CLIENT ALERT

Federal Reserve Reproposes Rules on Single-Counterparty Credit Limits for Large Banking Organizations

Continuing its implementation of Section 165(e) of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (*Dodd-Frank Act*), the Federal Reserve Board (Federal Reserve) reproposed its long-anticipated rule that would establish single-counterparty credit limits (SCCLs) for large banking organizations on March 4, 2016. Intended to impose limits on the amount of credit exposure these organizations can have to an unaffiliated company ("counterparty"[1]) in order to reduce the risks arising from that counterparty's failure, the reproposed rules would apply to: 1) U.S. bank holding companies (BHCs) with at least $50 billion in total consolidated assets ("covered companies"[2]) and 2) foreign banking organizations (FBOs) operating in the United States with at least $50 billion in total consolidated assets and any U.S. intermediate holding company (IHC) of an FBO (collectively, "covered entities"[3]). The reproposal builds upon earlier proposed rulemakings released by the Federal Reserve Board in 2011 and 2012,[4] and includes some modifications based on comments received from banks, industry and trade associations, and public interest groups. Additionally, the Federal Reserve notes that the reproposal seeks to promote global consistency by generally following the 2014 supervisory framework for measuring and controlling large exposures released by the Basel Committee on Banking Supervision (BCBS framework).[5] Lastly, the Federal Reserve released an accompanying white paper[6] that explains the analytical and quantitative reasoning for the reproposal's more stringent 15 percent limit for credit exposures between global systemically important financial institutions, compared to the 25 percent statutory credit limit mandated by the *Dodd-Frank Act*.

In summary: Tailored to increase in stringency as the systemic footprint of a firm increases, the reproposed SCCLs would reinforce the Federal Reserve's stated intent to reduce the systemic impact of the largest banking organizations due to their interconnectedness in relation to other financial institutions and the financial sector as a whole. Although the reproposed methodology would be based on size alone for covered entities with at least $500 billion in total consolidated assets (i.e., "major covered entities"[7]), it would indirectly factor in size, complexity, interconnectedness, cross-border exposure, and substitutability for covered companies identified as global systemically important bank holding companies (G-SIBs) under the Federal Reserve's G-SIB capital surcharge rule[8] (i.e., "major covered companies"[9]). In alignment with the BCBS framework, the reproposal retains the previously proposed 25 percent limit of a covered company's total capital stock and surplus for most exposures, but would impose a tighter limit of 15 percent of a G-SIB's tier 1 capital base for exposures that the G-SIB could have to a major counterparty. Under the reproposal, a "major counterparty" would be defined as 1) any major covered company and all of its subsidiaries, collectively; 2) any FBO and all of its

[1] See Single-Counterparty Credit Limits for Large Banking Organizations – Notice proposed rulemaking.
[2] Ibid.
[3] Ibid.
[4] Although first included as a part of the Federal Reserve's proposed Enhanced Prudential Standards (EPS) rulemaking, SCCLs were not included in the final EPS rule (*Regulation YY*). See KPMG's Regulatory Practice Letter 14-07.
[5] See Supervisory framework for measuring and controlling large exposures – final standard.
[6] See Calibrating the Single-Counterparty Credit Limit between Systemically Important Financial Institutions.
[7] See Single-Counterparty Credit Limits for Large Banking Organizations – Notice proposed rulemaking.
[8] See *12 CFR Part 217.402* of *Regulation Q*.
[9] See Single-Counterparty Credit Limits for Large Banking Organizations – Notice proposed rulemaking.

subsidiaries, collectively, that would be considered a global systemically important FBO; or 3) any nonbank financial company designated by the Financial Stability Oversight Council (FSOC) for supervision by the Federal Reserve.[10] Although based on the more stringent tier 1 capital base, this 15 percent exposure limit to a major counterparty could provide some relief from the previously proposed 10 percent capital stock and surplus limit for exposures that BHCs with more than $500 billion in total consolidated assets could have to similarly sized BHCs or nonbank financial companies supervised by the Federal Reserve. The reproposal would also apply this more stringent measure of tier 1 capital to covered companies and covered entities with at least $250 billion in total consolidated assets or at least $10 billion in on-balance sheet foreign exposures. For covered companies falling under these thresholds, the reproposal retains the previously proposed measure of total capital stock and surplus, defined in the reproposal as total regulatory capital plus allowance for loan and lease losses (ALLL). Similarly tailored requirements would also be established for covered entities. The reproposed credit exposure limits for covered companies and covered entities are summarized in Table 1.

