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FRB Requests Comments on Proposed Single-Counterparty Credit Limits

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Introduction

The Board of Governors of the Federal Reserve System ("FRB") has requested comments on reissued proposed rules that would establish a single-counterparty credit limits ("SCCL") for domestic and foreign bank holding companies with $50 billion or more in total consolidated assets. The proposed rules are intended to implement Section 165(e) of the Dodd-Frank Act, which requires the FRB to impose limits on the amount of credit exposure that such domestic or foreign bank holding companies can have to unaffiliated companies in order to reduce the number of risks that might arise from the companies' failure.

Comments on the proposed regulations must be submitted by June 3, 2016.

Overview

The FRB reissued proposed regulations to implement the SCCL provisions of Section 165(e) of the Dodd-Frank Act. Section 165(e) applies to all bank holding companies and foreign banking organizations with total consolidated assets of $50 billion or more ("Covered Companies"). Section 165(e) caps the credit exposure of each such Covered Company at 25% of its capital, or at such lower amount as is set by the FRB. The SCCL is a significant regulation and will have a major impact on the approach and documentation of credit transactions.

The SCCL is *similar* conceptually to the "lending limit" that has applied to state and national banks (and the U.S. branches of foreign banks) for a long time, but it differs from that limit in the following important ways:

- The SCCL is calculated on an aggregate basis across an entire organization and not just the bank. For that reason, it casts a much wider net than the older lending limit and will require an enterprise-wide approach to credit exposure management.

- While bank-lending limits have a uniform concept of "counterparty," the concept of counterparty in the SCCL is more fluid, which essentially imposes an expanded definition of counterparty as credit exposures increase.
- Although the bank-lending limit imposes a uniform ceiling for all banks (based on each bank's "capital stock and surplus"), the SCCL essentially adopts three different ceilings depending on the size of the Covered Company and the nature of the counterparty.
- While the bank-lending limit caps the amount of total credit with sublimits for secured and unsecured credit, the SCCL is calculated based on aggregate net credit exposure, which means that collateral, credit enhancements or guarantees will free up capacity for additional credit exposure under the SCCL. However, only very limited types of collateral, credit enhancements, or guarantees qualify under the SCCL. Additionally, the SCCL deems the acceptance of collateral, credit enhancements or guarantees to create a credit exposure to the provider of the credit enhancement or guarantee, or to the issuer of the collateral.

The SCCL also has a "look-through" concept, which requires Covered Companies that have exposures to special purpose vehicles ("SPVs") and funds to "look through" those SPVs or funds (including securitizations) in order to identify any large exposures inside the SPVs or funds and interpret those exposures as creating separate credit exposures.

As proposed, the SCCL is extremely complicated and will create significant recordkeeping burdens for Covered Companies. In addition, Covered Companies will need to expand the credit underwriting procedures to gather even more data regarding their counterparties prior to funding. These provisions are the most relevant to lending and securitization practices:

- **Application**: The SCCL applies to all bank holding companies and foreign banking organizations with total consolidated assets of $50 billion or more.
- **Scope**: The SCCL applies to the Covered Company on an aggregate basis, and so includes all controlled subsidiaries of the Covered Company (using the FRB's existing definition of "control").
- **Credit Exposure**: The SCCL uses the expanded Dodd-Frank concept of "extension of credit" to include all loans, leases, letters of credit, guarantees, derivatives, repurchase agreements ("repos") and reverse repos, SEC lending and SEC borrowing agreements, and investment in the securities of the counterparty as creating a "credit exposure."
- **Credit Limit**: The single counterparty credit limit varies depending on the size of the Covered Company, as follows:
    - For a bank holding company ("BHC") or foreign banking organization ("FBO") that has assets less than $250 billion and foreign trading exposure of less than $10

billion: 25% of the Covered Company's total regulatory capital plus allowance for loan and lease losses.
  - For a BHC or FBO that has assets of more than $250 billion or foreign exposure of more than $10 billion, but is not a U.S. or foreign systemically important bank ("SIB"): 25% of Tier 1 capital.
  - For SIBs: 25% of Tier 1 capital for credit exposures to counterparties who are not SIBs of Financial Stability Oversight Council ("FSOC")-designated non-bank financial company, and 15% of Tier 1 capital for counterparties who are SIBs or FSOC-designated non-bank financial companies.

