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Another Brick in the Wall: The Fed Reproposes Single-Counterparty Credit Limits for Large Banking Organizations

*By Oliver I. Ireland and Jared D. Kaplan**

The Board of Governors of the Federal Reserve System recently issued a Notice of Proposed Rulemaking inviting comment on reproposed rules that would establish single counterparty credit limits for certain U.S. bank holding companies and foreign banking organizations and a white paper that provides the reasoning for the reproposed rules' more stringent 15 percent limit for credit exposures between systemically important financial institutions. This article discusses the reproposed rules and white paper.

The Board of Governors of the Federal Reserve System (the “Fed”) recently issued a Notice of Proposed Rulemaking (“NPRM”), inviting comment on reproposed rules (the “Reproposed Rules”) that would establish single counterparty credit limits for U.S. bank holding companies (“BHCs”) and foreign banking organizations (“FBOs”) with at least \$50 billion in total consolidated assets.¹ Pursuant to Section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), the Fed is required to prescribe rules that limit the amount of credit exposure that U.S. BHCs and FBOs can have to an unaffiliated company to reduce the risks that may arise from such a counterparty’s sudden failure. In addition to the NPRM, the Fed also issued a white paper (the “White Paper”) that provides the analytical and quantitative reasoning for the Reproposed Rules’ more stringent 15 percent limit for credit exposures between systemically important financial institutions (“SIFIs”).

The Fed originally proposed single-counterparty credit limits for U.S. BHCs and FBOs in December 2011 and December 2012, respectively (the “Originally Proposed Rules”).² The Fed has issued the Reproposed Rules to take into

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¹ Board of Governors of the Federal Reserve System, “Single-Counterparty Credit Limits for Large Banking Organizations,” Notice of Proposed Rulemaking, Mar. 4, 2016, *available at* <http://www.federalreserve.gov/aboutthefed/boardmeetings/sccl-fr-notice-20160304.pdf>, at 1.

² See *Enhanced Prudential Standards and Early Remediation Requirements for Covered*

consideration:

- (1) the extensive comments the Fed received in response to the Originally Proposed Rules;
- (2) the revised lending limit rules applicable to national banks;³
- (3) the Basel Committee on Banking Supervision's introduction of large exposures standards;⁴ and
- (4) the results of quantitative impact studies and related analysis conducted by the Fed to gauge the impact of the Originally Proposed Rules.⁵

The Reproposed Rules represent another effort to reduce interconnectedness in the financial system. While the Fed has sought to gauge counterparty credit risk through annual stress testing of large financial institutions,⁶ the Reproposed Rules would establish hard limits on these exposures. Comments on the NPRM were requested by June 3, 2016.

This article is divided into four parts. The first part provides an overview of the general requirements under Section 165(e). The second part highlights the requirements of the Reproposed Rules for both U.S. BHCs and FBOs. The third part provides a brief overview of the White Paper and discusses the Fed's justification for more stringent counterparty risk exposure requirements for SIFIs. Lastly, the fourth part provides a chart summarizing several of the key requirements of the Reproposed Rules.

SECTION 165(E) OF THE DODD-FRANK ACT

Under Section 165(e), the Fed is required to establish single-counterparty credit limits for U.S. BHCs ("Covered Companies") and FBOs with at least

Companies; Proposed Rule, 77 Fed. Reg. 594 (Jan. 5, 2012); and *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies*, 77 Fed. Reg. 76628 (Dec. 28, 2012).

³ See *Lending Limits*, 78 Fed. Reg. 37930 (June 25, 2013).

⁴ See "Final standard for measuring and controlling large exposures published by the Basel Committee," BIS Press Release, Apr. 15, 2014, available at <http://www.bis.org/press/p140415.htm>.

⁵ NPRM, *supra* note 1 at 7.

⁶ See Remarks by Chair of the Federal Reserve Janet L. Yellen, "Finance and Society" Conference, Washington, D.C., May 6, 2015, available at <http://www.federalreserve.gov/newsevents/speech/yellen20150506a.pdf> ("We are also employing annual stress tests to gauge large institutions' ability to weather a very severe downturn and distress of counterparties and, importantly, continue lending to households and businesses.").

\$50 billion in total consolidated assets,⁷ as well as any U.S. intermediate holding companies (“IHCs,” and, together with FBOs, the “Covered Entities”).⁸ While investment securities limits and lending limits are already in place for certain depository institutions, such as national banks, state-chartered banks, and state and federally chartered savings associations, pursuant to the National Bank Act of 1863 and the Federal Reserve Act, Section 165(e) requires separate and independent enhanced single-counterparty credit limits.

