Client Update
Federal Reserve Re-Proposes Single-Counterparty Credit Limits

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On March 4, 2016, the Board of Governors of the Federal Reserve System (the "Federal Reserve") published its re-proposal (the "Re-Proposal") of the single-counterparty credit limits ("SCCL") requirement mandated by Section 165(e) of the Dodd-Frank Act.[1] In broad terms, the SCCL framework is a response to the concern that the failure or financial distress of one large, interconnected financial institution could cascade through the financial system and impair the financial condition of that firm's counterparties, including other large, interconnected firms. As discussed below, the SCCL are intended to mitigate this risk by limiting the aggregate exposure between certain financial institutions and their counterparties. Whereas banking credit exposure limits historically have focused primarily on the regulated bank only (via lending limits)[2], the SCCL instead focus on the aggregate exposure of all entities within an affected organization. Comments on the Re-Proposal are due by June 3, 2016.

The Re-Proposal comes approximately one month prior to the second anniversary of the finalization of the Basel Committee on Banking Supervision's (the "Basel Committee") framework for measuring and controlling large exposures (the "Basel Framework")[3] and several years after the Federal Reserve's original SCCL proposals (the "Original Proposals").[4] At this stage, no major

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1 The text of the Re-Proposal, along with the preamble discussion, is *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20160304b.htm.

2 *See* 12 C.F.R. part 32 (OCC's lending limits for national banks and their domestic operating subsidiaries and for savings associations, their operating subsidiaries and consolidated service corporations).

3 Basel Committee, Standards: Supervisory Framework for measuring and controlling large exposures (April 2014), *available at* http://www.bis.org/publ/bcbs283.pdf.

4 Federal Reserve, Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (January 5, 2012), *available at* https://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf (U.S. banks); Federal

jurisdiction (including the European Union) has fully implemented the Basel Framework.[5]

Below we summarize key aspects of the Re-Proposal in a series of questions and answers. We also highlight a number of comparison points between the Original Proposals and the Basel Framework.

Guide to Relevant Q&A for U.S. and Non-U.S. Banks

U.S. Headquartered Banks: Section I (Questions A and D)

Non-U.S. Headquartered Banks: Section I (Questions B and E)

All Banks: Sections I (Question C), II, III and IV

Reserve, Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76628 (December 28, 2012), *available at* https://www.gpo.gov/fdsys/pkg/FR-2012-12-28/pdf/2012-30734.pdf (non-U.S. banks).

[5] Note that the EU adopted, as a part of the package of CRD IV reforms, its own version of large exposure limits. *See* Part Four of Regulation (EU) No 575/2013 of the European Parliament and of the Council.

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Roadmap to the SCCL and this Q&A

The SCCL limits the "net credit exposure" of covered financial firms ("Covered Companies"), on an organization-wide (*i.e.*, not a bank-only) basis, to a single counterparty to a specified percentage of a Covered Company's consolidated regulatory capital. The percentage limit and regulatory capital denominator (*i.e.*, the "eligible capital base") varies based on the "systemic footprint" of the Covered Company, measured by asset size and other factors. In formulaic terms, for each counterparty (and certain related entities):

$$\frac{\text{Net Credit Exposure to Counterparty}}{\text{Eligible Capital Base}} \leq \text{Specified \%}$$

Section I provides an overview as to which financial firms are subject to the Re-Proposal and the Re-Proposal's three-tiered approach of increasing stringency based on the Covered Company's systemic footprint, including a discussion of how the eligible capital base and specified percentage varies.

Section II describes how Covered Companies must aggregate credit exposure across affiliated or interconnected, yet legally distinct, counterparties.

Section III describes how Covered Companies must calculate "net credit exposure."

Section IV describes the timelines for compliance by Covered Companies and the consequences of noncompliance.

Appendix A provides a summary view of the three-tiered approach to implementation discussed in Section I.

Appendix B provides a summary view of the "gross credit exposure" calculation.

I. APPLICABILITY AND SCOPE

Section I: Summary and Roadmap

The Re-Proposal increases in stringency based on three tiers of Covered Companies. Both the eligible capital base that forms the denominator for measuring credit limits and the percentage limits vary for each tier of Covered Companies.

This section provides an overview of the different tiers of Covered Companies (**Questions I.A-C**) and describes how the eligible capital base and specified percentages vary for domestic (**Question I.D**) and non-U.S. (**Questions I.E and I.F**) Covered Companies.

A. Which U.S. Bank Holding Companies Are Subject to the Re-Proposal?

Each U.S. bank holding company ("BHC") that has $50 billion or more in total consolidated assets, after any applicable transition period (together with all of its "subsidiaries," "Covered U.S. BHCs"),[6] would be required to comply with the SCCL on a consolidated basis. The transition periods for various types of institutions are described in response to **Question IV.A** below.

