

Attachment II
Suggested Transmittal Letter

SUBJECT: Supervisory Guidance Regarding Counterparty Credit Risk Management

Dear _____:

On February 1, 1999, the Federal Reserve issued the enclosed supervisory guidance providing supervisors and bankers information on those elements of counterparty credit risk management systems at large complex banking organizations that may need special review and enhancement. The guidance was issued to address potential weaknesses identified as a result of losses stemming from recent market turbulence and supervisory reviews of bank counterparty credit risk management systems. These reviews found that at some institutions basic credit risk management policies, procedures, and internal controls were insufficient to address the risks of new, fast growing, or evolving products and activities.

The guidance reiterates and expands upon fundamental principles of counterparty credit risk management that are covered in existing supervisory materials of the Federal Reserve and other regulators and in established industry standards, including the Federal Reserve's supervisory manual entitled Trading and Capital Markets Activities.

As further described in the attached guidance and accompanying supervisory letter issued by the Board's Division of Banking Supervision and Regulation, examiners and supervisory staff are instructed to continue and, where appropriate, strengthen efforts to evaluate whether banking institutions:

- Devote sufficient resources and adequate attention to the management of the risks involved in growing, highly profitable or potentially high-risk activities and product lines.
- Have internal audit and independent risk management functions that adequately focus on growth, profitability, and risk criteria in targeting their reviews.
- Achieve an appropriate balance among all elements of credit risk management, including both qualitative and quantitative assessments of counterparty creditworthiness; measurement and evaluation of both on- and off- balance sheet exposures, including potential future exposure; adequate stress testing; reliance on collateral and other credit enhancements; and the monitoring of exposures against meaningful limits.
- Employ policies that are sufficiently calibrated to the risk profiles of particular types of counterparties and instruments to ensure adequate credit risk assessment, exposure measurement, limit setting, and use of credit enhancements.

- Ensure that actual business practices conform with stated policies and their intent.
- Are moving in a timely fashion to enhance their measurement of counterparty credit risk exposures, including the refinement of potential future exposure measures and the establishment of stress testing methodologies that better incorporate the interaction of market and credit risks.

To evaluate whether banking organizations are adequately meeting their risk management obligations, supervisors and examiners have been instructed to conduct sufficient targeted transaction testing on those activities, business lines, and products experiencing significant growth, above normal profitability or large potential future exposures.

In the event you have any questions regarding this matter, please contact

Enclosure