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ALERT MEMORANDUM

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The Federal Reserve's Single-Counterparty Credit Limit Re-Proposal: Modest Revisions Leave Plenty of Room for Industry Comment

In arguably its most focused attempt at tailoring a post-crisis rule yet, the Federal Reserve has re-proposed rules establishing single-counterparty credit limits for large bank holding companies and foreign banking organizations. The re-proposal draws from industry comments on the original 2011 and 2012 proposals, various quantitative analyses and impact studies, and further developments among international financial services regulators. Industry comments and quantitative analyses have led to some significant improvements from the banking industry's perspective. At the same time, international agreement on large exposure limits reached through the Basel Committee on Banking Supervision prompted the Federal Reserve to introduce several new and more restrictive elements to the limit structure, including a focus on Tier 1 capital as the limit's base and new exposure methodologies directed at funds and special purpose vehicles.

These new elements, as well as the Federal Reserve's dismissal of certain industry concerns, will undoubtedly provide sufficient bases for comment by the financial services industry. The Federal Reserve has attempted to alleviate potential concerns by applying the most granular and burdensome provisions to those institutions with $250 billion or more of consolidated total assets or $10 billion or more of foreign exposures (the cutoff for "advanced approaches" qualification under the U.S. Basel III capital rules). Even more constraining provisions focus on the largest U.S. and foreign banking organizations (a subset of the "advanced approaches"-qualifying institutions), including a much more restrictive limit (15% of Tier 1 capital) for exposures between "major" covered companies and similarly "major" counterparties.

Comments on the re-proposal are due June 3, 2016. The attached outline includes two parts: a high-level overview of the re-proposal, and "Key Takeaways," which highlight important issues for banking organizations and identify areas that are likely deserving of comment to the Federal Reserve.

Overview of Re-Proposal

- ***Background***

    - *Re-Proposal.* On Friday, March 4, 2016, the Board of Governors of the Federal Reserve System (the "Federal Reserve") re-proposed rules, pursuant to Section 165(e) of the Dodd-Frank Act, designed to limit the credit exposure of large banking organizations to a single counterparty (the "Re-Proposal"). The Federal Reserve originally proposed rules to implement Section 165(e) in 2011 for domestic bank holding companies ("BHCs"), and in 2012 for foreign banking organizations ("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 Standards").[1]

    - *Federal Reserve staff 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 their quantitative analysis justifies the more restrictive limits applied to larger institutions and particularly those applied to credit exposures between "major" covered companies and "major" counterparties (as described more fully below). 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 of such exposures, according to the Federal Reserve, are exposures between "major" counterparties. The Re-Proposal, however, does not include information regarding the expected quantitative impact on FBOs. The Federal Reserve specifically requested comments on these analyses (and requested submission of any specific analyses that would support an alternative view).

[1] Basel Committee, Supervisory Framework for Measuring and Controlling Large Exposures (Apr. 2014), *available at* http://www.bis.org/publ/bcbs246.pdf.

- ***Scope.*** The Re-Proposal would require that any BHC or FBO with $50 billion or more of total consolidated assets or any U.S. intermediate holding company ("IHC") required to be established by an FBO (each, a "Covered Company") adhere to certain aggregate net credit exposure limits with respect to any single counterparty. 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") are not covered by the Re-Proposal.

- ***Credit Exposure Limits.*** The Re-Proposal's approach to single-counterparty credit limits ("SCCL") would involve three increasingly stringent limits based primarily on size thresholds.

  - *Base $50 Billion Size Threshold*

    - A U.S. BHC or U.S. IHC with total consolidated assets of $50 billion or more would be prohibited from having aggregate net credit exposure to a single counterparty in excess of **25% of the Covered Company's consolidated capital stock and surplus** (which includes Tier 1 and Tier 2 capital as well as excess allowances for loan and lease losses ("ALLL") not otherwise included in Tier 2 capital).

    - An FBO with total consolidated global assets of $50 billion or more would be prohibited from having aggregate net credit exposure to a single counterparty in its combined U.S. operations (including its IHC, if any) in excess of **25% of the FBO parent's total consolidated regulatory capital**, as reported to the Federal Reserve.

  - *Advanced-Approaches-Qualifying Institutions Threshold*

    - A U.S. BHC or U.S. IHC with total consolidated assets of $250 billion or more, or $10 billion or more of on-balance-sheet foreign exposures,[2] would be prohibited from having aggregate net credit exposure to a single counterparty in excess of **25% of the Covered Company's Tier 1 capital**.

[2] Footnote 10 to the Federal Reserve Staff Memo accompanying the Re-Proposal states that the calculation of "foreign exposure" for purposes of the Re-Proposal would exclude exposures of the U.S. IHC or U.S. operations of an FBO to "both the foreign bank parent and the foreign bank parent's home country sovereign." However, this clarification does not appear in either the rule text or the preamble of the Re-Proposal. Further, it is unclear whether the term "foreign bank parent" is intended to also capture foreign affiliates of an FBO. Therefore, further clarification regarding the calculation of "foreign exposure" under the Re-Proposal may be necessary.

