ALERT MEMORANDUM

Single-Counterparty Credit Limits:

Industry Comment and Relief Act Lead to Tailored Final Rule

June 28, 2018

On June 14, 2018, the Federal Reserve issued a Final Rule establishing single-counterparty credit limits for large bank holding companies and foreign banking organizations.

After separate proposals in 2011, 2012 and 2016, the Final Rule implements Section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act and is the first application of Section 165's "enhanced prudential standards" since Congress raised the application threshold for enhanced prudential standards from $50 billion to $250 billion of total consolidated assets in the Economic Growth, Regulatory Relief and Consumer Protection Act. The Final Rule sets the baseline SCCL threshold for BHCs (and FBOs) at $250 billion in global consolidated assets.

In addition to the EPS threshold-related changes, the Federal Reserve also made a number of key modifications to its last proposal in 2016, including changes designed to streamline SCCL compliance and reduce burden in response to industry comments. The Final Rule also reflects changes to address concerns that the regulations, as proposed in 2016, would have subjected FBOs to multiple and possibly conflicting layers of SCCL.

This Alert Memorandum includes two parts:

- A high-level overview of the Final Rule, and
- "Key Takeaways", which identify significant divergences between the Final Rule and the prior proposals, and highlight for consideration a number of interpretive issues remaining in the Final Rule as Covered Firms prepare to comply.

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Overview of Final Rule

I. Background

— ***Final Rule.*** On June 14, 2018, the Board of Governors of the Federal Reserve System (the "Federal Reserve") finalized rules, issued pursuant to Section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), designed to limit the credit exposure of large banking organizations to a single counterparty (the "Final Rule"). The Federal Reserve originally proposed rules to implement Section 165(e) in 2011 for domestic BHCs, and in 2012 for FBOs (together, the "Original Proposals"). After the release of the Original Proposals, in April 2014 the Basel Committee on Banking Supervision ("Basel Committee") adopted international standards for controlling large exposures of internationally active banking organizations (the "Basel large exposures framework"). In 2016 the Federal Reserve issued a re-proposal (the "Re-Proposal") to take into account a number of developments since the Original Proposals, including the adoption of the Basel large exposures framework (as described in our March 2016 Alert Memorandum).

— ***Quantitative and Impact Analyses.*** Federal Reserve staff conducted both a quantitative analysis and an impact analysis following the Original Proposals. As described in the Re-Proposal, the Federal Reserve concluded that its quantitative analysis justified the more restrictive limits applied to larger institutions and particularly those applied to credit exposures between "major" covered firms and "major" counterparties. The impact analysis found that less than $100 billion in current exposures among covered domestic firms would be "excess" credit exposure requiring reduction under the Re-Proposal. Almost all such exposures, according to the Federal Reserve, are exposures between "major" counterparties. In further analysis before the Final Rule was issued, the Federal Reserve found that among companies covered by the Final Rule, there are very few credit exposures in excess of 5% of Tier 1 capital, the materiality threshold incorporated into a number of the Final Rule's requirements (e.g., the requirement to determine economic interdependence and control relationships, as described below). Neither the Re-Proposal nor the Final Rule included information regarding the expected quantitative impact on FBOs.

II. Scope

— ***Increased EPS Applicability Thresholds.*** Consistent with the revised enhanced prudential standards ("EPS") threshold enacted in the Economic Growth, Regulatory Relief and Consumer Protection Act (the "Relief Act"), the Final Rule applies to:

- any bank holding company ("BHC") with $250 billion or more of total consolidated assets or any BHC (regardless of size) that is a global systemically important bank holding company (a "U.S. GSIB"), but not including a BHC that is a U.S. intermediate holding company of an foreign banking organization ("FBO") (each a "Covered BHC");
- any FBO with global consolidated assets of $250 billion or more (a "Covered FBO"); and
- any U.S. intermediate holding company ("IHC"), including an IHC that is a BHC, that has total consolidated assets of $50 billion or more and that is a subsidiary of a Covered FBO (a "Covered IHC"), which includes all current IHCs.

The Re-Proposal would have applied the single-counterparty credit limits (the "SCCL") to any BHC or FBO with $50 billion or more of total consolidated assets and to all IHCs.

— ***Non-Banks Supervised by Federal Reserve.*** The Final Rule does not apply to non-bank financial companies designated as systemically important by the Financial Stability Oversight Council under Section 113 of the Dodd-Frank Act ("Non-Bank SIFIs"), but the Federal Reserve stated that it

intends to consider whether to apply the SCCL to Non-Bank SIFIs in the future.

III. Credit Exposure Limits

Consistent with the increase in the EPS threshold from $50 billion to $250 billion in the Relief Act, the Final Rule includes two credit exposure limits for Covered BHCs and Covered FBOs, but the Final Rule retains the three-limit structure for Covered IHCs (collectively, "Covered Firms"). The Final Rule also eliminates foreign exposure as a metric for the applicability thresholds.

— ***Base Thresholds for Covered Firms***

- A Covered BHC may not have aggregate net credit exposure to any counterparty in excess of **25% of Tier 1 capital**.
- A Covered FBO may not permit its combined U.S. operations to have aggregate net credit exposure to any counterparty in excess of **25% of the FBO parent's Tier 1 capital**; provided, however, that the Covered FBO may comply with the Final Rule by certifying as to compliance with home-country large exposure limits that are consistent with the Basel large exposures framework (as described below).
- A Covered IHC that has total consolidated assets of:
  - less than $250 billion may not have aggregate net credit exposure to any counterparty in excess of **25% of capital stock and surplus** (which includes Tier 1 and Tier 2 capital as well as excess allowances for loan and lease losses not otherwise included in Tier 2 capital); and
  - $250 billion or more (a "Large Covered IHC") may not have aggregate net credit exposure to any counterparty in excess of **25% of Tier 1 capital**.

