Federal Reserve Adopts Single Counterparty Credit Limits

July 10, 2018

On June 14, 2018, the Federal Reserve Board (the "FRB") adopted regulations (the "Final Rule") to implement the single-counterparty credit limits (the "SCCL") mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The Final Rule reflects reforms to the Dodd-Frank Act made by the recently enacted Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Regulatory Relief Act"), which, among other things, increased asset size thresholds that trigger applicability of the Dodd-Frank Act's enhanced prudential standards (including the SCCL).[2]

Debevoise & Plimpton

The basic requirement of the Final Rule is to limit the "net credit exposures" of covered firms to a single counterparty to a specified percentage of the firm's eligible capital base. The percentage for the SCCL and the eligible capital base against which the SCCL is measured vary depending on the size and regulatory status of the covered firm. In broad terms, the SCCL is a response to the concern that interconnections among large banking organizations and their counterparties can have cascading effects during times of stress, which can threaten financial stability. As discussed below, the SCCL is intended to address this issue by limiting the aggregate exposure between certain banking organizations and their counterparties. Unlike bank-level lending limits, which focus solely on a bank's exposures, the SCCL limits the exposures of the entire consolidated institution to its counterparties.

---

1 The text of the Final Rule, along with the preamble discussion, is available **here**. For more information on the Regulatory Relief Act, please refer to our client update available **here**. For more information on the FRB's 2016 proposed rule on SCCL, please refer to our client update available **here**.

2 Pub. L. No. 115-174, § 401, 132 Stat. 1296 (2018).

I. Applicability and Scope

U.S. banking organizations. The Final Rule applies to the following categories of U.S. banking organizations (see Table 1):

- U.S. bank holding companies ("BHCs") identified as global systemically important banks ("GSIBs") pursuant to the FRB's regulatory capital rules ("Major Covered Companies"); and

- U.S. BHCs that are not GSIBs with $250 billion or more in total consolidated assets (together with Major Covered Companies, "Covered Companies").

Table 1: Covered U.S. Banking Organizations

Category of Covered Company	Applicable Credit Exposure Limit
Major Covered Company	Aggregate net credit exposure to a Major Counterparty (defined below) cannot exceed 15 percent of the Major Covered Company's tier 1 capital. Aggregate net credit exposure to any other Counterparty (defined below) cannot exceed 25 percent of the Major Covered Company's tier 1 capital.
Covered Company that is not a Major Covered Company	Aggregate net credit exposure to a Counterparty cannot exceed 25 percent of a Covered Company's tier 1 capital.

"Major Counterparties" include U.S. GSIBs, FBOs that have the characteristics of GSIBs and nonbank financial companies designated by the Financial Stability Oversight Council for FRB supervision.

Foreign banking organizations. The Final Rule applies to foreign banking organizations ("FBOs") as follows (see Table 2):

- to the combined U.S. operations of FBOs that have the characteristics of a GSIB under the global methodology ("Major FBO") and IHCs with total consolidated assets of $500 billion or more ("Major IHC");

- to the combined U.S. operations of FBOs with $250 billion or more in total consolidated assets (measured on a global basis); and

- to U.S. intermediate holding companies ("IHCs") that such an FBO is required to form or designate.

The FBOs and IHCs subject to the Final Rule are referred to as "Covered Foreign Entities."

Table 2: Covered Foreign Entities

Category of Covered Foreign Entity	Applicable Credit Exposure Limit
Major FBO	Aggregate net credit exposure to a Major Counterparty cannot exceed 15 percent of the Major FBO's tier 1 capital. Aggregate net credit exposure to any other Counterparty cannot exceed 25 percent of the Major FBO's tier 1 capital.
Major IHC	Aggregate net credit exposure to a Major Counterparty cannot exceed 15 percent of the IHC's tier 1 capital. Aggregate net credit exposure to any other Counterparty cannot exceed 25 percent of the IHC's tier 1 capital.
Covered Foreign Entity that is not a Major FBO, Major IHC or IHC with total consolidated assets of less than $250 billion	Aggregate net credit exposure to a Counterparty cannot exceed 25 percent of the Covered Foreign Entity's tier 1 capital.
IHC with total consolidated assets of at least $50 billion but less than $250 billion	Aggregate net credit exposure to a Counterparty cannot exceed 25 percent of the IHC's consolidated capital stock and surplus.[3]