***Original Proposals**: The basic requirement is identical to the Original Proposals, consistent with the statutory mandate.*

***Basel Framework Comparison**: The Basel Framework expressly applies only to "internationally active banks," but gives national regulators the discretion to tailor the scope of applicability.*

B. How Does the Re-Proposal Apply to Non-U.S. Banks?

Each (i) foreign banking organization ("FBO") with a banking presence in the United States and total global consolidated assets of $50 billion or more (together with all of its subsidiaries, "Covered FBO"), and (ii) U.S. intermediate holding company ("IHC") established under the Federal Reserve's enhanced prudential standards for FBOs, in each case after any applicable transition period, would be required to comply with elements of the SCCL. The transition periods for various types of institutions are described in response to **Question IV.A** below.

[6] This term excludes intermediate holding companies discussed below, as well as BHC subsidiaries of foreign banking organizations.

***Original Proposals**: The scope of covered companies is identical to the Original Proposals.*

***Basel Framework Comparison**: The Basel Framework expressly applies only to "internationally active banks," but gives national regulators the discretion to tailor the scope of applicability.*

C. Are Savings and Loan Holding Companies or Nonbank SIFIs Similarly Subject to the Re-Proposal?

No. The Re-Proposal does not apply to savings and loan holding companies or nonbank financial companies designated by the Financial Stability Oversight Council for Federal Reserve supervision ("Nonbank SIFIs"). The Re-Proposal notes, however, that the Federal Reserve intends to apply similar requirements to Nonbank SIFIs by rule or order at a later time. The Re-Proposal, however, treats Nonbank SIFIs as a "major counterparty" (as discussed in the response to **Question II.A** and in Appendix A below) for purposes of the limits that apply to Covered Companies.

D. Does the Re-Proposal Apply Credit Limits Equally to Each Covered U.S. BHC?

No. The Re-Proposal implements a three-tiered system of limits for Covered U.S. BHCs, as summarized below and described more fully in Appendix A. The move from a two-tiered system in the Original Proposals to a three-tiered system in the Re-Proposal is consistent with the Federal Reserve's stated objective of creating more differentiation between banking institutions depending on their "systemic footprint".

Specifically, the Re-Proposal distinguishes between:

Covered Company	Definition
Mid-Sized BHCs	Covered U.S. BHCs that have less than $250 billion in total consolidated assets and less than $10 billion in on-balance-sheet foreign exposure.
Advanced Approaches BHCs	U.S. BHCs that are not U.S. global systemically important banks ("G-SIBs"), but have $250 billion or more in total consolidated assets or $10 billion or more

	in on-balance-sheet foreign exposure.
U.S. G-SIBs	U.S. BHCs identified by the Federal Reserve as global systemically important BHCs.

***Original Proposals**: The Re-Proposal introduces a three-tiered approach on increasing stringency, in contrast to the two tiers (Covered Companies that have greater than or equal to $500 billion in total consolidated assets and those that do not) under the Original Proposals.*

***Basel Framework Comparison**: The Basel Framework contemplates a two-tiered approach to applicability, consistent with the Original Proposals.*

E. Does the Re-Proposal Apply Credit Limits Equally to Each Covered FBO and/or IHC?

No. The Re-Proposal implements a three-tiered system of limits for Covered FBOs and IHCs. The three tiers are described more fully in Appendix A. In each case, the focus of the limits is on credit exposure of U.S. entities/operations (*e.g.*, IHCs or the "combined U.S. operations" of FBOs, which would include all of a Covered FBO's U.S. branches and agencies, any IHC and any other U.S. subsidiaries).

For Covered FBOs (including those without IHCs), the Re-Proposal distinguishes between:

Covered Company	Definition
Mid-Sized FBOs	Covered FBOs that have less than $250 billion in global total consolidated assets and less than $10 billion in on-balance-sheet foreign exposure.
Large FBOs	Covered FBOs that have $250 billion or more in global total consolidated assets or $10 billion or more in on-balance-sheet foreign exposure.
Major FBOs	Covered FBOs that have $500 billion or more in global total consolidated assets, respectively.

For IHCs, the Re-Proposal distinguishes between:

Covered Company	Definition
Mid-Sized IHCs	IHCs that have less than $250 billion in total consolidated assets and less than $10 billion in on-balance-sheet foreign exposure.
Large IHCs	IHCs that have $250 billion or more in total consolidated assets or $10 billion or more in on-balance-sheet foreign exposure.
Major IHCs	IHCs that have $500 billion or more in total consolidated assets, respectively.

In addition to different requirements based on size, as described in additional detail in Appendix A, the Re-Proposal prescribes further differences in applicability between IHCs and the U.S. operations of Covered FBOs. For example, the eligible capital base for an IHC is based on the regulatory capital of the IHC, while the eligible capital base for the combined U.S. operations of a Covered FBO is based on the Covered FBO's **global** capital levels. This distinction could lead banks to consider how to optimize booking practices as between their branch network and their IHC and its subsidiaries.