— ***"Major" Threshold***

- A Covered BHC that is a U.S. GSIB (a "Major BHC") may not have aggregate net credit exposure to a "Major Counterparty" (as defined below) in excess of **15% of the Major BHC's Tier 1 capital**. Aggregate net credit exposure to any other counterparty would be limited to the base threshold of 25% of the Major BHC's Tier 1 capital.
- The combined U.S. operations of a Covered FBO that is unable to certify compliance with a home-country large exposure regime consistent with the Basel large exposures framework and that (i) determines that it would be a GSIB under the Basel Committee's GSIB methodology ("Non-U.S. GSIB") or (ii) the Federal Reserve determines would meet the criteria for a U.S. or Non-U.S. GSIB (a "Major FBO") may not have aggregate net credit exposure to a "Major Counterparty" in excess of **15% of the Major FBO's global Tier 1 capital**. Aggregate net credit exposure of the Major FBO's combined U.S. operations to any other counterparty would be limited to the base threshold of 25% of the FBO parent's Tier 1 capital.
- A Covered IHC with total consolidated assets of $500 billion or more (a "Major IHC") may not have aggregate net credit exposure to a "Major Counterparty" in excess of **15% of the Major IHC's Tier 1 capital**. Aggregate net credit exposure to any other counterparty would be limited to the base threshold of 25% of the Covered IHC's Tier 1 capital. There are currently no Major IHCs.

A "Major Counterparty" is defined in the Final Rule as any counterparty that is or includes (i) any U.S. GSIB, (ii) any FBO that determines that it would be a Non-U.S. GSIB, (iii) an FBO or IHC that the Federal Reserve determines would meet the criteria for a U.S. GSIB or Non-U.S. GSIB and (iv) any Non-Bank SIFI.

— ***Substituted Compliance with Home Country SCCL Rules.*** In a significant shift from the Re-Proposal, the Final Rule permits a Covered FBO to certify that it meets, on a consolidated basis, large exposure standards established by its home-country supervisor that are consistent with the Basel large

exposures framework, in lieu of having its combined U.S. operations comply with the limits set forth in the Final Rule. However, any IHC of a Covered FBO that can so certify would still be covered by the SCCL described above. In addition, the Federal Reserve retains authority, through a written determination following notice to the Covered FBO, to require compliance with the Final Rule by a Covered FBO's combined U.S. operations.

IV. Subsidiaries

The SCCL apply to a Covered Firm on a consolidated basis, including any subsidiaries. Whereas the Re-Proposal defined "subsidiary" of a Covered Firm as a company directly or indirectly controlled pursuant to criteria established under the Bank Holding Company Act of 1956 (the "BHCA"), the Final Rule adopts a financial consolidation approach for identifying "subsidiaries" and "affiliates" that is based on applicable accounting standards.

V. Counterparties

— ***Definition of "Counterparty".*** The definition of "counterparty" under the Final Rule includes:

- a natural person (together with the members of the person's immediate family, collectively, if the Covered Firm has credit exposure to such person exceeding 5% of the Covered Firm's Tier 1 capital (or 5% of capital stock and surplus for Covered IHCs with total assets under $250 billion));
- in the case of a Covered BHC, any company that is not a subsidiary of the Covered BHC (together with that counterparty's affiliates) and in the case of a Covered FBO or Covered IHC, any company that is not an affiliate of the Covered FBO or Covered IHC (together with that counterparty's affiliates);
- a U.S. state and all of its agencies, instrumentalities and political subdivisions; and
- any foreign sovereign that is assigned a risk weight greater than 0% under the Federal Reserve's capital rules (other than the home-country foreign sovereign of a Covered FBO), including all of its agencies and instrumentalities, but not including any of its political subdivisions (which are treated as separate counterparties).

— ***Affiliates.*** Whereas the Re-Proposal would have used percentage ownership tests to aggregate related counterparty exposure, the Final Rule adds the term "affiliate", adopting a consolidation standard, as in the definition of "subsidiary". Although the definition in the rule itself is not as precise, the preamble clarifies that an affiliate of a counterparty includes any parent company of the counterparty and any other company that is consolidated with the counterparty (or together with the counterparty into a parent company) under applicable accounting standards.

— ***Economic Interdependence.*** The Final Rule requires Covered Firms (not including Covered IHCs with less than $250 billion of total consolidated assets) ("Large Covered Firms") to assess "economic interdependence" among counterparties to determine whether exposure to separate counterparties should nevertheless be combined in the calculation of the Covered Firm's aggregate single-counterparty credit exposure. Consistent with the Re-Proposal, a Large Covered Firm is required to assess economic interdependence only if it has aggregate net credit exposure to an unaffiliated counterparty that exceeds 5% of its Tier 1 capital.

"Economic interdependence" is defined broadly to encompass situations where "the failure, default, insolvency, or material financial distress of one counterparty would cause the failure, default, insolvency, or material financial distress of the other counterparty". The Final Rule then lists five factors that should be taken into account in determining whether two counterparties are economically interdependent:

- whether 50% or more of one counterparty's gross revenue is derived from, or gross

expenditures are directed to, transactions with the other counterparty;

- whether Counterparty A has fully or partially guaranteed the credit exposure of Counterparty B or is liable by other means, in an amount that is 50% or more of the Large Covered Firm's net credit exposure to Counterparty A;
- whether 25% or more of a counterparty's production or output is sold to the other counterparty, which cannot easily be replaced by other customers;
- whether the expected source of funds to repay the loans of both counterparties is the same and neither counterparty has an independent source of income from which the loans must be serviced and fully repaid; and
- whether two or more counterparties rely on the same source for the majority of their funding and, if the common funding provider were to default, an alternative funding provider could not be found.

— ***Control Relationships.*** The Final Rule similarly requires Large Covered Firms to assess "control relationships" among counterparties to determine whether exposure to separate counterparties should be combined. As with the economic interdependence analysis, a Large Covered Firm is required to assess control relationships between separate counterparties only if it has aggregate net credit exposure to an unaffiliated counterparty that exceeds 5% of its Tier 1 capital.

