Federal Reserve Adopts Single-Counterparty Credit Limits

On June 14, 2018, the Board of Governors of the Federal Reserve System ("Federal Reserve") finalized single-counterparty credit limits ("SCCLs") for US and non-US banking organizations ("Final Rules").[1] The Final Rules retain the overall approach of the re-proposal issued by the Federal Reserve in March 2016 ("Reproposal"), but changes have been made to address comments on the Reproposal and to partially incorporate the changes made by the recently enacted Crapo Act.[2] At the same time it adopted the Final Rules, the Federal Reserve also proposed SCCL reporting requirements that are subject to a 60-day comment period.

The Final Rules impose limits on the aggregate amount of net credit exposure that a covered company (defined in the next paragraph) may have to an unaffiliated counterparty. Depending on the size and regulatory status of the parties, these limits will range from 25 percent of total capital plus ALLL to 15 percent of tier 1 capital. Attached in Appendix A is a chart that summarizes the limits that apply under the Final Rules.[3] Below we summarize the changes that have been made to the Final Rules and the proposed reporting requirements.

Narrower Overall Scope. The Final Rules apply to (i) US global systemically important banks ("G-SIBs"), (ii) US bank holding companies ("US BHCs") with $250 billion or more in total assets, (iii) the US operations of foreign banking organizations ("FBOs") that have $250 billion or more in total global assets and (iv) intermediate holding companies ("IHC") with $50 billion or more in total assets (collectively, "covered companies").[4] The Federal Reserve estimates that the Final Rules will apply to the eight US G-SIBs, two US BHCs, 82 FBOs and 12 IHCs.

The thresholds used in the Final Rules are consistent with the changes that the Crapo Act made to Section 165 of the Dodd-Frank Act and stand in contrast to the Reproposal, which would have applied to all US BHCs, FBOs and IHCs with at least $50 billion in consolidated assets. While the Final Rules apply to a smaller set of banking organizations than the Reproposal, the thresholds for FBOs continue to be tied to global total consolidated assets, which is why the Final Rules will apply to nearly 10 times as many FBOs as US BHCs and US G-SIBs combined. Moreover, an IHC that is also a bank holding company would be subject to a $50 billion threshold, while a US BHC would have the $250 billion threshold.

The Federal Reserve notes in the preamble to the Final Rules that it is developing a comprehensive proposal on the application of enhanced prudential standards to FBOs with between $100 billion and $250 billion in global total assets (including any subsidiary IHCs). The staff memo also states that the Federal Reserve is developing a proposal on the extent to which enhanced prudential standards should be applied to banking organizations with between $100 billion and $250 billion in total assets.

Narrower Definition of Major FBO. The Final Rules adopted a revised version of the definition of "major FBO" to rely more strongly on global methodology issued by the Basel Committee on Banking Supervision ("BCBS") and eliminate the Reproposal's $500 billion in total global assets

triggering threshold. This has the effect of removing the US operations of larger FBOs that are not considered G-SIBs by the Financial Stability Board from the most restrictive variant of the SCCL (15 percent of tier 1 capital).

Substituted Compliance for Certain FBOs. The Final Rules allow the combined US operations of an FBO to comply by having the FBO certify to the Federal Reserve that the FBO complies with a home country large exposures or SCCL regime that is consistent with the BCBS's large exposures framework.[5] This revision aligns the Federal Reserve's approach to SCCL with its approach to FBO stress testing under Section 165 of the Dodd-Frank Act. FBOs based in jurisdictions that have not adopted a regime that is consistent with the BCBS's large exposures framework will need to comply with the Final Rules in substantially the same manner as was contemplated in the Reproposal, as modified by the changes made in the Final Rules—i.e., their combined US operations would need to comply with the Final Rules with respect to net credit exposures to counterparties.