Deemed compliance. A Covered Foreign Entity need not comply with the SCCL's limits on the aggregate net credit exposure of combined U.S. operations if the FBO certifies on behalf of its combined U.S. operations to the FRB that it meets large exposure standards

[3] This amount is equal to the IHC's total regulatory capital plus the balance of its allowance for loan and lease losses not included in tier 2 capital.

on a consolidated basis established by its home-country supervisor that are consistent with the large exposures framework published by the Basel Committee on Banking Supervision ("Basel Committee"). However, as of April 2018, only four jurisdictions (Australia, India, Saudi Arabia and Switzerland) had published a final rule adopting the Basel Committee's framework.[4]

II. Counterparties

The Final Rule requires Covered Companies and Covered Foreign Entities to identify each counterparty for which such Covered Company or Covered Foreign Entity has credit exposures, as well as affiliated and interconnected entities deemed to be part of the same counterparty (each a "Counterparty"). Table 3 illustrates the scope of the Counterparty definition. The U.S. Government (together with its agencies and instrumentalities), foreign sovereigns that qualify for a zero percent risk weight under the FRB's risk-based capital rules, and, for Covered Foreign Entities, home country foreign sovereigns, are not included in the Counterparty definition. Further, as noted below in Section V, credit transactions with the European Commission, the European Central Bank and certain multilateral banks and supranational organizations are exempted from the SCCL; therefore, exposures to such entities are not subject to the SCCL.

Table 3: Counterparties

Category of Counterparty	Definition
A natural person	The natural person. However, if the credit exposure of the Covered Company or Covered Foreign Entity to such natural person exceeds 5 percent of: (1) tier 1 capital, in the case of a Covered Company, Covered Foreign Entity that is an FBO or IHC with total consolidated assets of $250 billion or more; or (2) capital stock and surplus, in the case of an IHC with total consolidated assets of less than $250 billion, the relevant Counterparty includes the natural person and members of such natural person's immediate family.

[4] *See* Basel Committee, Fourteenth progress report on adoption of the Basel regulatory framework (Apr. 23, 2018), available at https://www.bis.org/bcbs/publ/d440.htm.

A company that is not an affiliate of the Covered Company or Covered Foreign Entity	The company together with its affiliates.
A state	The state together with all of its agencies, instrumentalities and political subdivisions (including any municipalities).
A foreign sovereign entity that is not assigned a zero percent risk weight under the standardized approach in the FRB's regulatory capital rules (other than the home country foreign sovereign entity of an FBO)	The foreign sovereign entity together with all of its agencies and instrumentalities (but not including any political subdivision).
A political subdivision of a foreign sovereign entity	The political subdivision of the foreign sovereign entity together with all of its agencies and instrumentalities.

Definition of "subsidiary" and "affiliate." The Final Rule applies a financial consolidation standard to the definition of subsidiary (rather than using typical BHC Act definitions of control), specifically:

- An affiliate is defined as any subsidiary of a company and any other company that is consolidated with the company under applicable accounting standards.

- In turn, a subsidiary is defined as any company consolidated by another company under applicable accounting standards.

In the preamble to the Final Rule, the FRB states its view that the move from a BHC Act-based control standard to the "subsidiary" and "affiliate" definitions would exclude most investment funds from the scope of Counterparty, as investment funds generally are not consolidated with asset managers other than during the seeding period or other periods in which the manager holds an "outsized portion" of the fund's interest.

