



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

This module should be read in conjunction with the [Introduction](#) and with the [Glossary](#), which contains an explanation of abbreviations and other terms used in this Manual. If reading on-line, click on blue underlined headings to activate hyperlinks to the relevant module.

Purpose

To set out the HKMA's supervisory approach to credit derivative instruments, particularly in relation to capital requirements and treatment for large exposures

Classification

A statutory guideline issued by the MA under the Banking Ordinance, §16(10)

Previous guidelines superseded

Circular "Supervisory Approach to Credit Derivatives" dated 26.11.99

Application

To all AIs, with capital requirements applicable only to locally incorporated AIs

Structure

1. Introduction
 - 1.1 Background
 - 1.2 Key concepts
 - 1.3 Use of credit derivatives
 - 1.4 Types of credit derivatives
 - 1.5 Types of credit event payment
2. Management of credit derivatives
 - 2.1 Credit derivatives policy
 - 2.2 Risk management



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

- 2.3 Information to be maintained
- 2.4 Credit derivatives in the trading book
- 3. General criteria for recognition of credit protection
- 4. Capital adequacy for the banking book
 - 4.1 General provisions
 - 4.2 Protection buyer
 - 4.3 Protection buyer - maturity mismatch
 - 4.4 Protection buyer - currency mismatch
 - 4.5 Protection buyer - multiple entities
 - 4.6 Protection seller
 - 4.7 Protection seller - multiple entities
- 5. Capital adequacy for the trading book
 - 5.1 General provisions
 - 5.2 Internal models approach
 - 5.3 Basel standardised approach
 - 5.4 Basel standardised approach - specific risk
 - 5.5 Basel standardised approach - maturity mismatch
 - 5.6 Basel standardised approach - general market risk
 - 5.7 Counterparty risk
 - 5.8 Foreign exchange risk
- 6. Large exposure treatment
 - 6.1 Reporting
 - 6.2 Protection buyer
 - 6.3 Protection buyer - maturity mismatch
 - 6.4 Protection buyer - currency mismatch
 - 6.5 Protection buyer - multiple entities
 - 6.6 Protection seller



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

1. Introduction

1.1 Background

1.1.1 Credit derivatives are financial instruments based on forward contracts, swaps, options or a mixture of the three and may be entered into through exchanges or over the counter. They allow market participants to transfer credit risks on loans and other assets but they give rise to complex issues. The market is evolving rapidly and Als are becoming increasingly involved in the credit derivatives market. Hence clarification of the HKMA's supervisory approach to these instruments is apposite.

1.1.2 The HKMA will continue to assess the use and development of credit derivatives in the market. The supervisory approach set out below may therefore be subject to revision and additional guidance.

1.1.3 Als should consult the HKMA on the appropriate treatment of credit derivatives if the structure or scheme involved is not covered in this module.

1.2 Key concepts

Credit event	An event under a credit derivative contract that triggers a credit event payment, e.g. bankruptcy, a payment default, repudiation of an obligation, rescheduling, restructuring or a rating downgrade in respect of the reference entity.
Credit event payment	The amount that is paid following a credit event, as defined in a credit derivative contract. The types of payment are listed in para. 1.5.2.
Protection buyer	The party from whom the credit risk is transferred (without transfer of title to the underlying asset); also referred to as the credit risk seller.
Protection seller	The party to whom the credit risk is transferred (without transfer of title to the underlying asset); also referred to



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

	as the credit risk buyer.
Reference entity	The party, corporate or sovereign, upon whose credit status the contract is based.
Reference obligation	An obligation of the reference entity which is uniquely specified in a credit derivative contract. It mainly provides a basis for cash settlement or defines the seniority of deliverable obligations for physical settlement where applicable.
Underlying asset	The asset or a basket of obligations (a security, loan or off-balance sheet exposure), that a protection buyer is seeking to hedge. The obligations may be of one or multiple obligors.

1.3 Use of credit derivatives

- 1.3.1 Als can use credit derivatives to manage risk or enhance revenue.
- 1.3.2 In the former case, Als reduce (in the case of a protection buyer) or acquire (in the case of a protection seller) credit risk exposure.
- 1.3.3 In the latter case, Als may be market makers with roughly square positions but earn income from the market spread. They may arbitrage between different markets to exploit price differentials or they may take outright positions.
- 1.3.4 Credit derivatives can also be used to create new assets for investors.
- 1.3.5 Als are usually end-users of credit derivatives but as market makers they may intermediate between end-users.

