

Guidance Note

AGN 113.4 - Treatment of Credit Derivatives in the Trading Book

1. This Guidance Note details the approach to be used by Australian ADIs to determine the capital to be held against credit derivative instruments in the trading book. The capital adequacy rules pertaining to credit derivatives in ADIs' banking books are described in [AGN 112.4 – Treatment of Credit Derivatives in the Banking Book](#).
2. When determining whether a credit derivative transaction should be allocated to the banking or trading book, consideration should be given to the trading book requirements detailed in [AGN 113.1](#) (paragraphs 1-2). Consistent with the approach applied to interest rate and equity related instruments, each ADI will be required to seek APRA's approval before credit derivative transactions can be included in the trading book. Amongst other requirements, an ADI will be required to demonstrate to APRA that such credit derivative positions have been taken on with a trading intent and can be marked-to-market on a daily basis.
3. The approach set out here is broadly consistent with the existing capital adequacy rules applied to other trading book instruments. APRA recognises that the relatively simple structure on which the existing rules are based constrains the ability to accommodate the flexibility of credit derivatives without undermining the efficacy of those rules. While the capital treatment is conservative, APRA is of the view that such an approach is justified given the uncertainties present in the global credit derivatives market.
4. While there are currently no internationally agreed capital adequacy guidelines for credit derivatives, work is continuing. It is APRA's intention to be involved with, and closely monitor, any developments in this area and, if deemed necessary, amend this Guidance Note accordingly.

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Scope

5. This Guidance Note applies to the most commonly traded credit derivatives: credit-default swaps, total-rate-of-return swaps, credit-linked notes and first-to-default baskets. APRA is aware that more complex credit derivative products will undoubtedly emerge. ADIs transacting in more complex credit derivatives or in structures with non-standard features (such as those involving portfolios of reference obligations, other than first-to-default baskets) will be expected to approach APRA to discuss an appropriate capital treatment for such instruments. If, over time, these other types of credit derivative product are seen to become commonplace, APRA will, where practicable, incorporate the capital adequacy treatment of such products into this Guidance Note.
6. The evolution of instruments capable of transferring credit risk raises many important issues for prudential supervisors, many of which are common to a range of products. Of particular concern to APRA is the effect of credit derivatives on the transparency of individual credit portfolios. Since credit derivatives facilitate the transformation of credit risk profiles, large exposures and concentrations within ADIs' portfolios may become increasingly difficult to identify. Where APRA considers a particular ADI to be undertaking significant credit derivative activity, as either a purchaser or seller of protection, such that large exposures and concentrations are a potential concern, APRA may require the ADI to adopt an alternative capital treatment to that which is described in this Guidance Note.
7. Under APRA's current reporting framework, ADIs will be expected to provide APRA with details of credit derivative transactions that give rise to large exposures as required by the Large Exposures Return.
8. ADIs have the choice of using either the standard method or, with APRA's approval, an internal model to measure the general market risk and specific risk charges on credit derivative positions in the trading book. This Guidance Note details how the capital charge for credit derivatives should be calculated under the standard method only. ADIs will need to seek APRA's approval before an internal risk measurement model can be used to generate the regulatory capital charge.

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Terminology

9. Credit derivatives are part of a broader family of instruments that enable users to transfer the credit risk of an asset from one party, the *protection buyer*, to another, the *protection seller*, in isolation from other risks.
10. In this Guidance Note, the following terminology has been used when describing a credit derivative transaction:
 - *underlying asset* – the asset which is being protected by the credit derivative;
 - *reference entity* – the legal entity whose credit risk is being transferred by the credit derivative. In the case of first-to-default baskets, the reference entity is not a single entity but a ‘basket’ or portfolio of reference entities;
 - *obligation* – any financial obligation of the reference entity or of an entity that is unconditionally and irrevocably guaranteed by the reference entity, as defined under the terms of the credit derivative contract, on which a credit event must occur for the credit derivative to be triggered;
 - *credit events* – events affecting the reference entity that trigger a credit-event payment under the terms of the credit derivative contract;
 - *credit-event payment* – the amount that is paid following the occurrence of a credit event. The payment can be in the form of physical settlement (payment of par in exchange for physical delivery of a deliverable obligation of the reference entity) or cash settlement (payment of a fixed amount, or payment of the par value of the reference obligation less that obligation’s recovery value);
 - *deliverable obligation* – any obligation of the reference entity that can be delivered, under the terms of the contract, if a credit event occurs. A deliverable obligation is relevant for credit derivatives that are to be physically settled; and
 - *reference obligation* – the obligation which determines the amount of the credit-event payment. A reference obligation is relevant for obligations that are to be cash settled (on a par less recovery basis).

