



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

June 30, 2000

Interpretive Letter #945
November 2002
12 CFR 3

Dear []:

This is in response to your presentation of June 6, 2000, requesting an opinion on the risk-based capital treatment for a proposed portfolio credit default swap transaction. In your presentation, you request approval to substitute a 20% risk weight for a 100% risk weight on a portfolio of reference assets because of the credit protection purchased from [*state trust company*] ([] or counterparty). Subject to the conditions described in this letter, the OCC approves this capital treatment for the first two and a half years of the proposed transaction. During the year preceeding the repricing of the transaction, additional capital will be required as described below.

Background

In the proposed transaction, [*NB1*] and [*NB2*] (together, [*NB1*] or the bank) would purchase default protection via a credit default swap referencing a portfolio of the bank's ABS/MBS securities. The portfolio consists of approximately 107 reference assets with a minimum rating of Aaa by Moody's or AAA by S&P. The weighted average credit quality of the reference securities is AAA/Aaa and the expected weighted average maturity is 3.7 years. The maximum final maturity of the portfolio is 35 years. Over the term of the transaction the bank will have the ability to replace securities that have amortized or matured. The bank may, at its option, substitute or replace reference assets according to certain eligibility criteria and guidelines agreed to by the bank and its counterparty.

The credit default swap purchased by the bank would have a final maturity of 35 years. However, the bank has the right to terminate the transaction in one year and every six months from that date in the event of a regulatory capital change that would permit the bank to assign a

risk weight of less than 100% to the underlying portfolio or a risk weight greater than 20% to the counterparty in the transaction. The bank may call the transaction for any reason after 18 months and every six months thereafter. If in three and a half years the bank has not exercised these options, the premium paid by the bank to its counterparty will be refixed based on then-prevailing market prices and the outstanding portfolio amount. If the bank experiences a credit loss on any of the reference assets, the counterparty will pay the bank an amount equal to the loss on the security at maturity or at the call date if the transaction is called by the bank.

Risks to the Bank

The transaction described above poses risks to the bank for which the OCC requires adequate risk-based capital. The reference assets for which the bank has purchased credit protection have various final maturities, the longest of which is 35 years. However, the bank has obtained protection against credit losses on the reference securities for effectively three and a half years. The refixing of the premium on the credit default swap in three and a half years is equivalent to entering into a new credit protection arrangement since the refixed premium will be based on then-prevailing market prices and condition of the underlying portfolio. Although the proposed transaction protects the bank from default events of any of the reference assets, it does not protect the bank from changes in value of the reference assets due to deteriorating credit quality of the issuers or changes in market conditions. The bank has purchased protection only on credit losses, i.e. a reduction in the principal of a reference asset or a failure to pay by the issuer. Although the counterparty has committed to continue to provide credit protection after three and a half years, the repricing feature leaves the bank exposed to the risk of credit deterioration in the reference assets.

Risk-Based Capital Treatment

The credit default swap enables the bank to transfer the credit risk of the portfolio of reference assets to the counterparty. Since the counterparty is obligated to reimburse the bank for any credit losses in the reference assets, the proposed credit derivative transaction is functionally equivalent to a standby letter of credit issued by the counterparty. During the period of effective credit protection, the bank's credit risk exposure under the proposed transaction is to the counterparty. Therefore, under 12 CFR Part 3 Appendix A, the bank may substitute the risk weight of the counterparty, an OECD bank (20%), for that of the reference assets. However, because the maturity of the proposed credit protection is effectively three and a half years (significantly shorter than the final maturity of some of the reference assets), the bank will be exposed to the credit risk of the reference assets in three and a half years. The OCC believes it is appropriate that the bank increase the regulatory capital held for the risks of the reference assets during the year prior to the effective maturity date of the transaction.

Starting with the end of the fourth quarter prior to the effective maturity date of the transaction (i.e., the repricing date), the bank should recognize only a portion of the credit protection provided by the counterparty. The portion of credit protection recognized would decrease over the last year, effectively increasing regulatory capital, so that at the end of the last quarter prior to the effective maturity date the full amount of regulatory capital for the unprotected reference

assets is allocated for the portfolio. Specifically, when calculating risk weighted assets at the end of the fourth quarter prior to the effective maturity date, the bank would recognize the credit protection provided by the counterparty for only 75% of the underlying portfolio, i.e. 75% of the underlying portfolio would receive the risk weight of the counterparty and 25% would receive the risk weight appropriate for the reference assets. At the end of the third quarter prior to the effective maturity date, 50% of the reference assets would receive the risk weight of the counterparty and 50% would receive the risk weight of the reference assets. At the end of the second quarter prior to the effective maturity date, only 25% of the reference assets would receive the risk weight of the counterparty. At the end of the last quarter prior to the effective maturity date, 100% of the reference assets would be considered unprotected. Assuming the reference assets are otherwise subject to a 100% risk weight, the effective risk weight on the portfolio would be 40% at the end of the fourth quarter, 60% at the end of the next quarter, 80% at the end of the second to last quarter, and 100% at the end of the last quarter.

As part of this risk-based capital interpretation, the OCC carefully considered the high credit quality of both the reference assets and the counterparty. The OCC also considered the bank's ability to adequately manage and monitor the risks of the transaction. The bank must continue to manage and maintain adequate regulatory capital for the credit risk of its assets that has not been transferred as a result of this transaction. The proposed transaction does not confer any benefits to the bank for purposes of calculating its Tier 1 leverage ratio because the reference assets remain on the bank's balance sheet.

Additionally, under the substitution agreement between the bank and the counterparty the bank may substitute an asset with a higher rating than that of the asset it is replacing. However, such a substitution might raise questions concerning the actual transference of credit risk of the reference assets to the counterparty and could result in the OCC reconsidering the capital treatment outlined in this letter.

This risk-based capital treatment applies only to transactions that meet the description and satisfy the conditions outlined in this letter. If you have further questions, please do not hesitate to contact the resident OCC examiners, the Capital Policy Division on 202-874-5070 or the Treasury and Market Risk Division on 202-874-5670.

Sincerely yours,

-signed-

Tommy Snow
Director, Capital Policy