

## Office of the Comptroller of the Currency

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## Board of Governors of the Federal Reserve System

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### Interpretive Letter #946 November 2002 12 CFR 3

September 27, 2001

Dear [ ]:

This letter is in response to your April 30, 2001 letter to Jennifer Burns and Morris Morgan requesting a risk-based capital interpretation for a series of credit derivative structures. In addition, your letter poses a number of questions concerning the application of 12 CFR 3, Appendix B; 12 CFR 208, Appendix E; and 12 CFR 225, Appendix E (“market risk rules”) and the proposal “Risk Based Capital Standards; Recourse and Direct Credit Substitutes”<sup>1</sup> (“Proposed Rules”) to credit derivatives. This letter provides views as to the appropriate risk-based capital treatment for all but one of the structures described. On the fifth structure, the variable funding credit-linked note, we are unable to provide a risk-based capital interpretation until more details are provided concerning the structure. The capital treatment set forth below for individual scenarios may not apply when the individual elements are combined together in one transaction. As a result, both the Office of the Comptroller of the Currency (OCC) and the Board of Governors of the Federal Reserve System (FRB) will continue to follow a case-by-case approach to risk-based capital interpretations for synthetic securitizations and credit derivatives transactions.

### Background

[ ] (the “Bank”) is considering providing second loss protection to a foreign OECD bank (“the Counterparty”) on a portfolio of margin loans (“Reference Portfolio”) originated in individual brokerage accounts in the U.S. The size of the pool will vary over time and is expected to be very diverse (over 1,000 borrowers.) For illustrative purposes you have assumed a notional amount for the portfolio of \$5 billion. The Counterparty will retain a first loss position of 2% per year and the third loss position. The Bank will assume the second loss position, not to exceed 10% of the portfolio over the life of the transaction. The second loss

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<sup>1</sup> 65 Fed. Reg. 12320 (March 8, 2000)

position is expected to be rated BBB. The maturity of the loans in the portfolio is not well defined, but the credit protection provided by the Bank will have a final maturity of 3 years and a call option exercisable by the Counterparty after 2.5 years.

In your letter, you describe five possible transaction structures by which the Bank could assume the second loss position on the Reference Portfolio: (1) cash securitization, (2) credit linked note (CLN), (3) credit default swap (CDS) referencing a CLN held by the Counterparty, (4) CDS directly on the Reference Portfolio, and (5) variable funding credit linked note (VFCLN).

## **Bank's Questions**

### Structure 1: Cash Securitization

In your letter you describe the banking book and trading book risk-based capital calculation for a cash securitization. As part of your description of the trading book calculation, you indicate that "there would also be the applicable Counterparty Risk charge." Please note that a counterparty credit risk charge is not required for a cash security held by the Bank in its trading book because under the market risk rules, such a charge applies only to over-the-counter derivatives and foreign exchange contracts.

*Question 1: Were the Proposed Rules intended to apply only to banking book treatment, or would they affect the trading book treatment as well?*

For banking organizations that do not apply the market risk rules, the Proposed Rules are intended to apply to positions in both the banking book and trading book. For banking organizations that comply with the market risk rules, the Proposed Rules, if adopted, would apply only to positions in the banking book and the market risk rules would apply to positions in the trading book (including those arising out of securitizations).

### Structure 2: Credit Linked Note

*Question 2: We are under the impression that OCC 99-43, FRB SR 99-32 was intended to apply only to the banking book. This is based primarily on the reliance on risk-weights when determining the capital charge for a bank investing in the notes of the synthetic CLO and the fact that no specific mention was made of the trading book. Are we correct in this assumption? If so, would the trading book treatment be identical to that described in Structure 1: Cash Securitization?*

The capital treatment articulated in OCC 99-43 and FRB SR99-32 applies to the agencies' current leverage and risk-based capital guidelines. Although not explicitly stated, the OCC and FRB intended the capital treatment articulated in OCC 99-43 and FRB SR 99-32 to apply to CLNs held in the banking book. Banks investing in CLNs are required to use the higher of the risk weight applicable for the underlying reference asset or the issuer of the CLNs. If the Bank holds a CLN in its trading book and it complies with the market risk rules, it must calculate the general market risk and specific risk capital charges for its investment in the CLN. The Bank should use its own internal value-at-risk (VAR) model to calculate the capital charge for general

market risk. A bank may use its VAR model to calculate its specific risk charge, if accepted by its supervisor, or the standard approach described in the market risk rules. If a bank uses the standard approach for specific risk, it may use the rating on the CLNs to determine the appropriate charge.