- **Definition of "Counterparty"**: "Counterparty" is defined as follows:
  - For credit exposures less than 5% (i.e., 5% of regulatory capital or 5% of Tier 1 capital, as appropriate), "counterparty" includes all entities that (i) are controlled based on possession of 25% of a class of voting securities or possession of 25% of total equity, or (ii) consolidate for purposes of financial reporting. **Note that this is a slightly different standard of "control" than is used in the BHC Act generally, given that this "counterparty" definition doesn't include the "controlling influence" test but requires the inclusion of consolidated but non-controlled entities. Note also that this test differs from the standard test used in bank lending limits.**
  - For credit exposures of 5% or more, the Covered Company is required to include within the limit all exposures to other entities that are "economically interdependent," or subject to "control relationships" with the counterparty, as follows:
    - A Covered Company is required to determine whether the entities are "economically interdependent" based on the following factors:
    - whether 50% or more of one counterparty's gross receipts or gross expenditures are derived from transactions with the other counterparty;
    - whether one counterparty (counterparty A) has fully or partly guaranteed the credit exposure of the other counterparty (counterparty B), or is liable by other means, and whether the credit exposure is significant enough for counterparty B to likely default if presented with a claim relating to the guarantee or liability;
    - whether 25% or more of one counterparty's production or output is sold to the other counterparty, which cannot be replaced by other customers easily;
    - whether the expected source of funds to repay any credit exposure between the counterparties is the same and at least one of the

counterparties does not have another source of income from which the extension of credit may be fully repaid;
- whether the financial distress of one counterparty (counterparty A) is likely to impair the ability of the other counterparty (counterparty B) to fully and timely repay counterparty B's liabilities;
- whether one counterparty (counterparty A) has made a loan to the other counterparty (counterparty B) and is relying on the repayment of that loan in order to satisfy its obligations to the covered company, and counterparty A does not have another source of income that it can use to satisfy its obligations to the covered company; and
- any other indicia of interdependence that the Covered Company determines to be relevant to this analysis.

- A Covered Company also is required to assess whether "control relationships" exist based on the following factors:
  - the presence of voting agreements;
  - the ability of one counterparty to significantly influence the appointment or dismissal of another counterparty's administrative, management or governing body, or the fact that a majority of members of such body have been appointed solely as a result of the exercise of the first counterparty's voting rights; and
  - the ability of one counterparty to exercise a controlling influence over the management or policies of another counterparty.

For all practicable purposes, these requirements will significantly discourage any Covered Company from having exposure to any one counterparty in excess of the 5% threshold because of the significant due diligence that would be required for that credit exposure—as well as for any credit exposure to any new third party as long as the 5%+ exposure remains.

- **Calculation of the Credit Exposure**: The SCCL prescribed different methods for valuing the credit exposure based on its type (loans, leases, letters of credit, guarantees, derivatives, repos and reverse repos, SEC lending and SEC borrowing agreements, and investment in the securities of the counterparty). **Note that a debt security is valued differently depending on whether or not it is held in the trading book.** Guarantees are valued based on the maximum potential liability under the guarantee. **This provision will likely effectively prohibit the U.S. operations of foreign banking organizations from issuing unlimited guarantees.**
- **Effect of Collateral, etc.**: The presence of certain collateral or credit enhancement in a transaction will reduce the amount of exposure that counts against the aggregate limit (referred

to as the "net credit exposure"), but only a limited range of collateral suffices—cash, investment grade bank-eligible debt (other than asset-backed securities ("ABS") or mortgage-backed securities ("MBS") unless those securities are issued by a U.S. government-sponsored enterprise), and publicly traded equities or convertible bonds. Thus, collateral that is ABS, MBS or any non-bank-eligible debt security (i.e., not investment grade or readily marketable) will have no reductive value. The fair market value of any collateral also is required to be haircut based on the Basel III haircuts. Guarantees and credit enhancements (including credit derivatives and equity derivatives) are similarly limited to only certain forms and providers. A maturity mismatch between the credit exposure and the collateral (or credit enhancement) also will affect the reductive value of the collateral or credit enhancement adversely. Netting arrangements suffice to reduce credit exposure only to the extent to which they meet the definition of "qualifying master netting agreement" in Basel III.