- An FBO with total consolidated global assets of $250 billion or more, or $10 billion or more of on-balance-sheet foreign exposures,[2] would be prohibited from having aggregate net credit exposure to a single counterparty in its combined U.S. operations (including its IHC, if any) in excess of **<u>25% of the FBO parent's Tier 1 capital</u>**.

o *"Major" Threshold*

- A U.S. BHC that is a global systemically important bank pursuant to the U.S. capital surcharge rules ("<u>U.S. G-SIB</u>") or any U.S. IHC with total consolidated assets of $500 billion or more (each, a "<u>Major Covered Company</u>") would be prohibited from having aggregate net credit exposure to a "<u>Major Counterparty</u>" (as defined below) in excess of **15% of the Covered Company's Tier 1 capital**. Aggregate net credit exposure to any other counterparty would be limited to 25% of the Covered Company's Tier 1 capital.

- An FBO with total consolidated assets of $500 billion or more (also a "<u>Major Covered Company</u>") would be prohibited from having aggregate net credit exposure to a "<u>Major Counterparty</u>" in its combined U.S. operations (including its IHC, if any) in excess of **15% of the FBO parent's Tier 1 capital**. Aggregate net credit exposure of the FBO's combined U.S. operations to any other counterparty would be limited to 25% of the FBO parent's Tier 1 capital.

- A "<u>Major Counterparty</u>" is defined in the Re-Proposal as (i) any U.S. BHC that is a U.S. G-SIB, (ii) any FBO that the Covered Company determines would be a G-SIB under the Basel Committee's G-SIB methodology ("<u>Non-U.S. G-SIB</u>"), or an FBO or IHC that the Federal Reserve determines would meet the criteria for a U.S. G-SIB or Non-U.S. G-SIB and (iii) any Non-Bank SIFI. Like the Federal Reserve's recent proposal on total loss absorbing capacity,[3] the Re-Proposal would not specifically look to the Financial Stability Board's designation of G-SIBs to define the scope of FBOs that will be considered a "Major Counterparty" and thus effectively requires the Covered Company to assess whether its counterparty would be a Non-U.S. G-SIB.

[3] 80 Fed. Reg. 74,926 (Nov. 30, 2015).

- ***Subsidiaries.*** The SCCL would apply to a Covered Company on a consolidated basis, including any subsidiaries. "Subsidiary" is defined in the Re-Proposal as a company that is directly or indirectly controlled by the Covered Company pursuant to criteria established under the Bank Holding Company Act of 1956 (the "BHCA"). A Covered Company would not be required to include exposures retained by funds or other vehicles that are sponsored and advised by the Covered Company, provided that such vehicles are not otherwise controlled for purposes of the BHCA.

- ***Counterparties***

    - The definition of "counterparty" under the Re-Proposal includes:

        - An unaffiliated company, and any other person (i) over which the company can exercise the power to vote 25% or more of any class of voting securities, (ii) in which the company owns or controls 25% or more of the total equity or (iii) which is consolidated with the company;

        - A natural person and members of the person's immediate family;

        - A U.S. state and all of its agencies, instrumentalities and political subdivisions; and

        - Any foreign sovereign entity that is assigned a risk weight greater than 0% under the Federal Reserve's risk-based capital rules, including all of its agencies and instrumentalities, but not including any of its political subdivisions (which are treated as separate counterparties).

    - In addition, the Re-Proposal includes a new requirement to assess "economic interdependence" among counterparties to determine whether exposure to separate counterparties should nevertheless be combined in the calculation of the Covered Company's aggregate single-counterparty credit exposure. "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 Re-Proposal then lists several factors that should be taken into account. The requirement to assess economic interdependence would be applicable only if a Covered Company has an aggregate net credit exposure to an unaffiliated counterparty that exceeds 5% of its SCCL base (capital stock and surplus for companies not meeting the advanced approaches thresholds, or Tier 1 capital for companies exceeding those thresholds).

- The Re-Proposal introduces a new requirement to assess "control relationships" among counterparties to determine whether exposure to separate counterparties should be combined. These "control relationships" are similar to the subjective "controlling influence" criteria employed by the Federal Reserve in the context of determining control under the BHCA.

- In a significant new addition, consistent with the Basel Standards, the Re-Proposal includes specific rules for exposures to securitizations, investment funds and special purpose vehicles (collectively, "SPVs"). The terms "securitization," "investment fund" and "special purpose vehicle" are not defined in the Re-Proposal.

  - For an investment in an SPV, a Covered Company would generally recognize exposure to the SPV, rather than the SPV's underlying assets, equal to the value of its investment in the SPV. However, a Covered Company with total consolidated assets of $250 billion or more, or $10 billion or more of on-balance-sheet foreign exposures, would be required to "look-through" an SPV if it cannot demonstrate that its exposure to each underlying investment (when considering only the holdings of the SPV) is smaller than 0.25% of the Covered Company's SCCL capital base. The look-through would require the Covered Company to recognize exposure to each issuer of the underlying assets held by the SPV. If a Covered Company is unable to identify the issuer of an underlying asset, the Covered Company 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 would depend on how the Covered Company has invested in the SPV (e.g., *pari passu* investment versus investment in tranches).

