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# Regulatory Capital Treatment of SBLC Risk Participations

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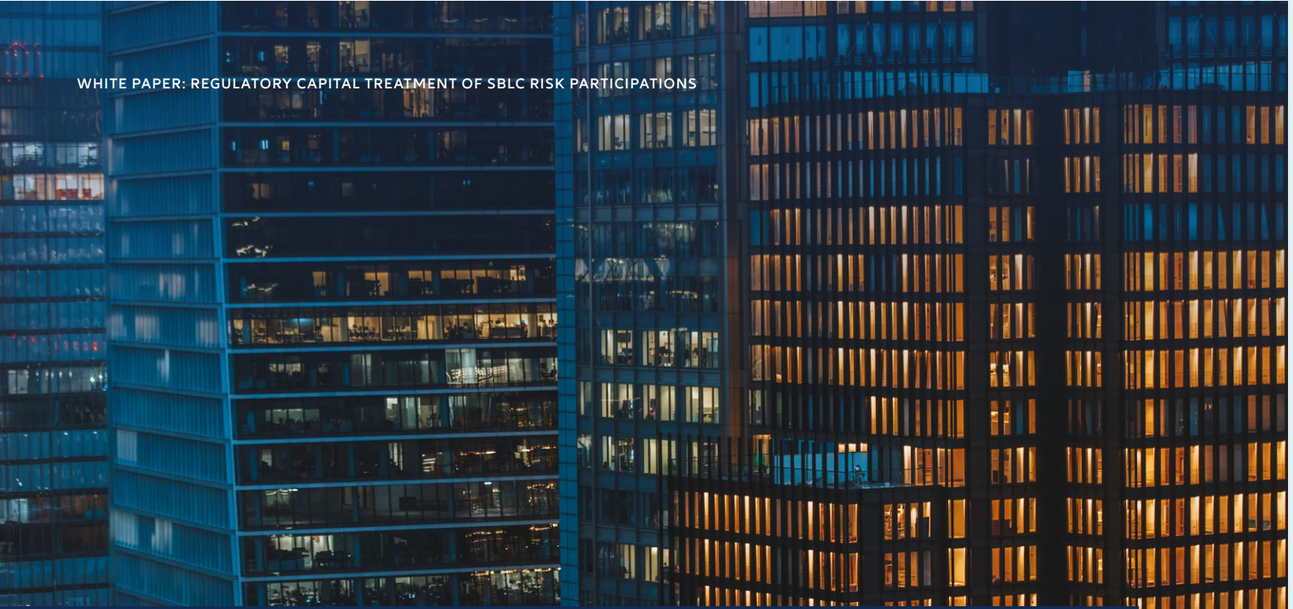

# Contents



# Issue

Whether a U.S. bank may reduce the risk-weighted assets ("**RWA**[1]") associated with a standby letter of credit ("**SBLC**") when it sells an unfunded, non-recourse, pro-rata risk participation in the SBLC to certain highly rated entities ("**Eligible Participant**") under a true participation structure. Specifically, we address if and how U.S. regulatory capital rules permit RWA relief in such transactions, despite the bank's continued GAAP obligation on the full SBLC amount and provide specific guidance on the identification of an Eligible Participant.



# Summary


U.S. banking organizations can obtain RWA reduction on SBLC exposures by selling pro-rata risk participations to Eligible Participants, third parties, *provided the participation agreement meets the criteria of an "eligible guarantee" under the regulatory capital framework*. Under U.S. Basel III rules (12 C.F.R. Part 217 Regulation Q), credit risk mitigants such as guarantees and participations allow a bank to substitute the risk weight of the Eligible Participant for that of the obligor, or to apply "double default"[1] treatment in the advanced approaches, thereby lowering RWA[2]). The regulatory capital rules focus on legal risk transfer and credit enhancement provided by the participation, rather than GAAP accounting de-recognition.[3] If the participation constitutes a bona fide unfunded credit risk transfer (true sale participation), the bank may reflect the risk-sharing in its RWA calculations and regulatory reports.

**Our analysis includes:**

- discussion of basic concepts used in RWA calculations
- description of the "Simple CRM Approach" relying primarily on PD Substitution and LGD Adjustment (each as defined below) together with sample mechanics for application of that approach
- description of the "Advanced Approach" relying on PD Substitution, LGD Adjustment and Double Default methodology (See Section I. Subsections A-C)
- comparison of the relative benefits applying the respective approaches (See Section I.D.).

In Section I. E., we have identified various Eligible Participants and included a discussion of the potential inclusion of additional entities as Eligible Participants.

We discuss relevant regulatory guidance in Appendix A and best practices in Appendix B.

# Regulatory Capital Framework

## A. SOME BASIC CONCEPTS:

**Calculation of RWA depends on the determination of four key factors:**

1. Probability of Default ("**PD**") is calculated by the bank projecting the likelihood of default, often running a migration analysis on similarly rated loans to determine the percentage that default over a set period.
2. Loss Given Default ("**LGD**") estimates the percentage of an exposure that a lender would lose if a borrower defaults, and allows for consideration of additional factors, such as collateral and other mitigating factors to accurately determine the true risk of loss.
3. Exposure at Default ("**EAD**") factors in undrawn but available credit exposure (where applicable) and is calculated by adding (i) the current exposure plus (ii) the product of the Credit Conversion Factor multiplied by the undrawn (but available) credit exposure.
4. Credit Conversion Factor ("**CCF**") is determined by regulators based on the type and risk of an off-balance sheet item, converting it into a "credit equivalent" amount that can then be risk-weighted.