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General Principles – General Market Risk

11. General market risk is the risk that the market price of a security will rise and fall owing to changes in the general level of market interest rates and/or the general level of credit spreads. For ADIs that use the standard method, credit derivatives based on a single reference entity are treated in the same way as interest rate related derivatives (refer Section “Interest Rate Risk” of [AGN 113.3](#)) for the purposes of calculating a general market risk capital charge. Each credit derivative instrument is broken down into a notional debt instrument, to reflect the interest rate or fee-paying leg (if regular fees are paid under the terms of the contract) and, where applicable, a position in the reference obligation.
12. These positions should be included in the maturity ladder applicable to the currency of the cash flows and reported at their market values.

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General Principles – Specific Risk

13. Specific risk is the risk that the price of a particular security will rise and fall due to factors other than those explained by general market movements. Although similar in nature to credit risk, specific risk is a broader concept in the sense that it captures the risk of shorter-term fluctuations in the value of the security (termed idiosyncratic risk) as well as event and default risk. This distinction has implications for the treatment of matched positions (refer [paragraphs 29-33](#) below). While default risk is captured by the cash flows attached to all the credit derivative instruments covered by this Guidance Note (ie credit-default swaps, total-rate-of-return swaps and credit-linked notes), the idiosyncratic component of specific risk may only be captured by the cash flows associated with total-rate-of-return swaps.
14. The amount reported for specific risk purposes depends on the type of credit-event payment specified in the credit derivative contract. Where the credit-event payment is defined as the par value of the reference obligation less its recovery value (ie the credit derivative is cash settled), the amount reported should be the par value of the reference obligation. Where the credit-event payment is defined as a fixed amount, the amount reported should be the fixed amount. Similarly, where there is payment of the par value of an obligation in exchange for its physical delivery, the amount reported should be the par value of the obligation. In the latter two cases, the amount reported should reflect a position in the reference

entity with maturity equal to the term to maturity of the credit derivative.

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General Principles – Counterparty Risk

15. In general, counterparty risk charges are calculated for all off-balance sheet derivatives whether in the banking book or the trading book. ADIs undertaking particular types of credit derivative transaction in the trading book will be expected to calculate a counterparty risk charge using the Current Exposure Method described in [AGN 112.2 – Risk-Weighted Off-Balance Sheet Credit Exposures](#). This method calculates the regulatory capital charge for counterparty risk as the sum of the mark-to-market value of the derivative (if positive) and a measure of future potential credit exposure, where the latter is based on an ‘add-on’ factor that depends on the type and maturity of the derivative transaction.
16. The current add-on factor matrix does not include a specific factor for transactions such as credit derivatives, which have debt as the underlying asset. APRA intends to consider appropriate add-on factors for credit derivatives in due course. In the interim, the add-on factors to be used to determine regulatory capital will be based on the existing matrix. Where the reference entity is ‘qualifying’ (refer paragraph 8 of [AGN 113.3](#)) the equity add-ons are to be used, otherwise commodity add-ons will apply.

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Credit-Default Swaps

17. The *protection buyer* in a credit-default swap should enter into the maturity ladder a short position in a notional debt instrument, where regular interest or fee cash flows are to be paid, to reflect the general market risk associated with those cash flows. A specific risk capital charge must also be calculated on a short position in the reference entity (refer [paragraph 14](#) above).
18. The *protection seller* in a credit-default swap should enter into the maturity ladder a long position in a notional debt instrument, where regular interest or fee cash flows are to be received, to reflect the general market risk associated with those cash flows. A specific risk capital charge must also be calculated on the long position in the reference entity (refer [paragraph 14](#) above).

19. The protection buyer must always calculate a counterparty risk charge, however the protection seller need only calculate a counterparty risk charge if interest payments or fees are outstanding.