Aggregation due to economic interdependence or control relationships. A Covered Company or Covered Foreign Entity (other than an IHC with less than $250 billion in total consolidated assets) must look not only to its direct Counterparty, but if the Covered Company or Covered Foreign Entity's aggregate net credit exposure to any direct Counterparty exceeds 5 percent of its tier 1 capital, the Covered Company or Covered Foreign Entity must assess whether the direct Counterparty is: (1) "economically interdependent" with one or more other Counterparties; or (2) connected by a control

relationship with one or more other Counterparties. If either such relationship exists, the exposures between the direct Counterparty and other Counterparty must be aggregated for purposes of the SCCL.

Economic Interdependence. To determine whether economic interdependence exists between two Counterparties, a Covered Company or Covered Foreign Entity must assess whether the financial distress of one Counterparty (Counterparty A) would prevent the other Counterparty (Counterparty B) from fully and timely repaying Counterparty B's liabilities and whether the insolvency or default of Counterparty A is likely to be associated with the insolvency or default of Counterparty B, by evaluating:

- whether 50 percent or more of one Counterparty's gross revenue is derived from, or gross expenditures are directed to, transactions with the other Counterparty;
- whether Counterparty A has fully or partly guaranteed the credit exposure of Counterparty B, or is liable by other means, in an amount that is 50 percent or more of the Covered Company's or Covered Foreign Entity's net credit exposure to Counterparty A;
- whether 25 percent or more of one Counterparty's production or output is sold to the other Counterparty, which cannot easily be replaced by other customers;
- whether the expected sources of funds to repay the loans of both Counterparties is the same and neither Counterparty has another independent source of income from which the loans may be serviced and fully repaid; and
- whether two or more 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.

Control Relationship. To determine whether a "control relationship" exists between two Counterparties, a Covered Company or Covered Foreign Entity must determine whether one Counterparty holds 25 percent or more of any class of voting securities or controls the election of a majority of the directors, trustees, general partners or individuals exercising similar functions of the other Counterparty. The preamble provides the following example: A Covered Company or a Covered Foreign Entity has credit exposures to a bank equal to 6.5 percent of the Covered Company's or Covered Foreign Entity's eligible capital base and credit exposures to a fund sponsored by the bank equal to 2.0 percent of such Covered Company's or Covered Foreign Entity's eligible capital base. The bank has the power to appoint a majority of the directors of the fund, although it does not own 25 percent or more of any voting class of the securities of the fund. Under the Final Rule, the Covered Company or Covered Foreign Entity

would be required to aggregate its credit exposures to the bank and the fund, which would yield an aggregate concentration of 8.5 percent of the Covered Company's or Covered Foreign Entity's eligible capital base to the Counterparty.

III. Quantifying Credit Exposures

The Final Rule's fundamental purpose is to limit "net credit exposure" to a given Counterparty. To calculate net credit exposure, a Covered Company or Covered Foreign Entity first identifies which transactions are "credit transactions," then calculates "gross credit exposure," and finally arrives at net credit exposure by making certain adjustments, including by taking into account the effect of "eligible collateral," "eligible guarantees" and other items.

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 issued on behalf of the Counterparty;
- purchases of securities issued by, or investments in, the Counterparty;
- credit exposures to the Counterparty in connection with derivatives transactions with the Counterparty;
- credit exposures to the Counterparty in connection with a credit derivative or equity derivative transaction between the Covered Company or Covered Foreign Entity and a third party, the reference asset of which is an obligation or equity security of, or equity investment in, the Counterparty; and
- any transaction that is the functional equivalent of the above.

Gross credit exposure with respect to a credit transaction is calculated in accordance with the rules set forth in the Final Rule (described in more detail in Appendix A). The Final Rule includes an "attribution rule," under which a transaction with any person is treated 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 Final Rule, the FRB reiterates that, in contrast to the standards often applied under the FRB's Regulation W, the FRB would not expect to apply this attribution rule to transactions made in the ordinary course of business.