1.4 Types of credit derivatives

Credit default swap	The protection buyer pays a fee to the protection seller in exchange for a credit event payment if a credit event occurs.
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Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

Total return swap	The protection buyer agrees to pay the protection seller all cash flows arising from the reference obligation plus any appreciation in market value of the reference obligation. In exchange the protection buyer receives a spread over a specified index plus any depreciation in value of the reference obligation during the term of the swap.
Credit-linked note	The protection buyer issues a note which is linked to a reference entity and the note pays a fixed or floating interest rate. The note holder, i.e. the protection seller, buys the note at market value. If no credit event occurs, the note will be redeemed at par. If a credit event occurs, the deliverable obligations will be delivered to the note holder for settlement. Effectively a credit-linked note is composed of a regular note issued by the issuer and a credit default swap in which the issuer is a protection buyer.

1.5 Types of credit event payment

1.5.1 The amount of protection that can attract a lower risk weight for capital purposes depends on the payment defined in the credit derivative contract when a credit event occurs.

1.5.2 There are normally three types of payment, as listed below.

- Type 1 The protection seller pays the principal amount specified in the contract to the protection buyer in exchange for delivery of the deliverable obligations with the same principal amount, which are specified in the credit derivative contract.
- Type 2 The protection seller pays the principal amount specified in the contract less the



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

market value of the reference obligation to the protection buyer (the market value is calculated by specified calculation agents at some pre-determined point in time after a credit event has occurred).

- Type 3 The protection seller pays a fixed amount to the protection buyer.

2. Management of credit derivatives

2.1 Credit derivatives policy

2.1.1 The credit derivatives activity of an AI should be under the adequate oversight of its Board of Directors and senior management.

2.1.2 Written policies and procedures should be established to cover credit derivatives business. These should cover inter alia:

- the AI's strategy, appetite and limits for different types of credit derivatives business;
- authorities for engaging in such business;
- identification of those responsible for managing it;
- procedures for measuring, monitoring, reviewing, reporting and managing the associated risks;
- criteria for classifying credit derivatives in the trading or the banking book; and
- internal controls, accounting guidelines, tax treatment and independent auditing.

2.1.3 There should be adequate separation between the function of transacting credit derivatives business and those of monitoring, reporting and risk control.

2.1.4 All staff engaged in such business should be fully conversant with the relevant policies and procedures.

2.1.5 Any changes to the policy or engagement in new types of credit derivatives business should be approved by the Board.



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

2.2 Risk management

- 2.2.1 Als should consider carefully all related risks and rewards before entering the credit derivatives market. They should not enter into such transactions unless their management has the ability to understand and manage properly the credit and other risks associated with these instruments. They should establish sound risk management policies and procedures, integrated into their overall risk management processes, and effective internal controls for such transactions.
- 2.2.2 A counterparty risk assumed in connection with a credit derivative should undergo the AI's usual credit approval procedures and henceforth be subject to established review, monitoring and information requirements.
- 2.2.3 Market risk associated with credit derivatives in the trading book should be managed by measuring portfolio exposures frequently - at least daily but ideally in real time - using value-at-risk or other similarly robust methodology.
- 2.2.4 Apart from funding its credit derivatives activity an AI also faces liquidity risk in that individual positions may not be able to be squared at an acceptable price owing to temporary market disturbances. A further risk may arise where counterparties are able to terminate transactions prematurely under the contract. These should be catered for in the AI's general liquidity management policy.
- 2.2.5 Als should be aware of the potential legal risk arising from an unenforceable contract, e.g. from inadequate documentation, lack of authority for a counterparty to enter into the contract (or to transfer the asset upon occurrence of a credit event), uncertain payment procedures associated with bankruptcy proceedings or inability to determine market value when an estimate is required. They should consult their legal advisors about these and related legal issues before engaging in such transactions.



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

2.3 Information to be maintained

2.3.1 In order to be able to manage the risks properly, AIs should maintain comprehensive information on their credit derivatives activity, including:

- what types of derivative transactions are carried out;
- what the corresponding risks are;
- what trading income is earned or losses incurred, realised and unrealised, from the different types of risks/exposures;
- the contribution of derivatives to their total business and risk portfolio; and
- the value of derivative positions and any related on-balance sheet positions.