F. How Else Are the Requirements for Covered U.S. BHCs and Covered FBOs/IHCs Different?

In addition to the different tiers discussed above, the Re-Proposal treats Covered FBOs and IHCs differently from Covered U.S. BHCs in other respects.

For example, "eligible collateral" (discussed below) for the U.S. operations of Covered FBOs and IHCs would exclude debt or equity securities issued by an affiliate of the U.S. IHC or any part of the combined U.S. operations of the Covered FBO. Similarly, the definition of "eligible protection provider" would exclude the Covered FBO and any affiliate of the Covered FBO's IHC or any part of the Covered FBO's combined U.S. operations. In contrast, Covered U.S. BHCs do not face similar restrictions on eligible collateral or eligible protection providers. Another key difference is that the Re-Proposal would not apply to exposure of the combined U.S. operations of a Covered FBO or an IHC to the Covered Company's home country sovereign, regardless of the risk weight assigned to that sovereign under the U.S. risk-based capital rules. The Federal Reserve noted in the preamble to the Re-Proposal that this exemption was intended to allow foreign banks to deal in their home country sovereign obligations (*e.g.*, as may be required by home country laws or in order to facilitate the normal course of business).

II. COUNTERPARTIES

Section II: Summary and Roadmap

The Re-Proposal requires Covered Companies to identify each counterparty for which it must calculate credit limits as well as affiliated or interconnected entities whose exposure is aggregated with the counterparty's exposure.

This section describes exactly which counterparties of a Covered Company are subject to credit limits, and which counterparties the Re-Proposal excludes from the scope of credit limits (**Questions II.A and B**).

This section then describes how Covered Companies must combine credit exposure across legal entities to affiliated (**Question II.C**) and unaffiliated (**Question II.D**) counterparties.

A. To Which Counterparties Must a Covered Financial Institution Limit Its Exposure?

Counterparties within the scope of the Re-Proposal include:

- natural persons, together with their immediate families;
- companies and all persons that the counterparty controls (the "control" standard is discussed in response to **Question II.C** below);
- U.S. states, together with their agencies, instrumentalities and political subdivisions (including municipalities);
- non-U.S. sovereigns that are not assigned a 0% risk weight under the Federal Reserve's risk-based capital rules (together with their agencies and instrumentalities, but not including their political subdivisions);[7] and
- political subdivisions of all foreign sovereigns, together with their agencies and instrumentalities.

***Original Proposals**: The Original Proposals did not exclude from the scope of "counterparty" 0% risk-weighted non-U.S. sovereigns.*

***Basel Framework Comparison**: The Basel Framework exempts <u>all</u> sovereigns (i.e., not just limited to 0% risk weight) from the scope of "counterparty."*

[7] As discussed in the response to **Question IV.B** below, Covered FBOs and IHCs may exclude credit exposure to home country sovereigns, regardless of the risk weight. Note that these sovereigns are nonetheless not excluded from the definition of "counterparty."

B. Which Entities May Covered Companies Disregard as "Counterparties"?

The Re-Proposal does not include the U.S. government (together with its agencies and instrumentalities) in the definition of "counterparty." In other words, any credit exposure to the U.S. government may be disregarded. For example, U.S. treasuries are therefore excluded from the scope of the framework.[8] Also notably not included from the definition of "counterparty" under the Re-Proposal are foreign sovereigns (together with their agencies and instrumentalities) that qualify for a 0% risk weight under the Federal Reserve's risk-based capital rules. In the preamble to the Re-Proposal, the Federal Reserve noted that this omission was "in the public interest." Although the Re-Proposal's treatment of foreign sovereigns is more favorable than that in the Original Proposals, it is not as favorable as the Basel Framework, which exempts all foreign sovereigns and their central banks (as well as public sector entities treated as sovereigns under the risk-based capital rules) from the scope of its SCCL.

The omission of certain counterparties from the framework (which effectively exempts all credit exposures to those counterparties) is separate and distinct from the specific exemptions that the Re-Proposal grants certain categories of credit exposures. These exemptions are discussed in additional detail in the response to **Question III.E**.

***Original Proposals**: The Original Proposals included all foreign sovereigns within the scope of the "counterparty," together with their agencies, instrumentalities and political subdivisions.*[9]

***Basel Framework Comparison**: The Basel Framework exempts <u>all</u> sovereigns, regardless of risk capital risk weight, from the scope of "counterparty."*

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[8] The equivalent exemption for Covered FBOs and IHCs is the exclusion of their home country sovereigns as counterparties.

[9] As a technical matter, the Original Proposals also did not exclude from the definition of "counterparty" the U.S. government, but rather excluded credit transactions with the U.S. government from counting towards the limits.

C. How Does the Re-Proposal Aggregate Exposure of a Counterparty and Related Entities?

For the purposes of establishing credit limits to a "counterparty" that is a company, Covered Companies must aggregate exposure to the direct counterparty and to any company or person with respect to which the counterparty (1) owns, controls or holds with power to vote 25% or more of a class of voting securities, (2) owns or controls 25% or more of the total equity, or (3) consolidates for financial reporting purposes.