To reduce gross credit exposure to arrive at net credit exposure, Covered Companies and Covered Foreign Entities must account for certain eligible credit risk mitigations (described in more detail in Appendix B). However, as part of the FRB's "risk-shifting" framework, the Covered Company or Covered Foreign Entity must recognize a separate exposure to the issuer of any eligible collateral and to any eligible guarantor. Thus, if a Covered Company or Covered Foreign Entity reduces its gross credit exposure using a form of eligible credit risk mitigation, it must treat the credit risk mitigant itself as a credit exposure. That is, the credit risk migitant is treated as an exposure to the issuer of "eligible collateral" or the "eligible protection provider" in the case of an "eligible guarantee."

The requirement to recognize eligible credit risk mitigation highlights the need to closely monitor both direct exposure and collateral / guarantee exposure because collateral / guarantee exposure increases credit exposure to the issuer of such collateral or the guarantor, as applicable. As such, the Final Rule encourages Covered Companies and Covered Foreign Entities to actively manage their collateral / guarantee pool to achieve greater Counterparty diversity. Finally, to avoid discouraging overcollateralization, the Final Rule caps credit exposure attributable to a collateral issuer or guarantor to the amount of credit exposure to the original Counterparty.

For purposes of credit risk mitigation, 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" includes only cash on deposit, gold bullion, certain investment grade debt, publicly traded equities and publicly traded convertible bonds, but excludes money market fund shares and liquid mutual fund shares, each of which are included in the definition of "financial collateral."

IV. Aggregation Rules for Investment Funds and Special Purpose Vehicles

The Final Rule recognizes that, in some instances, a Covered Company's or Covered Foreign Entity's credit exposure to the issuers of the underlying assets held by a securitization fund, investment fund or other special purpose vehicle ("SPV") may be so significant as to require a Covered Company or Covered Foreign Entity to recognize an

exposure to each such issuer of underlying assets for every SPV in which such Covered Company or Covered Foreign Entity invests.

Under the "look-through approach" included in the FRB's 2016 proposed rule on the SCCL, a Covered Company or Covered Foreign Entity would have been required to: (1) look through to individual issuers of an SPV's underlying assets if the Covered Company or Covered Foreign Entity could not demonstrate that its exposure to each issuer was less than 0.25 percent of such Covered Company's or Covered Foreign Entity's tier 1 capital; and thus, (2) recognize an exposure to each issuer of such underlying assets of the SPV that exceeded 0.25 percent of its tier 1 capital. Conversely, a Covered Company or Covered Foreign Entity would have been permitted to recognize an exposure to solely the SPV (and not the issuers of the underlying assets) only if the Covered Company or Covered Foreign Entity was able to demonstrate that its indirect exposure to each issuer of the SPV's underlying assets were less than 0.25 percent of its tier 1 capital (considering only exposures that arise from the SPV).

The Final Rule has been modified to apply a "partial look-through approach." This approach requires a Covered Company or Covered Foreign Entity (other than an IHC with less than $250 billion in total consolidated assets) to look through to individual issuers of underlying assets of an SPV only if the exposure to such issuer is at least 0.25 percent of the company's tier 1 capital, even if the Covered Company or Covered Foreign Entity cannot demonstrate that its exposure to each issuer of underlying assets of the SPV is less than 0.25 percent of the Covered Company's or Covered Foreign Entity's tier 1 capital. In addition, the Covered Company or Covered Foreign Entity will be required to aggregate indirect exposures to unknown issuers of underlying assets of an SPV and to aggregate all such exposures of such issuers to a single "unknown counterparty." Look-through is not required for exposures to issuers of underlying assets of the SPV if those exposures do not exceed the 0.25 threshold. The preamble also notes that Covered Companies or Covered Foreign Entities may be able to ascertain that an SPV does not contain any exposures of at least 0.25 percent of tier 1 capital based on characteristics of the SPV without having to measure each specific exposure within the SPV.

