood of repayment as well as on the assets' potential effect on

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[6]See Section 2050.1 of the Commercial Bank Examination Manual.

the bank's safety and soundness.[7] When evaluating the quality of a loan, examiners should review the overall financial condition of the borrower; the borrower's credit history; any secondary sources of repayment, such as guarantees; and other factors. The primary focus in the review of a loan's quality is the original source of payment. The assessment of the credit quality of a troubled loan, however, should take into account support provided by a "financially responsible guarantor."[8]

The protection provided on an underlying asset by a credit derivative from a financially responsible guarantor may be sufficient to preclude classification of the underlying asset, or reduce the severity of classification. Sufficiency depends upon the extent of credit protection that is provided. In order for a credit derivative to be considered a guarantee for purposes of determining the classification of assets, the credit risk must be transferred from the beneficiary to the financially responsible guarantor; the financially responsible guarantor must have both the financial capacity and willingness to provide support for the credit; the guarantee (i.e., the credit derivative contract) must be legally enforceable; and the guarantee must provide support for repayment of the indebtedness, in whole or in part, during the remaining term of the underlying asset.

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[7]Loans that exhibit potential weaknesses are categorized as "special mention," while those with well-defined weaknesses and a distinct possibility of loss are assigned to the general category of "classified." The classified category is divided into the more specific subcategories of "substandard," "doubtful," and "loss." The amount of classified loans as a percent of capital is the standard measure of the overall quality of a bank's loan portfolio.

[8]See Section 2060.1 of the Commercial Bank Examination Manual.

However, credit derivatives tend to have a shorter maturity than the underlying asset being protected. Furthermore, there is uncertainty as to whether the credit derivative will be renewed once it matures. Thus, examiners need to consider the term of the credit derivative relative to the maturity of the protected underlying asset, the probability that the protected underlying asset will default while the guarantee is in force, as well as whether the credit risk has actually been transferred, when determining whether to classify an underlying asset protected by a credit derivative. In general, the beneficiary banking organization continues to be exposed to the credit risk of the classified underlying asset when the maturity of the credit derivative is shorter than the underlying asset. Thus, in situations of a maturity mismatch, the presumption may be against a diminution of the severity of the classification of the underlying asset.

For guarantor banking organizations, examiners should review the credit quality of individual reference assets in derivative contracts in the same manner as other credit instruments, such as standby letters of credit. Thus, examiners should evaluate a credit derivative, in which a banking organization provides credit protection, based upon the overall financial condition and resources of the reference obligor; the obligor's credit history; and any secondary sources of repayment, such as collateral. As a rule, exposure from providing credit protection through a credit derivative should be classified if the reference asset is classified.[9]

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[9]A guarantor banking organization providing credit protection through the use of a credit derivative on a classified asset of a beneficiary bank may preclude classification of its derivative contract by laying off the risk exposure to another financially responsible guarantor.

(continued...)

Allowance for Loan and Lease Losses

In accordance with the Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL), institutions must maintain an ALLL at a level that is adequate to absorb estimated credit losses associated with the loan and lease portfolio. Federal Reserve staff continues to review accounting issues related to credit derivatives and reserving practices and may issue additional guidance upon completion of this review or when more definitive guidance is provided by accounting authorities. Likewise, consideration will be given to improving disclosures in regulatory reports to improve the transparency of credit derivatives and their effects on the credit quality of the loan portfolio, particularly if the market for credit derivatives grows significantly.

Transactions Involving Affiliates

Although examiners have not seen credit derivative transactions involving two or more legal entities within the same banking organization, the possibility of such transactions exists. Transactions between or involving affiliates raise important supervisory issues, especially whether such arrangements are effective guarantees of affiliate obligations, or transfers of assets and their related credit exposure between affiliates. Thus, banking organizations should carefully consider existing supervisory guidance on interaffiliate transactions before entering into credit derivative arrangements involving affiliates, particularly when substantially

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[9](...continued)
This could be accomplished through the use of a second offsetting credit derivative transaction.

the same objectives could be met using traditional guarantee instruments.