2.3.2 These positions should be updated regularly, at least daily for credit derivatives in the trading book and monthly for those in the banking book.

2.4 Credit derivatives in the trading book

2.4.1 The inclusion of credit derivatives in the trading book should be in line with the AI's policy statement for the trading book.

2.4.2 Such instruments should genuinely be held for trading purposes. The HKMA may assess whether there is a trading intent by examining whether the AI has an adequate operating structure available to support such business. Relevant factors include how the positions are managed, the use of standard documentation and market conventions, the number of market makers for the product and for the instruments hedging it and the availability of screen prices.

2.4.3 AIs wishing to hold credit derivatives in the trading book should be able to mark them to market on a daily basis. Valuation should be prudent and consistent. Where valuation is problematic (e.g. the market is thin) they should establish a reserve and a limit on exposure from open positions in credit derivatives in accordance with a laid-down policy. If an AI wants to include credit



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

derivatives referenced to relatively illiquid reference obligations in the trading book, it should consult the HKMA.

3. General criteria for recognition of credit protection

- 3.1 This section sets out the general criteria to which credit derivatives should conform in order to be recognised as protection for capital adequacy purposes.
- 3.2 A credit derivative should represent a direct claim on the protection seller.
- 3.3 The credit protection should be linked to specific exposures, so that the extent of the cover is clearly defined and incontrovertible.
- 3.4 The credit protection should be legally enforceable in all relevant jurisdictions.
- 3.5 Other than a protection buyer's non-payment of money due in respect of the credit derivative contract, there should be no clause in the contract that would allow the protection seller unilaterally to cancel the credit cover.
- 3.6 There should be no clause in the credit derivative contract that could prevent the protection seller from being obliged to pay out in a timely manner in the event that the original obligor fails to make the payment(s) due.
- 3.7 The protection seller should have no formal recourse to the protection buyer for losses.
- 3.8 The credit events specified in a credit default swap or a credit-linked note should adequately cover the credit risk of the reference entity itself.
- 3.9 Contracts allowing for cash settlement are recognised for capital adequacy purposes in so far as a robust valuation process is in place in order to estimate loss reliably. There should be a clearly specified period for obtaining post-credit-event valuations of the reference obligation, typically no more than 30 days.



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

- 3.10 The protection buyer should have the right/ability to transfer the underlying exposure to the protection seller, if required for settlement.
- 3.11 The identity of the parties responsible for determining whether a credit event has occurred should be clearly defined. This determination should not be the sole responsibility of the protection seller. The protection buyer must have the right/ability to inform the protection seller of the occurrence of a credit event.
- 3.12 Regarding the underlying asset and the reference obligation, the following requirements should be met for all credit derivatives:
- the underlying asset and the reference obligation should have the same obligor; and
 - the underlying asset should have equal seniority with, or greater seniority than, the reference obligation, and legally effective cross-reference clauses (e.g. cross-default or cross-acceleration clauses) should apply.

4. Capital adequacy for the banking book

4.1 General provisions

- 4.1.1 The following is intended to guide AIs in reporting their credit derivative positions in the banking book, either for hedging their underlying assets or for acquiring credit exposures to a reference entity, in the "Return of Capital Adequacy Ratio - MA(BS)3" (the CAR Return).
- 4.1.2 When an AI engages in a credit derivative transaction for hedging an underlying asset in the banking book, the transaction should be reported in the same book so that, in calculating the capital requirement for the underlying asset, a lower credit risk weight can be allowed on that asset.
- 4.1.3 In some credit derivative contracts, a materiality threshold may be specified for determining the level of loss that must be reached before a credit event is triggered. Therefore, the materiality threshold may affect the amount of protection that is recognised. All credit



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

derivatives involving materiality thresholds should be referred to the HKMA for recognition of protection.

4.2 Protection buyer

4.2.1 In the following treatments for a protection buyer, the time to maturity of the credit derivative contract should be no less than that of the underlying credit exposure to be hedged. If there is a maturity mismatch, a currency mismatch or a credit derivative referenced to multiple obligors, the capital adequacy treatment is as stated in subsections 4.3 to 4.5 below.

