

Division of Supervision MEMORANDUM SYSTEM	Classification Number 6300 (I)(S)	
	Date August 15 , 1996	
	Issuing Office DOS/OCM	
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	Notice	Memorandum X

TO: Regional Directors

FROM: Nicholas J. Ketcha Jr.
Director

SUBJECT: Supervisory Guidance for Credit Derivatives

1. Purpose. To provide preliminary examination guidance for the supervisory analysis and treatment of credit derivatives at insured financial institutions. Credit derivatives are relatively new instruments in the marketplace, thus the examination guidance and capital treatment that follows is general in nature and will be refined in the future. This memorandum provides an overview of credit derivatives and presents a framework for analyzing the risks incurred by insured institutions that use these off-balance sheet instruments.

Credit derivatives are financial instruments used to assume or lay off credit risk, sometimes only to a limited extent. Depository institutions are increasingly employing these off-balance sheet instruments either as end-users that purchase credit protection from or provide credit protection to counterparties, or as dealers intermediating such protection. This guidance stresses the need for examiners to ensure that depository institutions using credit derivatives for such purposes as risk management, yield enhancement, reduction of credit concentrations, or diversification of overall risk have established sound risk management policies and procedures.

The analytical techniques used to manage credit derivatives may provide new insights into credit risk and its management. Currently, U.S. banking supervisors, as well as banking supervisors abroad, are analyzing credit derivatives in order to develop appropriate supervisory policies. The discussions with the other U.S. and international banking regulators may result in revised or additional guidance on the appropriate supervisory treatment of credit derivatives.¹

2. Background. Credit derivatives are off-balance sheet arrangements that allow one party (the "beneficiary") to transfer the credit risk of a "reference asset" to another party (the "guarantor").² The beneficiary often actually owns the reference asset but the guarantor does not need to purchase the reference asset directly to assume the associated credit risk. Credit derivative transactions, however, unlike traditional guarantee arrangements, often are documented using master agreements developed by the International Swaps and Derivatives Association (ISDA) in a manner similar to swaps or options.

¹Once 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.

²For purposes of this memorandum, 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.

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

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 to the writer of the put from the buyer of the put.

3. Supervisory Policy. 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 depository institution 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, depository institutions providing credit protection through a credit derivative should hold capital against their exposure to the reference asset. This broad principle holds for all credit derivatives, but must be modified somewhat for credit derivative contracts that incorporate periodic payments for depreciation or appreciation such as most total rate of return swaps. For these credit derivatives, the guarantor can deduct the amount of depreciation paid to the beneficiary (net of any amounts paid by the beneficiary for appreciation) from the notional amount of the contract in determining the amount of reference exposure subject to a capital charge.

In some cases, such as total rate of return swaps, both the guarantor and the beneficiary are 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, i.e., the credit risk measurement generally employed for derivative contracts.

³The 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 regulatory issues, such as credit exposure, asset classification, allowance for loan and lease losses, and transactions involving affiliates; and guidance on the appropriate accounting and regulatory reporting treatment for credit derivatives.

⁴Credit 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.

⁵The determination of whether credit derivatives are guarantees to be included in the legal lending limits under applicable law are the purview of the state banking regulators and the OCC.

For banks acting as dealers that have matching offsetting positions, the counterparty risk could be the primary risk to which the dealer banks are exposed from credit derivative transactions.

In reviewing a credit derivative entered into by a beneficiary depository institution, 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. *Only 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 the derivative provides the beneficiary 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 depository institution. 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 depository institution 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

⁶Further guidance on examining the risk management practices of depository institutions, including guidance on derivatives, which examiners may find helpful in reviewing an organization's management of its credit derivative activity, is contained in the DOS Manual of Examination Policies; Examination Guidance

4. Action Required. This document should be distributed to all examiners. Examiners should contact their regional capital markets specialists when encountering off-balance sheet credit derivatives or on-balance sheet credit linked notes.

If you have any questions on the supervisory or capital issues related to credit derivatives, please contact William A. Stark, Assistant Director (202/898-6972), or Miguel D. Browne, Deputy Assistant Director (202/898-6789). Questions concerning the accounting treatment for these products may be addressed to Stephen G. Pfeifer, Examination Specialist (202/898-8904).