This concept of "control" is consistent with the Federal Reserve's increasingly strict stance with respect to what level of equity ownership rises to the level of control (compared, for example, to the 33% total equity permissible under the Federal Reserve's 2008 policy statement on minority equity investments).

The Re-Proposal's approach towards control also raises the practical issue of how a Covered Company would know which entities belong to an affiliated group of counterparties, as 25% ownership stakes may not appear in GAAP or other financial statements.

***Original Proposals**: The Original Proposals applied the same 25% test for control.*

***Basel Framework Comparison**: The Basel Framework applies a higher 50% threshold test for control.*

D. When and How Must Covered Companies Aggregate Exposure to Unaffiliated Counterparties?

If total exposure to a single counterparty (as described in **Question II.C**, above) exceed 5% of a Covered Company's eligible capital base (as defined in Appendix A), the Covered Company would need to add to its exposure levels to that counterparty all exposure to other counterparties that are "economically interdependent" with the first counterparty. For example, if a Covered Company had a total net credit exposure to a counterparty X equal to 6% of the Covered Company's eligible capital base, and the counterparty in turn was economically interdependent with an unaffiliated counterparty Y, the Covered Company would have to combine any exposure to unaffiliated counterparty Y with that of counterparty X for purposes of determining compliance with the SCCL.

Two counterparties are economically interdependent if 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 appears to contemplate that a Covered Company would make this determination on its own. In making the determination, the Re-Proposal mandates that the Covered Company would have to take into account whether:

- 50% of one counterparty's gross revenue or gross expenditures are derived from transactions with the other counterparty;
- 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;
- 25% or more of one counterparty's production or output is sold to the other party, which cannot easily be replaced by other customers;
- the expected source of funds to repay any credit exposure between the counterparties is the same and at least one of the counterparties does not have another source of income from which the extension of credit may be fully repaid;
- the financial distress of one counterparty is likely to impair the ability of the other counterparty to fully and timely repay liabilities; and
- 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.

In addition to these factors, the Federal Reserve may determine, after notice and opportunity for a hearing, that one or more unaffiliated counterparties are economically interdependent.

Covered Companies also would be required to aggregate exposure to counterparties connected by control relationships that may arise due to the following factors:

- the presence of voting agreements;
- 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 of such body have been appointed solely as a result of the exercise of the first counterparty's voting rights; and

- the ability of one counterparty to significantly influence senior management or to exercise a controlling influence over the management or policies of another counterparty.

These additional criteria for aggregation are consistent with the Basel Framework (and, in many cases, the Federal Reserve's "control" precedents), but represent a significant development compared to the Original Proposals. The Re-Proposal's approach introduces questions about how Covered Companies would be expected to evaluate the factors noted above, given that many of the relevant facts may not be ascertainable without nonpublic information.

***Original Proposals**: The Original Proposals did not include a requirement to aggregate unaffiliated counterparties.*

***Basel Framework Comparison**: The Basel Framework's requirements to aggregate unaffiliated counterparties are similar to the requirements contained in the Re-Proposal.*

III. NET CREDIT EXPOSURE

Section III: Summary and Roadmap

The Re-Proposal's fundamental effect is to limit "net credit exposure" to a given counterparty. This section describes how a Covered Company calculates its "net credit exposure" by starting with "gross credit exposure" (**Questions III.A**), then arriving at "net credit exposure" by making certain adjustments, including by taking into account the effect of "eligible collateral," "eligible guarantees" and other items (**Question III.D**).

This section also contains a special discussion of how to calculate "gross credit exposure" for OTC derivatives **(Question III.B**) and securities financing transactions (**Question III.C**), and also the special rules for calculating "net credit exposure" for certain securities financing transactions.

Finally, this section briefly discusses the types of credit exposure that are excluded from the definition of "net credit exposure" under the rule (**Question III.E**) and the special "look-through" applicable to certain fund and special purpose vehicle ("SPV") investments.

A. How Is "Gross Credit Exposure" Measured?

Gross credit exposure with respect to a credit transaction is calculated in accordance with the rules set forth in the Re-Proposal. Credit transactions with a counterparty include:

- extensions of credit to the counterparty, including loans, deposits and lines of credit, but excluding uncommitted lines of credit;
- repurchase and reverse repurchase transactions with the counterparty;
- securities lending and borrowing transactions with the counterparty;
- guarantees, acceptances, or letters of credit (including any endorsement, confirmed letter of credit, or standby letter of credit) issued on behalf of the counterparty;
- purchases of, or investment in, securities issued by the counterparty;
- credit exposure to the counterparty in connection with derivatives transactions with the counterparty;
- credit exposure to the counterparty in connection with a credit derivative or equity derivative transaction between the Covered Company and a third party, the reference asset of which is an obligation or equity security of the counterparty; and

- any transaction that is the functional equivalent of the above.