## B. SIMPLE CRM APPROACH (PD SUBSTITUTION / LGD ADJUSTMENT):

Under §217.134, a bank may treat an eligible guarantee as if the exposure's PD or LGD is that of the protection provider. In effect, the guarantor's risk profile "substitutes" for the obligor's risk on the guaranteed portion. The rules provide that if an exposure is fully or pro-rata covered by an eligible guarantee, the bank can use either: (a) a *PD substitution approach*; using the guarantor's PD for the covered portion (or a blend of obligor/guarantor PDs if partial cover), and possibly adjust LGD; or (b) an *LGD adjustment approach*; assign a lower LGD to the portion due to the guarantee).[4] For example, if Bank A issues an SBLC backing a client (obligor) and obtains a pro-rata participation from an Eligible Participant, Bank A could, for the participated portion, use the Eligible Participant's PD in its risk-weight formula. If the Eligible Participant has a stronger credit profile than the underlying obligor, the PD is lower, directly reducing the RWA on that portion. The unguaranteed portion continues to use the obligor's PD. The foregoing approach essentially treats the transaction as two exposures; one to the obligor (for the unprotected share) and one to the Eligible Participant (for the protected share).[5] In either case, the capital requirement for the protected portion should not be less than the capital requirement of a direct exposure to the guarantor alone.

In the standardized risk-based capital rules (which many smaller banks and also large banks for their non-advanced calculations use), a direct substitution rule applies. If an SBLC (which is an off-balance sheet commitment) is covered by an eligible guarantee, the bank can substitute the risk weight of the guarantor for the portion covered, while the uncovered portion retains the obligor's risk weight.[6] Off-balance sheet exposures like SBLCs are first converted to a credit equivalent amount by applying a credit conversion factor (typically 100% for financial SBLCs). For example, assume a $100 SBLC to a corporate client that normally carries a 100% risk weight (if unrated in the U.S. standardized approach, most corporate exposures are effectively 100% risk weight). If the bank participates out 50% ($50) to a investment grade rated bank (20% risk weight category), it can risk-weight $50 at 20% and the remaining $50 at 100%. The RWA calculation would be: $50 * 20% + $50 * 100% = $10 + $50 = $60, versus $100 if no participation. This yields a 40% RWA reduction. Banks report this by allocating the credit equivalent amount across the appropriate columns of Schedule RC-R. Indeed, the Call Report instructions explicitly say to include in the 20% risk weight bucket any portion of an SBLC that is "conveyed" to a U.S. bank (20% risk weight) or guaranteed by a party that qualifies for 20%.[7] They similarly mention portions qualifying for 50% or 0% in those buckets. Thus, the mechanics are straightforward: split the exposure and apply the risk weights according to guarantor vs obligor.

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> "...the capital requirement for the protected portion should not be less than the capital requirement of a direct exposure to the guarantor alone.

## C. ADVANCED APPROACHES

Large U.S. banking organizations subject to the Advanced Approaches (generally, those with $250B+ assets or significant foreign exposure) calculate RWA using internal risk parameters under Subpart E of Regulation Q (12 C.F.R. Part 217) (collectively, the "**Advanced Approaches**"). Under the Advanced Approaches, banks determine credit risk RWA based on formulae that incorporate PD, LGD, EAD and maturity, among other factors[8]. The Advanced Approaches allow banks to recognize credit risk mitigation (CRM) from guarantees and credit derivatives in two principal ways: PD substitution (or LGD adjustment) (described in the preceding paragraph) and double default treatment ("**Double Default**"), discussed in the following subsection.

**1. Double Default Approach.**

Section 217.135 provides an alternative, potentially more favorable, capital treatment for hedged exposures when both the obligor and the Eligible Participant are relatively low-risk and not closely correlated. The "double default" framework recognizes that the risk of both the borrower and a well-capitalized, independent guarantor defaulting on the same obligation is much lower than the risk of either defaulting alone. In technical terms, double default allows a reduced capital charge by accounting for the joint default probability. To use this treatment, a number of strict criteria must be met. Importantly, under the U.S. rule, the guarantor must be an "eligible double default guarantor," meaning a creditworthy, regulated financial firm whose normal business includes providing credit protection or managing credit risk.[9] If applicable, the double default capital requirement is computed by a special formula that scales down the capital requirement ($K_0$) of the underlying exposure by a factor that depends on the guarantor's PD and obligor's PD, reducing RWA significantly when PD for the borrower and the guarantor is low, reflecting the low likelihood of simultaneous default. Double default generally yields greater capital relief than simple substitution but comes with more stringent conditions and supervisory oversight (including a requirement that the bank have Board-approved processes to detect excessive correlation between obligor and guarantor).[10]

**2. Eligible Guaranty Criteria.**

a) For the SBLC risk participation to be recognized as a risk mitigant, it must meet the requirements of an "eligible guarantee." U.S. capital regulations define eligible guarantee in detail in 12 C.F.R. §217.2, which requires that the risk participation (i) be in writing and legally enforceable, (ii) be unconditional, (iii) covers all or a proportional share of all contractual payments under the SBLC, (iv) provides for a direct claim against the participant for its share, (v) cannot be unilaterally cancelable by the protection provider (participant) for reasons other than beneficiary's breach, (vi) must be legally enforceable against the protection provider in any jurisdiction where the provider has assets, (vii) requires the Participant to pay without the bank first having to take legal action against the obligor, (viii) not contain provisions that increase the cost of protection due to deterioration in credit quality of the underlying obligor, and (ix) not be an affiliate of the bank, unless it is an affiliate that is a regulated bank, broker-dealer, or insurer and meets certain stringent conditions (no control, independent supervision).

b) In cases where the Standardized Approach is taken, the guarantee must be provided by an "eligible guarantor", defined to include sovereign governments, U.S. government agencies, banks, multilateral development banks, and entities with investment-grade debt or creditworthiness, excluding those predominantly engaged in credit protection like monoline insurers. Note that the need for an "eligible guarantor" does not apply to the Advanced Approaches.