  - Additionally, such a Covered Company would be required to recognize exposures to third parties with contractual or business relationships with the SPV whose failure or material financial distress would cause a loss in the value of the Covered Company's investment in the SPV. Relevant third parties could include credit support providers to the SPV, liquidity providers to the SPV or fund managers. A Covered Company would be required to recognize an exposure to such third parties that is equal to the value of the

Covered Company's investment in the SPV, in addition to the exposure to the SPV itself or to the issuers of underlying assets.

- ***Gross Credit Exposures.*** The SCCL would apply to (i) extensions of credit; (ii) repurchase transactions or reverse repurchase transactions; (iii) securities lending or securities borrowing transactions; (iv) guarantees, acceptances and letters of credit; (v) the purchase of, or investment in, securities issued by the counterparty; (vi) credit exposures in connection with derivative transactions; and (vii) any transaction that is the functional equivalent of (i) – (vi), as well as any transaction that the Federal Reserve determines to be a credit transaction.

- ***Net Credit Exposures***

  - The SCCL would 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 position hedges.

  - Under the "risk-shifting" approach utilized in the Re-Proposal, using these mitigants would shift the credit exposure to the collateral issuer or protection provider. In contrast to the Original Proposals, the Re-Proposal would now require both exposure offset and risk-shifting in the context of receipt of eligible collateral. Both the Original Proposals and the Re-Proposal would require such risk-shifting in the context of eligible credit and equity derivatives and eligible guarantees.

- ***Exemptions***

  - The Re-Proposal would exempt credit exposures to (i) 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), and (ii) foreign sovereign entities that are assigned a 0% risk weight under the Federal Reserve's risk-based capital rules. Trade-related exposures to qualifying central counterparties ("QCCPs") would also be exempt. Gross credit exposure collateralized by obligations of the exempt government entities, or protected by an eligible credit or equity derivative with a QCCP, would also be exempt through the "risk-shifting" requirement.

  - Intraday credit exposure to any counterparty would be exempt from the SCCL.

- ***Compliance***
    - A U.S. BHC, FBO or U.S. IHC with total consolidated assets less than $250 billion and less than $10 billion of on-balance-sheet foreign exposures would have a **two-year compliance period** from the effective date of the final SCCL rule and would be required to comply on a **quarterly basis**.
    - A U.S. BHC, FBO or U.S. IHC with total consolidated assets of $250 billion or more, or $10 billion or more of on-balance-sheet foreign exposures, would have a **one-year compliance period** from the effective date of the final SCCL rule and would be required to comply on a **daily basis** and submit a report demonstrating compliance on a **monthly basis**.
    - The Federal Reserve expects to develop new reporting forms for Covered Companies to evidence compliance.

Key Takeaways

Below we highlight key takeaways from the Re-Proposal, identify certain differences between the Re-Proposal and the Original Proposals, or between the Re-Proposal and the Basel Standards, and provide considerations for Covered Companies and other industry members when addressing possible comments to the Federal Reserve.

I. *General Takeaways*

- ***Tailoring for systemic risk***
  - The Re-Proposal is designed to be less stringent for smaller Covered Companies that are less likely to pose a risk to U.S. financial stability. Covered Companies with between \$50 billion and \$250 billion of consolidated total assets and less than \$10 billion of on-balance-sheet foreign exposures would: (i) be able to use a broader definition of capital (capital and surplus versus Tier 1), (ii) not be subject to a more restrictive SCCL for exposures to Major Counterparties, (iii) not be subject to the more complex "look-through" mechanisms for SPVs, (iv) be able to comply on a quarterly (versus daily) basis and (v) have a two-year (versus one-year) period to come into compliance.
  - However, those institutions that meet the advanced approaches criteria (\$250 billion or more of total consolidated assets or \$10 billion or more of on-balance-sheet foreign exposures), but that are not otherwise "Major Covered Companies," would be captured in a new category of Covered Companies that is subject to more restrictive requirements than what would have been applicable to these companies under the Original Proposals, primarily because the capital base for the 25% SCCL is now proposed to be Tier 1 capital rather than total capital and surplus.

II. *Bases for Limit and Size of Limit*

- ***Tier 1 capital***
  - The Re-Proposal uses a more limited definition of capital than the Original Proposals (or Section 165(e)) for Covered Companies with total consolidated assets of \$250 billion or more or \$10 billion or more of on-balance-sheet foreign exposures. To justify the departure from the explicit capital denominator in Section 165(e), the Federal Reserve relies on language in Section 165(e)(2) to the effect that the Federal Reserve may establish "such lower amount as [it] may determine by regulation to be necessary to mitigate the risks to the financial stability of the United

States." The Federal Reserve refers to the post-crisis and Basel III focus on higher-quality forms of capital and concludes that the base should reference measures of capital that are intended to absorb losses on a going-concern basis. However, it does not appear to conclude specifically that the lower capital base used for these Covered Companies is "necessary," which would appear to be required by the Dodd-Frank Act. The Federal Reserve suggests that the narrower definition of capital would have a limited impact because, as of September 31, 2015, Tier 1 capital represented approximately 82% of total regulatory capital plus ALLL for Covered Companies required to use the stricter measure, and the narrower definition of capital would result in total "excess exposure" (i.e., exposure that would have to be reduced if the Re-Proposal were in effect) among U.S. BHCs of approximately $30 billion.