The Re-Proposal also contains an attribution rule aimed at preventing evasion: Covered Companies must 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 transferred to that counterparty. In the preamble to the Re-Proposal, the Federal Reserve indicated that its intention is "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."

More information on how to calculate gross exposure is contained in Appendix B.

***Original Proposals**: The Original Proposal's formulation of "credit transaction" and "gross credit exposure" is largely consistent with the Re-Proposal, subject to some key differences discussed below.*

***Basel Framework Comparison**: The Basel Framework contains a broad formulation of "exposure," meant to align with the Basel III risk-based capital rules.*

B. How Is Gross and Net Credit Exposure for Derivatives Calculated?

The gross credit exposure calculation for derivatives depends, in large part, on whether or not the transaction is subject to a qualifying master netting agreement.

In the case of a single OTC derivative contract not subject to a qualifying master netting agreement, to measure gross exposure, the Covered Company would apply the Current Exposure Method (the "CEM") to the transaction, which is the prevailing methodology for measuring counterparty credit exposure to OTC derivatives under the U.S. risk-based capital rules. In short, the gross credit exposure would be equal to the sum of the current exposure (greater of mark-to-market value or zero) and the potential future exposure calculated by multiplying the effective notional amount of the contract by a prescribed multiplier.

In contrast, a Covered Company may, with respect to transactions subject to qualifying master netting agreements, calculate gross exposure using any method available to the Covered Company under the Federal Reserve's

regulatory capital rules, potentially including the internal models methodology available to advanced approaches institutions under the regulatory capital rules.[10]

As with other transactions, Covered Companies must reduce their gross credit exposure (in either of the above scenarios) by applying eligible credit risk mitigation (including taking into account the effect of "eligible collateral") to obtain the net credit exposure.

In the preamble to the Re-Proposal, the Federal Reserve noted that the Basel Committee recently finalized a revised standardized approach (the "SA-CCR") for measuring credit exposure to a derivatives counterparty (which is more complicated and in some respects, more punitive than the CEM) and that it would consider incorporating the SA-CCR into the SCCL in the future.

***Original Proposals**: The Original Proposal's methodology for quantifying derivatives exposure is largely consistent with the Re-Proposal.*

***Basel Framework Comparison**: The Basel Framework contemplates the use of the SA-CCR methodology, which is vastly different than the CEM methodology in place in the United States.*

C. How Is Gross and Net Credit Exposure for Securities Financing Transactions Calculated?

The calculation of gross credit exposure for securities financing transactions ("SFTs") that either (i) are not subject to bilateral netting agreements or (ii) do not meet the definition of "repo-style transaction" under the U.S. risk-based capital rules is as follows:

Credit Transaction	Calculation Methodology
Repurchase Transactions	Market value of the securities transferred by the Covered Company to the counterparty, increased by a standard supervisory haircut (as set forth in the U.S. risk-based capital rules) based on a five-day liquidation period.
Reverse Repurchase	Cash transferred by the Covered Company to the

[10] Note that not all Covered Companies may use the internal models methodology under the capital rules.

Transactions	counterparty.
Securities Borrowing Transactions	Amount of cash collateral transferred by the Covered Company to the counterparty plus the market value of securities collateral transferred by the Covered Company to the counterparty, increased by a standard supervisory haircut (as set forth in the U.S. risk-based capital rules) based on a five-day liquidation period.
Securities Lending Transactions	Market value of the securities lent by the Covered Company to the counterparty, increased by a standard supervisory haircut (as set forth in the U.S. risk-based capital rules) based on a five-day liquidation period.

A Covered Company would then apply the credit risk mitigation techniques (*e.g.*, by recognizing the effect of eligible collateral securing the SFT) described in the response to **Question III.D** below to arrive at net credit exposure for such SFTs.

In contrast, to the extent that an SFT both meets the definition of "repo-style transaction" under the U.S. risk-based capital rules and is subject to a bilateral netting agreement, the Re-Proposal prescribes a special method for taking into account collateral securing the SFT exposure in arriving at net credit exposure. Specifically, a Covered Company must apply the collateral haircut approach described in the U.S. risk-based capital rules to quantify its net credit exposure.

As to repo-style transactions, in the preamble to the Re-Proposal, the Federal Reserve explained that it considered a number of alternative methodologies for calculating net credit exposure, including the more favorable methodology proposed by the Basel Committee in December 2015, in its second consultative document relating to revisions to the standardized approach for credit risk.

The methodology proposed by the Basel Committee in December 2015 favorably departs from the current U.S. standardized approach in a manner that could potentially significantly reduce the amount of exposure resulting from SFTs. Although the Re-Proposal solicits additional comments on this matter, the rejection in the preamble to the Re-Proposal of the methodology proposed by the Basel Committee in December 2015 raises two distinct but related concerns: (i) the Federal Reserve may be inclined to finalize the SCCL without providing the benefit of the more favorable exposure calculation set forth in the Basel Committee's 2015 proposal, and (ii) even if the Basel Committee finalizes the revision as currently proposed, the Federal Reserve declines to amend the U.S.

capital rules to provide that capital benefit to U.S. banking institutions subject to those rules.