The Dodd-Frank Act defines “credit exposure” to a particular company as:

- all extensions of credit to a company, including loans, deposits, and lines of credit;
- all repurchase agreements (“Repos”), reverse repurchase agreements (“Reverse Repos”), and securities borrowing and lending transactions with a company (to the extent that such transactions create credit exposure for the Covered Company or Covered Entity);
- all guarantees, acceptances, and letters of credit (including endorsement or standby letters of credit) issued on behalf of the company;
- all purchases of, or investments in, securities issued by the company;
- counterparty credit exposure to the company in connection with derivative transactions between the Covered Company, or Covered Entity, and the company; and
- any other similar transaction that the Fed determines, through regulation, to be a credit exposure under Section 165(e).⁹

Covered Companies and Covered Entities are prohibited from maintaining credit exposure to any unaffiliated companies that exceeds 25 percent of the “capital stock and surplus” of the Covered Company or Covered Entity, or any such amount that the Fed determines may be necessary to mitigate risks to the financial stability of the U.S. economy.¹⁰ The Fed may additionally issue any such regulations and orders as it deems necessary to administer and carry out the requirements set forth under section 165(e), as well as exempt from the definition of “credit exposure” certain transactions if it finds that the exemption is in the “public interest and consistent with the purposes of section 165(e).”¹¹

⁷ Notwithstanding Section 165(a)(2), the Fed has not proposed a threshold higher than \$50 billion for applying Section 165(e).

⁸ See 12 U.S.C. § 5365(e)(1).

⁹ See 12 U.S.C. § 5365(e)(3).

¹⁰ See 12 U.S.C. § 5365(e)(2).

¹¹ See 12 U.S.C. § 5365(e)(5)–(6).

Lastly, the Fed is authorized to establish single-counterparty credit limits for any nonbank financial companies designated as a SIFI by the Financial Stability Oversight Council.¹²

THE REPROPOSED RULES

The Reproposed Rules establish separate requirements for U.S. BHCs (*i.e.*, Covered Companies) and FBOs and IHCs (*i.e.*, Covered Entities), albeit the requirements are largely analogous. Specifically, the Reproposed Rules establish:

- (1) three levels of increasingly stringent credit exposure limits;
- (2) the methodology for calculating “aggregate net credit exposures”;
- (3) exemptions from the credit exposure limits;
- (4) compliance requirements; and
- (5) the timing in which Covered Companies and Covered Entities must comply with the Reproposed Rules’ requirements.

Credit Exposure Limits for U.S. BHCs (Covered Companies)

Overview of Reproposed Rules as Applied to U.S. BHCs

Section 165(e) directs the Fed to impose single-counterparty credit limits on the “capital stock and surplus” of a Covered Company, which is defined under the Reproposed Rules as the “sum of the [Covered Company’s] total regulatory capital as calculated under the capital adequacy guidelines applicable to that [Covered Company] under Regulation Q . . . and the balance of the [Covered Company’s] allowance for loan and lease losses (“ALLL”) not included in tier 2 capital under the capital adequacy guidelines applicable to that [Covered Company] under Regulation Q.”¹³

Under the Reproposed Rules, the “aggregate net credit exposure” of a Covered Company to a single counterparty would be subject to one of three categories of credit exposure limits, each with increasing stringency. The Reproposed Rules define “aggregate net credit exposure” as the sum of all net credit exposures of a Covered Company or Covered Entity to a single counterparty.¹⁴ The below credit exposure limits would apply to a Covered Company on a consolidated basis, including any of the Covered Company’s

¹² See NPRM, *supra* note 1 at 5.

¹³ See Reproposed Rule § 252.71(d).

¹⁴ See Reproposed Rule § 252.71(b).

subsidiaries, to any unaffiliated counterparty:¹⁵

- *Category 1.* The first category of limits would apply to Covered Companies with less than \$250 billion in total consolidated assets and less than \$10 billion in on-balance-sheet foreign exposures.¹⁶ Such Covered Companies would be prohibited from maintaining aggregate net credit exposure to an unaffiliated counterparty in excess of 25 percent of the Covered Company's total capital stock and surplus.¹⁷
- *Category 2.* The second category of exposure limits would prohibit any Covered Company with at least \$250 billion or more in total consolidated assets or at least \$10 billion or more in total on-balance-sheet foreign exposures from maintaining aggregate net credit exposure to an unaffiliated counterparty that exceeds 25 percent of the Covered Company's tier 1 capital.¹⁸
- *Category 3.* The third category of exposure limits would prohibit any Covered Company that is a globally systemically important banking organization ("G-SIB" or "Major Covered Company") from maintaining aggregate net credit exposure that exceeds (i) 15 percent of the Major Covered Company's tier 1 capital to any "Major Counterparty"¹⁹ and (ii) 25 percent of the Major Covered Company's tier 1 capital to any other counterparty.²⁰

¹⁵ A "subsidiary" of a Covered Company includes any "company that is directly or indirectly controlled by the specified company for purposes of the Bank Holding Company Act of 1956." NPRM, *supra* note 1 at 13 (citing 12 U.S.C. § 1841). However, the Fed notes that, to the extent an investment fund or vehicle is not controlled by a Covered Company, the exposures of such a fund or vehicle to their counterparties would not be aggregated to the Covered Company for purposes of the Covered Company's single-counterparty credit limits. *See* NPRM, *supra* note 1 at 13.

¹⁶ NPRM, *supra* note 1 at 11.

¹⁷ The Reproposed Rules defines "total capital stock and surplus" as the Covered Company's total regulatory capital plus ALLL.

¹⁸ NPRM, *supra* note 1 at 11.

¹⁹ A "major counterparty" is defined as a G-SIB or a nonbank financial company supervised by the Fed (*i.e.*, a nonbank SIFI). NPRM, *supra* note 1 at 12.