**3. Key eligibility and operational criteria for double default:**[11]

a) **Eligible Guarantor and Instrument:** The exposure must be hedged by an eligible guarantee (meeting all criteria as above) or eligible credit derivative, and the guarantor must qualify as an "eligible double default guarantor." This term is defined (in §217.2 and in §217.135) to mean a "creditworthy, regulated financial firm whose normal business includes the provision of credit protection or the management of a diversified portfolio of credit risk."[12] Examples include banks, securities firms, insurance companies, or possibly large funds, that are subject to prudential regulation and regularly engage in credit risk taking. In practice, a highly rated asset manager might qualify if, for instance, it manages a credit fund that provides such guarantees and the asset manager is a regulated entity (e.g., registered investment advisor managing a diversified... portfolio of credit exposures). If the participant is not itself a regulated financial institution (e.g., an asset manager managing third-party money), it may or may not meet this definition; this is a point to evaluate. The 12 C.F.R. §217.135 criteria were originally written with entities like monoline insurers, banks, or securitization conduits in mind. For our case, assume the asset manager is considered "creditworthy" and "regulated" (perhaps SEC-regulated, though not a prudential regulator) and in the business of managing credit risk. If there is uncertainty, the bank might opt for the substitution approach instead of double default, or seek clarification from regulators. Double default cannot be used unless the guarantor clearly fits the definition.[13]

b) **Pro Rata or Full Coverage, Single-Name:** The hedged exposure must be fully or pro-rata covered by the guarantee on a single-name basis. This means exactly our scenario: a pro-rata participation on one SBLC (not a basket or tranche). Nth-to-default basket swaps or tranched protections are generally excluded from double default (except a special nth-to-default case not relevant here).

**4. Hedged Exposure is a Wholesale Exposure:**

The underlying obligor exposure must be a wholesale exposure (corporate, bank, etc.), not a retail exposure and not a sovereign exposure. SBLCs to corporate customers are wholesale exposures, so that fits. The rule prevents double default for retail loans, likely due to modeling difficulty.

**5. No Excessive Correlation:**

The bank must have a process in place (approved in writing by regulators) to detect "excessive correlation" between the creditworthiness of the obligor and the guarantor. If the obligor and guarantor are affiliated or vulnerably dependent on common factors, double default is disallowed. In practice, this means the participant (guarantor) should not be, say, a parent or subsidiary of the obligor, or even too concentrated in the obligor's industry such that a single event can impair both. In our scenario, an independent asset manager providing credit protection to an unrelated corporate obligor likely satisfies this (assuming no →

> The bank must have a process in place (approved in writing by regulators) to detect "excessive correlation" between the creditworthiness of the obligor and the guarantor.

strange relationship like the asset manager's fund only invests in the obligor's company). The bank's risk management should document that the obligor and guarantor are distinct credit profiles with no undue correlation (different industries, etc.).

**6. No Double Counting of CRM:**

The bank can't also use other CRM techniques on the same portion if applying double default (it must exclusively use double default for that hedged portion).

**7. Advanced Approaches Mechanics:**

As discussed above, applying the Advanced Approaches, the bank effectively performs a bifurcation of the exposure into protected and unprotected portions.[14] For the protected portion, the bank uses either the guarantor's PD (substitution) or applies the double default formula, and for the unprotected it uses the obligor's PD with no credit from the guarantee. The total RWA is then the sum of the RWA for each portion.

a) **PD Substitution Example:** The account party (obligor) is a risky corporate with PD equivalent to, say, a BB rating (e.g., 2% PD), and the asset manager participant is highly rated with PD equivalent to an AA rating (e.g., 0.10% PD). The SBLC EAD is $100. If the bank keeps 50% and the participant covers 50%, the bank sets up two exposures: $50 with obligor PD 2%, LGD say 45%; and $50 with guarantor's PD 0.10%, LGD adjusted if the guarantee isn't full (the rules might allow lower LGD on the portion as well, acknowledging the bank's loss is only if guarantor fails too). The capital requirement for the $50 guaranteed portion will drop significantly because the PD is an order of magnitude lower. The precise RWA depends on the risk-weight function formula, but clearly there is relief. The rules also ensure the capital for the guaranteed portion cannot be less than if the bank had an exposure directly to the guarantor for $50, which in this case would be very low anyway (since AA obligor risk weight is low).[15] The unprotected $50 remains with higher risk. Summing them yields a reduced total RWA.

b) **Double Default Example:** If conditions are met (e.g., obligor is a corporate, guarantor is a regulated financial firm, not correlated), the bank can apply the double default formula to the $50 portion. The formula in §217.135 essentially multiplies the capital requirement for the underlying exposure (if unhedged) by a factor that includes a 0.15 base plus 160×PDg, capped by some function of LGDs.[16] If the guarantor's PD is very low, this factor can be well below 1.0, thus reducing capital. Roughly speaking, double default might produce even less RWA than pure substitution because it acknowledges that the bank only loses if both defaults happen. In our numbers, obligor PD 2%, guarantor PD 0.10% might result in a factor like 0.15 + 160×0.001 = 0.31 (31%). If $K_0$ (capital requirement for $50 unhedged) was, say, $4 (for a high PD), under double default it becomes $4 * 0.31 ≈ $1.24. Compare this to substitution: capital if treating it as guarantor exposure of $50 (0.1% PD) maybe $0.50. Substitution might yield lower in some cases, but double default particularly shines when the guarantor PD is low relative to obligor. Regulators ensure it's not overly generous by the formula's floor.