Proposal: *The Original Proposal's methodology for quantifying exposure for SFTs and repo-style transactions is largely consistent with the Re-Proposal, with a key difference being the relaxation of the 10-day liquidation period assumption (to a five-day liquidation period) for the purposes of calculating the applicable haircuts.*

Basel Framework Comparison: *The Basel Framework contemplates the use of whatever it finalizes as revisions to the standardized approach. The approach proposed by the Basel Committee in December 2015 greatly differs from the collateral haircut approach contemplated by the Re-Proposal.*

D. How Is Gross Credit Exposure Reduced to Obtain Net Credit Exposure?

In order to reduce gross credit exposure to arrive at net credit exposure, Covered Companies must apply certain eligible credit risk mitigation, if present. Specifically, Covered Companies must reduce their gross credit exposure with respect to a credit transaction by recognition of:

Credit Risk Mitigation	Extent of Mitigation
Eligible Collateral	The market value of the eligible collateral (haircut based on a 10-day liquidation period, and further adjusted based on potential maturity mismatches).
Eligible Guarantees	The amount of the eligible guarantee (as adjusted based on potential maturity mismatches).
Eligible Credit and Equity Derivatives	The notional amount of any such eligible credit or equity derivative from an eligible protection provider (as adjusted based on potential maturity mismatch).
Other Eligible Hedges	The face amount of a short sale of the counterparty's debt or equity security provided certain requirements are met.

Unused Commitments	For credit lines and revolving credit facilities, the amount of the unused portion of such facility to the extent the Covered Company does not have the legal obligation to advance funds (until the counterparty provides sufficient collateral to cover the unused line).

Note that the definition of "eligible guarantee" is broadly consistent with the same term under the U.S. risk-based capital rules, while "eligible collateral" is more restrictive than "financial collateral" under the U.S. risk-based capital rules. For example, "eligible collateral" only includes cash on deposit, certain investment grade debt, publicly traded equities and publicly traded convertible bonds, but does not include gold bullion, money market fund shares and liquid mutual fund shares, each of which are included in the definition of "financial collateral."

Also note that these mitigants generally do not eliminate credit exposure for purposes of the SCCL, but rather reallocate it. If a Covered Company reduces its gross credit exposure, using a form of eligible credit risk mitigation, the Covered Company generally must include the amount of this reduction as an additional exposure in calculating total exposure to the mitigant, *e.g.,* taking into account the additional exposure to the issuer of "eligible collateral" or the "eligible protection provider," in the case of an "eligible guarantee." To avoid discouraging overcollateralization, the Re-Proposal caps credit exposure attributable to a collateral issuer or guarantor to the amount of the credit exposure to the original counterparty.

This risk-shifting approach underscores the need to closely monitor both direct exposure and collateral/guarantee exposure, because collateral/guarantee exposure would increase credit exposure to the issuer of such collateral or the guarantor, as applicable. It may even be desirable for Covered Companies to actively manage their collateral/guarantee pool to achieve greater counterparty diversity.

***Original Proposals**: The Original Proposal's methodologies for credit risk mitigation are substantially similar to the Re-Proposal.*

***Basel Framework Comparison**: The Basel Framework's credit risk mitigation methodology is largely in line with the Re-Proposal.*

E. Which Types of Credit Exposure Are Exempted from the Re-Proposal?

The Re-Proposal exempts certain categories of credit exposure from accumulating towards a Covered Company's SCCL (whether such exposure arises as a direct exposure or as a mitigant to a direct exposure). In contrast to the exclusions from the definition of "counterparty," which cover all credit exposure to an excluded counterparty, the exemptions for credit exposure are transaction-specific and, therefore, are limited to specified categories of transactions with respect to certain counterparties. The exempted exposure categories are as follows:

- 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 the Federal Home Loan Mortgage Corporation, but only while operating under the conservatorship or receivership of the Federal Housing Finance Agency, and any additional obligations issued by a U.S. government-sponsored entity as determined by the Federal Reserve;
- intraday credit exposure;
- trade exposure to qualifying central counterparties ("QCCP") related to the Covered Company's clearing activity, including potential future exposure arising from transactions cleared by the QCCP and pre-funded default fund contributions; and
- any other transaction the Federal Reserve exempts.