These "control relationships" are similar to the two objective prongs of the control test under the BHCA, without the more subjective "controlling influence" test under the BHCA. Specifically, Counterparty A will be deemed to control Counterparty B if:

- Counterparty A owns, controls, or holds with the power to vote 25% or more of any class of voting securities of Counterparty B; or
- Counterparty A controls in any manner the election of a majority of the directors, trustees, general partners (or individuals exercising similar functions) of Counterparty B.

— ***Reservation of Authority on Control Relationships and Economic Interdependence***

- Under the Final Rule, the Federal Reserve retains discretion to determine, after notice and opportunity for hearing, that counterparties are "economically interdependent" or connected by "control relationships" based on a more nuanced analysis than the objective factors that a Large Covered Firm must consider. In addition to the factors Large Covered Firms must consider in determining whether counterparties are "economically interdependent", the Federal Reserve may consider "any other indicia of economic interdependence" it finds relevant. With respect to "control relationships", in addition to the analysis prescribed for Large Covered Firms, the Federal Reserve may also take into account whether (i) Counterparty A has the power to vote 25% or more of any class of voting securities of Counterparty B pursuant to a voting agreement, (ii) Counterparty A has the power to exercise a controlling influence over the management or policies of Counterparty B or (iii) Counterparty A has a significant influence in the appointment or dismissal of Counterparty B's governing body. In addition, the Federal Reserve retains discretion to determine that a Covered Firm must aggregate exposures in order to prevent evasion of the Final Rule.
- The Final Rule also provides that a Large Covered Firm may request in writing a determination that counterparties are not "economically interdependent" or connected by "control relationships" even if one or more of the factors outlined above is met. While considering such a request, the Federal Reserve may in its discretion grant temporary relief to the Large Covered Firm that would permit it not to

aggregate the counterparties for purposes of determining its compliance with the SCCL.

— ***Exposures to Special Purpose Vehicles.*** Consistent with the Basel large exposures framework, the Final Rule includes specific rules for investments in and certain exposures to securitizations, investment funds and special purpose vehicles (collectively, "SPVs") that are not subsidiaries of a Covered BHC or affiliates of a Covered FBO or a Large Covered IHC. This requirement does not apply to Covered IHCs with less than $250 billion of total consolidated assets.

- The Final Rule applies these special rules only to (i) investments in the debt or equity of the SPV, or (ii) credit or equity derivative transactions for which the Large Covered Firm is the protection provider and the reference asset is an obligation or equity of the SPV ("SPV Exposure").
- A Large Covered Firm generally must recognize exposure either to (i) the SPV (rather than the SPV's underlying assets), equal to the value of its investment in the SPV or (ii) one or more issuers of the SPV's underlying assets, provided that the Large Covered Firm identifies the issuer as a counterparty and aggregates its exposure to the issuer through the SPV investment with any other gross credit exposures to that same counterparty.
- A Large Covered Firm is required to aggregate exposure to an issuer of an SPV's underlying assets only if the SPV's holding of assets of the issuer constitute at least 0.25% of the Large Covered Firm's Tier 1 capital. Unlike the Re-Proposal, but consistent with the Basel large exposures framework, the Final Rule incorporates a "partial" look-through approach, which requires Large Covered Firms to look through only to individual underlying assets for which the exposure value is at least 0.25% of Tier 1 capital, rather than to each asset of the SPV. If the Large Covered Firm's exposure, solely through the SPV, to the underlying issuer of assets held by the SPV is less than 0.25% of its Tier 1 capital, then the Large Covered Firm has the option to apply such exposure generally to the SPV as a counterparty or to the issuer of the underlying assets.
- When applying this partial look-through approach, if a Large Covered Firm is unable to identify the issuer of an underlying asset for which the SPV's exposure value is at least 0.25% of the Large Covered Firm's Tier 1 capital, the Large Covered Firm must recognize an exposure to an "unknown" counterparty and then aggregate all exposures to the unknown counterparty as if they related to a single counterparty. The specific calculation of the exposure to underlying assets depends on how the Large Covered Firm has invested in the SPV:
  - For investments in an SPV where all investors rank *pari passu*, gross credit exposure is the Large Covered Firm's *pro rata* share of the SPV multiplied by the value of the particular underlying asset for which exposure is being calculated.
  - For investments in a tranched SPV, gross credit exposure is the *pro rata* share of the Large Covered Firm's investment in the tranche multiplied by the lesser of (i) the market value of the tranche (or the amortized purchase price of the securities if the investment is a debt security held to maturity) and (ii) the value of the particular underlying asset for which exposure is being calculated.
- Additionally, a Large Covered Firm is required to recognize exposures to third parties that have a contractual obligation to provide credit or liquidity support to the SPV whose failure or material financial distress would cause a loss in the value of the Large Covered Firm's SPV Exposure. A Large Covered Firm is required to recognize an exposure to such third parties that is equal to the value of the Large Covered Firm's investment in the SPV, in addition to the

exposure to the SPV itself or to the issuers of underlying assets.

VI. Gross Credit Exposures

— ***Scope.*** The SCCL apply to (i) deposits of the Covered Firm placed at the counterparty; (ii) extensions of credit (excluding uncommitted lines of credit); (iii) repurchase transactions or reverse repurchase transactions; (iv) securities lending or securities borrowing transactions; (v) guarantees, acceptances and letters of credit; (vi) the purchase of securities issued by the counterparty or any other investment in the counterparty; (vii) credit exposures in connection with derivative transactions, including direct credit exposure to a derivative counterparty and indirect exposures to an underlying reference entity arising from a credit or equity derivative for which the Covered Firm is the protection provider; and (viii) any transaction that is the functional equivalent of (ii) – (vii), as well as any transaction that the Federal Reserve determines to be a credit transaction.