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Total-Rate-of-Return Swaps

20. The *protection buyer* in a total-rate-of-return swap should enter into the maturity ladder a position in a notional debt instrument, where regular interest or fee cash flows are to be exchanged, to reflect the general market risk associated with those cash flows. General market risk and specific risk capital charges must also be calculated on the short position in the reference obligation (refer paragraphs 12 and 14 above).
21. The *protection seller* in a total-rate-of-return swap should enter into the maturity ladder a position in a notional debt instrument, where regular interest or fee cash flows are to be exchanged, to reflect the general market risk associated with those cash flows. General market risk and specific risk capital charges must also be calculated on the long position in the reference obligation.
22. In a total-rate-of-return swap payments are made to settle any changes in the mark-to-market value of the reference obligation. Each party may be exposed to the other for payment. This means that both the protection buyer and the protection seller should calculate a counterparty risk charge.

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Credit-Linked Notes

23. The *protection buyer* in a credit-linked note should enter into the maturity ladder a short position in the underlying interest rate instrument for general market risk purposes. A specific risk capital charge must also be calculated on the short position in the reference entity (refer [paragraph 14](#) above).
24. The *protection seller* in a credit-linked note should enter into the maturity ladder a long position in the underlying interest rate instrument for general market risk purposes. A specific risk capital charge must be calculated on the long position in the reference entity (refer [paragraph 14](#) above).

above) and the long position in the underlying interest rate instrument (ie the long position in the protection buyer).

25. No counterparty risk charges are required for transactions in credit-linked notes.

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First-to-Default Baskets

26. The *protection buyer* in a first-to-default basket should enter into the maturity ladder a short position in a notional debt instrument, where regular interest or fee cash flows are to be paid, to reflect the general market risk associated with those cash flows. A specific risk capital charge must also be calculated on a short position in only one reference entity in the basket, with that entity being chosen by the ADI (refer [paragraph 14](#) above).
27. The *protection seller* in a first-to-default basket should enter into the maturity ladder a long position in a notional debt instrument, where regular interest or fee cash flows are to be received, to reflect the general market risk associated with those cash flows. A specific risk capital charge must also be calculated on the long positions in all reference entities in the basket (refer [paragraph 14](#) above). The amount of capital held should be capped at the maximum payout possible under the credit derivative contract.
28. The protection buyer must always calculate a counterparty risk charge, however the protection seller need only calculate a counterparty risk charge if interest payments or fees are outstanding.

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Specific Risk Offsetting

Offsetting between credit derivatives

29. In line with the existing trading book treatment (refer paragraphs 32-35 of [AGN 113.3](#)), an ADI may only offset the specific risk capital charges on equal and opposite credit derivative positions.¹ Where the credit

¹ The general market risk capital charges may also be offset.

derivatives are equal and opposite in all respects other than tenor, the specific risk capital charges cannot be offset. Instead, a single specific risk capital charge should be calculated, based on the reference entity (refer [paragraph 14](#) above).

30. The specific risk capital charges arising from different credit derivative product structures cannot be offset (refer [paragraph 33](#) below).

Offsetting between a credit derivative and the associated underlying asset

31. For total-rate-of-return swaps, an ADI may offset the specific risk capital charges on the credit derivative and the corresponding underlying asset, provided the position is both ‘asset matched’ and ‘maturity matched’.² An asset-matched position requires the reference obligation and the underlying asset to be identical in all respects (ie the same issuer, coupon, currency and maturity). A maturity-matched position requires the maturities of the total-rate-of-return swap and the underlying asset to be the same. Where the reference obligation and the underlying asset are asset-matched, but the position is not maturity matched (ie the tenors of the total-rate-of-return swap and the underlying asset differ), a single specific risk charge should be calculated on the position in the reference obligation.
32. For credit-default swaps, credit-linked notes and first-to-default baskets, the specific risk capital charges on the credit derivative and the corresponding underlying asset cannot be offset. Where the reference entity and the underlying asset are asset matched (as defined in [paragraph 31](#) above), a single specific risk charge should be calculated on the position in the reference entity. The protection seller in a first-to-default basket may only apply this offsetting treatment to a single specific risk position in a reference entity, with that reference entity being chosen by the ADI.

Review process

33. APRA plans to review the arrangements for specific risk offsetting over the course of the year and, as part of this process, will examine in more detail the credit derivative pricing models being used by Australian ADIs.

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² The general market risk capital charges on the reference obligation may also be offset.