***Original Proposals**: The Original Proposals did not include an exemption for trade exposure to QCCPs.*

***Basel Framework Comparison**: The Basel Framework deferred a final decision on whether to exclude exposure to QCCPs. In addition, the Basel Framework's exemption for intraday credit is limited to intraday interbank credit.*

F. How Must Covered Companies Treat Exposures to Funds and SPV Structures?

The Re-Proposal provides that, in some instances, certain Covered Companies' credit exposure to the issuers of the underlying assets held by an investment fund may be so significant as to require the Covered Company to recognize an exposure to each issuer of underlying assets for every fund in which such bank invests. This recognition is reflected in the Re-Proposal's look-through requirement applicable to Advanced Approaches BHCs, U.S. G-SIBs, Large and

Major IHCs and the U.S. operations of Large and Major FBOs (together, "Large Covered Companies"). Unless a Large Covered Company can demonstrate that its exposure to each underlying asset in an investment fund is less than 0.25% of its eligible capital base (considering only exposure that arises from the fund), such Large Covered Company would be required to look through the fund to recognize exposure to the underlying assets rather than just to the fund. In addition to the requirements described above, such Large Covered Company also would be required to recognize an exposure (equal to the value of its investment in the fund) to any third party whose failure or distress would likely result in a loss in the value of its investment, which could include fund managers. To the extent a Large Covered Company cannot identify each issuer of assets held by a securitization vehicle, investment fund or other SPV, the Large Covered Company must attribute the gross credit exposure to a single unknown counterparty, and apply the SCCL to that counterparty. The above look-through requirements do not apply to Covered Companies that are neither U.S. G-SIBs nor Advanced Approaches BHCs, unless the Federal Reserve makes a separate determination otherwise.

This look-through requirement is largely consistent with the Basel Framework and, together with the requirements to aggregate unaffiliated counterparties (including unconsolidated funds), goes hand-in-hand with recent Basel Committee consultations on the identification and measurement of "step-in risk," *i.e.*, the risk that banks will provide financial support to unaffiliated entities (including unconsolidated funds) in times of market stress beyond or in the absence of any contractual obligations to do so.[11] That is, the requirement to aggregate unaffiliated counterparties under the Re-Proposal and the requirement to potentially consolidate entities that present step-in risk are premised on the idea that funds and affiliated entities are likely to experience financial distress on a correlated basis.

***Original Proposals**: The Original Proposals included a reservation of authority for the Federal Reserve to look through some SPVs to either the issuer of the underlying assets or to the sponsor, and considered whether there should be an automatic look-through if the SPV failed certain discrete concentration tests (e.g., having exposures to more than 20 underlying entities).*

***Basel Framework Comparison**: The Basel Framework applies a similar approach to SPVs and funds as the Re-Proposal, requiring banks to apply a detail look-through*

[11] *See* Basel Committee, Consultative Document: Identification and measurement of step-in risk (December 2015), *available at* http://www.bis.org/bcbs/publ/d349.pdf.

approach unless the bank's exposure to the underlying asset is less than 0.25% of eligible capital. Notably, the Basel Framework's look-through would apply to all banks covered by the framework, in contrast to the Re-Proposal, which only requires a look-through for Large Covered Companies.

IV. TIMELINE/COMPLIANCE

Section IV: Summary and Roadmap

The Re-Proposal applies a two-tiered system of implementation (**Question IV.A**) and ongoing compliance reporting (**Question IV.B**), one tier for Large Covered Companies, and another, more lenient, tier for other Covered Companies. Subject to very limited exceptions and grace periods, Covered Companies must comply or potentially face enforcement actions or other penalties (**Question IV.C**).

A. When Do Covered Companies Need to Comply under the Re-Proposal?

Covered Company	Effective Date
Mid-Sized BHCs	**Two years** from the effective date of the rule.
Advanced Approaches BHCs and U.S. G-SIBs	**One year** from the effective date of the rule.
Mid-Sized FBOs and Mid-Sized IHCs	**Two years** from the effective date of the rule.
Large/Major FBOs and IHCs	**One year** from the effective date of the rule.

A firm that becomes a Covered Company after the effective date of the final SCCL rule generally would be subject to its limitations beginning on the first day of the fifth calendar quarter after it becomes a Covered Company. For the purposes of determining when a company becomes a Covered Company, "total consolidated assets" are measured on the last day of each quarter and are based on a four-quarter running average (to the extent available). In other words, a firm that crosses the $50 billion asset threshold may not become a Covered Company until several quarters later, when its four-quarter average total consolidated assets exceed $50 billion.

In contrast, a Covered Company remains subject to the requirements unless and until the Covered Company has less than $50 billion in total consolidated assets based on each of (as opposed to the average of) its four most recent quarters.

***Original Proposals**: The Original Proposals provided similar grace period following the effective date.*

***Basel Framework Comparison**: The Basel Framework is to be fully implemented by January 1, 2019.*

B. How Frequently Must Covered Companies Calculate and Report Under the Re-Proposal?

Covered Company	Effective Date
Mid-Sized BHCs	**Quarterly** compliance and **quarterly** reporting.
Advanced Approaches BHCs and U.S. G-SIBs	**Daily** (end of each business day) compliance and **monthly** reporting.
Mid-Sized FBOs and Mid-Sized IHCs	**Quarterly** compliance and **quarterly** reporting.
Large/Major FBOs and IHCs	**Daily** (end of each business day) compliance and **monthly** reporting.

