

treatment across institutions and, if so, views on what methods would best reflect industry practices. In this regard, the Agencies would be particularly interested in information on how banking organizations are currently treating various forms of guarantees within their economic capital allocation systems and the methods used to adjust PD, LGD, EAD, and any combination thereof.

#### Double Default Effects

The Agencies are proposing that neither the banking organization's criteria nor rating process for guaranteed/hedged exposures be allowed to take into account so-called "double default" effects—that is, the joint probability of default of the borrower and guarantor. As a result of not being able to recognize double default probabilities, the adjusted risk weight for the hedged obligation could not be less than the risk weight associated with a direct exposure on the protection provider. The Agencies are seeking comment on the proposed nonrecognition of double default effects. On June 10, 2003, the Federal Reserve released a white paper on this issue entitled, "Treatment of Double Default and Double Recovery Effects for Hedged Exposures Under Pillar I of the Proposed New Basel Capital Accord." Commenters are encouraged to take into account the white paper in formulating their responses to the ANPR.

The Agencies also are interested in obtaining commenters' views on alternative methods for giving recognition to double default effects in a manner that is operationally feasible and consistent with safety and soundness. With regard to the latter, commenters are requested to bear in mind the concerns outlined in the double default white paper, particularly in connection with concentrations, wrong-way risk (especially in stress periods), and the potential for regulatory capital arbitrage. In this regard, information is solicited on how banking organizations consider double default effects on credit protection arrangements in their economic capital calculations and for which types of credit protection arrangements they consider these effects.

#### Requirements for Recognized Guarantees and Credit Derivatives

The Agencies are not proposing any restrictions on the types of eligible guarantors or credit derivative providers. Rather, a banking organization would be required to have clearly specified criteria for those guarantors they will accept as eligible for regulatory capital purposes. It is proposed that guarantees and credit derivatives recognized for regulatory

capital purposes: (1) Be required to represent a direct claim on the protection provider; (2) explicitly reference specific exposures or classes thereof; (3) be evidenced in writing through a contract that is irrevocable by the guarantor; (4) not have a clause that would (i) allow the protection provider unilaterally to cancel the credit protection (other than in the event of nonpayment or other default by the protection buying banking organization) or (ii) increase the effective cost of credit protection as the credit quality of the underlying obligor deteriorates; (5) be in force until the underlying obligation is satisfied in full (to the amount and tenor of the guarantee); and (6) be legally enforceable against the guarantor in a jurisdiction where the guarantor has assets to attach and enforce a judgment.

The Agencies view the risk mitigating benefits of conditional guarantees—that is, guarantees that prescribe certain conditions under which the guarantor would not be obliged to perform—as particularly difficult to quantify. The Agencies are proposing that as a general matter such guarantees would not be recognized under the A-IRB approach. In certain circumstances, however, conditional guarantees could be recognized where the banking organization can demonstrate that its assignment criteria fully reflect the reduction in credit risk mitigation arising from the conditionality and that the guarantee provides a meaningful degree of credit protection.

#### Additional Requirements for Recognized Credit Derivatives

The Agencies are proposing that credit derivatives, whether in the form of credit default swaps or total return swaps, recognized for A-IRB risk-based capital purposes meet additional criteria. The credit events specified by the contracting parties would be required to include at a minimum: (i) Failure to pay amounts due under the terms of the underlying obligation; (ii) bankruptcy, insolvency, or inability of the obligor to pay its debt; and (iii) restructuring of the underlying obligation that involves forgiveness or postponement of principal, interest, or fees that results in a credit loss.

With regard to restructuring events, the Agencies note that the New Accord suggests that a banking organization may not need to include restructuring credit events when it has complete control over the decision of whether or not there will be a restructuring of the underlying obligation. This would occur, for example, where the hedged obligation requires unanimous consent

of the creditors for a restructuring. The Agencies have concerns that this approach could have the incidental effect of dictating terms in underlying obligations in ways that over time could diverge from creditors' business needs. The Agencies also question whether such clauses actually eliminate restructuring risk on the underlying obligation, particularly as many credit derivatives hedge only a small portion of a banking organization's exposure to the underlying obligation.

The Agencies invite comment on this issue, as well as consideration of an alternative approach whereby the notional amount of a credit derivative that does not include restructuring as a credit event would be discounted. Comment is sought on the appropriate level of discount and whether the level of discount should vary on the basis of, for example, whether the underlying obligor has publicly outstanding rated debt or whether the underlying obligor is an entity whose obligations have a relatively high likelihood of restructuring relative to default (for example, a sovereign or PSE). Another alternative that commenters may wish to discuss is elimination of the restructuring requirement for credit derivatives with a maturity that is considerably longer—for example, two years—than that of the hedged obligation.

Consistent with the New Accord, the Agencies are proposing not to recognize credit protection from total return swaps where the hedging banking organization records net payments received on the swap as net income, but does not record offsetting deterioration in the value of the hedged obligation either through reduction in fair value or by an addition to reserves. The Agencies are considering imposing similar non-recognition on credit default swaps where mark-to-market gains in value are recognized in income and, thus, in Tier 1 capital, but no offsetting deterioration in the hedged obligation is recorded. (This situation generally would not arise where both the hedged obligation and the credit default swap are recorded in the banking book because under GAAP increases in the swap's value are recorded in the Other Comprehensive Income account, which is not included in regulatory capital.)

Comment is sought on this matter, as well as on the possible alternative treatment of recognizing the hedge in these two cases for regulatory capital purposes but requiring that mark-to-market gains on the credit derivative that have been taken into income be deducted from Tier 1 capital.

#### Mismatches in Credit Derivatives Between Reference and Underlying Obligations

The Agencies are proposing to recognize credit derivative hedges for