— ***Securities Financing Transactions and Derivatives Exposures***

- The Final Rule permits Covered Firms to measure exposure to securities financing transactions (i.e., a repurchase or reverse repurchase agreement or a securities borrowing or lending transaction) ("SFTs") using any methodology authorized under the Federal Reserve's capital rules, including internal models when applicable. The Re-Proposal, in contrast, generally would have used an exposure at default amount, discounted by certain standardized collateral haircuts, to measure exposure arising from an SFT.
- The Final Rule also permits Covered Firms to use any methodology authorized under the capital rules, including internal models when applicable, to value any derivatives transaction. Under the Re-Proposal, Covered Firms would have been permitted to use such methodologies only in connection with derivative transactions subject to a qualifying master netting agreement.

— ***Attribution Rule***

- The Final Rule includes an attribution rule that requires a Covered Firm to treat any transaction with any natural person or entity as a credit transaction with another party to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, the other party.
- Consistent with the discussion of the attribution rule in the Re-Proposal, the preamble to the Final Rule states: "It is the [Federal Reserve]'s intention to avoid interpreting the attribution rule in a manner that would impose undue burden on [Covered Firms] by requiring firms to monitor and trace the proceeds of transactions made in the ordinary course of business. In general, credit exposures resulting from transactions made in the ordinary course of business will not be subject to the attribution rule".

VII. Net Credit Exposures

— The SCCL apply to net credit exposure, reflecting reductions in gross exposure due to mitigants such as eligible guarantees, eligible collateral, eligible credit and equity derivatives or certain short cash position hedges.

— The Final Rule adopts the Re-Proposal's "risk-shifting" approach, under which these mitigants (other than short cash positions) shift the credit exposure to the collateral issuer, guarantor or protection provider.

- The eligible mitigants recognized under the Final Rule are similar to, but narrower than, the range of credit risk mitigants recognized under the Federal Reserve's capital rules. Specifically, the capital rules recognize a wider set of "financial collateral" that includes private label mortgage-backed securities and shares in money market mutual funds, which are not considered "eligible collateral" under the Final Rule.

- The Final Rule also requires that all eligible guarantees and eligible equity and credit derivatives be provided by an eligible guarantor. The definition of eligible guarantor in the Final Rule cross references the capital rules' definition. However, this requirement is stricter than the advanced approaches capital rules, which permits advanced approaches banks (including all Covered BHCs) to recognize credit risk mitigation benefits arising from eligible guarantees that are not provided by an eligible guarantor.

— The Final Rule also retains the requirement to apply this "risk-shifting" approach to credit transactions involving exempt counterparties. In cases where a Covered Firm has a credit transaction with an exempt counterparty and the Covered Firm has obtained eligible collateral from that exempt counterparty or an eligible guarantee or eligible credit derivative from an eligible guarantor, the Covered Firm must shift its exposure from the exempt counterparty to the issuer of such eligible collateral or to the eligible guarantor.

- This requirement to apply "risk-shifting" even to transactions with exempt counterparties has the effect of removing certain transactions from complete counterparty exemptions merely because additional protection in the form of collateral or derivatives is sought. For example, if a Covered Firm were to receive eligible collateral (other than cash, gold or zero-risk-weighted sovereign bonds) from a qualifying central counterparty ("QCCP") in the ordinary course of cleared transactions, this eligible collateral effectively eliminates the QCCP trade exposure exemption that would otherwise apply to the BHC's cleared transaction.

VIII. Exemptions

— As in the Re-Proposal, the Final Rule exempts credit exposures to:

- the U.S. Government (including agencies, Fannie Mae and Freddie Mac while in conservatorship, and other government-sponsored entities as determined by the Federal Reserve);
- foreign sovereign entities that are assigned a 0% risk weight under the Federal Reserve's risk-based capital rules;
- the home-country foreign sovereign entity of a Covered FBO (regardless of the applicable risk-weight); and
- QCCPs, including trade exposure, potential future exposure and pre-funded default fund contributions.

— In addition, the Final Rule adds two new exemptions for credit exposures to:

- the Bank of International Settlements, the International Monetary Fund or institutions that are members of the World Bank Group; and
- the European Commission or European Central Bank.

— Gross credit exposure collateralized by obligations of the exempt government entities, or protected by an eligible credit or equity derivative from one of the exempt entities, is also exempt through the "risk-shifting" requirement.

— Intraday credit exposure to any counterparty is exempt from the SCCL.

— The Federal Reserve may also exempt any transaction from the SCCL requirements pursuant to a finding that such exemption is in the public interest and is consistent with the purposes of the Final Rule.

IX. Compliance

— Major FBOs, Major BHCs and Major IHCs have **18 months** (until January 1, 2020) to complete compliance preparations. All other Covered Firms have a **2-year period** (until July 1, 2020).

— Covered IHCs with total consolidated assets of less than $250 billion are required to comply with the Final Rule on a **quarterly basis**. All other Covered Firms are required to comply with the Final Rule on a **daily basis**.

— BHCs, FBOs or IHCs that become Covered Firms after the Final Rule's effective date will have a **2-year period** from the date they become subject to the Final Rule to complete compliance preparations.

X. Cure Period

— The Final Rule provides a cure period of 90 days (or, with prior notice from the Federal Reserve, a longer or shorter period) for Covered Firms that fall out of compliance with the SCCL as a result of certain enumerated circumstances:

- a decrease in the Covered Firm's capital stock and surplus;
- the merger of a Covered BHC with another Covered BHC, or the merger of a Covered FBO or Covered IHC with another Covered FBO or Covered IHC;
- the merger of two counterparties;
- an "unforeseen and abrupt change in the status of a counterparty" that causes the Covered Firm's credit exposure to that counterparty to become limited by the SCCL; or
- any other factors the Federal Reserve determines are appropriate.

