

## The Transfer of Credit Risk and Capital Requirements

Brazil's current economic recession and its pressure on rising credit risk and default rates have triggered significant changes in the national financial system.

Among these changes, there is one that deserves special attention due to its legal complexity: the growing number of financial transactions aimed at transferring credit risks. They are intended to neutralize the effect of credit default on the regulatory capital of financial institutions, thus allowing new transactions and generating more liquidity in the credit market.

One of the elements considered in the calculation of the capital requirements of Brazilian financial institutions is the exposure of the institution to credit risks. The institution must keep minimal capital reserves determined as a function of such exposure. Hence, the transfer of credit risks will affect the calculation of the required reserves.

There are three main alternatives for a financial institution to transfer risks of its credit transactions to third parties: assignment of credits, derivatives and participations, which include the fundraising through credit linked loans regulated by Resolution No. 2,921, dated January 17, 2002, from the National Monetary Council (*Conselho Monetário Nacional* - CMN).

### Credit Assignments

In a credit assignment transaction, the original creditor (assignor) transfers the ownership of the asset to a third party (assignee), who becomes the new creditor. This may be done through a separate instrument or by endorsement of securities representing the credit, such as Real Estate Credit Bills (*Cédulas de Crédito Imobiliário* – CCI) or Bank Credit Bills (*Cédulas de Crédito Bancário* – CCB), both regulated by Law No. 10,931, of August 2, 2004. As the new party entitled to receive payments from debtors, the assignee becomes the bearer of the credit risk. The assignor is in turn no longer subject to the risk of default. These transactions are made for consideration and may be carried out unrestrictedly between financial institutions. However, if the assignee is not a member of the Brazilian Financial System, compensation for the assignment must be paid immediately upon the assignment, and there can be no recourse against the assignor.

Once the assignment is done, it remains to be known whether the original creditor may disregard the transferred risk in the calculation of its minimal capital requirements. Since the transferred asset shall no longer be recorded in the assignor's books, its risks shall no longer be computed for the purpose of determining minimum capital requirements. However, this is true only if under the assignment the assignor has not retained any risk. Risk retention would exist, for instance, if the assignor guaranteed the payment of the transferred credits.

### Credit Derivatives Transactions

Under credit derivatives, the credit risk of an asset, but not the asset itself, is transferred. Upon a credit event, such as default, insolvency or administrative liquidation of the debtor, the new party who accepted the risk under the derivative is to pay the creditor. In spite of the credit derivative transaction, the risk of the underlying asset cannot be excluded from the calculation of the financial institution's capital requirements due to the absence of express regulatory permission for such.

However, according to the regulation in force, the credit risk may be mitigated if the derivative, either a credit default swap or a total rate of return swap, has as counterparty central banks, financial institutions based in Brazil or in jurisdictions with good investment ratings, Multilateral Development Entities or entities whose transactions registered in the

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Credit Information System of the Central Bank of Brazil (“SCR”) amount to over BRL 100 Million. In addition, the relevant documentation must prohibit unilateral termination of the derivative and the increase of protection costs upon credit deterioration. The termination date of the derivative instrument may not be earlier than maturity and payment of the underlying credit. If these and other requirements are met, the derivative is considered as an instrument of credit risk mitigation, which modifies the calculation of capital requirements, as exposed below.

The minimum required capital is calculated by the application of a percentage (Risk Weighting Factor or FPR) over the value of the asset that creates the credit risk. In the absence of a risk mitigation derivative, the FPR to be applied corresponds to the original debtor’s credit quality. If the risk is reduced by a credit derivative, the applied FPR becomes the one corresponding to the risk transferee. This typically reduces the minimal capital requirement, since the risk transferee in derivatives tends to attract smaller indexes of FPR.

**Participations and the Credit Linked Fundraisings under Resolution No. 2921/2002**

Another form of transfer of credit risk is participations. Other than corporate participations, which entail purchase of shares of a legal entity, credit participations or hidden participations consist of contracts whereupon a lender commits to transfer to a third party (participant) all benefits received from the debtor, for consideration. Such transactions must observe applicable regulation. If such contract is drafted in compliance with Resolution No. 2,921/2002, the risks of the underlying credit transaction are expressly excluded from computation of the minimal capital requirements. Essentially the contract must state that any payments to the participant are conditional upon lender receiving payments from its debtor under the underlying transaction, and payments to the participant must be due not before the maturity dates of the original loan. The participations covered by the referred ruling may be in the form of credit linked notes (CLN) or another instrument.

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