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Fed Issues FAQs Clarifying That Credit-Linked Notes Can Serve as Valid Capital Relief Tools for U.S. Banks

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On September 28, the Federal Reserve Board ("FRB") posted three new FAQs to its website regarding Regulation Q (Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks). The FAQ guidance provides additional clarity on the use of credit-linked notes ("CLNs") to transfer credit risk and offer capital relief to U.S. banks. While in some respects the FAQs merely confirm positions that the FRB has already taken in regard to individual CLN transactions, these FAQs are nevertheless important inasmuch as they publicly memorialize the FRB's view of these products as valid capital management tools.

The FAQs speak to two different formats of CLNs: those issued by special purpose vehicles ("SPV CLNs") and those issued directly by banks ("Bank CLNs"). The FRB's view of SPV CLNs is relatively straightforward: per the FAQs, the FRB recognizes that properly structured SPV CLNs constitute "synthetic securitizations" for purposes of Regulation Q and that the collateral for such SPV CLNs can serve as a credit risk mitigant that banks can use to reduce the risk-weighting of the relevant assets.

The FRB's posture toward Bank CLNs, however, is more nuanced. According to the FRB, unlike SPV CLNs, Bank CLNs do not technically satisfy all of the definitional elements and operational criteria applicable to "synthetic securitizations" under Regulation Q, such that banks that issue Bank CLNs would not be able to *automatically* recognize the capital benefits of such transactions (as would be the case with properly structured SPV CLNs). The reasons for this are twofold: first, Bank CLNs are not executed under standard industry credit derivative documentation; and second, the issuance proceeds from Bank CLNs generally are owned outright by the issuing bank (rather than held as collateral in which the issuing bank has a security interest). Nevertheless, the FRB recognized that Bank CLNs can effectively transfer credit risk; as such, the FRB is willing to exercise its "reservation of authority" to grant capital relief on a case-by-case basis for Bank CLNs where the only two features of the Bank CLNs that depart from the strictures of Regulation Q are those described above. In other words, Bank CLNs can offer capital relief, but only if the issuing bank specifically requests such relief from the FRB and the FRB decides to grant such relief under its reservation of authority powers.

In his statement dissenting on the issuance of the U.S. Basel III endgame proposed rules—our discussion of which is available here—Federal Deposit Insurance Corporation ("FDIC") Director Jonathan McKernan argued for increased clarity on the FRB's position with respect to CLNs in order to provide U.S. banks with better parity in relation to their European counterparts (which routinely issue CLNs in different formats). While these FAQs may not fully address FDIC Director McKernan's concerns, they do begin to provide some clarity concerning the effective use by banks of CLNs as capital management tools.