***Original Proposals**: The Original Proposals required all Covered Companies to comply with the requirements on a daily basis and report on a monthly basis.*

***Basel Framework Comparison**: The Basel Framework permits national authorities to specify the frequency of compliance and reporting.*

C. What Are the Consequences of Non-Compliance?

The Re-Proposal generally provides a 90-day cure period for breaches attributable to the following events, provided the Covered Company uses reasonable efforts to return to compliance during that period:

- decreases in the Covered Company's eligible capital base;

- merger of a Covered U.S. BHC with another Covered U.S. BHC or the merger of an IHC or FBO with a Covered U.S. BHC, Nonbank SIFI, an FBO or an IHC;
- merger of two unaffiliated counterparties; or
- any other circumstance that the Federal Reserve determines is appropriate.

The Federal Reserve is not specific about what penalties may result from otherwise failing to comply with the SCCL, but presumably the Federal Reserve may bring an enforcement action against a Covered Company to enforce compliance.

***Original Proposals**: The Original Proposals contained the same grace periods as the Re-Proposal.*

***Basel Framework Comparison**: The Basel Framework specifies that breaches must be reported to the appropriate national supervisor immediately and rapidly fixed.*

Appendix A

U.S. Bank Holding Companies

Covered U.S. BHCs		Counterparty		%		Eligible Capital Base
All Covered U.S. BHCs	Net Credit Exposure to	Unaffiliated counterparties (and related entities, as described above).	≤	25%	of	Covered U.S. BHC's capital stock and surplus (tier 1 and tier 2 capital plus allowance for loan and lease losses not included in tier 2 capital).
Advanced Approaches BHCs and U.S. G-SIBs		Unaffiliated counterparties (and related entities, as described above).		25%		Covered U.S. BHC's tier 1 capital.
U.S. G-SIBs		Unaffiliated G-SIBs (on a global basis) and Nonbank SIFIs.		15%		Covered U.S. BHC's tier 1 capital.

U.S. Intermediate Holding Companies

IHCs		Counterparty		%		Eligible Capital Base
All IHCs	Net Credit Exposure to	Unaffiliated counterparties (and related entities).	≤	25%	of	IHC's capital stock and surplus (tier 1 and tier 2 capital plus allowance for loan and lease losses not included in tier 2 capital).
Large IHCs and Major IHCs		Unaffiliated counterparties (and related entities).		25%		IHC's tier 1 capital.
Major IHCs		Unaffiliated G-SIBs (on a global basis) and Nonbank SIFIs.		15%		IHC's tier 1 capital.

Foreign Banking Organizations

Covered FBOs		Counterparty		%		Eligible Capital Base
Combined U.S. operations of all Covered FBOs	Net Credit Exposure to	Unaffiliated counterparties (and related entities).	≤	25%	of	Covered FBO's worldwide total risk-based capital.
Combined U.S. operations of Large FBOs and Combined U.S. operations of Major FBOs		Unaffiliated counterparties (and related entities).		25%		Covered FBO's worldwide tier 1 capital.
Combined U.S. operations of Major FBOs		Unaffiliated G-SIBs (on a global basis) and Nonbank SIFIs.		15%		Covered FBO's worldwide tier 1 capital.

Appendix B

Gross Exposure Calculation Methodology

Credit Transaction	Calculation Methodology
Loans and Leases	Amount owed by the counterparty to the Covered Company under the transaction.
Debt Securities	Market value of the securities, for trading and available-for-sale securities. Amortized purchase price of the securities, for securities held to maturity.
Equity Securities	Market value of the securities.
Repurchase Transactions	Market value of the securities transferred, increased by a standard supervisory haircut based on a five-day liquidation period.[12]
Reverse Repurchase Transactions	Cash transferred by the Covered Company to the counterparty.
Securities Borrowing Transactions	Amount of cash collateral transferred by the Covered Company to the counterparty plus the market value of securities collateral transferred by the Covered Company to the counterparty, increased by a standard supervisory haircut based on a five-day liquidation period.
Securities Lending Transactions	Market value of the securities lent by the Covered Company to the counterparty, increased by a standard supervisory haircut based on a five-day liquidation period.
Committed credit lines	Face amount of the credit line.
Guarantees and letters of credit	Maximum potential loss to the Covered Company on the transaction.
Derivatives transactions not subject to a qualifying master netting agreement	Sum of the current exposure (greater of mark-to-market value or zero) and the potential future exposure calculated using the Current Exposure Method, unless required to be excluded as an exposure to an eligible protection provider.

[12] The standard supervisory haircut is the same haircut prescribed by the risk-based capital rules for "repo-style transactions."

Credit Transaction	Calculation Methodology
Derivatives transactions subject to a qualifying master netting agreement	Valued using methods that the Covered Company is authorized to use under the U.S. risk-based capital rules, unless required to be excluded as an exposure to an eligible protection provider.
Credit or equity derivative transactions with a third party referencing a counterparty security.	Maximum potential loss to the Covered Company on the transaction.