Consolidation Standard. The Final Rules apply to top-tier covered companies and their subsidiaries on a consolidated basis with respect to exposures of the covered company to a single counterparty and its affiliates. The Final Rules define "subsidiary" and "affiliate" by reference to financial consolidation rules under relevant accounting standards rather than to the "control" test of the Bank Holding Company Act referenced in the Reproposal.[6] Consolidated joint ventures are treated as subsidiaries, even if they are co-owned with a counterparty, and a covered company's unconsolidated, minority-owned joint ventures are treated as counterparties of the covered company.

The change to the consolidation standard applies to the determination of both the covered company and the counterparty. It should result in less complexity and a decreased burden in identifying entities and exposures that are subject to the SCCL. This change also will be welcome by covered companies that use consolidated funding vehicles that are controlled by third parties to fund structured finance and other customer transactions.

Covered Counterparties. In addition to private entities, covered counterparties under the Final Rules would continue to include non-US sovereign governments that do not receive a zero percent risk weight and US state governments and their subdivisions. Provincial subdivisions of foreign sovereign governments would be treated as separate counterparties in the same fashion as US states.

The Final Rules retain the exclusions and exemptions in the Reproposal (e.g., for intraday credit exposures and credit exposures to Fannie Mae and Freddie Mac while they remain in conservatorship and to qualified central counterparties) and add exemptions for any credit transaction with the Bank for International Settlements, the International Monetary Fund, members of the World Bank Group, the European Commission and the European Central Bank. The Final Rules add exclusions for (i) counterparties who are natural persons if the covered company's exposure to the person is five percent or less of its tier 1 capital[7] and (ii) for any covered company that is an FBO, the non-US sovereign entity that is such covered company's home country sovereign.

Internal Models for Derivatives and SFTs. Unlike in the Reproposal, the Final Rules allow a covered company to calculate its exposure to a derivative or securities financing transaction ("SFT") counterparty using any methodology that the covered company is authorized to use under the risk-based capital rules, including internal models.

Clearer Aggregation Requirements. The Final Rules retain the "economic interdependence" and "control" tests for aggregating exposures to connected counterparties. However, a covered company is required to assess compliance with the economic interdependence *and* control tests only in cases in which the covered company has an exposure to a counterparty that exceeds five percent of such covered company's tier 1 capital.[8] Additionally, the Final Rules clarify the factors that would require a covered company to aggregate

counterparties under the two tests (e.g., reframing the test for assessing guarantees of credit exposures to use a quantitative formula instead of subjective determinations). Furthermore, the Final Rules allow covered companies to request a determination from the Federal Reserve that two counterparties are not economically interdependent or controlled, even if one or more regulatory factors suggesting aggregation are met.

Narrower Aggregation Requirements for Smaller IHCs. The Final Rules revise the aggregation requirements to exempt IHCs with less than $250 billion in total assets from having to analyze exposures under the "economic interdependence" and "control" tests.

Partial Look-Through Approach for SPVs. The Final Rules revise the requirement that certain covered companies look through special purpose vehicles ("SPVs") to analyze their credit exposure to the underlying issuers. The Final Rules require relevant covered companies to look through SPVs only with respect to underlying assets for which the exposure value is at least 0.25 percent of the covered company's eligible capital base, even if that covered company cannot demonstrate that its exposure to each underlying asset in the SPV is less than 0.25 percent of its tier 1 capital. However, unlike under the Reproposal, covered companies are no longer required to aggregate exposures to unknown issuers into a single exposure, which would be subject to analysis as an exposure to a single counterparty under the SCCL if it exceeded the 0.25 percent threshold.

Narrower Third-Party Exposure Analysis Requirement. The Final Rules narrow the circumstances under which a covered company must recognize a gross credit exposure to third-parties with certain types of relationships with an SPV. Under the Final Rules, a covered company must recognize a gross credit exposure to a third party only if the third party provides credit or liquidity support to the SPV.

Revised Compliance Timing. The Final Rules adopt a revised compliance timeline under which US G-SIBs and FBOs that are G-SIBs must comply by January 1, 2020, and other covered companies must comply by July 1, 2020.

Proposed Reporting Requirements. The Federal Reserve has proposed creating a new Form FR 2590 on which covered companies would report quarterly on their compliance with the Final Rules. The FR 2590 would capture a covered company's credit status as a major or non-major covered company and its exposures to its top 50 counterparties, among other metrics.