*Question 3: Generally, what would be the appropriate notional amount to which the risk-weight should be applied under OCC 99-43, FRB SR 99-32 – the notional amount of the note purchased or the notional amount of the underlying portfolio? For example, if a synthetic CLO had a \$100 million BBB tranche referencing a \$10 billion portfolio and SCP (“Structured Credit Products Group”) purchased \$20 million of that tranche, to what notional should the risk-weight be applied to calculate the capital charge against the \$20 million position?*

The risk weight should be applied to the maximum amount the bank could lose from its investment. For example, if a bank purchased rated CLNs with a face amount of \$20 MM and the maximum amount the bank could lose is \$20 MM, the appropriate risk weight would be applied to \$20 MM.

*Question 4: Was it the intention of the Proposed Rules to give synthetic securitizations and cash securitizations the same capital treatment?*

The Proposed Rules generally are intended to treat recourse obligations and direct credit substitutes more consistently than under the current risk-based capital standards, as well as to better match capital requirements to credit risk exposure. To the extent that synthetic securitizations and cash securitizations pose the same economic risk to a bank, the Proposed Rules, if adopted, should result in similar risk-based capital requirements.

### Structure 3: Credit Default Swap referencing a CLN held by the Counterparty

*Question 5: Would the notional amount of the CLN on which the default protection is written be the correct notional to use in the calculation of the Specific Risk capital charge and the Counterparty Risk capital charge?*

In this structure, the Bank has entered into a derivative contract with its Counterparty. The market risk rules require that in determining the standard specific risk charge “for debt positions that are derivatives, a bank must risk weight... the market value of the effective notional amount of the underlying debt instrument.” (Section 5(c)(1)(i)(A) of 12 CFR 3, Appendix B and 12 CFR 225 Appendix E). The CLN is the debt instrument underlying the CDS. The standard specific risk charge for the Bank should be calculated based on the market value of the underlying CLN and the rating of the CLN.

In the described transaction the Bank has sold credit protection to the Counterparty in return for a premium. The Bank’s only credit exposure to the Counterparty is future premiums, which, if discontinued, eliminate the Bank’s obligation to provide protection. Therefore, a counterparty risk capital charge is not necessary.

*Question 6: Is a literal reading of FRB SR 97-18 appropriate for the calculation of capital in this case?*

We assume that you are referring to the treatment for specific risk of credit derivatives described in FRB SR 97-18, “Application of Market Risk Capital Requirements to Credit Derivatives.” The SR letter states that “standard specific risk charges for credit derivatives may be calculated using the specific risk weighting factors that apply to the referenced asset.” In the case of a CDS referencing a rated CLN, the referenced asset is a rated CLN. For the transaction described, the Bank should calculate the standard specific risk charge by applying the risk weight appropriate for a debt instrument with the same rating and maturity as the CLN to the market value of the CLN.

#### Structure 4: Credit Default Swap

*Question 7: Would the CDS notional be the correct notional against which to apply the risk-weight in this scenario? [Banking book treatment]*

Under the current banking book rules, the CDS would be treated as a direct credit substitute. The CDS is equivalent to a guarantee type standby letter of credit on third party assets. To calculate the risk-based capital requirement for a standby letter of credit, the Bank would apply the appropriate risk weight to the face amount of the letter of credit. In the transaction described in your letter, the Bank would apply a 100% risk weight to the size of its second loss position, which is 10% of the underlying Reference Portfolio. If the CDS is structured in such a way that the bank could lose more than the notional amount of the CDS, that larger amount should be risk weighted.

However, if the Proposed Rules are adopted, the risk-based capital requirement could be significantly different. The Bank’s position would be treated as a non-traded and unrated position. The Bank’s risk-based capital charge would be the appropriate risk weight, 100%, applied to its second loss position plus the senior risk positions that it supports, subject to low-level recourse rules.

