



Federal Deposit Insurance Corporation
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Counterparty Credit Risk Management: Supervisory Guidance

Summary: The FDIC, with the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, is issuing guidance to clarify supervisory expectations and sound practices for an effective counterparty credit risk (CCR) management framework. The guidance emphasizes that banks should use appropriate reporting metrics and limits systems, have well-developed and comprehensive stress testing, and maintain systems that facilitate measurement and aggregation of CCR throughout the organization.

Summary of Applicability to Institutions under \$1 Billion in Total Assets: This guidance applies to banks with significant derivatives portfolios. It does not apply to banks with limited derivatives exposure, particularly noncomplex exposures that are typical for community banks, such as embedded caps and floors on assets or liabilities, forward agreements to sell mortgages, or isolated interest rate swaps. Banks using derivatives that are more complex and/or those with significant noncomplex derivatives exposure should refer to the guidance for applicable risk management principles and practices.

Suggested Distribution:

FDIC-Supervised Banks (Commercial and Savings)

Suggested Routing:

Chief Financial Officer
Chief Information Officer
Chief Risk Officer

Related Topics:

Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities, FIL-45-1998

Attachment:

Interagency Supervisory Guidance on Counterparty Credit Risk

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Highlights:

- An effective CCR management framework should include measurement metrics appropriate for the organization's risk profile. Banks should formalize CCR exposure limits, monitor exposures against established thresholds, and maintain adequate risk controls to mitigate limit exceptions.
- To ensure accurate CCR reporting and concentration tracking, banks should conduct timely and comprehensive aggregation of exposures at various levels of granularity. Banks should measure, monitor, and control CCR concentrations by legal entity and across the organization.
- Collateral margin policies and practices contained in the guidance offer sound risk management practices and considerations. On April 11, 2011, the FDIC, Board of Governors of the Federal Reserve System, and Office of the Comptroller of the Currency jointly published a notice of proposed rulemaking (NPR) that would impose requirements for certain "covered swap entities," as defined in the NPR, to collect initial and variation margin. With respect to commercial end users, the NPR stated that covered swap entities are not required to collect initial and/or variation margin from commercial end user counterparties as long as the covered swap entity's exposure to the commercial end user is below the credit exposure limits that have been established under appropriate credit processes and standards. The NPR did not impose new counterparty credit risk management practices for the establishment of credit exposure limits for commercial end users that hedge business risks through the use of derivatives. This guidance should not be interpreted as altering that stance. The guidance provides regulatory expectations for safe and sound management of counterparty credit risks, while the NPR imposes specific margin requirements for certain transactions.

Counterparty Credit Risk Management: Supervisory Guidance

The FDIC has joined with the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision to reiterate and clarify existing guidance on counterparty credit risk (CCR) management, which has been consolidated in the attached document. This guidance discusses critical aspects of effective management of CCR exposures and sets supervisory expectations and sound practices for an effective CCR management framework. The guidance emphasizes that banks should use a variety of measurement and reporting metrics, have well-developed and comprehensive stress testing, and maintain systems that facilitate measurement and aggregation of CCR throughout the organization.

This guidance is primarily for banks with significant derivatives portfolios, typically referred to as large dealer banking organizations. However, other banks with significant CCR exposures should tailor the guidance to fit the complexity and risk profile of their derivatives activities. The guidance does not apply to banks with limited derivatives exposure, particularly noncomplex exposures that are typical for community banks, such as embedded caps and floors on assets or liabilities, forward agreements to sell mortgages, or isolated interest rate swaps. Banks using derivatives that are more complex and/or those with significant noncomplex derivatives exposure should refer to the guidance for applicable risk management principles and practices.

Governance

Senior management and the board of directors are responsible for setting risk tolerances for CCR; measuring, monitoring, and controlling CCR risk exposures; and developing and implementing effective policies and procedures. They should also ensure that independent audit and risk management functions cover CCR management. Senior management should receive comprehensive CCR exposure reports at least monthly.

Risk Measurement

CCR Metrics

Banks should use a range of CCR metrics based on the organization's risk profile, typically consisting of a key and secondary set of metrics applied to single exposures, groups of counterparties (for example, industry or region), and the consolidated portfolio. For each metric used, banks should assess the largest exposures (for example, the top 20 exposures.) CCR metrics include, but are not limited to, current exposure (gross and net of collateral), forward-looking exposure and stressed exposure (by market risk factors, and/or by scenario), aggregate and stressed credit valuation adjustment (CVA) and CVA sensitivity factors, largest exposures by individual business line and product types, risk from correlations (for example, wrong-way risk), and additional relevant risk measures (for example, jump-to-default risk), as described in the guidance.

Aggregation of Exposures

Aggregation is critical as it helps management identify concentrations. Banks should be able to measure CCR exposure at various levels of granularity, such as by business line, geographic region, industry, and on a consolidated basis. Aggregation should be timely and include all trades.

CCR Concentrations

Banks should use quantitative and qualitative means to identify concentrations and should manage concentration risk at the legal entity level as well as across the organization. Concentration measurement should consider all credit exposures (for example, loans, over-the-counter derivatives, and securities settlements) and the size of settlement and clearing lines or other committed lines.