> In either advanced approach method, partial guarantees are handled by dividing the exposure. Section 217.134 and 135 both instruct that if a guarantee covers less than the full exposure, the bank must treat the covered portion as a separate exposure and the remainder as another, for RWA purposes.[17] This means the bank must have the systems to allocate EAD accordingly. Practically, banks should ensure their capital reporting (e.g., FFIEC 101 for advanced RWA) reflects two exposures in such cases.



## D. COMPARISON OF AVAILABLE APPROACHES

The Simple CRM approach, while widely used and well known to regulators, results in a material overstatement in connection with calculations of RWA. Although only available to the largest, most complex banks ($250 Billion of more in assets or $10 Billion in foreign exposure), both the first Advanced Approach (using of the adjustments to PD and LGD calculations which utilizes metrics that are incorporated into Regulations Q) and if available, utilization of the Double Default methodology results in the most accurate assessment of risk because it factors in the practical risk of a double default on the part of the obligor and the guarantor (or Eligible Participant).

## E. CURRENT ELIGIBLE PARTICIPANTS FOR DOUBLE DEFAULT TREATMENT AND POTENTIAL EXPANSION OF THIS CATEGORY.

The term "Eligible Guarantor" describes entities that (aside from the various sovereign, multinational and national debt issues) include, a depository institution, a bank holding company, a savings and loan holding company, a credit union, a foreign bank, or a qualifying central counterparty; or any other entity (other than a special purpose entity) that has outstanding investment grade indebtedness, is not engaged predominantly in the business of providing credit protection (such as a monoline bond insurer or re-insurer) and whose creditworthiness is not positively correlated with the credit risk of the exposures being guaranteed (12 C.F.R. 271.01). The term "Eligible Double Default Guarantor" describes entities that may be a depository institution, a bank holding company, a savings and loan holding company, or a securities broker or dealer registered with the SEC under the Securities Exchange Act, if at the time the guarantee is issued or anytime thereafter, has issued and outstanding investment grade debt.

Entities such as investment advisors ("**IA**") and investment managers ("**IM**"), each of whom are regulated by the SEC (but not in the same manner as securities broker or dealer) can enter into SBLCs either directly (if they issue investment grade debt) or for the account of the funds they manage (many of which issue investment grade debt securities). Accordingly, a strong argument can be made that Eligible Participants should include highly rated IAs and IMs.

# II. Regulatory Guidance and Basel Standards

A. U.S. regulators (OCC, Federal Reserve, FDIC) have long acknowledged the credit risk mitigation benefits of participations and similar guarantees. While there is no one specific "SBLC participation guidance" bulletin, various interagency documents implicitly cover these principles. For instance, the 1989, 1992, and 2001 risk-based capital guidelines treated standby letters of credit and participations as forms of direct credit substitutes or guarantees, carrying equivalent capital treatment for the guarantor and relief for the seller. The OCC's 2003 final rule integrating Basel II terminology (12 CFR Part 3 Appendix) included the definition of "risk participation" (quoted earlier) and made clear that the originating bank remains liable, but the acquiring bank (participant) should hold capital as if it guaranteed that portion.[18] This implies the converse: the originating bank can consider that portion guaranteed by the participant. Additionally, Call Report and FFIEC instructions, effectively regulatory guidance for reporting, explicitly instruct banks on how to report participations sold in the RWA calculation.[19] These instructions are authoritative for regulatory reporting purposes and can be cited in support of the bank's RWA treatment. They show that banking agencies expect RWA to shift when exposures are participated out or otherwise guaranteed by eligible parties.

B. The **OCC Bank Accounting Advisory Series** (updated annually) also provides relevant insight on accounting versus capital. In particular, it emphasizes that selling a risk participation does not remove the contingent liability (for accounting), but if the participation is a "true sale" (meaning a legally valid transfer of risk with no effective obligation to repurchase or support the interest), then for risk-based capital the transfer is recognized. Banks often seek a true-sale opinion for loan participations (funded assets) to ensure removal from assets; for unfunded SBLC participations, true-sale analysis might focus on bankruptcy remoteness (ensuring that if the bank went bankrupt, the participant's obligation would remain, and vice versa). While not explicitly required by regulation, obtaining legal confirmation of the risk transfer can bolster the position that the participation is effective and enforceable – thus eligible for capital relief.

C. Regulators have also addressed credit risk insurance and why certain forms are or are not recognized. Notably, U.S. rules do not recognize private credit insurance policies from unregulated insurers as eligible guarantees in many cases (as the DCW article cited notes, non-payment insurance isn't given capital relief for U.S. banks)[20]. This is due to the "eligible guarantor" restriction excluding insurance companies that primarily provide credit protection (monolines). By contrast, a typical unfunded participation from a fund or asset manager (since it's not an insurance *policy* and the asset manager is not likely to be classified as a monoline insurer) can be structured to meet the criteria without falling into that excluded category. The regulators' intent is to ensure credit risk mitigation is credible; they are somewhat stricter on who can mitigate credit risk. This memo's scenario (highly rated asset manager) appears to navigate those rules by using the form of a guarantee/participation rather than insurance, and by presumably selecting a participant that meets the creditworthiness and business criteria.