4.2.2 Where an underlying asset is protected by a total return



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

4.3 Protection buyer - maturity mismatch

- 4.3.1 If the residual maturity of the credit derivative is less than one year, no protection is recognised.
- 4.3.2 If the residual maturity of the credit derivative is one year or over, protection is recognised, but an add-on is made to account for the forward credit exposure to the underlying asset when the credit derivative contract matures. This forward credit exposure is treated as an exposure under other commitments in the Third Schedule to the Banking Ordinance. It attracts a 50% credit conversion factor (CCF) if the maturity of the forward credit exposure is one year or over.
- 4.3.3 As an illustration, assume that the underlying asset is a corporate loan with four years to maturity, risk weighted at 100%, and credit risk protection is bought from a bank incorporated in a Tier 1 country in the form of a credit default swap maturing in two years' time. The risk weight on the loan is then reduced to 20% (being the risk weight of a bank incorporated in a Tier 1 country for the guaranteed portion of the exposure) with an add-on of 50%, i.e. 50% (CCF) x 100% (risk weight of the corporate counterparty), to account for the forward credit exposure to the underlying asset when the credit derivative contract matures. So the total risk weight for the loan is 70%, i.e. 20% + 50%. Once the residual maturity of the credit derivative contract reaches one year, protection ceases to be recognised and the risk weight will revert to 100%.
- 4.3.4 If the underlying asset is an exposure categorised under other commitments with an original maturity of one year or over (i.e. with 50% CCF), the risk weight on it is further reduced to 10% (guaranteed portion of the exposure) with an add-on of 25% for the forward credit exposure¹. So the total risk weight for the underlying asset is 35%, i.e. 10% + 25%. When the residual maturity of the credit derivative contract reaches one year, protection ceases to be recognised and the risk weight will revert to 50%.

¹ The risk weight for the underlying asset and the add-on for the forward credit exposure in para. 4.3.4 is reduced from 20% and 50% to 10% and 25% respectively by applying the 50% CCF to the underlying asset.



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

4.4 Protection buyer - currency mismatch

4.4.1 Where the credit derivative is denominated in a different currency from the underlying asset (excluding the mismatch between Hong Kong dollars and US dollars), the amount of credit protection recognised is reduced by 8% to take account of the contingent foreign currency risk. The 8%, which reflects the potential fluctuation in the value of protection, is currently used for calculating capital charges of foreign exchange risk (standardised approach) under the market risk regime.

4.4.2 For example, assume that an AI has a HK\$7 million asset which is protected by a Euro-denominated credit derivative (with matched maturity) of Euro 1 million. If the exchange rate at the outset is HK\$7: Euro 1, the amount of protection recognised after the 8% reduction would be HK\$6.44 million. If the amount of protection purchased were Euro 1.087 million, the asset would be recognised as fully protected.

4.4.3 Since the protection will vary with currency movements, the foreign currency positions of credit derivatives should be revalued at least monthly.

4.4.4 The HKMA may consider waiving the 8% discount factor where:

- an AI can demonstrate that it has hedged the contingent foreign currency risk; or
- the foreign currency positions of credit derivatives are revalued daily and protection is recognised only to the extent of the revalued amount.

4.4.5 Foreign currency positions created by credit derivatives should also be recorded when measuring the capital requirement for the AI's market risk exposure.

4.5 Protection buyer - multiple entities

4.5.1 Where the credit derivative is referenced to more than one entity (sometimes known as a basket or multiple-name product) the nature of the credit protection provided will depend on the structure of the contract.

4.5.2 If the contract terminates and pays out on the first entity to default in the basket, then protection is only recognised



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

against one entity in the basket. Als may choose which asset in the basket attracts protection.

- 4.5.3 If the contract allocates protection proportionately among entities in the basket, protection is recognised by setting capital relief against all the reference entities in the basket according to their share of protection under the contract. For example, there are two reference entities, each with a 50% share of protection, in a HK\$10 million credit derivative contract. The amount of recognised protection for an underlying asset which is issued by one of the reference entities is HK\$5 million. This amount is then subject to the risk weight of the protection seller, if the risk weight is lower than that of the underlying asset.