²⁰ Pursuant to Section 165(a)(1)(B) of the Dodd-Frank Act, the Fed may establish enhanced prudential standards based on factors such as "the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company." *See* 12 U.S.C. § 5323; and 12 U.S.C. § 5365(e). The establishment of enhanced credit exposure limitations for Major Covered Companies is consistent with Section 165(a)(1)(1)(B) of the Dodd-Frank Act and discussed in further detail below.

Counterparty and Interdependence

The definition of “counterparty” would include: (i) any natural persons (including the person’s immediate family); (ii) a U.S. State (including all of its agencies, instrumentalities, and political subdivisions); and (iii) certain foreign sovereign entities (including their agencies, instrumentalities, and political subdivisions).²¹ The Fed has included within the definition of “counterparty” individuals and certain governmental entities because “credit exposures to such entities create risks to the [Covered Company] that are similar to those created by large exposures to companies.”²² Accordingly, the Reproposed Rules would subject credit exposures to all individuals, U.S. States, and municipalities, as well as foreign sovereign governments that do not receive a zero percent risk weight under the Fed’s risk-based capital rules under Regulation Q.²³

A Covered Company’s exposures to a “counterparty” would include both exposures to that particular entity and any exposures to any person with respect to which the counterparty: (1) owns, controls, or holds at least 25 percent voting power of a class of voting securities; (2) owns or controls at least 25 percent of the total equity; or (3) consolidates for financial reporting purposes.²⁴ Additionally, a Covered Company would need to consider if the counterparty is “economically interdependent” or in a “control relationship” with another counterparty, as discussed below.

- *Economic Interdependence Among Counterparties.* Where total exposures to a single counterparty exceed five percent of the Covered Company’s eligible capital base (*i.e.*, total regulatory capital plus ALLL or tier 1 capital), the Covered Company would need to add to its exposures to that counterparty all exposures to other counterparties that are “economically interdependent” with the first counterparty.²⁵ Under the Reproposed Rules, a Covered Company would be required to take into account whether:
 - 50 percent of one counterparty’s gross receipts or gross expenditures are derived from transactions with the other counterparty;
 - one counterparty has fully or partially guaranteed the exposure of

²¹ See Reproposed Rule § 252.71(e).

²² See NPRM, *supra* note 1 at 14.

²³ See *id.* at 14–15.

²⁴ See *id.* at 15–16.

²⁵ See *id.* at 16.

the other counterparty, or is liable by other means, and the exposure is significant enough that the guarantor is likely to default if a claim occurs;

- a significant portion of one counterparty's production or output is sold to the other counterparty (which cannot be easily replaced by other customers);
 - one counterparty has made a loan to the other counterparty and is relying on repayment of that loan in order to satisfy its obligations to the Covered Company, and the first counterparty does not have another source of income that it can use to satisfy its obligations to the Covered Company;
 - it is likely that financial distress of one counterparty would cause difficulties for the other counterparty in terms of full and timely repayment of liabilities; and
 - in the event of the common provider's default, an alternative provider cannot be found (to the extent that both counterparties rely on the same source for the majority of their funding).²⁶
- *Control Relationships.* A Covered Company is required to add to the exposures of an unaffiliated counterparty all exposures to other counterparties that are connected by certain *control relationships*, which are demonstrated by: (1) the presence of voting agreements; (2) the ability of one counterparty to significantly influence the appointment or dismissal of another counterparty's administrative, management, or supervisory body, or the fact that a majority of members have been appointed solely as a result of the exercise of the first entity's voting rights; and (3) the ability of one counterparty to significantly influence senior management or to exercise a controlling influence over the management or policies of another counterparty.²⁷

Credit Exposure Limits

Under the Reproposed Rules, no Covered Company may have aggregate net credit exposure to any unaffiliated counterparty in excess of 25 percent of the capital stock and surplus or tier 1 capital, as applicable, of the Covered Company.²⁸ Furthermore, Major Covered Companies would be prohibited

²⁶ See Reproposed Rule § 252.76(a).

²⁷ See Reproposed Rule § 252.76(b).

²⁸ See Reproposed Rule § 252.72(a)–(b).

from having aggregate net credit exposure to any Major Counterparty in excess of 15 percent of the Major Covered Company's tier 1 capital.²⁹

Gross Credit Exposure and Calculation of Aggregate Net Credit Exposure

The Reproposed Rules impose limits on a Covered Company's "aggregate net credit exposure," as opposed to its "aggregate gross credit exposure," to a counterparty. The Fed has clarified that the key difference between the two amounts is that "a [Covered Company's aggregate] net credit exposure would take into account any available credit risk mitigants, such as collateral, guarantees, credit or equity derivatives, and other hedges, provided the credit risk mitigants meet certain requirements in the rule."³⁰

Net Credit Exposure

The Reproposed Rules would impose limits on a Covered Company's "aggregate net credit exposure" to a counterparty, which is defined as the sum of all net credit exposures of a Covered Company to a single counterparty.³¹ In calculating its aggregate net credit exposure to a counterparty, a Covered Company would need to: (i) first calculate its "gross credit exposure" to the counterparty on each credit transaction in accordance with valuation and other requirements specified under the Reproposed Rules; (ii) reduce its gross credit exposure amount based on eligible credit risk mitigants (including any "eligible collateral," "eligible guarantees," "eligible credit and equity derivative hedges," and "other eligible hedges"); and (iii) add together all of its net credit exposures to the counterparty.³² Credit exposures to collateral, guarantors and protection providers are then included in the gross credit exposure to any exposures to the collateral issuer, guarantor or protection provider.