- **Risk Shifting**: The SCCL introduces a new concept of "risk-shifting." Under the new concept, the posting of eligible collateral or an eligible credit enhancement will reduce the net credit exposure to the counterparty, but it also will be deemed to create a new credit exposure to the issuer of the collateral (if securities) or to the provider of the credit enhancement (i.e., to the guarantor or the protection provider). For guarantees and derivatives, the amount of credit exposure to the protection provider will depend on whether the protection provider is a "financial entity." This provision will discourage Covered Companies from granting unconstrained collateral substitution rights, and Covered Companies will be required to track collateral pools held across the enterprise.
- **Attribution Rule**: The SCCL has an "attribution rule" much like Regulation W, whereby an extension of credit to one party also is deemed an extension of credit to another party if the proceeds of the initial extension of credit are transferred to that other entity. However, the Preamble states that the FRB does not expect Covered Companies to trace the proceeds; rather, the FRB apparently will apply the attribution rule only if the Covered Company knows that the proceeds will be transferred.
- **Unused Credit Lines**: For the unused portion of a committed line, the SCCL requires inclusion of the entire line as a credit exposure, unless the Covered Company can refuse to advance further draws until the existing drawn amount is fully collateralized by cash, U.S. Treasuries, or government-sponsored enterprise ("GSE") guaranteed securities. It should be expected that this language may begin appearing in credit lines going forward.
- **Look Through**: For credit exposures to funds and SPVs (including securitizations), the SCCL requires a Covered Company with assets of at least $250 billion or foreign exposures of at least $10 billion to include credit exposures to the issuers of the underlying assets held by the SPV or fund, if the Covered Company cannot demonstrate that its gross credit exposure to each issuer of assets held by the SPV or fund is less than 0.25% of the Covered Company's Tier 1 capital (disregarding any exposures the Covered Company may have to the issuers outside of the SPV

or fund). (For a $250-billion Covered Company, 0.25% of Tier 1 equates to roughly $50 million). If a Covered Company has gross credit exposure to each issuer of assets held by the SPV or fund of less than 0.25% of its Tier 1 capital, the Covered Company will only have to recognize its credit exposure directly to the particular SPV or fund. If, on the other hand, a Covered Company cannot demonstrate that its gross credit exposure to each issuer of the underlying assets held in the SPV or fund is less than the 0.25%, the Covered Company is required to "look through" and recognize its credit exposure to the issuers of the underlying assets (using a weighted average approach).

While the current SCCL proposal is clear that gross credit exposure for purposes of a "look through" should be calculated using a weighted average approach, the proposal is unclear how a Covered Company is to calculate its gross credit exposure to issuers for purposes of determining whether look through is required, especially with respect to tranched vehicles. However, the accompanying explanation states that look through would never be required when the Covered Company's total investment in the SPV or fund is less 0.25% of Tier 1 capital.

- **Liquidity Providers and Managers**: With respect to funds and SPVs (including securitizations), the SCCL also requires a Covered Company to deem a credit exposure to exist to any third party the failure or financial distress of which would cause a loss in the Covered Company's investment in the SPV or fund—including a liquidity provider or fund manager. The amount of the Covered Company's exposure to this third party is the gross amount of the Covered Company's investment in the fund or SPV. This provision effectively will require Covered Companies to underwrite fund managers, etc.

- **Exemptions**: The SCCL limits do not apply to credit exposures to the U.S. government, any foreign government assigned a 0% risk weighting under Basel III, the GSEs or qualifying central clearing parties, or to intraday credit exposures. For an FBO, exempt entities include the FBO's home country (regardless of risk weighting).

- **Compliance**: All Covered Companies would be expected to adopt systems capable of tracking credit exposures on a daily basis. Covered Companies with assets of <$250 billion and foreign exposures of <$10 billion would be required to be in compliance at the end of each quarter and file a quarterly report to the FRB. Larger Covered Companies must be in compliance on a daily basis, and also must provide a monthly report establishing daily compliance. To the extent that a Covered Company relies on qualifying master netting agreements to reduce credit exposure, the Covered Company also must adopt a procedure to monitor changes in law that would impact whether the qualifying manger netting agreement continued to comply with Basel III.

- **Application to Foreign Banking Organizations**: As mentioned above, the SCCL also applies to FBOs with consolidated global assets of $50 billion or more. However, the credit exposure limits apply only to credit exposures held by the U.S. Intermediate Holding Company ("IHC") and its subsidiaries (or, if the FBO is not required to establish a U.S. IHC, by the combined U.S.

operations of the FBO—i.e., the U.S. branches, U.S. agency offices, and U.S. subsidiaries of the FBO). The SCCL would not apply to credit exposures from the non-U.S. operations of the FBO, even if made to U.S. counterparties.

Effective Date

For smaller Covered Companies (i.e., with assets of <$250 billion and foreign exposures of <$10 billion), the SCCL would become effective two years after final regulations were adopted. For larger Covered Companies, the SCCL would become effective one year after final regulations were adopted.

If you have any questions regarding the foregoing, please contact the authors below.

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