D. **Basel Standards:** The Basel Committee on Banking Supervision ("BCBS") framework under Basel II and III explicitly allows recognition of unfunded credit protection. Basel II's original text (¶189-201 for standardized, ¶283-287, ¶480-487 for IRB) set out conditions very similar to the U.S. eligible guarantee definition).[21] The concept of *double default* was introduced by BCBS in 2005, recognizing that "the risk of both a borrower and a guarantor defaulting on the same obligation may be substantially lower than the risk of only one of the parties defaulting".[22] The U.S. implementation of double default (in §217.135) aligns with the Basel approach and was vetted in rulemaking. In fact, in the Federal Register notices around 2007 (Basel II NPR) and 2013 (Basel III final rule), regulators discussed public comments on guarantees and double default. They ultimately removed the limitation of "eligible guarantor" for non-securitization exposures in advanced approaches to broaden recognition of protection[23], consistent with the Basel framework's intention to recognize a wide range of guarantors, provided they are creditworthy (Basel allows corporates with A- or better internal rating under IRB[24], which the U.S. mirrored before Dodd-Frank removed references to ratings).

The Basel Committee's publications (e.g., *Basel II: International Convergence of Capital Measurement and Capital Standards,* June 2006) can be cited as persuasive guidance. They emphasize that for a guarantee to reduce capital, it must be "*direct, explicit, irrevocable and unconditional*," which exactly matches our rule.[25] Basel's rationale is that such guarantees effectively shift risk such that capital can be held against the guarantor's risk, not the borrower's. Additionally, the Basel framework (CRE22 and CRE32 in the current Basel consolidated framework) outline how partial guarantees are handled (proportional approach) and how double default is an exceptional but allowed technique.

By aligning the SBLC participation with these standards, a bank is not doing anything novel or aggressive; it is utilizing a well-established risk mitigation technique endorsed by international standards. Indeed, many global banks engage in risk distribution of trade finance exposures (including SBLCs) through unfunded participations to entities like insurance companies or funds, to manage capital. The Basel *Trade Finance* guidance and FAQs also have recognized that when structured properly, such participations/insurance reduce risk and hence capital – although they caution about legal certainty.

> In summary, both U.S. guidance and Basel standards support the permissibility of RWA reduction through genuine risk participations. The bank should, if needed, reference these standards in conversations with auditors or examiners to show this treatment is grounded in widely accepted prudential concepts.
>
> Our recommended best practices are set forth in Appendix A. In Appendix B, we have provided a roadmap for defending the use of RWA Reduction in Regulatory Reporting.

# III. Conclusion

U.S. banking law and regulation permit, and indeed encourage, prudent transfer of credit risk to third parties. Selling an unfunded, pro-rata risk participation in an SBLC to a highly rated Eligible Participant can legitimately reduce a bank's risk-weighted assets, improving its regulatory capital ratios, *so long as the transaction is structured as a true guarantee meeting the regulatory criteria for* an "eligible double default guarantor."