- *Eligible Collateral.* In computing its net credit exposure to a counterparty with respect to a credit transaction, a Covered Company would be required to reduce its gross credit exposure on the transaction by the adjusted market value of any "eligible collateral."³³ "Eligible collateral" would be defined to include collateral in which the Covered Company has a perfected, first priority security interest in the form of: (i) cash on

²⁹ See Reproposed Rule § 252.76(c).

³⁰ NPRM, *supra* note 1 at 27–28.

³¹ See Reproposed Rule § 252.71(x).

³² NPRM, *supra* note 1 at 28.

³³ See Reproposed Rule § 252.74(c).

deposit with a Covered Company; (ii) debt securities that are bank-eligible investments and have an investment grade rating; (iii) equity securities that are publicly traded; or (iv) convertible bonds that are publicly traded.³⁴

- *Eligible Guarantees.* In calculating its net credit exposure to the counterparty, a Covered Company would be required to reduce its gross credit exposure to the counterparty by the amount of any “eligible guarantee from an eligible protection provider.”³⁵ “Eligible guarantees” would be defined as “guarantees that meet certain conditions, including having been written by an eligible protection provider.”³⁶ Moreover, the Covered Company would have to then include the amount of the eligible guarantee when calculating its gross credit exposure to the eligible protection provider.³⁷ A Covered Company’s gross credit exposure to an eligible protection provider could not exceed its gross credit exposure to the original counterparty on the credit transaction prior to the recognition of the eligible guarantee.³⁸
- *Eligible Credit and Equity Derivative Hedges.* The Reproposed Rules would treat “eligible credit and equity derivatives” similarly to the proposed treatment of “eligible guarantees.” Specifically, a Covered Company would be required to reduce its gross credit exposure to a counterparty by the “notional amount of any eligible credit or equity derivative hedge that references the counterparty if the Covered Company obtains the derivative from an eligible protection provider.”³⁹ Additionally, as with the treatment of “eligible collateral” and “eligible guarantees,” the gross exposure to the eligible protection provider could not “be greater than it was to the original counterparty

³⁴ See Reproposed Rule § 252.71(k).

³⁵ See Reproposed Rule § 252.74(d).

³⁶ See Reproposed Rule § 252.71(n). The Reproposed Rules would define “eligible protection provider” as the same as the definition of “eligible guarantor” under Section 217.2 of Regulation Q (e.g., a sovereign, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, a multilateral development bank, a depository institution, a BHC, a savings and loan holding company, a credit union, a foreign bank, or a qualifying central counterparty). NPRM, *supra* note 1 at 45.

³⁷ See Reproposed Rule § 252.72(d)(1)–(2).

³⁸ See Reproposed Rule § 252.74(d)(2).

³⁹ See NPRM, *supra* note 1 at 48 (citing Reproposed Rule § 252.74(e)).

prior to recognition of the eligible credit or equity derivative.”⁴⁰

- *Other Eligible Hedges.* Under the Reproposed Rules, a Covered Company would be permitted to reduce its credit exposure to a counterparty “by the face amount of a share sale of the counterparty’s debt or equity securities, provided that the instrument in which the [Covered Company] has a short position is junior to . . . the instrument in which the [Covered Company] has the long position.”⁴¹

The Reproposed Rules specifically address securities financing transactions, unused credit lines, maturity mismatches, and credit transactions involving exempt and excluded persons.

- *Calculation of Net Credit Exposure for Securities Financing Transactions.* A Covered Company’s net credit exposure to a counterparty—in the context of Repos, Reverse Repos, and securities borrowing and lending transactions with a counterparty that is subject to a bilateral netting agreement with that counterparty and that meets the definition of a Repo-style transaction under Regulation Q—would be generally equal to the exposure at default amount calculated under Section 217.37(c)(2) of Regulation Q (applying the standard haircuts).⁴²
- *Treatment of Maturity Mismatches.* Where the residual maturity of the credit risk mitigant is less than that of the underlying exposure, the Reproposed Rules would only recognize the credit risk mitigant if the credit risk’s mitigant’s original maturity is “equal to or greater than one year and its residual maturity is not less than three months from the current date.” In such a scenario, the underlying exposure would be adjusted using the same approach that is provided under Regulation Q to address a maturity mismatch.⁴³
- *Unused Credit Lines.* In computing its net credit exposure to a counterparty for an unused credit line or revolving credit facility, a Covered Company would be permitted to reduce its gross credit exposure by “the amount of the unused portion of the credit extension to the extent that the [Covered Company] does not have any legal obligation to advance additional funds under the facility, until the counterparty provides collateral that qualified under the credit line or revolving credit facility equal to or greater than the entire used portion

⁴⁰ See Reproposed Rule § 252.74(e)(2)(i).

⁴¹ See NPRM, *supra* note 1 at 52 (citing Reproposed Rule § 252.74(f)).

⁴² See 12 C.F.R. 217.37(c)(3).