Attachments

Transmittal No. 96-066

for Financial Derivatives (FIL 34-94, RD 94-059); Assessment of Interest Rate Risk (FIL 60-94, RD 94-121); Examination Guidance for Structured Notes (FIL 61-94, RD 94-130); Calculation of the Potential Future Exposure of Derivatives (FIL 50-95).

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 depository institution 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 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.

¹Another 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.

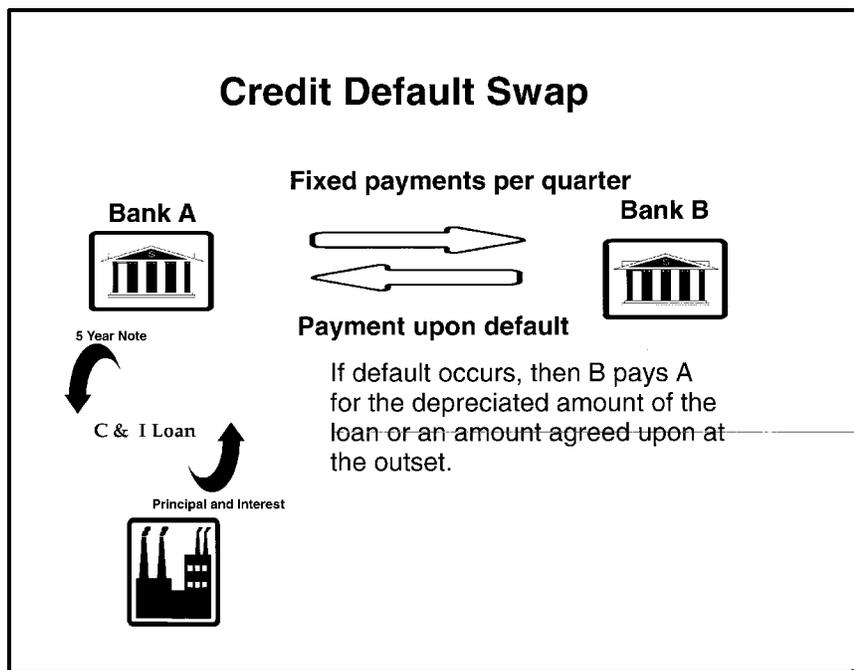


Figure 1 Credit Default Swap Cash Flow Diagram

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 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 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 over the term of the swap.

²The 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.

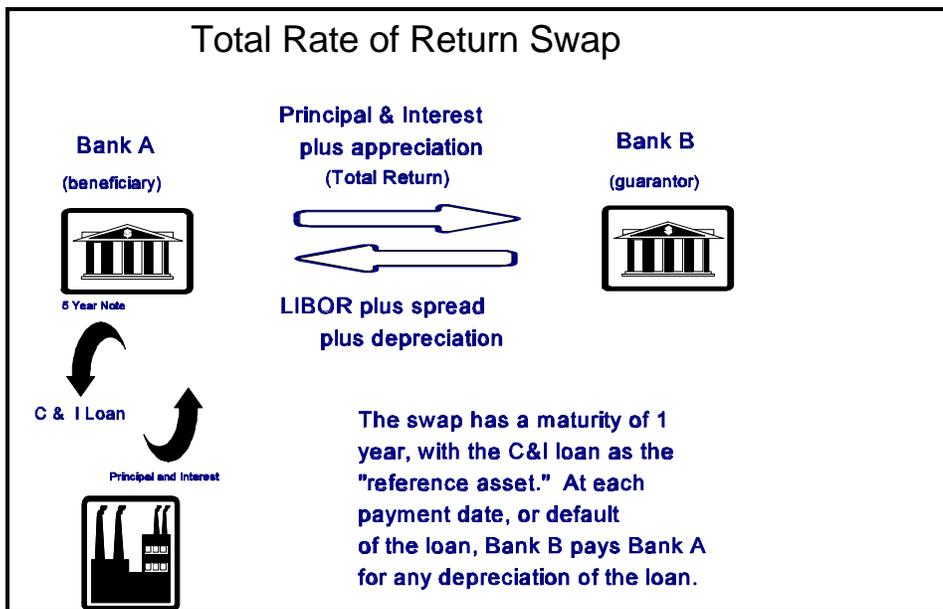


Figure 2 Total Return Swap Cash Flow Diagram

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 5} 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.

