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OF THE
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DIVISION OF BANKING
SUPERVISION AND REGULATION

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TO THE OFFICER IN CHARGE OF SUPERVISION AND APPROPRIATE SUPERVISORY AND EXAMINATION STAFF AT EACH FEDERAL RESERVE BANK

SUBJECT: Impact of High-Cost Credit Protection Transactions on the Assessment of Capital Adequacy

This letter provides direction to supervisory and banking organization staff on the potential impact of high-cost credit protection transactions on their assessment of a banking organization's overall capital adequacy.

Credit risk mitigation techniques can significantly reduce a banking organization's level of risk. Depending on the credit quality of the protected assets, among other considerations, banking organizations may be required to pay high premiums or fees to purchase credit protection. For specific transactions, it may be appropriate for a banking organization to pay these costs as part of its overall risk-management strategy.

In some instances, however, the high premiums or fees paid for certain credit protection, combined with other terms and conditions, call into question the degree of risk transfer of the transaction and may be inconsistent with safety and soundness. Rather than contributing to a prudent risk-management strategy, the primary effect of these high-cost credit protection transactions is to embed a high percentage of expected losses into the premiums and fees paid, under the premise that the transaction would receive favorable risk-based capital treatment in the short term and defer recognition of losses over an extended period. Supervisors will scrutinize such transactions and, based on the factors and analysis described below, may preclude favorable risk-based capital treatment.

Banking organizations should analyze and document the economic substance of credit protection transactions that have unusually high-cost or innovative features to assess the degree of risk transfer and the associated impact on the organization's overall capital adequacy. The analysis should also specify how the transaction aligns with the banking organization's overall risk-management strategy. In evaluating the degree of risk transfer of a transaction, banking organizations should consider and supervisors will assess the following factors, among others, as applicable:

- A comparison of the present value of premiums relative to expected losses over a variety of stress scenarios;

- The pricing of the transaction relative to market prices;
- The timing of payments under the transaction, including potential timing differences between the banking organization's provisioning or write downs and payments by the counterparty;
- A review of applicable call dates to assess the likely duration of the credit protection relative to the potential timing of future credit losses;
- An analysis of whether certain circumstances could lead to the banking organization's increased reliance on the counterparty at the same time that the counterparty's ability to meet its obligations is weakened;
- An analysis of whether the banking organization can prudently afford the premiums given the banking organization's earnings, capital, and overall financial condition; and
- A review of any internal memos or records outlining the rationale for the transaction and the organization's analysis of the anticipated costs and benefits of the transaction.

Supervisory staff should take high-cost credit protection transactions into account in their assessment of a banking organization's overall capital adequacy. In some cases, supervisory staff may determine that a transaction should be discounted in the assessment of the banking organization's management of its risk profile and capital needs, or that the cost of the transaction should be judged as having a negative impact on the banking organization's earnings and capital. In particular cases, the Board may determine that a transaction should not be recognized as a guarantee for risk-based capital purposes. Misuse of credit protection transactions may negatively impact the organization's supervisory ratings (including management and risk management), its ability to pay dividends and effect equity redemptions and repurchases, and the evaluation of the merits of acquisitions and other applications.

Reserve Banks are asked to distribute this letter to institutions supervised by the Federal Reserve and to supervisory and examination staff. Questions regarding this letter or regarding individual transactions may be directed to Constance Horsley, Senior Supervisory Financial Analyst, at (202) 452-5239, or Chris Powell, Financial Analyst, Capital and Regulatory Policy, at (202) 912-4353.

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