⁴³ See NPRM, *supra* note 1 at 53 (citing 12 C.F.R. § 217.36(d)).

of the facility.”⁴⁴

- *Credit Transactions Involving Exempt and Excluded Persons.* Where a Covered Company has reduced its credit exposure to a counterparty that would be exempt under the Reproposed Rules by “obtaining eligible collateral from that entity, or by obtaining an eligible guarantee or an eligible credit or equity derivative from an eligible protection provider,” the Covered Company must then “recognize an exposure to the collateral issuer or eligible protection provider to the same extent as if the underlying exposure were to an entity that is not exempt.” Likewise, where a Covered Company has reduced its exposure to an entity that is excluded from the definition of “counterparty” under the Reproposed Rules (*e.g.*, by obtaining eligible collateral from that entity or by obtaining an eligible guarantee or an eligible credit or equity derivative from an eligible protection provider), the Covered Company must recognize an exposure to the collateral issuer or eligible protection provider to the same extent as if the underlying exposure were to an entity that is not excluded from the definition of a counterparty.⁴⁵

Exposures to Funds and Securitizations

The Reproposed Rules would contain special considerations for measuring credit exposure of a Covered Company to a securitization fund, investment fund, or other special purpose vehicle (collectively, “SPVs”). Covered Companies with at least \$250 billion or more in total consolidated assets or \$10 billion or more in total on-balance-sheet foreign exposures would be required to “analyze their credit exposure to the issuers of the underlying assets in an SPV in which the [Covered Company] invests or to which the [Covered Company] otherwise has credit exposure.” If a Covered Company is unable to show that its exposure to the issuer of each underlying asset held by an SPV constitutes less than .25 percent of the Covered Company’s tier 1 capital, the Covered Company would then be required to apply a “look-through approach” and recognize an exposure to each issuer of the assets held by the SPV.⁴⁶ Conversely, where a Covered Company can demonstrate that its exposure to each underlying asset in an SPV is less than .25 percent of the Covered Company’s tier 1 capital, the Covered Company would be permitted to recognize an

⁴⁴ See Reproposed Rule § 252.74(g).

⁴⁵ See NPRM, *supra* note 1 at 52 (citing Reproposed Rule § 252.74(h)).

⁴⁶ See NPRM, *supra* note 1 at 57.

exposure solely to the SPV and not the underlying assets.⁴⁷

In the case of a Covered Company that is required to apply the “look-through approach” (but is unable to identify an issuer of assets underlying an SPV), the Covered Company would need to attribute the exposure to a single “unknown counterparty.”⁴⁸

Exemptions

As previously discussed, single-counterparty credit limits would not apply to exposures to the U.S. government or a foreign sovereign entity that receives a zero percent risk weight under Regulation Q, as such entities do not fall within the definition of a “counterparty.”⁴⁹ Additionally, Section 165(e) authorizes the Fed to issue a regulation or order to exempt transactions from the definition of “credit exposure” where it finds that such an exemption is in the “public interest and is consistent with the purposes of [Section 165(e)].”⁵⁰

The Reproposed Rules also expressly set forth exemptions from the single-counterparty credit limits, including:⁵¹

- for intraday credit exposures to a counterparty;⁵²
- for trade exposures to a central counterparty that meet the definition of a qualified central counterparty (“QCCP”) under Regulation Q, including potential future exposure arising from transactions cleared by a QCCP and pre-funded default fund contributions;⁵³
- for direct claims on, and the portions of claims that are directly and fully guaranteed as to principal and interest by, the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, while these entities are operating under the conservatorship or receivership of the Federal Housing Agency;⁵⁴ and
- a “catch-all” exemption for any transaction which the Fed determines to

⁴⁷ Reproposed Rule § 252.75.

⁴⁸ See NPRM, *supra* note 1 at 58.

⁴⁹ See *id.* at 61.

⁵⁰ See 12 U.S.C. § 5365(e)(6).

⁵¹ See Reproposed Rules § 252.77.

⁵² See Reproposed Rules § 252.77(a)(2).

⁵³ See Reproposed Rules § 252.77(a)(3).

⁵⁴ See Reproposed Rules § 252.77(a)(1).

be in the public interest and consistent with the purposes of Section 165(e).⁵⁵

Lastly, the Reproposed Rules would implement Section 165(e)(6) of the Dodd-Frank Act, which further exempts credit exposures to Federal Home Loan Banks.⁵⁶

Compliance

Covered Companies with less than \$250 billion in total consolidated assets and \$10 billion in total on-balance-sheet foreign exposures would be required to (i) demonstrate compliance with the Reproposed Rules on a quarterly basis and (ii) submit a quarterly compliance report to the Fed.⁵⁷ Covered Companies with \$250 billion or more in total consolidated assets or at least \$10 billion in total on-balance-sheet foreign exposures would be required to (i) comply with the Reproposed Rules on a daily basis as of the end of each business day and (ii) submit a monthly compliance report to the Fed.⁵⁸

Where a Covered Company fails to comply with the requirements of the Reproposed Rules solely due to (1) a decrease in the Covered Company's capital stock and surplus, (2) the merger of the Covered Company with another Covered Company, (3) a merger of two unaffiliated counterparties, or (4) any other circumstance the Fed determines is appropriate, such a Covered Company will be granted a "temporary exception" from enforcement actions for a period of 90 days if the Covered Company "uses reasonable efforts to return to compliance . . . during this period."⁵⁹

However, a Covered Company will be prohibited from engaging in any additional credit transactions with a counterparty in contravention of the Reproposed Rules during the 90-day period, except where the Fed determines that "such credit transactions are necessary or appropriate to preserve the safety and soundness of the [Covered Company] or U.S. financial stability."⁶⁰ The Fed may additionally impose any additional supervisory oversight and reporting

⁵⁵ See Reproposed Rules § 252.71(a)(4).

