

Our Ref: B9/24C

26 November 1999

The Chief Executive
All Locally Incorporated Authorised Institutions

Dear Sir/Madam,

Supervisory Approach to Credit Derivatives

In view of the rapid evolution of credit derivatives and banking institutions' increasing involvement in the credit derivatives market, the Hong Kong Monetary Authority ("HKMA") is setting out its current approach to these instruments, in particular relating to capital requirement and large exposures treatment. The HKMA will continue to assess the use and development of credit derivatives in the market. The supervisory approach set out in this letter will therefore be subject to revision and additional guidance.

The capital requirements set out in this letter are primarily for credit derivative transactions recorded in the banking book. Institutions should consult the HKMA about the treatment of credit derivatives under the market risk regime if the transactions are recorded in the trading book.

Definitions

Credit derivatives are designed to allow market participants to transfer credit risk on loans and other assets from one party, the *protection buyer*, to another party, the *protection seller*. An *underlying asset* is the asset that a protection buyer is seeking to hedge. Banking institutions can use credit derivatives to reduce (in the case of protection buyer) or acquire (in the case of protection seller) credit risk exposure. The payment defined in a credit derivative contract depends on the occurrence of a *credit event* to a *reference entity*. The reference entity could be a corporate or a

sovereign. Credit events could include bankruptcy, any payment default, repudiation or restructuring in respect of the reference entity. A *reference obligation* which is an obligation of the reference entity is uniquely specified in a credit derivative contract. Its main purpose is to provide a basis for cash settlement or to define the seniority of *deliverable obligations* for physical settlement where applicable.

There are generally three types of credit derivatives: credit default swaps, total return swaps and credit linked notes. In a credit default swap, the protection buyer pays a fee to the protection seller in exchange for a guarantee against any loss that may occur if a credit event occurs. Under a total return swap, the protection buyer agrees to pay the protection seller the “total return”, which includes all contractual payments plus any appreciation in market value of the reference obligation, in exchange for a spread over a specified index plus any depreciation in value of the reference obligation during the term of the swap. For a credit linked note, the protection buyer issues a note which is linked to a reference entity and the note pays a fixed or floating interest rate. The note holder (i.e. the protection seller) buys the note at market value. If no credit event occurs, the note will be redeemed at par. If a defined credit event occurs, the deliverable obligations would be delivered to the note holder for settlement. Therefore, the credit linked note can be considered as a transaction composed of a regular note issued by the issuer and a credit default swap in which the issuer is a protection buyer. The credit linked note holder provides a guarantee against any loss if a credit event occurs.

HKMA’s approach

Risk management

The issues relating to credit derivatives are quite complex, and the market is still evolving. It is therefore the HKMA’s view that banking institutions should carefully consider all related risks and rewards before entering into this market. An institution should not enter into credit derivative transactions unless its management has the ability to understand and properly manage the credit and other risks associated with these instruments. Institutions that use credit derivatives should establish sound risk management policies and procedures and effective internal controls.

Apart from policies and internal controls, institutions should be aware of potential legal risk arising from credit derivative transactions. Legal risk refers to the risk of loss resulting from an unenforceable credit derivative contract. Factors contributing to such risk include inadequate

documentation, lack of authority for a counterparty to enter the contract, uncertain payment procedures associated with bankruptcy proceedings, etc. Institutions should consult their legal advisors about adequate documentation and other related legal issues of credit derivative contracts before engaging in any such transactions.

Capital adequacy requirements in banking book

The following capital treatments are set out for reporting credit derivatives held in the banking book. It is a set of methods to guide institutions to report their credit derivative positions, either for hedging their underlying assets or for acquiring credit exposures to a reference entity, in the Return of Capital Adequacy Ratio (MA(BS)3). When an institution engages in a credit derivative transaction for hedging an underlying asset in the banking book, the transaction should be reported in the same book so that a different credit risk weight in calculating the capital requirement for the underlying asset can be allowed.

In order for a protection to be recognised for the purposes of capital adequacy, the following requirements must be met for all credit derivatives:

- a) The underlying asset and the reference obligation should have the same obligor;
- b) The underlying asset should have equal or greater seniority than the reference obligation;
- c) The credit events specified in a credit default swap or credit-linked note must adequately cover the credit risk of the reference entity itself; and
- d) The protection seller must have no formal recourse to the protection buyer for losses.

In the following treatments, the time to maturity of the credit derivative contract or the instrument should be no less than that of the underlying credit exposure to be hedged. If there is a maturity mismatch, a currency mismatch or a credit derivative referenced to multiple obligors, the institution should consult the HKMA about the proper treatment.

