

Cir. No. FSG 42/2000

Date: 30 Nov 2000

To All Banks

Dear Sir/Madam

MAS NOTICE 627 - CAPITAL TREATMENT FOR CREDIT DERIVATIVES

This circular clarifies MAS' position on credit-linked notes and amends sections 3.3.2 and 3.3.3 of Notice 627 ("Notice").

2 In a typical credit-linked note ("CLN") transaction, the protection seller acquires credit exposure to both the reference asset and to the protection buyer. Where the protection buyer is a special purpose vehicle ("SPV") that has been specially set up to issue the notes, the protection seller bears credit exposure to the reference asset and the collateral owned by the SPV.

3 Accordingly, MAS has adopted the most prudent methodology to determine the appropriate capital charge for these exposures. Section 3.3.2 of the Notice requires the protection seller to sum up the risk-weighted exposures to both the reference asset and the protection buyer/collateral. A capital charge of 12% is then applied to this aggregate credit exposure and capped at the maximum payout possible.

4 However, given limitations in the current Basel Accord with regard to differentiating good credit risks from poorer ones, the above treatment would result in a uniform 24% capital charge for protection-selling banks. This would clearly be excessive, especially when the contract references assets are of very high credit quality. Thus, while the methodology set out in section 3.3.2 of the Notice is sound, the inherent limitations in the current Accord could give rise to excessive capital charges.

5 In its June 1999 consultative paper, the Basel Committee for Banking Supervision, has proposed a more risk-sensitive standardised approach using external credit ratings to determine capital charges for credit exposures. Pending the finalisation of this risk-sensitive capital adequacy framework, there is a need to ensure that banks acting as protection sellers in a credit-linked note transaction are not unduly penalised by the application of the current Basel Accord.

6 Therefore, with immediate effect, banks acting as protection sellers in a credit-linked note transaction will be allowed to apply the higher of the risk charges appropriate to the reference asset(s) or protection buyer/collateral, subject to the condition that both the reference asset(s)

and protection buyer/collateral are rated as being of investment grade ¹ or higher. Should the credit quality of any one of the reference assets or protection buyer/collateral fall below investment grade, a dual capital charge must be applied to the credit exposures of *both* the reference asset(s) and protection buyer/collateral. Where either reference asset(s) or protection buyer/collateral is/are not rated, MAS may at its discretion, waive the additive rule on a case-by-case basis, if it can be demonstrated to MAS' satisfaction, that the risk faced by the protection seller is adequately addressed by a single capital charge.

7 MAS recognises that the above treatment may cause a sudden increase in capital charge when one or both of the assets subsequently fall below investment-grade. This is not unreasonable as historical default data from international rating agencies have shown that default probabilities do tend to increase sharply when the credit quality of assets falls below investment-grade.

8 MAS will continue to monitor market developments, seek feedback, and review its policy on credit derivatives as appropriate. Please feel free to contact Mr Lim Tuang Lee at 6229 9876 or Ms Ho Hern Shin at 6229 9852 should you require any further clarification.

Yours faithfully

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¹ Rated Baa or higher by Moody's and BBB or higher by Standard and Poor's.

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