— Covered Firms must make "reasonable efforts" to restore compliance during any period of non-compliance. While out of compliance with the SCCL with respect to a particular counterparty, a Covered Firm may not engage in additional credit transactions with that counterparty unless the Covered Firm has obtained a temporary credit exposure limit increase from the Federal Reserve.

XI. Reporting Requirements

— Under the Final Rule, all Covered Firms are required to submit a report on a **quarterly basis** demonstrating compliance and providing data for their top 50 counterparties.

- In conjunction with the release of the Final Rule, the Federal Reserve proposed a new reporting form (FR 2590) for Covered Firms to evidence compliance with the SCCL. The proposed FR 2590 includes nine schedules that collect information related to gross and net credit exposure. The schedules require specific information relating to general exposures, SFTs and derivative exposures, risk-shifting exposures, eligible collateral and other mitigants, as well as the presence of economic interdependence and control relationships between counterparties.

— The Final Rule also requires any Covered FBO that controls an IHC to report by January 1 of each calendar year whether (i) its home-country supervisor has adopted standards consistent with the Basel Committee's methodology for identifying GSIBs; (ii) the Covered FBO prepares or reports the indicators used to identify Non-U.S. GSIBs; and (iii) whether the Covered FBO has determined that it has the characteristics of a Non-U.S. GSIB. Any Covered FBO that prepares or reports such indicators is required to make a determination about whether it meets the criteria for a Non-U.S. GSIB. The preamble to the Final Rule notes that these reporting requirements "mirror requirements in other [Federal Reserve] regulations to identify foreign GSIBs", and a Covered FBO that already provides such reports in connection with other regulatory requirements is not required to provide separate reports for purposes of complying with the Final Rule.

Key Takeaways

Below we highlight key takeaways from the Final Rule, identify significant changes in the Final Rule from the prior proposals and highlight for consideration interpretive issues remaining in the Final Rule as Covered Firms prepare to comply.

I. Scope of Application

— ***Tailoring for Systemic Risk Consistent with the Relief Act***

- *U.S. BHCs.* The Final Rule reflects the elevated applicability thresholds for EPS in the Relief Act. In contrast to prior proposals, BHCs (that are not IHCs) with total consolidated assets of less than $250 billion (that are not otherwise GSIBs) are not subject to the SCCL.
- *FBOs.* The Final Rule also shifted the SCCL applicability threshold upward for FBOs to $250 billion in global consolidated assets (from $50 billion), and the Final Rule's restrictions will continue to apply only with respect to an FBO's combined U.S. operations.
  - In response to industry comments on prior proposals, the Final Rule permits substituted compliance for the combined U.S. operations of Covered FBOs. Accordingly, a Covered FBO would only become subject to the SCCL with respect to its combined U.S. operations if either (i) the Covered FBO cannot certify to the Federal Reserve that it meets large exposure standards on a consolidated basis established by its home-country supervisor that are consistent with the Basel large exposures framework; or (ii) the Federal Reserve determines in writing after notice to the Covered FBO that compliance with the Final Rule is required.
- *IHCs.* The applicability threshold for IHCs (including IHCs that are also BHCs) remains $50 billion, but it is tailored to apply only to an IHC whose parent FBO's total global consolidated assets meet or exceed $250 billion. The Federal Reserve staff memo acknowledges, however, that such tailoring does not in fact currently exempt any IHC from application of the SCCL.
  - The Final Rule provides some more meaningful tailoring for IHCs with under $250 billion in total assets by exempting such IHCs from the requirements to apply (i) a "look-through" approach to exposures to SPVs and (ii) the economic interdependence test and control relationship test to aggregate exposures to related counterparties.
- *All Institutions.* The preamble indicates that the Federal Reserve "is developing a comprehensive proposal on the extent to which it should apply the SCCL and other enhanced prudential standards to banking organizations with total consolidated assets of $100 billion but less than $250 billion". The Federal Reserve retains discretion under the Relief Act to apply EPS, including the SCCL, to BHCs in this asset range, subject to a determination that it would be appropriate to mitigate risks to U.S. financial stability or to promote safety and soundness. In addition, the Federal Reserve retains discretion to tailor the application of EPS to FBOs in this asset range. The preamble's discussion of a future proposal raises questions as to whether (i) the Federal Reserve will allow any exemptions for institutions in this range or will simply tailor the EPS to reduce burden, and (ii) the Federal Reserve will use its discretion under the Relief Act to accelerate the off-ramp from EPS for any BHCs in this range.

— ***Certification Procedure for Substituted Compliance Unclear***

- The Final Rule does not specify the frequency or form of the certification, in contrast to other Federal Reserve EPS regulations that require similar certifications (e.g., Regulation YY requirements for FBOs to certify to compliance with home country capital adequacy standards). However, the instructions to the draft quarterly

report (Form 2590) released in connection with the Final Rule ask a Covered FBO respondent to indicate (with a yes or no) if it has certified to the Federal Reserve that it meets large exposure standards on a consolidated basis established by a home-country supervisor that are consistent with the Basel large exposures framework, which suggests that certification of compliance may be required on the FR Y-7 (as required for other EPS certifications). There is also no indication whether a Covered FBO that has previously certified compliance would have an affirmative duty to report to the Federal Reserve if it falls out of compliance with its home-country SCCL framework.

- It is unclear whether the Basel large exposures framework will be fully implemented by Covered FBOs' home-country supervisors in time for these firms to certify compliance by the Final Rule's effective date (January 1, 2020 for Non-US GSIBs and July 1, 2020 for all other Covered FBOs). In particular, the EU Capital Requirements Regulation (the "CRR"), which is being revised to implement the Basel large exposures framework, has an anticipated effective date in 2021.
- The standard for certification of substituted compliance in the SCCL rule is also vague. It is unclear how consistency of a home country's regime with the Basel large exposures framework will be assessed. The Basel Committee has indicated it will undertake an evaluation of various jurisdictions' implementation of the large exposures framework and will publish the results as part of its Regulatory Consistency Assessment Program ("RCAP"). The RCAP large exposures evaluation questionnaire was published in March 2018. However, it is unclear how long it will take to complete these evaluations for the 28 jurisdictions covered by the RCAP and whether evaluations for the relevant Covered FBO jurisdictions will be completed before certifications are required. The RCAP process results in a grade of "compliant", "largely compliant", "materially noncompliant" or "noncompliant". Presumably, a jurisdiction deemed "largely compliant" (as is the case with the CRR's implementation of the Basel liquidity framework) will be considered to have implemented counterparty credit limits "consistent with" the Basel large exposures framework for purposes of the Final Rule, although this is not addressed in the preamble.