The preamble provides the following example. Assume an SPV holds $10 of bonds issued by one unidentified company, $14 of bonds issued by another unidentified company and $20 of bonds issued by a third unidentified company and a Covered Company or Covered Foreign Entity invests in the SPV. Assume further the Covered Company's or Covered Foreign Entity's pro rata share in the SPV is 50 percent

(assuming all investors are *pari passu*).[5] Now assume the ratio of pro rata investment in each bond (A, B and C) to tier 1 capital of the Covered Company or Covered Foreign Entity is 0.24 percent, 0.34 percent and 0.48 percent, respectively. In this example, the Covered Company or Covered Foreign Entity would have to recognize a $5 exposure to the SPV (*i.e.*, 50 percent of the $10 exposure to the first unidentified company) and a $17 exposure to an unknown counterparty (*i.e.*, 50 percent of the $14 exposure to the second unidentified company and 50 percent of the $20 exposure to the third unidentified company). This example applies both the partial look-through approach (as to the first unidentified company) and the unknown counterparty treatment (as to the second and third unidentified counterparties).

Furthermore, under the Final Rule, a Covered Company or Covered Foreign Entity (other than an IHC with less than $250 billion in total consolidated assets) must recognize a gross credit exposure to each third party that has a contractual obligation to provide credit or liquidity support to an SPV whose failure or material financial distress would cause a loss in the value of the company's SPV exposure. This incremental exposure would be capped at the maximum contractual obligation of that third party to the SPV.

V. Exemptions

The Final Rule exempts certain categories of credit exposures from counting toward a Covered Company's or Covered Foreign Entity's net credit exposure. These exemptions are similar, but not identical, to the exclusions from the definition of Counterparty discussed in Section II above, in that the exclusions from the definition of Counterparty affect all credit exposures to that Counterparty, while these exemptions are, in some cases, limited to specified categories of transactions.

Explicitly exempted from the scope of the Final Rule are:

- 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;

- intraday credit exposures;

---

[5] If all investors in the SPV are not *pari passu*, a Covered Company or Covered Foreign Entity that is required to use the look-through approach would measure its exposure to an issuer of assets held by the SPV for each tranche in the SPV in which the Covered Company or Covered Foreign Entity invests.

- trade exposures to qualifying central counterparties ("QCCP"), including potential future exposure arising from transactions cleared by the QCCP and pre-funded default fund contributions;

- any credit transaction with the Bank for International Settlements, the International Monetary Fund, the International Bank of Reconstruction and Development, the International Finance Corporation, the International Development Association, the Multilateral Investment Guarantee Agency or the International Centre for Settlement of Investment Disputes;

- any credit transaction with the European Commission or the European Central Bank; and

- any other transaction the FRB exempts.

VI. Compliance Timeline

Major Covered Companies, Major FBOs and Major IHCs must comply with the Final Rule by January 1, 2020. All other Covered Companies and Covered Foreign Entities must comply with the Final Rule by July 1, 2020. Generally, Covered Companies and Covered Foreign Entities that become subject to the Final Rule at a future date will be required to comply beginning on the first day of the ninth calendar quarter after the company reaches the applicable asset threshold.

Covered Companies and Covered Foreign Entities (excluding IHCs with total consolidated assets of less than $250 billion) are required to comply with the requirements on a daily basis as of the end of each business day. An IHC with total consolidated assets of less than $250 billion is required to comply with the requirements on a quarterly basis. The Final Rule permits Covered Companies and Covered Foreign Entities to rely on the most recent available information. Covered Companies and Covered Foreign Entities are required to report their compliance to the FRB on a quarterly basis, as of the end of the quarter.

The Final Rule generally provides a 90-day cure period for breaches attributable to:

- decreases in the Covered Company's or Covered Foreign Entity's capital stock and surplus;

- merger of a company with a Covered Company or Covered Foreign Entity;

- merger of two unaffiliated Counterparties;
- an unforeseen and abrupt change in the status of a Counterparty that results in the Covered Company's or Covered Foreign Entity's credit exposure to the Counterparty exceeding the SCCL; or
- any other circumstance that the FRB determines is appropriate.