⁵⁶ See 12 U.S.C. § 5365(e)(6).

⁵⁷ See Reproposed Rules § 252.78(a).

⁵⁸ *Id.*

⁵⁹ See Reproposed Rules § 252.78(c). The 90-day period may instead be amended to "such other period determined by the [Fed] to be appropriate to preserve the safety and soundness of the [Covered Company] or U.S. financial stability[.]" *Id.*

⁶⁰ *Id.*

measures that it deems appropriate to monitor compliance with the granting of any temporary exception.⁶¹

Timing

Covered Companies with total consolidated assets of less than \$250 billion and less than \$10 billion in total on-balance-sheet foreign exposures would be required to comply with the Reproposed Rules within two years of the effective date of the Reproposed Rules.⁶² Covered Companies with at least \$250 billion or more in total consolidated assets or at least \$10 billion in total on-balance-sheet foreign exposures would be required to comply with the Reproposed Rules within one year from the effective date of the Reproposed Rules.⁶³ However, the Fed would be able to extend either conformance period if provided in writing.⁶⁴

An entity that becomes subject to the Reproposed Rules after its effective date would be required to comply with the Reproposed Rules beginning on the “first day of the fifth calendar quarter after it becomes [subject to the Reproposed Rules], unless that time is accelerated or extended by the [Fed] in writing.”⁶⁵

Reproposed Rules for Covered FBOs and IHCs (Covered Entities)

Exposure Limit Categories

As in the case of Covered Companies, the aggregate net credit exposure of Covered Entities with total consolidated assets of at least \$50 billion to a single counterparty (*i.e.*, Covered Entities) would also be subject to one of three increasingly stringent credit exposure limits.⁶⁶ However, the credit exposure limits as applied to a Covered FBO would only apply with respect to credit exposures of the FBO’s combined U.S. operations (although the FBO’s total

⁶¹ Reproposed Rules § 252.78(d). While not expressly provided for in the Reproposed Rules, the Fed intends to develop reporting forms for Covered Companies and Covered Entities to “use to report credit exposures to their counterparties as those credit exposures would be measured under section 165(e).” See NPRM, *supra* note 1 at 65.

⁶² Reproposed Rules § 252.70(g)(1).

⁶³ Reproposed Rules § 252.70(g)(2).

⁶⁴ Reproposed Rules § 252.70(g)(1)–(2).

⁶⁵ Reproposed Rules § 252.70(h).

⁶⁶ See NPRM, *supra* note 1 at 67.

consolidated assets on a global basis would determine whether the credit exposure limits apply).⁶⁷

- *Category 1.* The first category of exposure limits would apply to Covered Entities with less than \$250 billion in total consolidated assets and less than \$10 billion in on-balance-sheet foreign exposures.⁶⁸ Such Covered Entities would be prohibited from having aggregate net credit exposure to an unaffiliated counterparty that exceeds 25 percent of the Covered Entity’s “capital stock and surplus.”⁶⁹
- *Category 2.* The second category of exposure limits would prohibit any Covered Entity with at least \$250 billion in total consolidated assets or \$10 billion in total on-balance-sheet foreign exposures (but less than \$500 billion in total consolidated assets) from maintaining aggregate net credit exposure to an unaffiliated counterparty that exceeds 25 percent of the Covered Entity’s tier 1 capital.
- *Category 3.* The third category of exposure limits would prohibit any Covered Entity with total consolidated assets of at least \$500 billion (a “Major Covered Entity”) from maintaining (a) aggregate net credit exposures greater than 15 percent of the tier 1 capital of the Major Covered Entity to a Major Counterparty; and (b) 25 percent of the tier 1 capital of the Major Covered Entity to any other counterparty.⁷⁰

While the Reproposed Rules for Covered Entities are largely analogous to those for Covered Companies, there are certain differences, which are summarized below.

Gross Credit Exposures

The valuation rules for Covered Entities for measuring “gross credit exposure” to a counterparty would largely be the same as those for Covered

⁶⁷ *Id.* at 67–68.

⁶⁸ *Id.* at 68.

⁶⁹ “Capital stock and surplus” is defined differently as applied to a Covered IHC or Covered FBO due to differences in international accounting standards. Specifically, in the case of a Covered U.S. IHC, “capital stock and surplus” is defined as the “sum of the [U.S. IHC’s] total regulatory capital, as calculated under the risk-based capital adequacy guidelines applicable to the [U.S. IHC], plus the balance of the ALLL of the U.S. IHC not included in tier 2 capital under the capital adequacy guidelines.” See NPRM, *supra* note 1 at 68. For a Covered FBO, “capital stock and surplus” is defined as “the total regulatory capital of the [FBO] on a consolidated basis, as determined in accordance with section 252.171(d) of the Reproposed Rule.” *Id.*

⁷⁰ See NPRM, *supra* note 1 at 69.