The FR 2590 also would be the means by which a qualifying FBO would certify that its home country large exposure or SCCL regime is consistent with the BCBS's large exposures framework. Such qualifying FBOs would be exempt from having to complete the remainder of the FR 2590.

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Appendix A

SUMMARY OF SCCLS UNDER THE FINAL RULES[9]

CATEGORY OF COVERED COMPANY	APPLICABLE NET CREDIT EXPOSURE LIMIT TO A COUNTERPARTY
US BHCs with Total Consolidated Assets of Less Than $250 Billion That Are Not US G-SIBs	None; Not a Covered Company
US BHCs with Total Consolidated Assets of $250 Billion or More That Are Not US G-SIBs	25 Percent of Tier 1 Capital
US BHCs That Are US G-SIBs	15 Percent of Tier 1 Capital for a Major Covered Company Counterparty
	25 Percent of Tier 1 Capital for All Other Counterparties
US Operations of FBOs with Total Consolidated Global Assets of Less Than $250 Billion	None; Not a Covered Company
US Operations of FBOs with Total Consolidated Global Assets of $250 Billion or More That Are Not G-SIBs	25 Percent of FBO's Tier 1 Capital
US Operations of FBOs That Are G-SIBs	15 Percent of FBO's Tier 1 Capital for a Major Covered Company Counterparty
	25 Percent of FBO's Tier 1 Capital for All Other Counterparties
US IHCs with Total Consolidated Assets of $50 Billion or More but Less Than $250 Billion	25 Percent of IHC's Total Capital Plus Excess ALLL
US IHCs with Total Consolidated Assets of $250 Billion or More but Less Than $500 Billion	25 Percent of IHC's Tier 1 Capital
US IHCs with Total Consolidated Assets of $500 Billion or More	15 Percent of IHC's Tier 1 Capital for a Major Covered Company Counterparty
	25 Percent of IHC's Tier 1 Capital for All Other Counterparties

Endnotes

[1] *Federal Reserve Board approves rule to prevent concentrations of risk between large banking organizations and their counterparties from undermining financial stability* (June 14, 2018), *available at* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180614a.htm.

[2] Please see our Legal Update on the Crapo Act at https://www.mayerbrown.com/Congress-Passes-Regulatory-Reform-for-Financial-Institutions-05-22-2018/.

[3] Please see our 2016 Legal Update on the Reproposal for a more detailed discussion of the contours of the SCCL (subject to the changes identified in this 2018 Legal Update) at https://www.mayerbrown.com/Federal-Reserve-Re-proposes-Single-Counterparty-Credit-Limits-for-US-and-Non-US-Banking-Organizations-03-24-2016/.

[4] Currently, all IHCs with $50 billion or more in total assets are subsidiaries of FBOs with $250 billion or more in total assets.

[5] As of April 2018, only four of 27 BCBS member jurisdictions (i.e., Australia, India, Saudi Arabia and Switzerland) had finalized large exposures regimes. *See* BCBS, *Fourteenth progress report on adoption of the Basel regulatory framework* (April 23, 2018). The BCBS has announced that it intends to publish evaluations of its member jurisdictions' implementations of the large exposures framework beginning in September 2018 and concluding in September 2020. *See* BCBS, *RCAP assessment schedule for member countries* (March 12, 2018).

[6] The preamble to the Final Rules clarifies that a covered company must treat an investment fund as a subsidiary for any period the company is required to consolidate the fund onto its financial statements, for example, during a seeding period.

[7] Covered companies also are exempt from the aggregation requirement with respect to a natural person and their immediate family members if the company's exposure to the person is five percent or less of its tier 1 capital.

[8] The Federal Reserve determined that, since 2012, the eight US G-SIBs would have triggered the five percent threshold under the economic interdependency test a total of 20 times per year.

[9] This chart assumes that the FBO is *not* subject on a consolidated basis to a large exposures or SCCL regime by its home-country regulator that is consistent with the large exposures framework published by the BCBS.