## END NOTES:

1. 12 C.F.R. § 217.36(a)(1) (Standardized Approach substitution treatment permitting a bank to use the protection provider's risk weight for the exposure) ( eCFR : 12 CFR 217.36 -- Guarantees and credit derivatives: substitution treatment. ).
2. 12 C.F.R. § 217.36(a)(2)(ii) (eligible guarantee may cover credit risk on a pro rata basis, with losses shared proportionately by guarantor and bank) ( eCFR : 12 CFR 217.36 -- Guarantees and credit derivatives: substitution treatment. ).
3. OCC, *Risk-Based Capital Guidelines*, 12 C.F.R. Part 3, Appendix A, §2(c)(16)(xvi) (definition of "Risk participation" as a participation where the originating bank remains liable for the full amount of the obligation)(https://www.occ.gov/news-issuances/news-releases/2003/nr-ia-2003-72b.pdf#:~:text=xvi,can%20be%20sold%20to%20investors).
4. 12 C.F.R. § 217.134(a)(1) (Advanced approaches: wholesale exposure credit risk fully or pro-rata covered by eligible guarantee may be recognized for mitigation) (12 CFR § 217.134 - Guarantees and credit derivatives: PD substitution and LGD adjustment approaches. | Electronic Code of Federal Regulations (e-CFR) | US Law | LII / Legal Information Institute); see also Basel Committee, *Basel II Framework* ¶189 (guarantees must be direct, explicit, irrevocable, and unconditional to be recognized).
5. Federal Financial Institutions Examination Council (FFIEC) Call Report Instructions, RC-R – Regulatory Capital, which direct banks to allocate the credit equivalent amount of guaranteed portions of off-balance sheet exposures to the corresponding risk weight of the guarantor. E.g., "Include in column C–0% risk weight, the portion of financial standby letters of credit ... that are secured by collateral or has a guarantee that qualifies for the zero percent risk weight... Include in column G–20% risk weight, the credit equivalent amount of the portion of financial standby letters of credit ... that has been conveyed to U.S. depository institutions..." (Part II. Risk-Weighted Assets) (Part II. Risk-Weighted Assets).
6. 12 C.F.R. § 217.2 (definition of "eligible guarantee") (guarantee must be written, unconditional, cover all or pro-rata payments, give a direct claim, not be cancelable by guarantor, be legally enforceable, provide for timely payment without first requiring action against the borrower, not increase cost on deterioration, and, for certain purposes, be provided by an eligible guarantor) ( Federal Register : Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule, Revisions to the Definition of Eligible Guarantee ) ( Federal Register : Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule, Revisions to the Definition of Eligible Guarantee ).
7. 12 C.F.R. § 217.2 (definition of "eligible guarantor") (includes sovereigns, agencies, banks, bank holding companies, and "an entity (other than a special purpose entity) that, at the time the guarantee is issued, has issued and outstanding an unsecured debt security without credit enhancement that is investment grade"; also excludes insurance companies primarily engaged in credit protection (monoline insurers).
8. Federal Register, 79 Fed. Reg. 44120, 44124 (July 30, 2014) (Interagency final rule revising definition of eligible guarantee) (removing requirement that a guarantor be an "eligible guarantor" for non-securitization exposures under advanced approaches) ( Federal Register :: Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule, Revisions to the Definition of Eligible Guarantee ) ( Federal Register :: Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule, Revisions to the Definition of Eligible Guarantee ).
9. 12 C.F.R. § 217.135(a) (criteria for double default treatment) (requires hedged exposure is wholesale, fully or pro-rata hedged by an eligible guarantee from an eligible double default guarantor; obligor is not an affiliate of guarantor; bank does not use any other CRM on the exposure; and bank has Board-approved process to detect excessive correlation) (12 CFR § 217.135 - Guarantees and credit derivatives: double default treatment. | Electronic Code of Federal Regulations (e-CFR) | US Law | LII / Legal Information Institute) (12 CFR § 217.135 - Guarantees and credit derivatives: double default treatment. | Electronic Code of Federal Regulations (e-CFR) | US Law | LII / Legal Information Institute).
10. 12 C.F.R. § 217.135(f) (definition of "eligible double default guarantor" as a "*creditworthy, regulated financial firm whose normal business includes the provision of credit protection or the management of a diversified portfolio of credit risk*") (Basel II Attachment 2).
11. Federal Reserve Board, *Basel II Final Rule – Technical Overview* (Nov. 2007) at 30-31 (explaining double default treatment: hedged exposure must be fully or pro-rata covered by single-reference guarantee from eligible double default guarantor; bank must determine no excessive correlation between obligor and guarantor) (Basel II Attachment 2) (Basel II Attachment 2).
12. Basel Committee on Banking Supervision, *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects* (July 2005) at 2 (noting the need for a prudentially sound capital treatment recognizing that "*the risk of both a borrower and a guarantor defaulting on the same obligation may be substantially lower than the risk of only one of the parties defaulting*") (The Application of Basel II to Trading Activities and the Treatment of Double Default Effects ).
13. 12 C.F.R. § 217.135(e) (double default capital formula). See also Basel II, ¶283-287 (establishing the double default framework; capital requirement is function of PDs of obligor and guarantor and must not be less than the risk weight of a direct exposure

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to the guarantor) (12 CFR § 217.135 - Guarantees and credit derivatives: double default treatment. | Electronic Code of Federal Regulations (e-CFR) | US Law | LII / Legal Information Institute) (International Convergence of Capital Measurement and Capital Standards - A Revised Framework, November 2005).

14. OCC Bank Accounting Advisory Series (BAAS), Topic 5: "Transfers of Financial Assets," Q&A (Aug. 2024) (clarifying that an unfunded risk participation in a standby letter of credit, where the bank remains primarily obligated to the beneficiary, does not remove the contingent liability from the bank's balance sheet, but the bank may still consider the risk transfer for risk management and capital purposes) (https://www.occ.gov/news-issuances/news-releases/2003/nr-ia-2003-72b.pdf#:~:text=xvi,can%20be%20sold%20to%20investors).
15. FFIEC 101 Reporting Instructions for Schedule A, item 7 (credit risk mitigants – guarantees) (advanced approaches bank should reduce the risk-weighted asset amount for exposures with eligible guarantees, either through PD substitution or double default, as appropriate, and disclose the effect of guarantees in Pillar 3 reports, if material).
16 Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Comprehensive Version, June 2006) ¶§ 189-194 (guarantee eligibility requirements under standardized approach) and ¶§ 480-487 (guarantees under IRB, disallowing double default in foundation IRB and introducing it in advanced IRB as an option) (International Convergence of Capital Measurement and Capital Standards - A Revised Framework, November 2005) (International Convergence of Capital Measurement and Capital Standards - A Revised Framework, November 2005).
17. 12 C.F.R. § 217.32 and § 217.34 (Standardized Approach credit conversion factors for off-balance sheet exposures) (financial standby letters of credit have a 100% credit conversion factor; performance standby letters 50%; demonstrating SBLCs are treated as full exposures for capital unless risk mitigated) (Part II. Risk-Weighted Assets) (Part II. Risk-Weighted Assets).
18. *Interagency Supervisory Guidance on Risk Management of Participations* (if any, reference generic guidance that purchasing banks must exercise due diligence and have agreements in writing – by inference, selling banks should too; although specific guidance is more on loan participations, the principles carry to SBLC participations in ensuring legal soundness).
19. Example bank disclosure (hypothetical): Bank XYZ 2024 Pillar 3 Report, Section "Credit Risk Mitigation," stating "The Bank routinely buys and sells risk participations on standby letters of credit to reduce or diversify credit risk. For regulatory capital purposes, the Bank recognizes the risk transfer of such participations in accordance with 12 C.F.R. Part 217, reducing the risk-weighted assets of exposures protected by eligible guarantees. As of 12/31/2024, $___ of standby letter of credit exposure was mitigated by participations from third-party institutions, yielding a ___ bps improvement in the Bank's Common Equity Tier 1 capital ratio."
20. Federal Reserve SR Letter 05-4 (Feb. 2005) (addressing interim capital treatment for small banks; while not directly on participations, it emphasized maintaining capital for off-balance sheet risks unless credibly mitigated by guarantees or participations).