Table 1: SCCLs Applicable to Covered Companies and Covered Entities

Category	Applicable Credit Exposure Limit
Covered companies and covered entities that have less than $250 billion in total consolidated assets and less than $10 billion in on-balance-sheet foreign exposures	• Aggregate net credit exposure of a **covered company** to a counterparty cannot exceed 25 percent of the covered company's total regulatory capital plus ALLL • Aggregate net credit exposure of an **FBO**, with respect to its combined U.S. operations, to a counterparty cannot exceed 25 percent of the FBO's total regulatory capital on a consolidated basis • Aggregate net credit exposure of an **IHC** to a counterparty cannot exceed 25 percent of the IHC's total regulatory capital plus the balance of its ALLL not included in its tier 2 capital under the capital adequacy guidelines in *12 CFR Part 252* of *Regulation YY*
Covered companies and covered entities that have at least $250 billion in total consolidated assets or at least $10 billion in on-balance-sheet foreign exposures, but are not major covered companies or major covered entities	• Aggregate net credit exposure of a **covered company** to a counterparty cannot exceed 25 percent of a covered company's tier 1 capital • Aggregate net credit exposure of an **FBO**, with respect to its combined U.S. operations, to a counterparty cannot exceed 25 percent of the FBO's worldwide tier 1 capital • Aggregate net credit exposure of an **IHC** to a counterparty cannot exceed 25 percent of the IHC's tier 1 capital
Major covered companies (i.e., any U.S. BHC identified as a G-SIB, and all of its subsidiaries) and major covered entities (i.e., any FBO or IHC with at least $500 billion in total consolidated assets)	• Aggregate net credit exposure of a **major covered company** to a major counterparty cannot exceed 15 percent of a major covered company's tier 1 capital • Aggregate net credit exposure of a **major covered company** to other counterparties cannot exceed 25 percent of a major covered company's tier 1 capital • Aggregate net credit exposure of a **major IHC** or, with respect to its combined U.S. operations, a **major FBO** to a major counterparty cannot exceed 15 percent of the major covered entity's tier 1 capital • Aggregate net credit exposure of a **major IHC** or, with respect to its combined U.S. operations, a **major FBO** to other counterparties cannot exceed 25 percent of the major covered entity's tier 1 capital

[10] Ibid.

Incentives for central clearing: In order to support the benefits of centralized clearing and prevent the spreading of covered companies' activities across a greater number of central counterparties, the reproposal would exempt trade exposures to a central counterparty meeting the definition of a qualifying central counterparty (QCCP) under *Regulation Q* related to a covered company's clearing activity. This would include potential future exposure arising from transactions cleared by a QCCP and pre-funded default contributions.

Additional categories of credit transactions that would be exempted from SCCLs include: 1) intraday credit exposures to a counterparty, 2) exposures to the U.S. government or foreign sovereign entities receiving a zero percent risk weight under *Regulation Q's* capital requirements, and 3) exposures to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, while these government-sponsored entities (GSEs) are operating under the conservatorship or receivership of the Federal Housing Finance Agency. Obligations issued by other U.S. GSEs would also be exempted, as determined by the Federal Reserve.

Nonbank financial companies exempted: Notably, the reproposed rules would not apply to nonbank financial companies designated by the FSOC for supervision by the Federal Reserve. Rather, consistent with the rationale offered with the adoption of *Regulation YY*, the Federal Reserve states that it intends to apply similar requirements to these companies separately by rule or order at a later date.

Exposure analysis, aggregation, and reporting implications: In cases where total exposures to a single counterparty exceed 5 percent of the covered company's eligible capital base (i.e., total regulatory capital plus ALLL or tier 1 capital for covered companies with at least $250 billion in total consolidated assets or at least $10 billion in total foreign exposures), the covered company would be required to aggregate its exposures to that counterparty and other counterparties that are "economically interdependent"[11] with the first counterparty. The Federal Reserve states that the purpose of this proposed requirement would be to limit a covered company's overall credit exposure to two or more counterparties where the underlying risk of one counterparty's financial distress or failure would cause the financial distress or failure of the other counterparty. Under the reproposal, two counterparties would be considered economically interdependent if one counterparty were to experience financial problems as the result of another counterparty experiencing financial problems.

Determining whether two entities are economically interdependent will likely pose significant challenges for covered companies, as this analysis would be based on multiple factors that may not be readily available. Under the reproposal, a covered company would be required to take certain considerations into account including:

- Whether 50 percent of one counterparty's gross receipts or gross expenditures are derived from transactions with the other counterparty;
- Whether one counterparty has fully or partly guaranteed the exposure of 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;
- Whether a significant part of one counterparty's production or output is sold to the other counterparty, which cannot easily be replaced by other customers;
- Whether 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;
- Whether 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

[11] Ibid.

- When both counterparties rely on the same source for the majority of their funding and, in the event of the common provider's default, an alternative provider cannot be found.

In addition to the economic interdependence analysis and aggregation requirements, covered companies would be required to aggregate their net credit exposure to multiple counterparties that are connected to each other by certain "control relationships,"[12] which would include factors such as the presence of voting agreements and the ability of one counterparty to influence the governing body, management, or policies of another counterparty.

Lastly, covered companies with at least $250 billion in total consolidated assets or at least $10 billion in total on-balance sheet foreign exposures would be required to calculate their exposure on a daily basis and report their compliance with these daily exposure calculations on a monthly basis. Covered companies falling under these thresholds would be required to calculate their exposure quarterly and report their compliance with these quarterly calculations on a quarterly basis. Taken in aggregate, the structural changes likely needed to support these enhanced requirements, including governance, data collection, and reporting implications, could be significant for most firms.

Potentially alluding to the possibility of future refinements to the reproposal, Federal Reserve Governor Daniel Tarullo noted that "this regulation would complement overall capital requirements, which are generally based on the size and nature of a bank's assets, but does not address the concentration of risk in specific borrowers or counterparties."

Comments on the reproposal are due to the Federal Reserve by June 3, 2016.

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[12] Ibid.