During this 90-day cure period, the Covered Company or Covered Foreign Entity must use reasonable efforts to return to compliance and may not engage in any additional credit transactions with such Counterparty during the period of noncompliance without FRB approval. Otherwise, the FRB may bring enforcement action against the Covered Company or Covered Foreign Entity for noncompliance.

Appendix A – Gross Exposure Calculation Methodology

Credit Transaction	Calculation Methodology
Loans and Leases	Amount owed by the Counterparty to the Covered Company or Covered Foreign Entity under the transaction.
Debt Securities	For trading and available-for-sale securities, market value of the securities. For securities held to maturity, amortized purchase price of the securities.
Equity Securities	Market value of the securities.
Securities Financing Transactions ("SFTs")	Valued using a method the Covered Company or Covered Foreign Entity is authorized to use under the FRB's risk-based capital rules to value such transactions (*e.g.*, VaR). SFTs that are not subject to bilateral netting or do not meet the definition of "repo-style transaction" under the FRB's risk-based capital rules must be calculated on a transaction-by-transaction basis. SFTs that are subject to bilateral netting and meet the definition of "repo-style transaction" must be calculated for the netting set. The FRB has indicated that it may revisit the approach to securities financing transactions permitted under the capital rules in the future.
Committed credit lines	Face amount of the credit line.
Guarantees and letters of credit	Maximum potential loss to the Covered Company or Covered Foreign Entity on the transaction.
Derivatives transactions	Value calculated using methodologies available under the FRB's risk-based capital rules.
Credit or equity derivative transactions with a third party referencing a Counterparty security.	Maximum potential loss to the Covered Company or Covered Foreign Entity (as the protection provider) on the transaction.

Appendix B – Credit Risk Mitigation Methodology

Credit Risk Mitigation	Extent of Mitigation
Eligible Collateral	For any credit transaction other than a Securities Financing Transactions ("SFT"), the market value of the eligible collateral plus (in the case of collateral transferred by the Covered Company or Covered Foreign Entity) or minus (in the case of collateral received by the Covered Company or Covered Foreign Entity) the haircut calculated in accordance with the FRB's risk-based capital rules depending on whether the collateral is transferred, and further adjusted based on potential maturity mismatches.
Eligible Guarantees	The amount of the eligible guarantee from an eligible guarantor (as adjusted based on potential maturity mismatches).
Eligible Credit Derivatives	The notional amount of any such eligible credit derivative from an eligible guarantor (as adjusted based on potential maturity mismatch).[6]
Eligible Equity Derivatives	The gross credit exposure to the Counterparty.[7]
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 or Covered Foreign Entity does not have the legal obligation to advance funds and the used portion of the credit extension has been fully secured by eligible collateral.

* * *

[6] The Final Rule further provides that in the case of eligible credit derivatives that are used to hedge covered positions subject to the FRB's market risk rule where the Counterparty on the hedged transaction is not a financial entity, the Covered Company or Covered Foreign Entity must reduce its gross credit exposure to the Counterparty on the hedged transaction by the notional amount of the eligible credit derivative that references the Counterparty if the Covered Company or Covered Foreign Entity obtains the derivative from an eligible guarantor. In addition, the Covered Company or Covered Foreign Entity must recognize a credit exposure to the eligible guarantor that is measured using methodologies the Covered Company or Covered Foreign Entity is authorized to use under the FRB's risk-based capital rules, rather than the notional amount.

[7] Please refer to footnote above.

Please do not hesitate to contact us with any questions.

New York

Gregory J. Lyons
gjlyons@debevoise.com

David L. Portilla
dlportilla@debevoise.com

Chen Xu
cxu@debevoise.com

Marie R. Cita
mrcita@debevoise.com

Washington, D.C.

Satish M. Kini
smkini@debevoise.com