Companies, except that the proposed valuation rules for derivatives exposures of U.S. branches and agencies would also be subject to a “qualifying master netting agreement.”⁷¹ In calculating a U.S. branch or agency’s gross credit exposure to a counterparty for a derivative contract that is subject to a qualifying master netting agreement, a Covered Entity could choose either to use: (1) the exposure at default calculation (as set forth under the Fed’s advanced approaches capital rules); or (2) the gross valuation methodology for derivatives not subject to a qualified master netting agreement.⁷²

Net Credit Exposure

Like for Covered Companies, the Reproposed Rules specify that a Covered Entity would, when determining its gross credit exposure amount, take into account (i) eligible collateral, (ii) eligible guarantees, (iii) eligible credit and equity derivatives, (iv) other eligible hedges, and (v) the effect of bilateral netting agreements (in the case of securities financing transactions). However, unlike for Covered Companies, the definition of “eligible collateral” for a Covered Entity would exclude debt or equity securities (such as convertible bonds) issued by a U.S. IHC’s affiliate or the combined U.S. operations of an FBO. Furthermore, the definition of “eligible protection provider” would exclude the FBO (or any of its affiliates).⁷³

Exemptions

In addition to the exemptions provided for the credit exposure limits of Covered Companies, the Reproposed Rules would provide an additional exemption for an FBO’s exposures to its home country sovereign (irrespective of the risk weight assigned to that sovereign under Regulation Q).⁷⁴

Compliance

An IHC or the combined U.S. operations of an FBO with less than \$250 billion in total consolidated assets and \$10 billion in total on-balance-sheet foreign exposures would be required to comply with the Reproposed Rules’ requirements as of the end of each quarter.⁷⁵ Any other IHC or FBO subject

⁷¹ See Reproposed Rules § 252.173(a)(11).

⁷² *Id.*

⁷³ See NPRM, *supra* note 1 at 75; Reproposed Rules § 252.171(k).

⁷⁴ See Reproposed Rules § 252.177(a).

⁷⁵ See Reproposed Rules § 252.178(a).

to the Reproposed Rules would be required to comply with the Reproposed Rules' requirements on a daily basis as of the end of each business day, as well as submit a monthly compliance report demonstrating compliance on a daily basis.⁷⁹ An FBO would also need to ensure the compliance of its U.S. IHC and its combined U.S. operations.⁷⁷

If either a U.S. IHC or the combined U.S. operations of a Covered FBO are not compliant with respect to a particular counterparty, then both the U.S. IHC and the combined U.S. operations would be prohibited from engaging in any additional credit transactions with such a counterparty, unless the Fed finds that such additional credit transactions "are necessary or appropriate to preserve the safety and soundness of the [FBO] or financial stability" (*i.e.*, provide a temporary exception).⁷⁸ As with Covered Companies, the Fed may impose supervisory oversight and reporting measures over such temporary exceptions that it determines are necessary to monitor compliance with the Reproposed Rules.⁷⁹

Timing

Covered Entities with less than \$250 billion in total consolidated assets and less than \$10 billion in total on-balance-sheet foreign assets would be required to comply with the Reproposed Rules within two years from the Reproposed Rules' effective date.⁸⁰ Covered Entities with at least \$250 billion in total consolidated assets or \$10 billion in total on-balance-sheet foreign assets would be required to comply with the Reproposed Rules within one year from the effective date of the Reproposed Rules.⁸¹ However, the Fed would be able to extend either conformance period if provided in writing.⁸²

THE FED'S WHITE PAPER

The White Paper, which was released in conjunction with the Reproposed

⁷⁹ *See id.*

⁷⁷ *Id.*

⁷⁸ *See* Reproposed Rules § 252.178(c).

⁷⁹ *See* Reproposed Rules § 252.178(d).

⁸⁰ *See* Reproposed Rules § 252.170(c)(1)(i)-(c)(2)(i).

⁸¹ *See* Reproposed Rules § 252.170(c)(1)(ii)-(c)(2)(ii). Like a Covered Company, any FBO or IHC that becomes a Covered Entity after the effective date of the Reproposed Rule would be required to comply with the Reproposed Rule "beginning on the first day of the fifth calendar quarter after it becomes a covered entity" (unless that period is accelerated or extended by the Fed in writing). *See* Reproposed Rules § 252.170(d).

⁸² *See* Reproposed Rules § 252.170(c)(1)-(2).

