Credit Risk Transfer, Simplified

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A well-trodden path for banks to achieve regulatory capital reductions by mitigating credit risk is through a synthetic securitization, either by issuing credit-linked notes (CLNs)[1] or engaging in bespoke bilateral credit derivative transactions. These transactions—while complex to execute—offer the significant advantage of transferring risk on a large, diversified portfolio of obligors, allowing investors to evaluate credit risk on a statistical basis. This lessens the need for investor diligence at the level of individual obligations, which facilitates risk transfer on obligors for whom information might be limited or costly to digest.

Cleared Credit Default Swaps

Synthetic securitization can also be used for credit exposures to obligors with significant public debt market presence. In this case, however, a different vehicle for credit risk mitigation—a standardized credit default swap (CDS) that is cleared through a qualifying central counterparty (QCCP) —may require less effort to execute. A CDS is a contract under which a protection buyer pays fixed periodic amounts to a protection seller in exchange for the right to a cash settlement payment following the occurrence of a "credit event" with respect to a reference entity or the right to deliver a "deliverable obligation" in exchange for a fixed amount (*e.g.*, the par value). Cash settlement based on industry-wide auction pricing is the norm for widely-traded names, with physical settlement as a fallback settlement method if an auction is not held or fails.

A cleared CDS is a CDS that is novated to a central counterparty (CCP) post-execution. In contrast to an uncleared transaction, the two parties who executed the CDS no longer face each other's performance risk after the transaction is accepted for clearing. Standardized terms for cleared CDS are set out in the CCP's rules and procedures, including the reference obligation, process for determining whether a credit event has occurred, settlement terms following a credit event, and the occurrence and consequences of succession events.[2] Generally, a cleared CDS will follow the actions of the industry-wide Credit Derivatives Determinations Committee and the cash settlement price determined in an industry-wide auction, with any other required determinations made by a committee of the CCP. For banking organizations that are not direct clearing members, access is available through intermediaries, such as broker-dealers or certain futures commission merchants, that are clearing members of the CCP. We refer to banking organizations that access CCPs in this manner as "clearing client banks."

Regulatory Capital Criteria for Recognition

Under the FRB's risk-based capital rule (Regulation Q) (and corresponding rules of the Office of the Comptroller of Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC)), a banking organization may recognize the credit risk mitigation benefit of a cleared CDS provided that the CDS is an "eligible credit derivative" and meets further criteria for recognition, which, in broad terms, are designed to ensure sufficient matching of the CDS to the exposures intended to be hedged.[3] The latter criteria are necessary because, in general, the exposure the banking organization wishes to hedge may differ from the reference obligation of the cleared CDS; for instance, the designated reference obligation for a cleared CDS might be a widely-held bond issued by the reference entity, while the exposure the organization seeks to hedge might be a syndicated loan.

The criteria that a CDS must satisfy to qualify as an "eligible credit derivative" include:

- failure to pay and insolvency are credit events;
- if the contract allows for cash settlement, the contract incorporates a robust valuation process to estimate loss reliably and specifies a reasonable period for obtaining post-credit event valuations of the reference exposure;

- if the contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of at least one of the exposures that is permitted to be transferred under the contract provide that any required consent to transfer may not be unreasonably withheld; and
- the contract clearly identifies the parties responsible for determining whether a credit event has occurred, specifies that this determination is not the sole responsibility of the protection provider, and gives the protection purchaser the right to notify the protection provider of the occurrence of a credit event.

In addition, the CDS must meet the criteria for an "eligible guarantee", including that it be unconditional, not unilaterally cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary and, for purposes of the standardized approach, that it be provided by an "eligible guarantor," which includes QCCPs.

If the eligible credit derivative hedges an exposure that is different from the reference exposure used for determining the credit derivative's cash settlement value, deliverable obligation, or occurrence of a credit event, then the banking organization may only recognize a credit risk mitigation benefit if:

(i) the reference exposure ranks pari passu with, or is subordinated to, the hedged exposure and

(ii) the reference exposure and the hedged exposure are to the same legal entity, and legally enforceable cross-default or cross-acceleration clauses are in place to ensure payments under the credit derivative are triggered when the obligated party of the hedged exposure fails to pay under the terms of the hedged exposure.

In addition, the CDS must either be for the full amount of the hedged exposure or cover the exposure on a pro rata basis (*i.e.*, the banking organization must share proportionately in any losses). This contrasts with a synthetic securitization, which requires a tranching of credit risk (reflecting at least two different levels of seniority).

If the foregoing conditions are met, the banking organization may substitute the risk weight applicable to the protection provider for the risk weight of the protected portion of the hedged exposure. However, prescribed haircuts must be applied to the effective notional amount of the CDS to account for any maturity or currency mismatch between the CDS and the hedged exposure, and for the absence of restructuring if not included as a credit event in the CDS.[4]

If the eligible credit derivative qualifies as a "cleared transaction" and the CCP is a QCCP, favorable risk weights of 2% or 4% apply to the trade exposure amount of the CDS.[5] For the CDS to qualify as a "cleared transaction," a clearing client bank must demonstrate that its clearing arrangements meet certain legal criteria. Specifically:

- **Collateral safeguarding:** Collateral posted by a clearing client bank must be held in a manner that prevents the bank from facing any loss due to an event of default, including insolvency, of either the clearing member or the clearing member's other clients;
- **Legal review and documentation:** The clearing client bank must conduct a sufficient legal review (backed by written documentation) to conclude with a well-founded basis that, if legally challenged (including in an insolvency) the arrangements would be held valid and enforceable under the law of the relevant jurisdictions; and
- **Portability:** The transaction with the clearing client bank's clearing member must be transferable under the governing documentation and applicable law to another clearing member if the bank's current clearing member defaults or enters receivership, insolvency, liquidation, or similar proceedings.