4.6 Protection seller

- 4.6.1 Where an AI sells protection through a total return swap or a credit default swap, it acquires exposure to the reference entity. The exposure should be treated as a direct credit substitute (Part III Item 1 in the CAR Return) and weighted according to the risk weight of the reference entity. The amount of exposure is the maximum amount that could be paid out under the contract.
- 4.6.2 Where the credit event payment is type 1 or 2 (see para. 1.5.2), the amount of exposure is the principal amount defined in the contract. Where it is type 3, the amount of exposure is equal to the fixed payment.
- 4.6.3 Through holding a credit-linked note, an AI acquires credit exposure on two fronts, to the reference entity of the note and also to the note issuer. This on-balance sheet exposure should be weighted by the higher of the risk weight of the reference entity or the risk weight of the note issuer. The amount of exposure is the book value of the note.

4.7 Protection seller - multiple entities

- 4.7.1 If the contract terminates and pays out on the first entity to default in the basket, the HKMA requires capital to be



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

held against all the reference entities in the basket². This means that risk weightings are applied to the maximum pay-out amount under the contract for each of the entities in the basket. The sum of the resultant capital charge³ against each reference entity is capped at the maximum liability under the contract.

- 4.7.2 For example, an AI with 20% risk weight issues a credit-linked note with a book value of HK\$10 million and the note is referenced to three corporate entities with 100% risk weight. The aggregate risk-weighted exposure of the note is HK\$30 million (i.e. HK\$10 million x 100% x 3) requiring a capital charge of HK\$2.4 million (i.e. HK\$30 million x 8%). If there are 13 corporate entities in the basket, the aggregate risk-weighted exposure of all the entities is HK\$130 million (i.e. HK\$10 million x 100% x 13), but the capital charge for the note, which is calculated to be HK\$10.4 million (i.e. HK\$130 million x 8%), is capped at HK\$10 million, the book value of the note.
- 4.7.3 The HKMA may consider disapplying the additive rule where an AI can demonstrate a very strong correlation among the entities in the basket.
- 4.7.4 A structure which is referenced to the entities in the basket proportionately should be risk-weighted according to the entities' share under the contract. Thus, if there are two reference entities in a HK\$100 million contract (one with a 100% risk weight and a 20% share of protection and the other with a 20% risk weight and a 80% share of protection), the risk-weighted exposure is \$36 million (i.e. HK\$20 million x 100% + HK\$80 million x 20%).

² For a credit-linked note, if the risk weight of the note issuer is higher than the sum of the risk weights of the reference entities, the book value of the note is weighted according to the risk weight of the note issuer.

³ The capital charge is defined as the risk-weighted exposure multiplied by 8%.



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

5. Capital adequacy for the trading book

5.1 General provisions

5.1.1 The following sets out the capital treatment applicable to credit derivatives in the trading book. It is a set of methods to guide AIs in reporting their credit derivative positions, either for hedging their underlying assets or for acquiring exposures to a reference entity, in the "Return of Market Risk Exposures - MA(BS)3A" (Market Risk Return). In addition, when potential future credit exposures arise from trading credit derivative contracts, counterparty risk charges should be reported under Part III Items 13 and 14 in the CAR Return.

5.2 Internal models approach

5.2.1 AIs may seek the HKMA's approval to include credit derivatives in their recognised models for calculating capital charges. The detailed requirements relating to the use of internal models are set out in a technical note which will be issued to AIs intending to adopt such an approach.

5.2.2 While some AIs may not be able to run full internal models to calculate market risk capital charges, they may, with the necessary expertise and systems, use pre-processing techniques to calculate capital charges for credit derivatives. AIs wishing to adopt these techniques should seek the HKMA's prior consent. The pre-processing models should be subject to verification by the HKMA.

5.2.3 AIs which do not have recognised models covering credit derivatives should follow the Basel standardised approach as described below.

5.3 Basel standardised approach

5.3.1 The following describes the positions to be recorded for credit derivatives for the purposes of calculating specific risk and general market risk charges under the standardised approach.

5.3.2 Total return swaps are represented as two legs:



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

- one is a notional position in the general market risk and specific risk of the reference obligation; and
- the other, representing interest payments under the swap, is a leg of an interest rate swap with the appropriate fixed or floating rate.