³Depending 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.

⁴For credit derivatives where the apparent notional amount differs from the effective notional amount, depository institutions must use the effective notional amount. For example, if a credit derivative is based on a \$100 million bond and the derivative's value changes \$2 for every \$1 change in the value of the bond the effective notional amount of the credit derivative, is \$200 million.

⁵As 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.⁶ A depository institution 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, if relevant, the nature of the collateral. On the other hand, a depository institution that owns the underlying asset upon which effective credit protection has been acquired through a credit derivative may 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 an OECD 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 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 depository institution providing credit protection through a credit derivative must hold capital against the underlying exposure while it is exposed to the credit risk of the reference asset.

Depository institutions 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, depository institutions 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

⁶Guarantor banks which have made cash payments representing depreciation on reference assets may deduct such payments (net of any payments received from the beneficiary for appreciation) 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.

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, are subject to mutual cross-default provisions. A depository institution 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. Depository institutions 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 depository institution 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 depository institution 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 certain thresholds of the bank's Tier 1 capital.⁷ Examiners should 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 should 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

⁷See "Report of Examination Instructions" in the DOS Manual of Examination Policies.

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 the bank's safety and soundness.⁸ 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 primary source of repayment. The assessment of the credit quality of a troubled loan, however, should take into account support provided by a financially responsible guarantor.

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.

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 depository institution 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 depository institutions, 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 depository institution 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.⁹

⁸Loans 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."

⁹ Section 3.7 of the DOS Manual of Examination Policies describes the classification criteria for other forms of direct credit substitutes such as standby letters of credit.

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. FDIC 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 bank holding company, 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, depository institutions should carefully consider existing supervisory guidance on interaffiliate transactions before entering into credit derivative arrangements involving affiliates, particularly when substantially the same objectives could be met using traditional guarantee instruments.

III. Accounting and Regulatory Reporting

Treatment for Credit Derivatives

The instructions to the Reports of Condition and Income (“Call Report”) 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, depository institutions 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. Depository institutions are strongly encouraged to consult with their outside accountants to ensure appropriate accounting practices in this area. Nevertheless, institutions’ accounting practices are subject to examiner review and criticism.

Pending any authoritative guidance from the accounting profession, banks should report credit derivatives in the Call Report in accordance with the following instructions.¹⁰ Beneficiary depository institutions 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 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. Amounts receivable under a credit derivative contract should not be reported as an adjustment to the ALLL.

¹⁰The 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 that are not covered by the instructions.

The notional amount of all credit derivatives entered into by beneficiary depository institutions 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 Schedule RI-E, item 9, "Other explanations."¹²

In Schedule RC-R, items 4 through 7, column A, 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. However, for underlying assets that are reported as available-for-sale securities the amortized cost rather than the carrying value (i.e. fair value) should be assigned to a risk category.

Banks that extend credit protection through credit derivatives (guarantors) should reflect all liabilities for expected losses arising from these contracts in their financial statements promptly. In addition, guarantor banks should report in the Call Report the notional amount of the credit derivatives in Schedule RC-L, item 12, "All other off-balance sheet liabilities," and the credit equivalent amounts of these contracts in Schedule RC-R, items 4 through 7, column B. In Schedule RC-R, credit equivalent amounts of their credit derivatives may be reported 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 through a credit derivative 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 OECD bank, the exposure may instead be assigned to the 20 percent risk category.

For Call Report purposes, the notional value of credit derivatives transactions should not be reported as interest rate, foreign exchange, commodity, or equity derivative transactions in Schedules RC-L and RC-R. Institutions that have been reporting credit derivatives as such derivative transaction in the Call Report do not have to amend past reports.

¹¹For credit derivatives where the apparent notional amount differs from the effective notional amount, depository institutions 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.

¹²Consideration 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.