Banking book – protection buyer

The amount of protection that can attract the lower risk weight depends on the payment defined in the credit derivative contract when a credit event occurs. There are normally three types of payment:

- (i) the protection seller pays the principal amount specified in the contract to the protection buyer in exchange for physical delivery of the deliverable obligations with the same principal amount, which are specified in the credit derivative contract; for example debt obligations of the reference entity that rank equally or higher in priority of payment with the reference obligation;
- (ii) the protection seller pays the principal amount specified in the contract less the market value of the reference obligation (the market value is calculated by specified calculation agents at some pre-designated point in time after a credit event has occurred) to the protection buyer; and
- (iii) the protection seller pays a fixed amount to the protection buyer.

Where an underlying asset is protected by a total return swap or a credit default swap, the capital treatment of the asset is the same as that of a guarantee as set out in para. 17 in the Completion Instructions of the Return. Therefore, the risk weight of the underlying asset can be replaced by the risk weight of the protection seller¹.

Where the payment is defined as type (i) or (ii), the underlying asset is regarded as fully protected. Where the payment is a fixed payment, i.e. type (iii), the amount of protection is the amount of the fixed payment. The remaining unprotected amount, if there is any, of the underlying asset should be reported according to the underlying asset's own risk weight.

Where an underlying asset is protected through issuing a credit linked note, the maximum amount of protection is the amount of the funds received from issuing the note. The protected amount is reported as a claim collateralised by cash deposits (Part II Item 5 in the Return). Therefore it attracts a 0% risk weight. The remaining unprotected amount, if there is any, of the underlying asset should be reported according to the underlying asset's own risk weight.

¹ If the risk weighting of the protection seller is higher than that of the underlying asset, the risk weighting does not have to be increased.

Where a protection is bought in the absence of an underlying exposure, i.e. the institution has an open short position, or where the bought protection is not recognised in calculating capital requirements for an underlying exposure, the credit derivative is ignored for capital adequacy purposes.

Banking book – protection seller

Where an institution sells protection through a total return swap or a credit default swap, it acquires exposure to the reference entity. The exposure should be treated as a direct credit substitute (Part III Item 1 in the Return) and weighted according to the risk weight of the reference entity. The amount of exposure is the maximum amount that could be paid out under the contract.

Where the payment is defined as type (i) or (ii), the amount of exposure is the principal amount defined in the contract. Where the payment is a fixed payment, i.e. type (iii), the amount of exposure is equal to the fixed payment.

Through holding a credit linked note, an institution acquires credit exposure in two fronts: from the reference entity of the note and also from the note issuer. This on-balance-sheet exposure should be weighted by the higher of the risk weight of the reference entity or the risk weight of the note issuer. The amount of exposure is the book value of the note.

Large exposure treatment

Credit derivatives should be included in the reporting of large exposures in the Return of Large Exposures (MA(BS)1D) for the purposes of Section 81 of the Banking Ordinance.

Protection Buyers

A credit default swap or a total return swap which is recognised as a protection of the underlying asset for capital adequacy purposes should be regarded as a guarantee and reported as an indirect off-balance-sheet exposure (commitment and contingency) to the protection seller in the Return of Large Exposures. The amount of the exposure is the same amount of protection that can attract the lower risk weight for capital adequacy purposes.

In a credit linked note which is recognised as a protection of the underlying asset for capital adequacy purposes, the protection buyer (the

note issuer) should report its exposure to the counterparty of the underlying asset as an exposure secured by a cash deposit. The amount of the secured exposure is the amount of the funds received from issuing the note. The unsecured amount, if there is any, of the exposure to the counterparty of the underlying asset should be reported as a direct exposure.

Protection Sellers

For protection sellers, a total return swap or a credit default swap should be treated in the same way as a direct credit substitute and reported as a direct off-balance-sheet exposure (commitment and contingency) to the reference entity in the Return of Large Exposure. The amount of the exposure to the reference entity is the maximum amount that could be paid out under the contract. Therefore, it is the same amount reported for the capital adequacy requirement.

In a credit linked note, the protection seller (the note buyer) has an on-balance sheet exposure to the note issuer. In addition, the protection seller has an off-balance sheet direct exposure (commitment and contingency) to the reference entity because of the embedded credit default swap in the note. The amount of this off-balance sheet exposure which should be reported is the book value of the note.

If you have any questions on the supervisory approach set out in this letter, please contact Mr. Cho-hoi Hui at 2878 1485 or Mr. Daniel Wong at 2878 1626.

Yours faithfully,

D T R Carse
Deputy Chief Executive