5.3.3 Credit default swaps are represented as a notional position in the specific risk of the reference obligation only (i.e. no general market risk position is created in the reference obligation) if there are no interest payments. If premium or interest payments are due under the swap, these cash flows are represented as a leg of an interest rate swap with the appropriate fixed or floating rate.

5.3.4 Credit-linked notes are treated as a position in the note itself, with an embedded credit default product. The credit-linked note has specific risk of the issuer and general market risk according to the coupon or interest rate of the note. The embedded credit default product creates a notional position in the specific risk of the reference obligation (with no additional general market risk position created).

5.4 Basel standardised approach - specific risk

5.4.1 As noted above, total return swaps, credit default swaps and credit-linked notes create a specific risk position in the reference obligation; the credit risk seller has a short position and the credit risk buyer has a long position.

5.4.2 The buyer of a credit-linked note should also record a long position in the specific risk of the note issuer.

5.4.3 Where credit default products and credit-linked notes are referenced to multiple entities, the positions recorded depend on the structure of the contract.

5.4.4 The credit risk seller of a first-to-default product or note should record a short position in one reference obligation in the basket only. This refers to the reference obligation with the largest specific risk in the basket.

5.4.5 The credit risk buyer of a first-to-default product or note should record long positions in each of the reference obligations in the basket, with the total capital charge for the product capped at the maximum liability of the credit



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

derivative contract or the value of the note. The HKMA may consider disapplying the additive treatment where an AI can demonstrate that there is a very strong correlation among the reference obligations in the basket.

- 5.4.6 Where the credit default product, total return swap or credit-linked note is referenced to multiple obligations under a proportionate structure, positions should be recorded in the reference obligations according to their respective proportions in the contract.
- 5.4.7 Where a multiple-entity credit-linked note is rated so as to meet the conditions for recognition as a rated issue⁴, the note buyer may record the specific risk position as a single long position of a rated issue. Similarly, the note seller may record the specific risk position as a single short position of a rated issue.
- 5.4.8 AIs may net notional positions in reference obligations created by credit derivatives with positions in underlying assets or other notional positions created by other credit derivatives if the following conditions are met:
- the underlying asset and the reference obligation have the same obligor; and
 - the underlying asset and the reference obligation having specific risk positions meet the matching criteria set out in Section C of the Completion Instructions of the Market Risk Return.
- 5.4.9 Where the reference obligation and the underlying asset do not meet the criteria for netting, no offset is allowed under the standardised approach.
- 5.4.10 Materiality thresholds, where payments under credit derivatives are not triggered until the amount payable reaches a minimum level, may affect the amount of the specific risk offset. AIs should refer all credit derivatives involving materiality thresholds to the HKMA for determining the specific risk offset.

⁴ Rated issues are defined in the Completion Instructions of the Market Risk Return.



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

5.5 Basel standardised approach - maturity mismatch

5.5.1 Where a credit derivative is of shorter maturity than the underlying asset, a specific risk offset is allowed by netting the long and short specific risk positions. The net result is a single specific risk charge for the longer maturity position in the underlying asset.

5.5.2 This treatment does not apply to total return swaps, which do not attract any forward specific risk charges in the case of maturity mismatches.

5.6 Basel standardised approach - general market risk

5.6.1 Credit default swaps do not normally create a general market risk position.

5.6.2 Total return swaps create a long or short position in the reference obligation and a short or long position in the notional bond representing the interest rate related leg of the contract.

5.6.3 Credit-linked notes create a long position in the note itself for the note (credit risk) buyer. They create a short position in the note itself for the note (credit risk) seller.

5.7 Counterparty risk

5.7.1 Counterparty risk charges should be reported under Part III Items 13 and 14 in the CAR Return. Each party to a total return swap relies on the other for payment, therefore each party records a counterparty risk charge. The reporting method is set out in the Completion Instructions of the CAR Return.

5.7.2 The credit risk seller (with a short position) in a credit default swap relies on the credit risk buyer (with a long position) for payment if a credit event occurs and therefore records a counterparty risk charge. The credit risk buyer is exposed to the credit risk seller only if there are future premiums or interest rate-related payments outstanding. Such future payments are treated as claims on the credit risk seller.