    - While the Federal Reserve portrays this effect as "limited," the 18% reduction (if the 82% calculation is correct) in maximum exposures that these Covered Companies can take on without breaching the limit, coupled with the fact, noted above, that many of these Covered Companies would be subject to additional burdens introduced in the Re-Proposal, could be significant.

  - The use of Tier 1 capital as the SCCL denominator is consistent with the Basel Standards, which were finalized between the Original Proposals and the Re-Proposal. While international consistency can be important in a number of contexts, the continued reliance by the U.S. bank and BHC regulators on "finalized" Basel Committee standards for "proposed" U.S. rules has increased frustration between the regulators and the industry, as well as between the regulators and Congress, as comments are more likely to be rejected in favor of adhering to the finalized international standard.

- ***15% exposure limit for Major Covered Companies***

  - The Re-Proposal would increase the exposure limit for Major Covered Companies facing Major Counterparties to 15% of the capital base, up from 10% in the Original Proposals. The 15% limit is consistent with the Basel Standards. However, unlike the Original Proposals the 15% limit is calculated against Tier 1 capital rather than capital and surplus.

  - Similar issues as those noted above concerning determination of "necessity" of such a limit and use of finalized Basel Standards arise in this context.

- o The 10% total capital and surplus limit was the primary lightning rod for comments on the Original Proposals, including the submission of significant quantitative and economic analyses by commenters. While an increase in the limit will therefore be welcome, the increase is smaller than 15% versus 10% would suggest. The modification technically represents an increase to approximately 12.3% of total capital and surplus (from 10% in the Original Proposals) if the 82% Tier 1-to-total capital and surplus ratio cited by the Federal Reserve is accurate. Other modifications (such as the change in calculation of derivative exposure, as noted below) may partially alleviate the concerns of the industry with this limit, but there would appear to be room to comment on the quantitative analysis developed by the Federal Reserve and why it supported only a small change.

III. *Scope of Covered Company*

- ***Aggregation of Subsidiaries of a Covered Company.*** Commenters on the Original Proposals sought to have the aggregate exposure of a Covered Company be based on accounting consolidation, similar to the risk-based capital rules. Not only did the Federal Reserve reject these comments, but the Re-Proposal would expand the definition of "subsidiary." The Original Proposals would have relied on the bright-line test of (i) owning, controlling or holding with the power to vote 25% or more of any class of voting securities, (ii) owning or controlling 25% or more of the total equity of the company, or (iii) consolidating the company for financial reporting purposes. The BHCA control definition, which includes a facts-and-circumstances "controlling influence" test, would capture a broader range of companies, including more companies whose exposures may not be consolidated or whose systems may not be integrated with the Covered Company. As a result, access to information to monitor all of the transactions of its BHCA subsidiaries may be challenging. More importantly, a Covered Company may lack sufficient managerial and operational control to be able to prevent the "controlled" company from engaging in credit transactions.

IV. *Scope of Counterparties*

- ***QCCPs.*** As a number of commenters to the Original Proposals requested, trade exposures (including credit exposure from a cleared portfolio or pre-funded default fund contributions) to a QCCP (as defined in the U.S. Basel III risk-based capital rules) would be exempt under the Re-Proposal. While the Basel Standards also exempt exposures to QCCPs, the lending limit rules promulgated by the Office of the Comptroller of the Currency (the "OCC")[4] specifically rejected

[4] 78 Fed. Reg. 37,930 (June 25, 2013).

such an exemption, thereby resulting in a divergence between the exposure methodology for subsidiary national banks and that applied to a Covered Company. This divergence implies a likely greater need for additional information technology system enhancements and complexity.

- ***High-quality sovereigns.*** Consistent with a large number of comments on the Original Proposals, the Re-Proposal extends the exemption for exposures to the U.S. government to foreign sovereign governments that receive a 0% risk weight under the Federal Reserve's risk-based capital rules.

- ***Counterparty subsidiaries.*** The definition of counterparty in the Re-Proposal continues to include any company in which the counterparty has at least a 25% voting or total equity stake. Many commenters on the Original Proposals pointed this out as problematic, because Covered Companies may not be able to discover whether a company is 25% owned by another counterparty.

- ***Economic Interdependence and Controlling Relationships.*** If exposures to a single counterparty exceed 5% of the Covered Company's eligible capital base (i.e., total capital and surplus or Tier 1 capital, as applicable), the Covered Company would also need to aggregate exposures of counterparties that are "economically interdependent." The Re-Proposal details a number of factors for determining economic interdependence aimed at judging whether, if one of the counterparties were to experience financial problems, the other counterparty would be likely to experience financial problems as a result. In addition, the Re-Proposal would require that the Covered Company aggregate exposures to counterparties that are connected by certain control relationships.

  - Given the considerable investigation required to determine economic interdependence and uncover certain control relationships, and the possibility that Covered Companies will not have access to such information, this requirement may pose serious compliance burdens for Covered Companies. Since this requirement applies to all Covered Companies, the compliance burdens and accompanying costs are likely to be especially taxing for those Covered Companies below the $250 billion total asset or $10 billion foreign exposure thresholds.

  - Moreover, the Re-Proposal provides scant discussion of how the factors to be used to determine the presence of a control relationship should be assessed. For example, the presence of a "voting agreement" is included as a factor indicative of a control relationship without further explanation and without discussion of relevant Federal Reserve precedent under which voting agreements have been deemed not to give rise to a controlling influence.