— ***Cross Trigger.*** The Re-Proposal included a "cross trigger" provision that would prevent additional credit transactions by any of a Covered FBO's combined U.S. operations if its IHC's SCCL to a particular counterparty were breached. The Final Rule provides no cross trigger for Covered FBOs that certify compliance with a home-country large exposure regime consistent with the Basel large exposures framework. For Covered FBOs that cannot certify and will therefore be subject to the SCCL with respect to their combined U.S. operations, the Final Rule provides that "the covered foreign entity" may not engage in any additional credit transactions with any counterparty with respect to which the covered foreign entity has breached its SCCL. A "covered foreign entity" appears, in the context of this statement, to be "the" covered foreign entity (either the IHC or combined U.S. operations) which has had the breach in its SCCL. This language was revised from the Re-Proposal's restriction that "neither the U.S. [IHC] nor the [combined U.S. operations] may engage in any additional credit transactions".

— ***Foreign Exposures Threshold Eliminated.*** The prior proposals would have incorporated the current two-prong threshold test for application of the "advanced approaches" in the agencies' capital rules ($250 billion in total assets or $10 billion in on-balance-sheet foreign exposure) to designate larger firms for stricter application of the SCCL.

By contrast, the Final Rule's applicability thresholds are based solely on asset size and GSIB status, consistent with the Relief Act and with other enhanced prudential standards (e.g., total loss-absorbing capacity and long-term debt requirements, the GSIB surcharge, etc.). The preamble does not discuss the decision to drop the "foreign exposure" prong. Since the proposals, the "foreign exposure" prong has also been eliminated by the Federal Reserve as a potential threshold for application of the public qualitative assessment under the annual Comprehensive Capital Analysis and Review ("CCAR"), which currently only applies to BHCs and IHCs with total assets of $250 billion or more or total nonbank assets of $75 billion or more.

II. Changes to the "Major" Threshold

— ***Increasing Reliance on GSIB Designation***

- The Final Rule made some changes to the "major" designation standard that may be beneficial for Covered FBOs. "Major" designation for Covered FBOs under the Final Rule is now based on the FBO's status as a Non-U.S. GSIB, rather than simply having total global consolidated assets in excess of $500 billion. The $500 billion total asset threshold is maintained in the Final Rule to designate Major IHCs, although currently no IHC meets the threshold for designation as "major".

  The Final Rule generally maintains the Re-Proposal's complex test for determining whether a Covered FBO is a GSIB (rather than including a cross reference to the list of GSIBs updated annually by the Basel Committee and the Financial Stability Board ("FSB")). The preamble notes, however, that the Basel Committee's global methodology for identifying GSIBs is "virtually identical" to Method 1 in the Federal Reserve's GSIB surcharge implementing rules, which strongly indicates that banking organizations listed on the FSB's annually updated GSIB list will be considered GSIBs for purposes of the SCCL.

III. Definition of Covered Firm and Counterparty

— ***Aggregation Standard Revised to Reduce Burden.*** Responding to industry comments, aggregation by a Covered Firm of its total exposures is no longer based on the overinclusive BHCA control standard, as in the prior proposals. The Final Rule revises the definition of "subsidiary" and includes a new definition of "affiliate", each based on financial consolidation under applicable accounting standards.

- *Scope of Affiliates.* The new definition of "affiliate" includes subsidiaries and "any other company that would be consolidated with the company under applicable accounting standards". The preamble clarifies that the affiliate definition captures both sister companies that are consolidated into the same parent company with the Covered Firm as well as holding companies. Because "affiliate" exposures are not included in the SCCL, a Covered IHC's credit exposure to a parent FBO (including its branches) or its affiliated non-U.S. sister companies would not be subject to the SCCL.

- *Joint Ventures Clarified.* The preamble also clarifies that joint ventures that are consolidated are treated as part of the Covered Firm, even if a counterparty also has an investment in the joint venture. If a Covered Firm invests in a minority-owned joint venture that is not consolidated, the Final Rule requires the Covered Firm to treat that joint venture as a counterparty and apply the SCCL to exposures to (including its equity investment in) the joint venture.

- *Merchant Banking, DPC and Fund Investments Clarified.* The preamble to the Final Rule indicates that merchant banking portfolio companies and companies held pursuant to debt previously contracted ("DPC") authority will be treated as part of the Covered Firm if they are

consolidated with the Covered Firm. Similarly, the preamble notes that the Federal Reserve would generally expect seeded funds to be treated as part of a Covered Firm, to the extent they are consolidated with the Covered Firm for accounting purposes during the seeding period. However, funds that are sponsored, advised or managed (even if "controlled" for BHCA purposes) by a Covered Firm would not generally be expected to be part of the Covered Firm, provided they are not consolidated with the Covered Firm from an accounting perspective.

— ***Economic Interdependence and Control Relationships Assessments Simplified.*** The Final Rule now requires that exposures to a counterparty include exposures to any entity consolidated with that counterparty. In addition, the Final Rule requires aggregation of exposures to certain related counterparties, but now limits this aggregation requirement to the most significant counterparties.

A materiality threshold of 5% of a Large Covered Firm's Tier 1 capital now applies when assessing both economic interdependence and control relationships of its counterparties. The Final Rule also modifies both the control test and economic interdependence test to make them less subjective and easier to administer.