Rules, sets forth the Fed's rationale for imposing more stringent credit exposure limits on exposures between SIFIs and Major Counterparties.⁸³ The Fed posits in the White Paper that because the failure of a SIFI could more significantly undermine financial stability as compared to a less systemically important institution, the "single-counterparty credit limit that applies when a [SIFI] faces another [SIFI] must reflect the greater risk that arises in the context of such inter-SIFI credit exposures."⁸⁴ Accordingly, the White Paper theorizes that SIFIs should be subject to a more stringent single-counterparty credit limit (of 15 percent) for credit extensions between SIFIs (the "inter-SIFI credit concentration limit"), as opposed to the statutory limit of 25 percent.⁸⁵

The White Paper describes in significant detail the quantitative credit risk model (the "Risk Model") that was utilized to inform the calibration of the inter-SIFI credit concentration limit.⁸⁶ Pursuant to the Risk Model, "setting the inter-SIFI limit at the original 25 percent limit results in a larger default probability than the SIFI to non-SIFI case, because the correlation between the assets of the credit-granting SIFI and the SIFI borrower are highly correlated relative to the non-SIFI borrower."⁸⁷ However, the probability of default declines as the inter-SIFI limit is tightened.⁸⁸ The Fed does, however, acknowledge in the White Paper certain qualifications for the Risk Model and the Fed's findings. For example, the particular results documented may be the result of the Risk Model being "calibrated in a particular way."⁸⁹ Moreover, the Risk Model analysis does not reflect (i) "the greater social costs associated with multiple SIFI defaults relative to a situation in which a SIFI defaults relative to a situation in which a SIFI entered default as the rest of a default of a non-SIFI," or (ii) "the additional knock on effects that could reverberate through the financial system following a multiple SIFI default event."⁹⁰

⁸³ See Board of Governors of the Federal Reserve System, Calibrating the Single-Counterparty Credit Limit between Systemically Important Financial Institutions, Mar. 4, 2016, available at <http://www.federalreserve.gov/aboutthefed/boardmeetings/sccl-paper-20160304.pdf>.

⁸⁴ See *id.* at 4.

⁸⁵ *Id.*

⁸⁶ See *id.* at 5–7.

⁸⁷ See *id.* at 9.

⁸⁸ *Id.*

⁸⁹ *Id.* at 10.

⁹⁰ *Id.*

SUMMARY CHART

COVERED COMPANIES (U.S. BHCs)			
Category	Category of Covered Company	Applicable Limits	Compliance Requirements
Category I	< \$250 billion in total consolidated assets <i>and</i> < \$10 billion in on-balance sheet foreign exposures	<ul style="list-style-type: none"> Aggregate net credit exposure must be $\leq 25\%$ of Covered Company's total regulatory capital plus ALLL 	<ul style="list-style-type: none"> Must comply with the Reproposed Rules' requirements as of the <i>end of each quarter</i> Must have system in place to calculate compliance on a <i>daily basis</i>
Category II	\geq \$250 billion in total consolidated assets <i>or</i> \geq \$10 billion or more in on-balance-sheet foreign exposures (<i>but not a Major Covered Company</i>)	<ul style="list-style-type: none"> Aggregate net credit exposure must be $\leq 25\%$ of Covered Company's tier 1 capital 	<ul style="list-style-type: none"> Must comply on a <i>daily basis</i> as of the end of each business day Must submit a <i>monthly compliance report</i> demonstrating daily compliance
Category III	Major Covered Companies (<i>i.e.</i> , G-SIBs)	<ul style="list-style-type: none"> Aggregate net credit exposure to a <i>Major Counterparty</i> must be $\leq 15\%$ of Major Covered Company's tier 1 capital Aggregate net credit exposure to <i>any other counterparty</i> must be $\leq 25\%$ of Major Covered Company's tier 1 capital 	

COVERED ENTITIES (FBOs; IHCs)			
Category	Category of Covered Entity	Applicable Limits	Compliance Requirements
Category I	FBO or U.S. IHC with < \$250 billion in total consolidated assets <i>and</i> < \$10 billion in on-balance-sheet foreign exposures	<ul style="list-style-type: none"> • <i>For IHC</i>: Aggregate net credit exposure must to a counterparty be $\leq 25\%$ of IHC's total regulatory capital (plus the balance of its ALLL not included in tier 2 capital under the capital adequacy guidelines) • <i>For FBO</i>: Aggregate net credit exposure to a counterparty must be (with respect to FBO's combined operations) $\leq 25\%$ of FBO's total regulatory capital on a consolidated basis 	<ul style="list-style-type: none"> • Must comply with the Reproposed Rules' requirements as of the <i>end of each quarter</i>
Category II	FBO or U.S. IHC with \geq \$250 billion in total consolidated assets <i>or</i> \geq \$10 billion in on-balance-sheet foreign exposures	<ul style="list-style-type: none"> • <i>For IHC</i>: Aggregate net credit exposure to a counterparty must be $\leq 25\%$ of IHC's tier 1 capital • <i>For FBO</i>: Aggregate net credit exposure to a counterparty must be (with respect to FBO's combined operations) $\leq 25\%$ of FBO's total worldwide tier 1 capital 	<ul style="list-style-type: none"> • Must comply on a <i>daily basis</i> as of the end of each business day • Must submit a <i>monthly compliance report</i> demonstrating daily compliance
Category III	Major Covered Entities (<i>i.e.</i> , Major U.S. IHCs and Major FBOs)	<ul style="list-style-type: none"> • Aggregate net credit exposure of Major Covered Entity to a <i>Major Counterparty</i> must be $\leq 15\%$ of Major Covered Entity's tier 1 capital • Aggregate net credit exposure for Major Covered Entity to any other counterparty must be $\leq 25\%$ of Major Covered Entity's tier 1 capital 	<ul style="list-style-type: none"> • FBO must ensure compliance of its U.S. IHC and combined U.S. operations