Stress Testing

Banks with significant CCR exposures should maintain a comprehensive and sufficiently severe stress testing framework that can be used to inform CCR exposure and concentration management and provide evidence of potentially excessive risk. Stress testing should be conducted at least quarterly, and management should initiate appropriate risk-reduction strategies when results indicate excessive risk.

Credit Valuation Adjustment (CVA)

CVA is the fair value adjustment made to reflect CCR in derivatives. CVA provides a market-based framework for understanding and valuing the CCR embedded in derivatives contracts. CVA is an important tool to value, manage, and make hedging decisions to mitigate the mark-to-market impact of CCR. CVA should include all products and all counterparties, and the method for incorporating counterparty credit quality into CVA should be reasonable and reviewed regularly.

CVA Value-at-Risk (VaR) Measurements

CVA VaR models can be used to supplement stress tests of CVA to measure potential losses. CVA VaR captures the variability of the CCR exposure, the variability of the counterparty's credit spread, and the dependency between them. All material counterparties covered by CVA valuation should be included in the VaR model, and CVA VaR should incorporate all forms of CVA hedging.

Wrong-way Risk (WWR)

WWR occurs when the exposure to a particular counterparty is positively correlated with the probability of default of the counterparty itself. Banks should maintain policies, tolerances, and management escalation procedures for managing WWR. Banks should measure WWR across over-the-counter derivatives and securities financing transaction portfolios.

Systems Infrastructure Considerations

Ideally, banks would have a single comprehensive CCR exposure measurement platform. However, if more than one system exists, the number of platforms/methodologies should be minimized. Multiple system measures should be aggregated conservatively. Banks are encouraged to limit the use of "add ons," which are measurements that occur outside the

main measurement system and are added to the main measurement to produce an exposure measurement. Additionally, banks should have appropriate data integrity and reconciliation practices and automation and tracking processes.

Risk Management

Counterparty Limits

Meaningful limits on CCR exposures is an important part of the risk management framework, and an appropriate independent exposure monitoring system should be in place that tracks exposures against established limits. Adequate risk controls should be in place to mitigate limit exceptions, and exception review steps should include escalation procedures commensurate with the size of the excess or the required mitigation steps.

Margin Policies and Practices

Margin policies and practices help mitigate CCR exposure; therefore, sound controls and policies in this area are important. Policies should address processes to establish and periodically review minimum haircuts, recognizing any volatility and liquidity concerns with underlying collateral. Policies should also address when CCR should lead to the decision to require posted margin to be segregated. Additionally, management should maintain policies and procedures for monitoring margin agreements involving third-party custodians that identify the location of the account, where collateral is posted, and methods for gathering adequate documentation from the custodian to confirm collateral disposition.

Validation of Models and Systems

Validation involves an evaluation of the conceptual soundness of the model, an ongoing monitoring program (process verification and benchmarking), and an outcomes-analysis process (back-testing). Banks should independently validate all CCR models and related systems initially and on an ongoing basis, as detailed in the guidance document and Appendix B.

Close-out Policies and Practices

A close-out is the process a bank goes through to fully collect all items due following default of a counterparty. Close-out policies and practices should help the bank effectively manage counterparties in distress. An exercise that will inform the process is a hypothetical close-out simulation. Banks should conduct hypothetical close-out exercises every two years for one of the most complex counterparties and should cycle the selected counterparty to avoid repeat simulations to the extent possible.

Managing Central Counterparty Exposures

At least annually, banks should review central counterparties where exposures exist. Such reviews should include a due diligence evaluation of the central counterparty's risk management framework. For example, management should review each central counterparty's membership requirements, guarantee fund contributions, margining practices, default-sharing protocols, and limits of liability. Additionally, management should consider the counterparty's procedures for handling the default of a clearing member, obligations at post-default auctions, and post-default assignment of positions.

Legal and Operational Risk Management

Banks should ensure proper control of, and access to, legal documentation and agreements, and should conduct a review of legal enforceability of collateral and netting agreements at least annually. Banks should use commonly recognized dispute resolution procedures and should assess client and deal appropriateness, considering the level of client sophistication and the client's financial condition.

Applicability to Banks with Significant Derivatives Portfolios that are Not Dealers

Although the guidance is primarily targeted to the largest dealer banking organizations, certain sound practices apply to smaller banks with significant derivatives portfolios. Larger banks that are not dealers and community banks with more complex derivatives activities (which are considered significant) should refer to the sections that address sound practices for collateral disposition, legal review of contracts, and data integrity and reconciliation, and tailor the guidance to their risk profile and derivatives activities.

To illustrate, the systems infrastructure section addresses basic data integrity and reconciliation considerations as well as automation and tracking action items that could apply to financial banks with smaller derivatives portfolios. Also, the margin policies and practices described in the guidance, such as monitoring collateral haircuts, collateral disposition, and margin agreements involving third-party custodians, are important risk management considerations. Similarly, the legal and operational risk management section describes sound practices to review derivatives contracts for legal enforceability, netting arrangements, and collateral dispute resolution.

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