- The Final Rule reduces the criteria for assessing economic interdependence to five objective factors and eliminates the requirement to assess "any other indicia of interdependence that the [Covered Firm] determines to be relevant". The remaining five factors have also been revised to make the assessment of economic interdependence more objective. For example, the Final Rule now provides that a guarantee by Counterparty A for the benefit of Counterparty B is demonstrative of economic interdependence only if the amount of the guarantee exceeds 50% of the Large Covered Firm's net credit exposure to Counterparty A. However, the five criteria will in many cases require significant investigation and evaluation by the Covered Firm.
- The Final Rule also streamlines the test Large Covered Firms must apply to identify control relationships to two factors, and no longer requires Large Covered Firms to affirmatively assess whether voting agreements exist between counterparties or to conduct a facts-and-circumstances analysis to determine whether one counterparty has the ability to exercise a controlling influence over the management or policies of another counterparty. However, the Federal Reserve retains authority to determine, after notice and opportunity for a hearing, that economic interdependence or control relationships exist, and the stated factors the Federal Reserve may consider in conducting this assessment include the presence of voting agreements and the ability to exercise a controlling influence. A Large Covered Firm may also request in writing a determination that counterparties are not "economically interdependent" or connected by "control relationships" even if one or more of the factors outlined above is met, and the Federal Reserve retains discretion to provide temporary relief from the SCCL for related exposures while considering the request.
- The Final Rule eliminates any reference to 25% of total equity as a standard for determining control, which was one of the aggregation criteria for identifying counterparties in the prior proposals. The Federal Reserve's 2008 policy statement on equity investments in banks and bank holding companies indicates that the Federal Reserve does not expect investments below one-third of total equity (of which less than 15% is voting) to result in a controlling influence absent other factors.
- The control attributes and the five criteria for determining economic interdependence are similar to, but not the same as, the "combination rules" set forth in the national bank lending limits of the Office of the Comptroller of the

Currency (the "OCC").[1] The OCC combination rules include a control/common control test using BHCA criteria, an expected source of income/no replacement source test, and a test finding combination warranted if 50% of one party's gross receipts or expenditures is derived from transactions with the other party, each of which is similar to an economic interdependence or control test in the Final Rule. The Final Rule also includes a test regarding whether exposure to a counterparty is guaranteed more than 50% by a second party and a 25% of production/output test, neither of which has a direct analog in the OCC rules. More broadly, there are other differences between the Final Rule and the OCC's lending limit rules that will make it challenging to use similar calculations and similar exposure capture systems between a Covered Firm subject to the Final Rule and a national bank or federal savings association subsidiary or a U.S. branch of a Covered FBO, each of which is subject to the OCC's rules.

— ***Other Changes to and Clarifications of the Counterparty Definition***

- *Limited Aggregation for Natural Persons.* In another concession to commenters, the Final Rule adopts a 5% materiality threshold with respect to the aggregation of exposures to natural persons. Aggregation of exposures to members of an immediate family is now required only if credit exposure to any individual exceeds 5% of a Large Covered Firm's Tier 1 capital (or 5% of the capital stock and surplus of a Covered IHC with total assets under $250 billion).
- *Aggregation of States with Political Subdivisions.* Under the Final Rule, government entities, including a State and all of its agencies, instrumentalities and political subdivisions (including municipalities), are aggregated collectively as a single counterparty. The Federal Reserve rejected commenters' requests to provide an exemption from aggregation for municipal revenue bonds, used to finance specific public works projects (such as toll roads and bridges, etc., that have an independent source of repayment).

  The Federal Reserve also rejected commenter requests to apply a materiality threshold to the aggregation of States with their agencies, instrumentalities and subdivisions.
- *Foreign Sovereigns.* The Federal Reserve rejected commenters' requests to include political subdivisions of foreign sovereigns together with the foreign sovereign itself. Instead, political subdivisions of a foreign sovereign, such as states, prefectures, municipalities, etc., are treated as separate counterparties.

IV. Gross Exposure Calculation

— ***SFTs and the Use of Internal Models.*** The Final Rule permits a more risk-sensitive exposure measurement methodology for SFTs that includes the use of any method authorized under the agencies' capital rules, including internal models if the Covered Firm has received supervisory approval in the regulatory capital context.

- The Federal Reserve indicated that the total amount of Covered Firms' credit exposure in excess of the limits described in the Re-Proposal would be materially reduced in large part because the Final Rule permits the use of internal models to measure SFT exposure, which the preamble indicates "was one of the major sources of excess exposure" in the 2016 quantitative analysis of the SCCL.
- However, this permission to use internal models may be of limited benefit for Covered IHCs, since internal models are available only under the advanced approaches in the Federal Reserve's capital rules, and most Covered IHCs are not subject to, or have opted out of, the

[1] 12 C.F.R. Part 32 and § 32.5.

advanced approaches. Those that have opted out have primarily done so because of the additional burden required to administer the advanced approaches capital calculations, given the significant divergences between the U.S. advanced approaches and the advanced approaches in the Basel capital framework (e.g., the Collins floor, etc.). There is no provision in the Final Rule to permit Covered IHCs to calculate SFT exposure using internal models approved by their FBO parent's home-country supervisor.

— ***Derivatives and SA-CCR.*** In response to requests from commenters, the Final Rule eliminates the distinction between derivative transactions that are subject to a QMNA and those that are not, and permits the use of internal models to measure both.