# Appendix A Best Practices

To effectively implement and support the RWA benefit from SBLC risk participations, we recommend the following best practices for banks:

- **Transaction Structuring:** Involve the legal, risk, and accounting teams early when structuring the SBLC participation. Ensure the participation agreement language meets the eligible guarantee criteria (no set-off that dilutes unconditionality, clear payment obligations, etc.). Use standard documentation (for example, the BAFT Master Participation Agreement or similar) which is usually crafted to be a true sale of the participation and meet regulatory standards.
- **True Sale and Enforceability Opinion:** Consider obtaining a legal opinion confirming that the participation constitutes a true sale/transfer of the credit risk and that the participant's obligations would be enforceable even in adverse scenarios (e.g., if the bank is in receivership, the FDIC would recognize the participant's interest; FDICIA protections for participations could be cited). While not required, such opinions give comfort that the risk transfer is effective, underpinning the capital treatment.
- **Due Diligence on Participant:** Since capital relief hinges on the participant's credit quality, perform due diligence on the asset manager. Verify it falls under "eligible guarantor" (if needed) and "eligible double default guarantor" criteria. Document the participant's credit rating (if available) or internal risk assessment. Ideally, the participant should be Investment Grade. If the asset manager is a fund, understand the fund's structure; is it collateralizing its obligation or is there any weakness? Strength of guarantor is crucial; remember, if the guarantor's credit deteriorates, the benefit may be moot (and the bank might then allocate capital for counterparty risk accordingly).
- **Internal Approval & Limits:** Treat unfunded participations as a form of credit exposure to the participant. The bank's credit committee should approve entering into the risk participation arrangement, effectively extending contingent credit to the asset manager (since the asset manager could fail to pay when called upon). Set appropriate limits on aggregate exposure to such participants to avoid concentration. This also helps from a regulatory perspective: it shows the bank manages the risk of the guarantor, not just blindly taking capital relief.
- **Accounting and Reporting Alignment:** Coordinate with the accounting team so that financial statement disclosures appropriately reflect the arrangement (e.g., disclose that certain SBLCs are subject to participations – perhaps in the contingent liabilities footnote). This transparency prevents any allegation that the bank hid obligations. And ensure the regulatory reporting (RC-R etc.) is done correctly – e.g., only count the net exposure or do the split in risk weight columns as required. Maintain worksheets that show how the notional is divided and which risk weight or PD was applied. These workpapers will be handy during exams.
- **Policy Documentation:** Update the bank's capital adequacy policies to explicitly mention that unfunded risk participations are recognized as credit risk mitigation per 12 C.F.R. Part 217. Set forth the conditions under which the bank will rely on such mitigation. For advanced approaches banks, this could be in

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the section of the policy dealing with credit risk mitigation and double default. For standardized approaches, it could be in the risk weight assignment procedures.

- **Regulator Communication:** If the strategy is significant (say the bank is doing this on a material portfolio of SBLCs), it may be wise to proactively discuss it with your regulators (Fed/OCC examiners) at a periodic meeting. Not for approval (since it's already allowed by rule) but to walk them through the program. Explain the rationale: "We have a program to distribute SBLC risk to strong third parties to manage our exposures and capital. We only do so under strict criteria and in compliance with capital rules." Such communication can preempt misunderstandings and demonstrate the bank's diligent risk management.
- **Monitoring and Contingency:** Post-execution, monitor the participant's financial health. The bank should have an exit strategy or replacement plan if the participant is downgraded below a threshold. For example, the participation agreement might allow the bank to terminate the participation (and perhaps replace it with another) if the participant's credit rating falls below investment grade – this protects the bank from losing capital relief while still being stuck with a weak guarantor. Also, include the participant in exposure stress testing: what if they default? Normally, that would coincide with the bank having to absorb the exposure again – ensure capital buffers for that unlikely scenario.
- **Pillar 3 Disclosure (if applicable):** Advanced approaches banks have to publish qualitative disclosures about CRM. Use that section to mention use of participations. This not only fulfills disclosure requirements but also normalizes the practice as part of the bank's risk management toolkit.

**Explain the rationale:**
"We have a program to distribute SBLC risk to strong third parties to manage our exposures and capital. We only do so under strict criteria and in compliance with capital rules."

# Appendix B Defense of RWA Reduction in Regulatory Reporting

When reporting the RWA reduction on regulatory filings (e.g., Call Report RC-R, FR Y-9C, or FFIEC 101 for advanced approaches), banks should be prepared to defend the treatment with documentation and references to authority. The defense essentially writes itself from the regulations:

1. **Cite the Regulations:** The primary defense is citation to 12 C.F.R. §217.36 (for standardized) and §217.134/135 (for advanced) that explicitly allow recognition of eligible guarantees. For example, §217.36(a)(1) states a bank "*may recognize the credit risk mitigation benefits of an eligible guarantee… by substituting the risk weight of the protection provider*".[26] Section 217.134 similarly allows recognition in IRB. And §217.135 provides the double default framework. By showing the participation meets the "eligible guarantee" definition (document how each criterion is satisfied in a memo or checklist), the bank demonstrates compliance with the rule requirements for capital relief.
2. **Show Legal Agreements:** The bank should retain the participation agreement and possibly a legal opinion or analysis confirming that the agreement is enforceable and constitutes a true transfer of credit risk. Key points to highlight: it is unconditional, irrevocable, etc., aligning with regulatory criteria. If there were any material exceptions, the bank should be transparent and have a mitigant (e.g., if the participation has a slight condition, explain why it still meets the spirit or why it's negligible).
3. **Internal Approvals and Policies:** The bank's internal capital policy should outline how guarantees and participations are treated. Demonstrating that the bank has a consistent framework (approved by risk management or the board) for recognizing credit risk mitigation bolsters the case that this is a normal, controlled practice. For advanced approaches banks, indicate that the credit risk mitigation is captured in the PD/LGD assignment process or via an adjustment in the risk systems per the Basel rule. If double default is used, evidence of the supervisory approval of the correlation detection process (as required by §217.135(a)(6)) should be on file.[27]
4. **Call Report Instructions and Precedent:** The bank can reference Call Report instructions (as quoted above) which clearly allow moving participated amounts to lower risk weight categories.[28] This is a powerful defense because it is the *official reporting guidance*. An examiner or auditor cannot argue with the Call Report rules that specifically contemplate participations ("conveyed" portions) getting different risk weights. For advanced approaches, the FFIEC 101 instructions similarly discuss reporting of hedged exposures and the use of double default if elected.
5. **Distinguish GAAP vs Regulatory Intent:** If someone raises the point "but the SBLC is still on your books," the bank should clarify that regulatory capital is not equivalent to accounting exposure. There are many instances in capital rules where accounting does not dictate capital treatment; for example, derivative netting, recognition of guarantees, or consolidation differences. The bank can point out that the purpose of capital rules is to ensure sufficient capital for actual risk. Here, actual credit risk has been partly laid off to

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a third party; ignoring that would overstate the bank's risk. Moreover, the bank still holds capital for the risk of the guarantor defaulting (in the form of substituting the guarantor's risk weight or PD), so the risk is still capitalized, just in a shifted manner. This argument aligns with the substance over form approach of prudential regulation.

6. **Consistent Application:** Ensure the bank is not "cherry-picking." If it sells participations on multiple SBLCs or loans, it should consistently take the capital relief for all that meet criteria (and not for those that don't). Consistency shows the bank isn't using this one-off to game metrics but as part of a broader risk management strategy.
7. **Stress Testing and Concentration:** Be prepared to discuss what happens if the guarantor fails. In capital planning (CCAR/DFAST) or internal stress tests, the bank presumably would consider the counterparty risk – i.e., if the asset manager went bankrupt at the same time as the SBLC obligor defaulted, the bank would be on the hook. However, that joint event is precisely what double default accounts for statistically. The bank can mention that it monitors the participant's financial condition and would take action (like replacing the participant or hedging) if it deteriorated. This helps alleviate any safety and soundness concerns the examiner might have about over-reliance on the guarantee.
8. **Regulatory Precedents:** If any, the bank could point to other banks that use similar structures. Trade finance industry groups have noted that U.S. banks use unfunded participations and have sought clarity on capital treatment. For example, industry comment letters to regulators (during Basel III implementation) supported recognizing insurance and participations as risk mitigants. While individual cases are usually confidential, the practice is not unheard of, and no rule forbids it. On the contrary, it's encouraged to disperse risk.

By assembling a concise analysis memo (which could be an internal version of this memo) and keeping it in the credit file or capital adequacy documentation, the bank can readily justify the RWA reduction at each examination or audit. In any regulatory filing (like Pillar 3 disclosures), the bank might also disclose that it uses credit risk mitigation techniques including participations to manage risk-weighted assets – adding transparency.

In short, the defense is: we follow the regulations. The capital rules explicitly allow this, and we have done it in accordance with those rules. That is a strong position that should satisfy regulatory scrutiny, especially if all supporting evidence is in order.



## REFERENCES


[1] 12 CFR § 217.135 - Guarantees and credit derivatives: double default treatment. | Electronic Code of Federal Regulations (e-CFR) | US Law | LII / Legal Information Institute

[2] eCFR : 12 CFR 217.36 -- Guarantees and credit derivatives: substitution treatment.

[3] https://www.occ.gov/news-issuances/news-releases/2003/nr-ia-2003-72b.pdf#:~:text=xvi,can%20be%20sold%20to%20investors

[4] International Convergence of Capital Measurement and Capital Standards - A Revised Framework, November 2005

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[7] Part II. Risk-Weighted Assets

[8] Basel II Capital Accord - Notice of Proposed Rulemaking (NPR) and Supporting Board Documents - Board Memorandum -- March 22, 2006

[9] Basel II Attachment 2

[10] 12 CFR § 217.135 - Guarantees and credit derivatives: double default treatment. | Electronic Code of Federal Regulations (e-CFR) | US Law | LII / Legal Information Institute

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[12] Basel II Attachment 2

[13] Basel II Attachment 2

[14] 12 CFR § 217.135 - Guarantees and credit derivatives: double default treatment. | Electronic Code of Federal Regulations (e-CFR) | US Law | LII / Legal Information Institute

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[21] Federal Register :: Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule, Revisions to the Definition of Eligible Guarantee

[22] The Application of Basel II to Trading Activities and the Treatment of Double Default Effects

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[25] Federal Register :: Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule, Revisions to the Definition of Eligible Guarantee

[26] https://www.ecfr.gov/current/title-12/chapter-II/subchapter-A/part-217/subpart-D/subject-group-ECFR90182ef648cc7a4/section-217.36#:~:text=%281%29%20General.%20A%20Board,as%20provided%20under%20this%20section

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[28] Part II. Risk-Weighted Assets


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