§ 324.134 Guarantees and credit derivatives: PD substitution and LGD adjustment approaches.

(a) Scope. (1) This section applies to wholesale exposures for which:
   (i) Credit risk is fully covered by an eligible guarantee or eligible credit derivative; or
   (ii) Credit risk is covered on a pro rata basis (that is, on a basis in which the FDIC-supervised institution and the protection provider share losses proportionately) by an eligible guarantee or eligible credit derivative.

(2) Wholesale exposures on which there is a tranche of credit risk (reflecting at least two different levels of seniority) are securitization exposures subject to §§ 324.141 through 324.145.

(3) An FDIC-supervised institution may elect to recognize the credit risk mitigation benefits of an eligible guarantee or eligible credit derivative covering an exposure described in paragraph (a)(1) of this section by using the PD substitution approach or the LGD adjustment approach in paragraph (c) of this section or, if the transaction qualifies, using the double default treatment in § 324.135. An FDIC-supervised institution’s PD and LGD for the hedged exposure may not be lower than the PD and LGD floors described in § 324.131(d)(2) and (d)(3).

(b) Rules of recognition. (1) An FDIC-supervised institution may only recognize the credit risk mitigation benefits of eligible guarantees and eligible credit derivatives.

(2) An FDIC-supervised institution may only recognize the credit risk mitigation benefits of an eligible credit derivative to hedge an exposure that is different from the credit derivative’s reference exposure used for determining the derivative’s cash settlement value, deliverable obligation, or occurrence of a credit event if:

\[
K_{CM} = \frac{IM_i}{IM_{CM}} \cdot K^*_{CM}
\]

Where

(1) \(IM_i\) equals the FDIC-supervised institution’s initial margin posted to the QCCP;
(2) \(IM_{CM}\) = the total of initial margin posted to the QCCP; and
(3) \(K^*_{CM}\) as defined above in this paragraph (d)(3)(iii).

(iv) Method 2. A clearing member FDIC-supervised institution’s risk-weighted asset amount for its default fund contribution to a QCCP, \(RWA_{DF}\), equals:

\[
RWA_{DF} = \text{Min} \{12.5 \times DF; 0.18 \times TE\}
\]

Where

(A) \(TE\) equals the FDIC-supervised institution’s trade exposure amount to the QCCP calculated according to section 133(c)(2);
(B) \(DF\) equals the funded portion of the FDIC-supervised institution’s default fund contribution to the QCCP.

(v) Total risk-weighted assets for default fund contributions. Total risk-weighted assets for default fund contributions is the sum of a clearing member FDIC-supervised institution’s risk-weighted assets for all of its default fund contributions to all CCPs of which the FDIC-supervised institution is a clearing member.
(i) The reference exposure ranks pari
passu (that is, equally) with or is junior
to the hedged exposure; and
(ii) The reference exposure and the
hedged exposure are exposures to the
same legal entity, and legally enforce-
able cross-default or cross-acceleration
clauses are in place to assure payments
under the credit derivative are trig-
gerated when the obligor fails to pay
under the terms of the hedged expo-
sure.

(c) Risk parameters for hedged expo-
sures—(1) PD substitution approach—(i) Full coverage. If an eligible guarantee
or eligible credit derivative meets the
conditions in paragraphs (a) and (b) of
this section and the protection amount
(P) of the guarantee or credit deriva-
tive is greater than or equal to the
EAD of the hedged exposure, an FDIC-
supervised institution may recognize
the guarantee or credit derivative in
determining the FDIC-supervised insti-
tution's risk-based capital requirement
for the hedged exposure by substituting
the PD associated with the rating
grade of the protection provider for the
PD associated with the rating grade of
the obligor in the risk-based capital
formula applicable to the guarantee or
credit derivative in Table 1 of §324.131
and using the appropriate LGD as de-
scribed in paragraph (c)(1)(iii) of this
section. If the FDIC-supervised institu-
tion determines that full substitution
of the protection provider's PD leads to
an inappropriate degree of risk mitiga-
tion, the FDIC-supervised institution
may substitute a higher PD than that
of the protection provider.

(ii) Partial coverage. If an eligible
guarantee or eligible credit derivative
meets the conditions in paragraphs (a)
and (b) of this section and P of the
guarantee or credit derivative is less
than the EAD of the hedged exposure,
the FDIC-supervised institution must
treat the hedged exposure as two sepa-
rate exposures (protected and unpro-
ected) in order to recognize the credit
risk mitigation benefit of the guar-
antee or credit derivative.

(A) The FDIC-supervised institution
must calculate its risk-based capital
requirement for the hedged exposure
under §324.131, where PD is the pro-
tection provider's PD, LGD is determined
under paragraph (c)(1)(iii) of this sec-
tion, and EAD is P. If the FDIC-superv-
ised institution determines that full
substitution leads to an inappropriate
degree of risk mitigation, the FDIC-su-
pervised institution may use a higher
PD than that of the protection pro-
vider.

(B) The FDIC-supervised institution
must calculate its risk-based capital
requirement for the unprotected expo-
sure under §324.131, where PD is the
obligor's PD, LGD is the hedged expo-
sure's LGD (not adjusted to reflect the
guarantee or credit derivative), and
EAD is the EAD of the original hedged
exposure minus P.

(C) The treatment in paragraph
(c)(1)(ii) of this section is applicable
when the credit risk of a wholesale ex-
posure is covered on a partial pro rata
basis or when an adjustment is made to
the effective notional amount of the
guarantee or credit derivative under
paragraphs (d), (e), or (f) of this sec-
tion.