- The Final Rule is silent on whether the Basel Committee's Standardized Approach to Counterparty Credit Risk ("SA-CCR"),[2] which provides a more risk-sensitive alternative to the "current exposure methodology" ("CEM") for measuring derivative exposure, will be implemented and made available in the context of the SCCL. However, Vice Chair Quarles' opening remarks suggest that the SA-CCR may be implemented in connection with changes to the capital rules arising from the so-called "Basel IV" reform package.[3] Once implemented as part of revisions to the agencies' capital rules, the SA-CCR could become a valuation option for derivatives under the SCCL.
- However, this delay in implementing SA-CCR could disadvantage Covered IHCs vis-à-vis Covered BHCs. All Covered BHCs are currently required to use the advanced approaches (and therefore more likely to use the internal models method to measure derivative exposure). Covered IHCs, by contrast, either are not subject to the advanced approaches or are strongly incentivized to opt out of the advanced approaches, and thus are more likely to be required to use the outdated CEM to measure derivative exposure under the SCCL. Adoption of the more risk-sensitive SA-CCR may help soften this disparate treatment of Covered BHCs and Covered IHCs, but it is unclear if the SA-CCR will be implemented before the July 2020 compliance deadline for Covered IHCs.

— ***Exposures to SPVs***

- The Final Rule scales back the "look-through" requirements with respect to exposures to SPVs. First, Covered IHCs with total assets of less than $250 billion will not be subject to the look-though requirement. Second, a "partial look-through" approach has been adopted that permits a Large Covered Firm to assign its gross credit exposure to an issuer of underlying assets of an SPV to the SPV itself, if the underlying issuer's exposure is less than 0.25% of the Large Covered Firm's tier 1 capital. The Re-Proposal, by contrast, would have required a "full look-though" generally, unless the Large Covered Firm could demonstrate that its gross credit exposure to each underlying asset in the SPV was less than 0.25% of the Large Covered Firm's tier 1 capital. Under the Re-Proposal's "full look-through", a Large Covered Firm's gross credit exposure to all issuers of an SPV's underlying assets would have had to be either aggregated with any other credit exposure of the Covered Firm's to such issuer, or, if the issuer was unknown, aggregated with exposures to unknown issuers as exposure to a single "unknown counterparty".
- The Final Rule also clarifies that the "partial look-through" approach applies only to "SPV exposure" arising from (i) an investment in the debt or equity of the SPV or (ii) a credit or equity derivative between the Large Covered Firm and a third party referencing an

[2] Basel Committee, *The Standardized Approach for Measuring Counterparty Credit Risk Exposures* (Mar. 2014).

[3] Basel Committee, *Basel III: Finalizing Post-Crisis Reforms* (Dec. 2017).

obligation of or equity security of an SPV where the Large Covered Firm is the protection provider. Neither the preamble nor the Final Rule expressly clarifies how Large Covered Firms should treat other credit exposures to SPVs (e.g., loans to an SPV secured by particular assets (in contrast to debt securities), lines of credit, liquidity facilities, SFTs or other types of derivative transactions with an SPV (e.g., interest rate derivatives or a repo on certain assets)). Presumably, such exposures would be treated as exposures to the SPV, calculated under the provisions relating to the determination of gross credit exposure and net credit exposure for similar exposures to non-SPVs.

  - Commenter requests to modify the look-through approach to exclude certain types of securitizations (e.g., retail, CMBS, small business receivables) were rejected.

- The Final Rule eliminates the Re-Proposal's requirement to apply the SCCL to exposures to third parties that have a non-contractual business relationship with an SPV. In response to comments, the Final Rule also explicitly limits the exposure that a Large Covered Firm is required to attribute to third parties to the maximum of its contractual obligation to the SPV, but it retains a requirement that this attributed exposure is in addition to the exposure to the SPV and/or its underlying assets (i.e., remains double-counted).

- The preamble clarifies that Large Covered Firms may "rely on a reasonable best effort in the event they lack access to information to comply with" the requirement to recognize gross credit exposure to each third party with a contractual or other business relationship to an SPV. While this "best efforts" standard is not explicitly included in the Final Rule, the Final Rule's provisions governing the scope of compliance have been revised to state that Covered Firms must comply with the SCCL "using all available data, including any data required to be maintained or reported to the Federal Reserve" in connection with the SCCL.

V. Net Exposure Calculation and Exposure Mitigants

The Final Rule maintains the "risk-shifting" approach in the prior proposals, and the Federal Reserve rejected commenters' requests for a *de minimis* exception or an exclusion for margin loans.

— ***Eligible Collateral Broadened and Clarified.*** The Final Rule does not align the definition of "eligible collateral" with the definition of "financial collateral" in the capital rules, as requested by commenters. However, the Final Rule does broaden the definition of eligible collateral to include gold bullion.

  - The Final Rule also clarifies that eligible cash collateral may be held on deposit with a third-party custodian for the benefit of the Covered Firm or on deposit with the Covered Firm itself or its subsidiaries (in the case of a Covered BHC) or its affiliates (in the case of a Covered FBO or Covered IHC). Such cash may be held inside or outside the United States, in U.S. dollars or a foreign currency.

  - To the extent that credit exposure to a counterparty is collateralized by cash on deposit or gold bullion, the risk associated with the collateralized portion of the exposure is eliminated, rather than shifted to another counterparty for purposes of the SCCL.

  - The Final Rule also clarifies that debt and equity securities and convertible bonds that are issued by the Covered Firm or its subsidiaries (in the case of a Covered BHC) or its affiliates (in the case of a Covered FBO or Covered IHC) are not eligible collateral for purposes of the SCCL.

— ***No Expansion of Eligible Guarantors.*** Consistent with the Re-Proposal, a Covered Firm is required to reduce credit exposure to a counterparty by the amount of any eligible guarantee, eligible credit derivative or eligible equity derivative from an eligible guarantor that covers the transaction.

> Commenters requested that the Federal Reserve remove the requirement for eligible guarantees to be provided by an eligible guarantor for eligible equity and credit derivatives that are "covered positions" under the Federal Reserve's market risk capital rule. The Federal Reserve declined to provide any different treatment for derivatives that are "covered positions" for purposes of the market risk rule, and similarly declined to permit risk-shifting to protection providers that are not "eligible guarantors" for purposes of the Federal Reserve's capital rules, which the Final Rule cross references.
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