- Also, notwithstanding the Federal Reserve's attempt to highlight that exposures to funds that are not sponsored and advised by a counterparty should not be aggregated with the counterparty unless the entity is 25% owned by, or otherwise consolidated with, the counterparty, the combination of the economic interdependence and the "controlling relationships" analyses are likely to capture a significant number of funds, special purpose vehicles, securitizations and other legally separate entities depending upon how aggressively these analyses are applied.

    - Coupled with the complexity of the analysis required of certain Covered Companies (those with $250 billion or more of total consolidated assets or $10 billion or more of on-balance-sheet foreign exposures) to analyze and look through exposures to SPVs, the increased granularity and prescriptiveness of the Re-Proposal on these relationships is likely to lead to considerable tracking, monitoring, recordkeeping and due diligence burdens on Covered Companies.

- ***Natural persons.*** Despite comments that individuals should be excluded from the definition of counterparty due to the extreme compliance burden resulting from monitoring and calculating such exposures (as well as the use of the term "company" under Section 165(e)), the Re-Proposal continues to include individual counterparties. The Federal Reserve justified such inclusion because it believes that large credit exposures to individuals create similar risks to Covered Companies as those created by large credit exposures to companies. As a practical matter, this limitation is likely to have the most effect in situations where exposures are required to be aggregated, under the Re-Proposal's methodology, between and among a natural person and companies controlled by, or considered economically interdependent with, such natural person.

V. *Gross Exposure Calculation*

- ***Non-credit derivative exposure calculations.*** Under the Original Proposals, Covered Companies were required to use the "Current Exposure Method" ("CEM") to calculate credit exposure from derivatives transactions. Under the Re-Proposal, Covered Companies would be permitted to use any methodology that may be used under the Federal Reserve's risk-based capital rules, including CEM or internal models for Covered Companies subject to the advanced approaches risk-based capital rules.

    - This change is responsive to a number of commenters that argued that CEM was insufficiently risk-sensitive and overstated the realistic exposure of derivatives transactions. It is also responsive to the industry push to make the exposure calculations for complex financial instruments consistent across various regulatory regimes, such as the capital rules and other exposure-dependent rules.

- This change is also consistent with the approach taken to calculating derivatives exposure under the OCC's lending limits applicable to national banks, although the OCC had also included a matrix look-up method primarily designed for smaller national banks.

- The Federal Reserve noted, however, that it will consider incorporating the Basel Committee's "standardized approach to counterparty credit risk" ("SA-CCR"),[5] when finalized, into both its risk-based capital rules and the SCCL. It is unclear from the Re-Proposal whether SA-CCR would be an additional option or a floor for calculating credit exposure.

- ***Exposures to SPVs***

  - As described above, Covered Companies with $250 billion or more of total consolidated assets, or $10 billion or more of on-balance-sheet foreign exposures, would be required to undertake a more granular analysis of exposures to SPVs and their underlying assets if the exposures to underlying assets cannot be demonstrated to be *de minimis*. A Covered Company may also need to treat its exposure to the SPV as exposure to third parties with certain relationships with the SPV. The Re-Proposal does not define the types of entities that would constitute securitizations, investment funds or special purpose vehicles, apparently leaving such categorization to the Covered Company itself.

  - The Re-Proposal is unclear about whether these requirements are applicable only to "investments in," or all exposures to, an SPV.

    - The introductory caption to the section indicates a focus on "investments in and exposures to" SPVs.

    - While Section 252.75(a)(2)(i) of the Re-Proposal indicates that the section may be primarily focused on SPVs "in which [the Covered Company] invests," the remaining subsections and paragraphs do not use that language consistently and focus on calculating gross credit exposure.

[5] Basel Committee, The Standardized Approach for Measuring Counterparty Credit Risk Exposures (Apr. 2014), *available at* http://www.bis.org/publ/bcbs279.pdf.

    - The discussion of the "look-through" approach contains provisions to assist Covered Companies in determining their exposure when "investors" in the vehicle are *pari passu* and when they are not, and discusses the instruments in which the Covered Company "has invested" in this context.

    - None of the provisions discuss whether an "investment" should be only an equity investment or can be a debt investment, although the discussion of non-*pari passu* tranching suggests that an investment in a debt instrument may also require the look-through approach.

    - Each of the examples described in this section of the preamble involves SPVs in which the Covered Company holds a debt or equity investment.

  The logic of the proposed investment calculations would appear to require that a Covered Company analyze, for possible application of the look-through approach, (i) equity investments and (ii) debt security or other extension of credit investments that are backed by the SPV's pool of assets generally. In contrast, it would not appear that credit exposure to an SPV under a derivative (unless it were a portfolio swap), or exposure under a repurchase/securities lending transaction related to specific assets, should constitute the type of "investment" exposure that would require analysis under the look-through thresholds and related provisions, unless perhaps it arises in connection with an SPV in which the Covered Company also holds a debt or equity investment.

- The requirement to treat a Covered Company's full gross credit exposure (apparently not limited to investment exposure) to an SPV as gross credit exposure <u>also</u> to a third party that "has a contractual or other business relationship with [an SPV and] . . . whose failure or material financial distress would cause a loss in the value of the [Covered Company's] investment in or exposure to the" SPV would appear to be a significant concern and one ripe for comment.