(iii) LGD of hedged exposures. The
LGD of a hedged exposure under the
PD substitution approach is equal to:

(A) The lower of the LGD of the
hedged exposure (not adjusted to re-
fect the guarantee or credit deriva-
tive) and the LGD of the guarantee or
credit derivative, if the guarantee or
credit derivative provides the FDIC-su-
pervised institution with the option to
receive immediate payout upon trig-
gering the protection; or

(B) The LGD of the guarantee or
credit derivative, if the guarantee or
credit derivative does not provide the
FDIC-supervised institution with the
option to receive immediate payout
upon triggering the protection.

(2) LGD adjustment approach—(1) Full
coverage. If an eligible guarantee or eli-
gible credit derivative meets the condi-
tions in paragraphs (a) and (b) of this
section and the protection amount (P)
of the guarantee or credit derivative is
greater than or equal to the EAD of the
hedged exposure, the FDIC-supervised
institution's risk-based capital require-
ment for the hedged exposure is the
greater of:

(A) The risk-based capital require-
ment for the exposure as calculated
under §324.131, with the LGD of the ex-
posure adjusted to reflect the guar-
antee or credit derivative; or
(B) The risk-based capital requirement for a direct exposure to the protection provider as calculated under §324.131, using the PD for the protection provider, the LGD for the guarantee or credit derivative, and an EAD equal to the EAD of the hedged exposure.

(ii) Partial coverage. If an eligible guarantee or eligible credit derivative meets the conditions in paragraphs (a) and (b) of this section and the protection amount (P) of the guarantee or credit derivative is less than the EAD of the hedged exposure, the FDIC-supervised institution must treat the hedged exposure as two separate exposures (protected and unprotected) in order to recognize the credit risk mitigation benefit of the guarantee or credit derivative.

(A) The FDIC-supervised institution’s risk-based capital requirement for the protected exposure would be the greater of:

(1) The risk-based capital requirement for the protected exposure as calculated under §324.131, with the LGD of the exposure adjusted to reflect the guarantee or credit derivative and EAD set equal to P; or

(2) The risk-based capital requirement for a direct exposure to the guarantor as calculated under §324.131, using the PD for the protection provider, the LGD for the guarantee or credit derivative, and an EAD set equal to P.

(B) The FDIC-supervised institution must calculate its risk-based capital requirement for the unprotected exposure under §324.131, where PD is the obligor’s PD, LGD is the hedged exposure’s LGD (not adjusted to reflect the guarantee or credit derivative), and EAD is the EAD of the original hedged exposure minus P.

(3) M of hedged exposures. For purposes of this paragraph (c), the M of the hedged exposure is the same as the M of the exposure if it were unhedged.

(d) Maturity mismatch. (1) An FDIC-supervised institution that recognizes an eligible guarantee or eligible credit derivative in determining its risk-based capital requirement for a hedged exposure must adjust the effective notional amount of the credit risk mitigant to reflect any maturity mismatch between the hedged exposure and the credit risk mitigant.

(2) A maturity mismatch occurs when the residual maturity of a credit risk mitigant is less than that of the hedged exposure(s).

(3) The residual maturity of a hedged exposure is the longest possible remaining time before the obligor is scheduled to fulfill its obligation on the exposure. If a credit risk mitigant has embedded options that may reduce its term, the FDIC-supervised institution (protection purchaser) must use the shortest possible residual maturity for the credit risk mitigant. If a call is at the discretion of the protection provider, the residual maturity of the credit risk mitigant is at the first call date. If the call is at the discretion of the FDIC-supervised institution (protection purchaser), but the terms of the arrangement at origination of the credit risk mitigant contain a positive incentive for the FDIC-supervised institution to call the transaction before contractual maturity, the remaining time to the first call date is the residual maturity of the credit risk mitigant.

(4) A credit risk mitigant with a maturity mismatch may be recognized only if its original maturity is greater than or equal to one year and its residual maturity is greater than three months.

(5) When a maturity mismatch exists, the FDIC-supervised institution must apply the following adjustment to the effective notional amount of the credit risk mitigant: $P_{m} = E \times \left(\frac{t - 0.25}{T - 0.25}\right)$, where:

(i) $P_{m}$ equals effective notional amount of the credit risk mitigant, adjusted for maturity mismatch;

(ii) $E$ equals effective notional amount of the credit risk mitigant;

(iii) $t$ equals the lesser of $T$ or the residual maturity of the credit risk mitigant, expressed in years; and

For example, where there is a step-up in cost in conjunction with a call feature or where the effective cost of protection increases over time even if credit quality remains the same or improves, the residual maturity of the credit risk mitigant will be the remaining time to the first call.
§ 324.135 Guarantees and credit derivatives: Double default treatment.

(a) Eligibility and operational criteria for double default treatment. An FDIC-supervised institution may recognize the credit risk mitigation benefits of a guarantee or credit derivative covering an exposure described in §324.134(a)(1) by applying the double default treatment in this section if all the following criteria are satisfied:

(1) The hedged exposure is fully covered or covered on a pro rata basis by:
   (i) An eligible guarantee issued by an eligible double default guarantor; or
   (ii) An eligible credit derivative that meets the requirements of §324.134(b)(2) and that is issued by an eligible double default guarantor.

(2) The guarantee or credit derivative is:
   (i) An uncollateralized guarantee or uncollateralized credit derivative (for example, a credit default swap) that provides protection with respect to a single reference obligor; or
   (ii) An nth-to-default credit derivative (subject to the requirements of §324.142(m)).

(3) The hedged exposure is a wholesale exposure (other than a sovereign exposure).

(4) The obligor of the hedged exposure is not:
   (i) An eligible double default guarantor or an affiliate of an eligible double default guarantor; or
   (ii) An affiliate of the guarantor.