*Question 8: What would be the appropriate notional on which the capital charge should be calculated for the Specific Risk charge and the Counterparty Risk charge? [Trading book treatment]*

The market risk rules require a bank to apply the specific risk weight factor to the “effective notional amount” of the underlying reference asset. However, the rules do not explicitly define “effective notional amount.” In the transaction described, the Bank is providing second loss credit protection on the Reference Portfolio. The Bank’s potential credit losses are limited to 10% of the Reference Portfolio. Based on the specific facts of the transaction described in your letter, we believe the term “effective notional amount” should be interpreted to mean the Bank’s loss exposure under the CDS. The Bank may apply the specific risk weight factor to the maximum amount the Bank could lose on the CDS.

In the described transaction the Bank has sold credit protection to the Counterparty in return for a premium. The Bank's only credit exposure to the Counterparty is future premiums. Therefore, a counterparty risk capital charge is not necessary.

*Question 9: If the swap itself were rated investment grade, could the Specific Risk charge be calculated as  $1.6\% \times \$500 \text{ million} = \$8 \text{ million}$  rather than \$40 million? In other words, although this does not follow from a literal reading of FRB SR 97-18, given that this structure is economically identical to Structure 3 above<sup>2</sup>, should it be treated differently under the capital rules?*

FRB SR 97-18, which addresses trading book capital requirements, was issued 4 years ago when credit derivatives were relatively new instruments and CDS's were not rated. Since then, the market for credit derivatives has evolved and rated CDS are increasingly common. We believe that an investment grade rating on a CDS provides information on the credit quality of both the underlying reference portfolio and the level of prior enhancement. A case can be made that the rating of a CDS should be used to determine the specific risk weighting factor in the calculation of the standard specific risk capital charge. The specific risk capital charge would be \$8 MM.

*Question 10: Was it the intention of the Proposed Rules that a rated CDS such as the one described would be treated the same as a cash and/or synthetic securitization?*

The Proposed Rules are intended to treat recourse obligations and direct credit substitutes more consistently than under the current risk-based capital standards and better match capital requirements to credit risk exposure. The proposed definition of direct credit substitute includes credit derivative contracts under which a bank assumes more than its *pro rata* share of credit risk on a third-party asset. To the extent that a rated CDS poses the same risks to the Bank as cash securitizations, the Proposed Rules, if adopted, should result in similar risk-based capital requirements.

#### Structure 5: Variable Funding Credit Linked Note

*Question 11: Would the capital treatment of the VFCLN be any different from the standard CLN or the cash securitization discussed above?*

As described in your letter, the VFCLN appears similar to a CDS. As in a CDS, the Bank has a cash outflow only when a loss on the reference portfolio occurs, and is unlikely to recover that cash payment from recoveries on the underlying Reference Portfolio. With CLNs or cash securitization, the credit protection seller "purchases" the instrument via a cash outflow and receives a return of that investment less any losses. Since the VFCLN structure is new, we are hesitant to opine on a risk-based capital treatment until we review the specific terms of the note.

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<sup>2</sup> The two would be economically identical provided that the terms of the CDS in Structure 4 and the CDS and CLN in Structure 3 were specified appropriately. All cashflows would be identical both in timing and amount.

## **Conclusion**

This letter outlines our views on a variety of credit derivative structures. The risk-based capital treatments outlined in this letter apply only to transactions described in your letter. The treatment of other transactions will depend on the structure and terms of those transactions. The OCC and FRB continue to review and issue risk-based capital interpretations on credit derivative transactions on a case-by-case basis. If you have further questions, please do not hesitate to contact the resident OCC examiners, Margot Schwadron in the Capital Policy Division on 202-874-6022 or Kurt Wilhelm in the Treasury and Market Risk Division on 202-874-4479 or Tom Boemio in the Supervisory and Risk Policy Division of the FRB at 202-452-2982.

Sincerely yours,

**-signed-**

Tommy Snow  
Director, Capital Policy  
Office of the Comptroller  
of the Currency

**-signed-**

Barbara Bouchard  
Assistant Director  
Board of Governors of the  
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