



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 11-10

July 5, 2011

**TO THE OFFICER IN CHARGE OF SUPERVISION AND APPROPRIATE
SUPERVISORY AND EXAMINATION STAFF AT EACH FEDERAL RESERVE BANK**

SUBJECT: Interagency Counterparty Credit Risk Management Guidance

The federal banking agencies¹ are issuing the attached *Interagency Supervisory Guidance on Counterparty Credit Risk Management*. It is intended primarily for use by banking organizations with large derivatives portfolios in establishing and maintaining counterparty credit risk (CCR) management practices, as well as for supervisors as they assess and examine such institutions' CCR management. This guidance would generally not be applicable to community banking organizations and banking organizations with insignificant derivatives portfolios. Banking organizations that primarily use derivatives to hedge interest rate risk, and already comply with previously established CCR guidance, should not be subject to any new requirements as a result of this guidance.

Counterparty Credit Risk Management

CCR is the risk that the counterparty to a transaction could default or deteriorate in creditworthiness before the final settlement of a transaction's cash flows. Unlike the credit risk of a loan, where only the lending banking organization faces the risk of loss, CCR creates a bilateral risk of loss because the market value of a transaction can be positive or negative to either counterparty. CCR is a multidimensional form of risk, affected by the exposure to and credit quality of the counterparty, both of which are sensitive to market-induced changes. It is also affected by the interaction of these risks, for example the correlation between an exposure and the credit spread of the counterparty, or the correlation of exposures among the banking organization's counterparties.

Constructing an effective CCR management framework requires a combination of risk-management techniques from the credit, market, and operational risk disciplines. This guidance reinforces sound governance of CCR management practices through prudent board and senior management oversight, management reporting, and risk-management functions. The guidance

¹ The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

also elaborates on the sound practices for an effective CCR management framework and associated characteristics of adequate systems infrastructure outlined below.

Governance

The board of directors or a designated board-level committee (board) should clearly articulate the banking organization's risk tolerance for CCR. Senior management should establish and implement a comprehensive risk measurement and management framework consistent with this risk tolerance that provides for the ongoing monitoring, reporting, and control of CCR exposures.

A banking organization's senior management should report counterparty exposures to its board at a frequency commensurate with the materiality of exposures and the complexity of transactions. To allow for an understanding of exposures and potential losses under severe market conditions, reports should include concentration analysis and CCR stress testing results. Reports should also include an explanation of any measurement weaknesses or limitations that may influence the accuracy and reliability of the CCR measures.

A banking organization's board and senior management should clearly delineate the respective roles of business lines versus risk management in terms of both initiating transactions that have CCR and ongoing CCR management. The board and senior management should ensure that the risk-management functions have adequate resources, are fully independent from CCR-related trading operations, and have sufficient authority to enforce policies and to escalate issues to senior management and the board (independent of the business line).

Risk Measurement

A banking organization cannot effectively manage CCR without effectively measuring this risk. Given the complexity of CCR exposures, a banking organization should employ a range of risk-measurement metrics and approaches in order to promote a comprehensive understanding of CCR and how it changes in varying environments. Concepts discussed in this section include

- use of appropriate metrics,
- measurement of exposure at various levels of aggregation,
- concentration identification and measurement,
- stress testing to inform the banking organization's exposure and concentration management,
- credit valuation adjustment measurement and management, and
- wrong-way risk² measurement and management.

² This risk occurs when the exposure to a particular counterparty is positively correlated with the probability of default of the counterparty itself.

Systems Infrastructure Considerations

A banking organization should ensure that its systems infrastructure keeps up with changes in the size and complexity of its CCR exposures and the over-the-counter (OTC) derivatives market in general. In order to maintain a systems infrastructure that supports adequate CCR management, the banking organization should pay particular attention to data integrity and reconciliation, automation and tracking, and appropriate use of add-on methodologies to capture exposures outside of the main measurement system(s).

Risk Management

The variable nature of CCR requires certain specific types of controls, such as meaningful limits on counterparty exposures based on potential future exposure and adequate margin and collateral haircut guidelines for all products with CCR. Effective management of CCR also includes validation of CCR models and a tested ability to manage, and close out if necessary, counterparties in distress.

Managing Central Counterparty (CCP) Exposures

Well-regulated and soundly managed CCPs can be an important means of reducing bilateral counterparty exposure in the OTC derivatives market. However, CCPs also concentrate risk within a single entity. Therefore, it is important that a banking organization centrally clear transactions through regulated CCPs with sound risk-management processes and strong financial resources, so that the CCPs will be able to meet their obligations under extreme stress conditions. To effectively manage CCP exposures, the banking organization should regularly review the individual CCPs to which it is exposed.

Legal and Operational Risk Management

A banking organization should ensure proper control of (and access to) legal documentation and agreements, incorporating accurate legal terms and provisions into its systems infrastructures. Significant credit losses can occur if a counterparty questions a contract's appropriateness.

Contacts

Reserve Banks are asked to distribute this letter to those banking organizations supervised by the Federal Reserve in their districts that have derivatives portfolios or otherwise have exposure to counterparty credit risk. Questions regarding this letter may be directed to David Lynch, Manager, Quantitative Risk Management, at (202) 452-2081; or Dwight Smith, Senior Supervisory Financial Analyst, Capital and Regulatory Policy, at (202) 452-2773. In addition, questions may be sent via the Board's public website.³

Patrick M. Parkinson
Director

Attachments:

- *Interagency Supervisory Guidance on Counterparty Credit Risk Management*

Cross References:

- SR letter 99-3, "Supervisory Guidance Regarding Counterparty Credit Risk Management"

³ See <http://www.federalreserve.gov/feedback.cfm>.