    - While generally consistent with the Basel Standards, this requirement creates significant risk of double-counting. Indeed, the requirement to <u>add</u> exposure to these third parties with relationships with an SPV would be <u>worse</u> than if the third party (provided that the third party were an eligible guarantor) had merely guaranteed the Covered Company's exposure to the SPV, as the eligible guarantee would create only one exposure to the guarantor and shift exposure away from the SPV. No explanation of this anomaly is described in the Re-Proposal, and no discussion appears in the preamble to the Re-Proposal of whether this double exposure is intended to override the risk-shifting under the eligible guarantee and credit and equity derivative provisions.

- Furthermore, although the Re-Proposal's rule text suggests that third parties "such as a fund manager or protection provider to such" SPV may be the type of entities that a Covered Company should look to under this provision, the preamble to the Re-Proposal suggests that liquidity providers to the SPV, as well as "originators of assets held by the SPV," may also have relationships that could cause concern. This statement is made notwithstanding that many securitizations are designed to be bankruptcy remote and otherwise legally separate from originators of the assets.

- It also appears possible that, because this provision is related to both "investment in or exposure to" an SPV, the additional exposure to a related third party may need to be calculated if a counterparty posts an interest in an SPV as collateral (assuming it is eligible collateral) to a Covered Company and the Covered Company is required to "shift the risk" calculation to an exposure to the SPV.[6]

o Both the look-through approach and the additional exposure to related third parties appear to create a significant diligence and information access burden at inception of an exposure, as well as ongoing granular and detailed monitoring and record-keeping requirements. No separate phase-in or transition period is provided for these requirements.

- ***Exposure calculations for securities lending and repurchase transactions (where a security has been delivered to the counterparty)***

  o The exposure calculations under the Re-Proposal for securities subject to a securities loan or a repurchase agreement would require an "add-on"

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[6] The Re-Proposal is silent, and therefore unclear, on this point. While the risk-shifting provisions related to eligible collateral indicate that "in no event will the . . . gross credit exposure to the issuer of collateral be in excess of [the] credit exposure to the counterparty on [the] credit transaction" (see § 252.74(c)(2), emphasis added), we note that the related party is not the "issuer" of the collateral and the related party provision is apparently intended to create a form of double-counting. This is likely an area requiring further clarification.

It also may be the case, however, that securities issued by many SPVs would not meet the definition of "eligible collateral", in which case this issue would not arise, or may be securities guaranteed by, e.g., Fannie Mae or Freddie Mac, in which case the collateral exempts the exposure.

related to the haircut for such securities under the Federal Reserve's risk-based capital rules.

- The use of an add-on generated significant criticism by commenters on the Original Proposals. However, by pulling in the risk-based capital rule haircuts, certain of the add-ons for corporate and municipal bonds would be larger (although some would be smaller) than the 2%, 6% and 12% add-on included in the Original Proposals, depending upon the risk weight of the issuer.

- In an attempt to address commenters' concerns, the Re-Proposal would allow (as do the risk-based capital rules), the use of a shorter 5-day closeout period (derived by multiplying the add-on by the square root of ½) compared to a 10-day period in relation to the volatility measure of the delivered securities in the Original Proposals.

  - Unlike the changes with respect to derivative exposure, and unlike the risk-based capital rules, the Re-Proposal would not permit a Covered Company to derive its own haircuts from internal models.

- ***Attribution Rule.*** While the Re-Proposal continues to contain a rule effecting the statutory "attribution rule" (requiring that a Covered Company treat a transaction with any person as a credit exposure to a counterparty to the extent the proceeds of the transaction are used for the benefit of, or are transferred to, that counterparty), the Federal Reserve's statements in the preamble are arguably the furthest that the Federal Reserve has gone to assuage the concerns of the industry about how the attribution rule will be enforced. The preamble states: "It is the Board's intention to avoid interpreting the attribution rule in a manner that would impose undue burden on covered companies 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."

  - While this statement is helpful, commenters on the Original Proposals had sought further clarity. The preamble to the Re-Proposal does not include much more than the statement above, although the Federal Reserve reiterates its request for comment on whether further clarity should be provided.

VI. *Net Exposure Calculation and Exposure Mitigants*

- ***"Risk-shifting."*** Under the Original Proposals, Covered Companies would have had the option to reduce credit exposure to a counterparty based on eligible collateral, but would have been required to do so for eligible protection obtained through a guarantee or credit or equity derivative. If a Covered Company opted to, or was required to, reduce credit exposure to the counterparty, it would have been required to recognize a dollar-for-dollar increase in exposure to the issuer of eligible collateral or the eligible protection provider.

- A number of commenters argued that shifting the full notional value of credit derivatives was overly conservative and recommended allowing Covered Companies to measure exposures from derivative hedges to eligible protection providers using the methodologies used for derivatives more generally.

- Under the Re-Proposal, a Covered Company would be required to reduce credit exposure to a counterparty based on eligible collateral (and is no longer permitted the option to reduce in relation to collateral) or eligible protection and, as a result, shift the exposure amount alleviated to the issuer of eligible collateral or the eligible protection provider.

