Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #893
October 2000
12 CFR 3

November 23, 1999

Dear **[ ]** and **[ ]**:

This is in response to your letter to James W. McPherson dated July 23, 1999, requesting an opinion on the appropriate specific risk capital treatment for a particular total return swap structure. In your letter, you assert that a total return swap transaction hedged by a long, trading book position in the reference asset is "matched" during the term of the swap, and therefore, the bank has no specific risk exposure to the reference asset during that time period. Since the risk of the reference asset is fully hedged in your view, you believe that the bank should not be required to hold specific risk capital against the transaction during the life of the swap. Subject to the conditions described below, a specific risk charge under Appendix B of 12 CFR 3 is not required for this transaction type. Transactions of this type continue to be subject to the other requirements of Appendix B including the general market risk capital charge.

Background

Among its activities, the **[ ]** (the "Desk") enters into transactions where it pays the total return on a reference asset through a total return swap with a counterparty and hedges the swap with a long position in the reference asset. The counterparty initiates the transaction by expressing interest to the Desk in receiving the total return on the reference asset. The Desk purchases the asset and enters into the swap with the counterparty at an initial price equal to the purchase price of the asset. All interest and fees actually received on the reference asset by the Desk are paid to the counterparty. The counterparty pays to the Desk a floating rate based on the initial price of the asset. Often the term of the swap is shorter than the term of the reference asset. At the maturity or termination of the swap, the Desk determines the current market value of the reference asset based on the weighted average sale price of the asset or the highest of firm bids on the asset. If no firm bids are received, the market value is deemed to be zero. If the market value is above the initial price, the Desk pays the appreciation to the counterparty. If the market value is below the initial price, the counterparty pays the depreciation to the Desk.

In subsequent conversations with the OCC, you indicated that the Desk intends to sell the reference asset at maturity of the swap. We also understand from those conversations that most of these transactions require upfront collateral with weekly margin requirements if the asset incurs depreciation. The amount of collateral varies with the quality of both the counterparty and the reference asset.

Risks to the Bank

The transaction described above poses two risks to **[ ]** (the bank) for which the OCC believes adequate risk-based capital is required. The first risk results from the exposure to the counterparty. The counterparty has an obligation to make the floating rate payments to the Desk and must make payments to cover any depreciation on the reference asset. If the counterparty is unable to make the payments to the Desk, the Desk is then exposed to the general market and specific risk of the reference asset. The second source of risk to the bank from this transaction is market risk upon the termination date of the swap. Although the Desk intends to sell the reference asset upon the maturity of the swap, there is no certainty that the sales proceeds will match the value used in settling the swap.

Risk-based Capital Treatment

Since the reference asset is held in the trading book, the market risk-based capital rules in Appendix B of 12 CFR 3 apply. Under these rules, the market risk capital charge has two components - general market risk and specific risk. Appendix B requires that the general market risk component be based on the bank's value-at-risk model (VAR). There are two options for the calculation of the specific risk component: the standardized approach or a models approach. We understand that as of the date of this letter, the bank has not implemented a qualifying specific risk model for calculating the capital charge, therefore the specific risk component is calculated using the standardized approach. Additionally, over-the-counter transactions are subject to the counterparty credit risk requirements of Appendix A of 12 CFR 3.

In your letter you assert that during the life of the swap, the Desk's exposure to the reference asset is fully hedged under the terms of the swap. Since the position is fully hedged, there is no specific risk exposure to the reference asset and specific risk capital is not needed. The OCC agrees that during the term of the swap the Desk's exposure to the reference asset is fully hedged or matched and that a specific risk capital requirement is not necessary. However, because of the risks to the bank described earlier in this letter, this capital treatment is conditional upon effective mitigation of those risks.

Specifically, to mitigate the credit risk exposure to the counterparty, the Desk should take steps to ensure that exposure is the equivalent of investment grade. To meet this condition, the counterparty should be rated investment grade, or if the counterparty is not publicly rated, it should be deemed to be the equivalent of investment grade within the bank's own internal credit risk rating system. Alternatively, the Desk could require sufficient investment grade collateral so that the secured exposure to the counterparty would achieve an investment grade or equivalent rating. The collateral should be sufficient to cover current depreciation of the underlying asset as well as price depreciation that might reasonably be anticipated prior to the next payment date. When determining the appropriate amount and type of collateral, the Desk should adequately consider the volatility of market value of the reference asset and the correlation between the value of the collateral and reference asset. The Desk should also take into account its pre-settlement risk exposure that could result from any delays or gaps between the time the swap is terminated or the counterparty defaults and the collateral is liquidated.

Additionally, the Desk should have a reasonable expectation that the reference asset will be marketable at the termination of the swap. That is, the Desk should be fairly confident that it could sell the reference asset at or close to the swap termination date at a price that corresponds reasonably to the market value used in settling the swap contract. Indications of market liquidity include the ability to obtain at least two firm bids for the reference asset and reasonable bid-ask spreads.

This risk-based capital treatment applies only to transactions that meet the description and satisfy the conditions outlined in this letter. If you have further questions, please do not hesitate to contact the resident OCC examiners, the Capital Policy Division on 202-874-5070 or the Treasury and Market Risk Division on 202-874-5670.

Sincerely yours,

-signed-

Tommy Snow
Director, Capital Policy