FRBS

Overview of Credit Derivatives Examination Work for 2005

The trading and structuring of credit derivatives by financial firms continues to be a key focus of the Bank Supervision Group. In 2005, substantial examination work will be undertaken at banks active in the marketing and trading of credit derivatives.

As part of its ongoing examination activity, Bank Supervision staff will lead or participate in OCC-led reviews of credit derivatives businesses at seven institutions, including six LCBOs (JPMC, Citigroup, Deutsche Bank, CSFB, BankAmerica and Wachovia).

- Credit Derivative businesses to be reviewed include Investment Grade, Index, High Yield and Emerging Markets flow trading activities, Correlation and Hybrid trading/structuring businesses, super-senior books, and structured credit activities (e.g., CDOs).

- Reviews will incorporate staff with expertise in credit derivatives, counterparty credit risk, market risk, and operational risk, depending on the specific review.

In general, the goal of the reviews is to assess the current strategies and products used by the various businesses, the risks resulting from the businesses/products and the corresponding controls firms have in place to manage them.

In addition to the credit derivative-specific reviews, Bank Supervision will perform two horizontal reviews – the Name Concentration Horizontal Review and the Complex Illiquid Products Horizontal Review – that will incorporate various elements of firms' controls over credit derivative activities.

- In the Name Concentration Horizontal Review, firms' abilities to monitor and control exposures to obligors or groups of obligors will be examined. Incorporated in this review will be exposures resulting from the various credit derivative businesses and products.

- In the Complex/Illiquid Products Horizontal Review, firms' valuation practices and controls for their most complex and illiquid exposures, including structured credit products, will be evaluated.

The combined reviews will provide us with a current assessment of the banks' overall risks from, and controls over credit derivatives activities. In addition, they will allow us to get a more comprehensive understanding of firm-specific or market practices in the following areas of supervisory interest:

<u>Credit Risk Aggregation and Monitoring</u>

Trading and marketing the suite of credit derivative products results in credit exposures to underlying reference credits with different loss profiles based on the product involved (i.e., CDS, CDO tranche, baskets). These products may challenge firms' ability to quantify, measure, and aggregate credit exposure from these products. As a result, firms' ability to monitor its exposure concentrations may be limited or impaired.

Key Questions – Credit Risk Aggregation and Monitoring

Counterparty Credit Risk Management

In order to mitigate credit exposure resulting from derivatives activity, firms are increasing their use of margin and collateral support agreements with clients. In the case of credit derivatives, the use of collateral has allowed firms to purchase credit protection from non-investment grade counterparties, particularly hedge funds.

As the types of credit derivative products offered to trading counterparties increase in complexity and model dependency, the valuation of transactions on which collateral calls are made are more dependent on unobservable parameters. This may increase the potential for disputes between counterparties when collateral calls are made, especially if valuation parameters change suddenly. Disputes can result in delayed posting of collateral (increasing credit risk), suspension of trading with a counterparty if the dispute is not quickly resolved (decrease liquidity), or lead to the liquidation of transactions between the two counterparties if the dispute is not resolved (market impact). While disputes may be less regular occurrences during stable market environments, there is a possibility that they may increase during times of market stress when exposures may increase and an effective collateral management process is most important.

Key Questions – Collateral

- How are initial collateral requirements determined for the various credit derivative products? Do the margins provide a sufficient buffer for large credit movements that may occur in a stress scenario?

- For model dependent transactions, how does the firm determine the value of transactions on which collateral is called? Is the valuation the same as the value used for the firm's own books (pre or post reserves)? If the valuation is different, why, and what are the resulting risks? Has the firm agreed with counterparties to standard assumptions that will be used for valuation?

- Does the firm's management believe that complex credit derivative transactions are more likely to have valuation disputes? What has been the cause of disputes to date and how were they resolved? What is the firm's process for resolving disputes?

As the credit derivatives market continues to evolve, hedge funds have increased their activity as buyers and sellers of credit default swap protection in both single name CDS products, index products, and correlation products. Because the valuation of these products can be highly model dependent and based on unobservable parameters, there is a risk that a counterparty may use different parameters for valuing its own books and records, potentially leading to the overstatement of its Net Asset Value ("NAV") if the valuation control processes at the counterparty are not effective.

Key Questions – Counterparty Valuation Due Diligence

- How does the institution manage the counterparty credit risk resulting from credit derivatives trading activity? What is the process to approve counterparties? Is there a separate policy and process to approve hedge fund counterparties? Are there any policy restrictions on buying protection from counterparties rated lower than the reference obligor?