  - The only exception to this mandatory risk-shifting of full notional amount would be in relation to an eligible credit derivative purchased to hedge exposure that is (i) subject to the market risk capital rules and (ii) to an entity that is <u>not a financial entity</u>. In this case, the Covered Company would be allowed to measure exposure to the eligible protection provider using the counterparty credit risk methodology for derivatives authorized under the Federal Reserve's risk-based capital rules. This approach is only partially responsive to commenters' arguments, but it is consistent with the Federal Reserve's focus in the Re-Proposal on the interconnections between financial entities and higher probability of correlated defaults among such entities.

- Despite commenters' requests to broaden the definition of eligible collateral, the Re-Proposal preserves the Original Proposals' definition. In contrast to the Basel III capital rules, which define financial collateral broadly to include all investment-grade debt securities (other than resecuritizations) and money market or mutual fund shares with a publicly-quoted daily price,[7] the Re-Proposal would limit the recognition of debt securities to investment-grade debt securities that are bank-eligible investments. Accordingly, private-label mortgage- and asset-backed securities, resecuritizations and money market and mutual fund shares

[7] 12 C.F.R. § 217.2 (financial collateral).

would not be recognized as eligible collateral even though they are frequently used as collateral for a wide variety of credit transactions.

- o In what appears to be a counterintuitive, and potentially serious, clarification in the Re-Proposal, the risk shifting required when receiving eligible collateral or benefiting from an eligible guarantee or credit/equity protection must occur even when the counterparty is an exempt or excluded counterparty (such as the U.S. government, a zero-risk weighted sovereign or a QCCP). The Federal Reserve rejected the argument generally that risk-shifting was, in effect, too blunt a requirement, given the need for both the underlying exposure to default and the collateral or protection provider to fail to cover the exposure. Indeed, the Federal Reserve has effectively exacerbated this issue by removing certain transactions from complete counterparty exemptions merely because additional protection in the form of collateral or derivatives is sought.

    - U.S. or foreign sovereign counterparties may not post collateral in ordinary course transactions, but applying risk-shifting to collateral from, e.g., a QCCP in the ordinary course of cleared transactions, in the form of anything other than cash or U.S./zero-risk-weighted sovereigns, would effectively eliminate the QCCP trade exposure exemption in the Re-Proposal (except for, counterintuitively, uncollateralized default fund exposures).

    - As another example, applying risk-shifting to the purchase of protection (as a risk management tool) on the bonds of a zero-risk-weighted sovereign in the ordinary course of asset-liability and liquidity management would effectively eliminate the exemption for the bond exposure to the sovereign, making prudent risk and liquidity management more costly.

    - This result does not appear to have been unintentional, as the Federal Reserve asks generally whether risk-shifting in these instances should be required and provides an example to illustrate the situation. However, neither the preamble nor the rule text in the Re-Proposal provide any reasoning for this result.

VII. *Key Takeaways of Interest to Foreign Banking Organizations*

- ***SCCL at the level of the U.S. IHC and U.S operations for FBOs.*** Despite a strong negative reaction from industry association commenters to the Original Proposals, the Re-Proposal would continue to apply the SCCL at the level of the U.S. IHC as well as at the level of U.S. operations (inclusive of the U.S. IHC) for FBOs. As in the Original Proposals, the limit on the U.S. IHC's exposure would be based on the U.S. IHC's eligible capital, while the limit on the U.S. operations' exposure would be based on the FBO parent's eligible capital. Therefore, Covered Company FBO's would have an SCCL at a sub-consolidated level (U.S. operations and the IHC, if any), whereas such a limit would not apply to any lower-tier holding company of a U.S. Covered Company.

- ***Size Considerations for FBOs***
  - *Total Global Consolidated Assets*. The Federal Reserve rejected arguments that an FBO's U.S. operations should not be subject to the SCCL unless the size of the FBO's U.S. operations crossed certain material thresholds. Under the Re-Proposal, the SCCL would continue to apply to the U.S. operations of an FBO with greater than $50 billion of <u>total global consolidated</u> assets, <u>regardless</u> of the size of its U.S. operations. In this respect, the tailoring so prevalent throughout the rest of the Re-Proposal is absent.
    - The Federal Reserve's approach would likely result in considerable investment in tracking and recordkeeping technology that may not be commensurate with an FBO's U.S. operations footprint. In addition, this threshold continues to ensure that the SCCL applies disproportionately to FBOs, as the number of FBOs affected would be several times more than the number of U.S. Covered Companies affected.
    - Other rulemakings, such as other enhanced prudential standards and even the final Volcker Rule regulations, have contained more granular tailoring of requirements, based on U.S. assets of FBOs.
  - *Determination of Major FBOs and U.S. IHCs.* The classification of an FBO or U.S. IHC as a Major Covered Company relies only on the size of the institution (total global consolidated assets of $500 billion or more), whereas the classification of a U.S. BHC as a Major Covered Company is based on the identification of such U.S. BHC as a U.S. G-SIB. A G-SIB determination is based on factors other than size, including interconnectedness and cross-border activities. Basing the classification of FBOs and U.S. IHCs on size alone may not fully account for the true systemic impact of such companies.
    - Furthermore, this discrepancy would result in significantly more FBOs being subject to the Major Covered Company restrictions than there are Non-U.S. G-SIBs, whereas the number would be the same for U.S. domestic Major Covered Companies.