In comparison, the risk weight for a corporate exposure, such as a loan, is generally 100%, resulting in risk-weighted assets under the standardized approach equal to 100% of the carrying value of the loan. The trade exposure amount for a cleared transaction under the standardized approach equals the sum of the current credit exposure, potential future exposure (PFE) and the fair value of the collateral posted by the clearing client bank and held by the CCP, clearing member, or custodian in a manner that is not bankruptcy remote.[6] Its numerical value will thus depend on factors such as the difference between fixed protection payments under the CDS and current market credit spreads, the maturity of the CDS, the amount of margin required to be posted and the arrangements for holding margin, as well as the notional amount of the cleared CDS. A rough sense of the relative sizes of the exposures (*i.e.*, before and

after a recognized CDS hedge) can be drawn from considering that, under the standardized approach, the notional amount of the CDS would generally be comparable to the carrying value intended to be hedged, augmented, if the banking organization chooses, by an amount to compensate for the applicable restructuring and maturity haircuts.

Practical Considerations

Clearing client banks who wish to make use of cleared CDS to mitigate credit risk should consider several practical steps to ensure they are prepared to meet the relevant criteria:

- **Establish clearing accounts:** If not already in place, a clearing client bank will need to enter into an agreement for clearing services with a clearing member to gain CCP access. Existing agreements should be reviewed to ensure they can accommodate CDS clearing and are consistent with the criteria for capital relief.
- **Review CCP rulebooks:** Clearing client banks should familiarize themselves with CCP rulebook and procedural provisions governing their rights and obligations, such as settlement procedures and the determination processes for credit events and cash settlement amounts.
- **Review of legal opinions:** Clearing client banks should ascertain whether their clearing arrangements and CCP rules conform to the assumptions of any industry or specifically-commissioned legal opinions used to conduct and document the legal review called for in the criteria for recognizing the benefit of the cleared CDS.
- **Prepare for physical settlement, if needed or desired:** Although cash settlement based on industry-wide auction pricing is the norm, it is implicit in the criteria for an eligible credit derivative that a banking organization have the practical ability to deliver a deliverable obligation if necessary to realize the value of the CDS. Clearing client banks should therefore prepare for the possibility of physical settlement. Moreover, even if physical settlement is not required, having the option to deliver the hedged exposure, if deliverable, or another deliverable obligation may help protect against an anomalous auction result or future changes in value of the hedged exposure from that used to determine the cash settlement amount. A clearing client bank should therefore confirm whether its clearing arrangements allow it to require its clearing member to submit physical settlement requests into an auction on the clearing client bank's behalf.
- **Review legal and regulatory constraints:** Clearing client banks should assess whether any limitations—such as rules governing the use of material nonpublic information (MNPI), or contractual or securities law restrictions on transfer—could affect their ability to physically settle a CDS.

For More Information

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1 Under FAQs issued by the Federal Reserve Board (FRB), FRB-regulated banking organizations may request approval to treat certain CLNs as synthetic securitizations, even though CLNs, in the FRB's view, do not technically meet all criteria. The FAQs are available at https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-q-frequently-asked-questions.htm.

2 See, *e.g.*, ICE Clear Credit Clearing Rules and Procedures, available at https://www.ice.com/clear-credit/regulation; LCH SA Clearing Rules and Procedures, available at https://www.lseg.com/en/post-trade/clearing/clearing-resources/rulebooks/lch-sa#t-over-the-counter-credit-default-swaps.

3 See 12 CFR 217.36, 217.134. The parallel regulations of the OCC and FDIC are codified at 12 CFR Part 3 (OCC) and Part 324 (FDIC). The section numbering is identical in all three sets of regulations.

4 The haircut for absence of restructuring is 40%. The Basel III Endgame proposal, applicable to large banking organizations and those with significant trading activity, would provide an exception from this haircut if the hedged exposure, and reference obligation, if different, require unanimous consent for certain amendments and the hedged exposure is subject to the U.S. Bankruptcy Code, the Federal Deposit Insurance Act, or a domestic or foreign insolvency regime with similar features that allow for a company to liquidate, reorganize, or restructure and provides for an orderly settlement of creditor claims. See 88 Fed. Reg. 64,028, 64,059 (Sept. 18, 2023).

5 12 CFR 217.35, 217.133 and corresponding sections of the OCC and FDIC regulations. The 2% risk weight applies if collateral posted by the clearing client bank is subject to an arrangement that prevents any losses to the clearing client bank due to the *joint default or a concurrent insolvency* of the clearing member and any other clearing member clients of the clearing member, and the clearing client bank has conducted a sufficient, documented legal review.

6 12 CFR 217.35 and 217.34(a), (b) and corresponding sections of the FDIC and OCC regulations.

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