III. Accounting and Regulatory Reporting Treatment for Credit Derivatives

The instructions to the bank and bank holding company regulatory reports do not contain explicit accounting guidance on credit derivatives at this time. Furthermore, there is no authoritative accounting guidance under GAAP that directly applies to credit derivatives. Accordingly, as a matter of sound practice, banking organizations entering into credit derivative transactions should have a written accounting policy that has been approved by senior management for credit derivatives and any asset (e.g., a loan or security) for which protection has been purchased. Banking organizations are strongly encouraged to consult with their outside accountants to ensure appropriate accounting practices in this area.

Pending any authoritative guidance from the accounting profession, banking organizations should report credit derivatives in the commercial bank Reports of Condition and Income ("Call Reports") in accordance with the following instructions.[10] Beneficiary banking organizations that purchase credit protection on an asset through a credit derivative should continue to report the amount and nature of the underlying asset for regulatory reporting purposes, without regard to

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[10]The accounting principles for the Call Reports are generally based on GAAP, and effective March 1997 will be consistent with GAAP. When supervisory concerns arise with respect to the lack of authoritative guidance under GAAP, the banking agencies may issue reporting guidance that is more specific than, but within the range of, GAAP. As indicated in the Call Report instructions, institutions should promptly seek a specific ruling from their primary federal bank supervisory agency when reporting events and transactions are not covered by the instructions.

the credit derivative transaction. That is, all underlying assets should be reported in the category appropriate for that transaction and obligor. Furthermore, the underlying asset should be reported as past due or nonaccrual, as appropriate, in Schedule RC-N in the Call Report, regardless of the existence of an associated credit derivative transaction.

The notional amount of all credit derivatives entered into by beneficiary banking organizations should be reported in Schedule RC-L, item 13, "All other off-balance-sheet assets," of the Call Report.[11] Furthermore, institutions may report the amount of credit derivatives that provide effective protection for their past due and nonaccrual assets in "Optional Narrative Statement Concerning the Amounts Reported in the Reports of Condition and Income" or in item 9 of Schedule RI-E, "Other explanations" of the Call Reports.[12]

In Schedule RC-R, the carrying value of all specifically identified underlying assets that are effectively guaranteed through credit derivative transactions may be assigned to the risk category of the guarantor or obligor, whichever is lower.

Both at inception and each reporting period thereafter, banking organizations that extend credit protection through credit derivatives (guarantors) should report in

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[11]For credit derivatives where the apparent notional amount differs from the effective notional amount, banking organizations must use the effective notional amount. For example, the effective notional amount of a credit derivative that is based on a $100 million bond, the value of which changes $2 for every $1 change in the value of the bond, is $200 million.

[12]Consideration may be given to capturing new information related to credit derivatives and other guarantee arrangements in specific line items in regulatory reports. The amount of past due and nonaccrual assets that are wholly or partially guaranteed by the U.S. Government is currently collected in regulatory reports.

the Call Report the notional amount of the credit derivatives in Schedule RC-L, item 12, "All other off-balance sheet liabilities," and Schedule RC-R, "credit equivalent amounts of off-balance sheet items," in the appropriate risk category. In addition, all liabilities for expected losses arising from these contracts should be reflected in financial statements promptly. For regulatory reporting purposes, the notional value of credit derivative transactions should not be reported as interest rate, foreign exchange, commodity, or equity derivative transactions. Institutions that have been reporting credit derivatives as such derivative transactions in the Call Report do not have to restate past reports.

In Schedule RC-R, the guarantor bank must report the carrying value of reference assets whose credit risk has been assumed in the risk category of the reference asset obligor or any guarantor, whichever is lower. For example, a bank that assumes the credit risk of a corporate bond would assign the exposure to the 100 percent risk category. However, if the bank laid off the corporate bond's credit risk by purchasing a credit derivative from another bank, the exposure would instead be assigned to the 20 percent risk category.