- ***Foreign Sovereign Exemption.*** Under the Re-Proposal there would be an exemption for exposures of an FBO to its home-country foreign sovereign, even if such sovereign does not have a 0% risk weight under the Federal Reserve's risk-based capital rules. It is unclear, however, whether the reference to a "home country sovereign entity" is intended to also include such entity's agencies and instrumentalities or political subdivisions. Under the definition of "counterparty" with respect to a "foreign sovereign entity," agencies and instrumentalities are explicitly included, and political subdivisions are explicitly excluded. There is no similar language in the exemption for home country sovereign entities.

- ***FBO Risk Mitigation.*** Under the Re-Proposal, just as in the Original Proposals, an FBO would not be able to reduce its gross exposures by way of collateral issued by, or credit protection provided by, affiliates of the FBO's U.S. IHC or its combined U.S. operations. Under the Re-Proposal, the definition of "eligible collateral" explicitly excludes debt or equity securities issued by an affiliate of the U.S. IHC or U.S. operations of an FBO and the definition of "eligible protection provider" similarly excludes the FBO or any affiliate of the FBO.

- ***IHC/U.S. Operations Non-compliance "Cross-Trigger".*** The Original Proposal for FBOs contained a provision that "[i]f either the [IHC] or the [FBO] is not in compliance with this subpart, neither the [IHC] nor the combined U.S. operations may engage in any additional credit transactions with such a counterparty in contravention of this subpart," unless the Board allows the additional transactions. This provision attracted significant comment from foreign bank and trade association commenters, as (among other reasons) the U.S. operations of an FBO (including the branches) have a larger capital base for the SCCL, and yet could be inadvertently constrained by an SCCL breach of a smaller limit at its IHC. The Re-Proposal provision (Section 252.178(c)) has been rewritten to incorporate certain cure period provisions seemingly unrelated to the "cross-trigger" from the Original Proposal. As the rule text has been rewritten, the Federal Reserve's intent with regard to a cross-trigger is less clear, and we would expect that FBOs will seek clarification on this point and confirmation that a cross-trigger should not apply.

VIII. *Compliance Timeline and Frequency*

- ***Compliance Phase-in.*** While the one- or two-year period appears to be significant, especially in light of the apparent progress made by large institutions since the crisis on developing more robust systems to aggregate and measure risk, Covered Companies should still consider whether the proposed timeline will be adequate.

- For example, the largest Covered Companies ($250 billion or more of total consolidated assets or $10 billion or more of on-balance-sheet foreign exposures) are subject to the shorter compliance timeline, but would also be subject to more stringent standards, including more granular and prescriptive requirements that were not in the Original Proposals. In addition, the Federal Reserve has estimated that most of the remedial action to be taken to reduce "excess" exposure above the limits would need to be undertaken by the larger Covered Companies.

- As another example, large FBOs that might have a more limited U.S. footprint should comment on whether the shorter compliance period may be unduly burdensome. Related considerations include whether such FBOs have the ability to aggregate exposures across separate U.S. legal entities (subsidiaries) and establishments (branches and agencies) in a manner solely related to U.S. operations rather than the organization as a whole.

- ***Frequency of Compliance Checks.*** While the Federal Reserve accepted a more infrequent compliance measurement when compared to the Original Proposals (quarterly instead of daily) for those Covered Companies with less than $250 billion of total consolidated assets and less than $10 billion of on-balance-sheet foreign exposures, such Covered Companies may, under the Re-Proposal's rule text, be subject to a Federal Reserve determination to provide information more frequently. The preamble to the Re-Proposal includes some concerning gloss on the required preparedness of such Covered Companies. The Federal Reserve suggests that "[t]hese companies would…need to have systems in place that would allow them to calculate compliance on a daily basis," in order to, in effect, prepare for the possibility that the Federal Reserve may notify the company that more frequent compliance is required. The industry may wish to comment and seek further clarification of this statement, including whether such systems would be required to be in place at initial compliance date and whether this preamble statement effectively undermines the rule text's phased-in approach to compliance measurement and reporting.

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Please feel free to contact any of your regular contacts at the firm or any of the contacts in our Financial Institutions practice listed below.

Derek M. Bush Partner	+1 202 974 1526	dbush@cgsh.com
Katherine M. Carroll Partner	+1 202 974 1584	kcarroll@cgsh.com
Michael H. Krimminger Partner	+1 202 974 1720	mkrimminger@cgsh.com
Hugh C. Conroy Jr. Counsel	+1 212 225 2828	hconroy@cgsh.com
Allison H. Breault Associate	+32 2 287 2129	abreault@cgsh.com
Temi R. Kolarova Associate	+1 212 225 2019	tkolarova@cgsh.com
Lauren Gilbert Associate	+1 212 225 2624	lgilbert@cgsh.com

CLEARY GOTTLIEB STEEN & HAMILTON LLP

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road, Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Cleary Gottlieb Steen & Hamilton LLP
45th Floor, Fortune Financial Center
5 Dong San Huan Zhong Lu
Chaoyang District
Beijing 100020, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Sila Tower, 27th Floor
Abu Dhabi Global Market Square
Al Maryah Island, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL
Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T:+82 2 6353 8000
F:+82 2 6353 8099