5.7.3 There is no counterparty risk charge for credit-linked notes.



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

5.7.4 The add-on used when calculating the counterparty exposure for a credit derivative is determined by whether the reference obligation is recognised as a rated debt item. If the reference obligation is a rated debt item, the counterparty risk charge is calculated using interest rate add-ons. Otherwise, equity add-ons should be used.

5.8 Foreign exchange risk

5.8.1 Where the credit derivative is denominated in a currency other than the Hong Kong dollar, it will feed into the AI's monitoring of its foreign exchange position in the normal way.

6. Large exposure treatment

6.1 Reporting

6.1.1 Credit derivatives should be included in the reporting of large exposures in the "Return of Large Exposures - MA(BS)1D" (Large Exposures Return).

6.2 Protection buyer

6.2.1 A credit default swap or a total return swap which is recognised as a protection of the underlying asset for capital adequacy purposes should be regarded as a guarantee and reported as an indirect off-balance sheet exposure (commitment and contingency) to the protection seller in the Large Exposures Return. The amount of the exposure is the same amount of protection that can attract the lower risk weight for capital adequacy purposes.

6.2.2 In a credit-linked note which is recognised as a protection of the underlying asset for capital adequacy purposes, the protection buyer (the note issuer) should report its exposure to the issuer of the underlying asset as an exposure secured by a cash deposit. The amount of the secured exposure is the amount of the funds received from issuing the note. The unsecured amount, if any, of the exposure to the issuer of the underlying asset should be reported as a direct exposure.

6.2.3 In the above cases, if AIs want to reduce any exposure to the underlying asset for the purposes of §81 of the



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

Banking Ordinance, they should seek the HKMA's prior approval. The criteria for approval are set out in [CR-L-2](#) "Exemption of Financial Exposures: §81(6)(b)(i)".

6.3 Protection buyer - maturity mismatch

6.3.1 Maturity-mismatched credit derivatives are reported in the Large Exposures Return according to paras. 6.2.1 and 6.2.2. Since forward credit exposure of the underlying asset is left by the maturity-mismatched credit derivative, there is no reduction of exposure to the underlying asset for the purposes of §81 of the Banking Ordinance.

6.4 Protection buyer - currency mismatch

6.4.1 Currency-mismatched credit derivatives are reported in the Large Exposures Return according to paras. 6.2.1 and 6.2.2. Als should seek the HKMA's approval for any reduction of the exposure to the underlying asset under §81 of the Banking Ordinance.

6.5 Protection buyer - multiple entities

6.5.1 A first-to-default contract that is recognised as protection of the underlying asset for capital adequacy purposes should be reported in the Large Exposures Return as an indirect off-balance sheet exposure (commitment and contingency) to the protection seller. The amount of the exposure is the same amount of protection that can attract the lower risk weight for capital adequacy purposes.

6.5.2 Similarly, a contract that allocates protection proportionately among entities in a basket and is recognised as protection of the underlying assets for capital adequacy purposes should be reported in the Large Exposures Return as an indirect off-balance sheet exposure (commitment and contingency) to the protection seller. The amount of the exposure is the same amount of protection that can attract the lower risk weight for capital adequacy purposes.

6.6 Protection seller

6.6.1 For protection sellers, a total return swap or a credit default swap should be treated in the same way as a



Supervisory Policy Manual

CR-G-12

Credit Derivatives

V.1 – 29.06.01

direct credit substitute and reported as a direct off-balance-sheet exposure (commitment and contingency) to the reference entity in the Large Exposures Return. The amount of the exposure to the reference entity is the maximum amount that could be paid out under the contract. It is therefore the same amount reported for the capital adequacy requirement.

- 6.6.2 In a credit-linked note, the protection seller (the note buyer) has an on-balance sheet exposure to the note issuer. In addition, the protection seller has an off-balance sheet direct exposure (commitment and contingency) to the reference entity because of the embedded credit default swap in the note. The amount of this off-balance sheet exposure which should be reported is the book value of the note.
- 6.6.3 Where credit derivatives are referenced to more than one entity (a basket or multiple-name product), if the contract terminates and pays out on the first entity to default in the basket, AIs are required to report exposures to all the reference entities in the basket.
- 6.6.4 Where the credit default product or credit-linked note is referenced to the entities in the basket proportionately, positions should be recorded in the reference entities according to the entities' share under the contract or note.

[Contents](#)

[Glossary](#)

[Home](#)

[Introduction](#)