TO: Board of Governors

FROM: Governor Tarullo

DATE: February 26, 2016

SUBJECT: Proposed rules to implement single-counterparty credit limits in section 165(e) of the Dodd-Frank Act

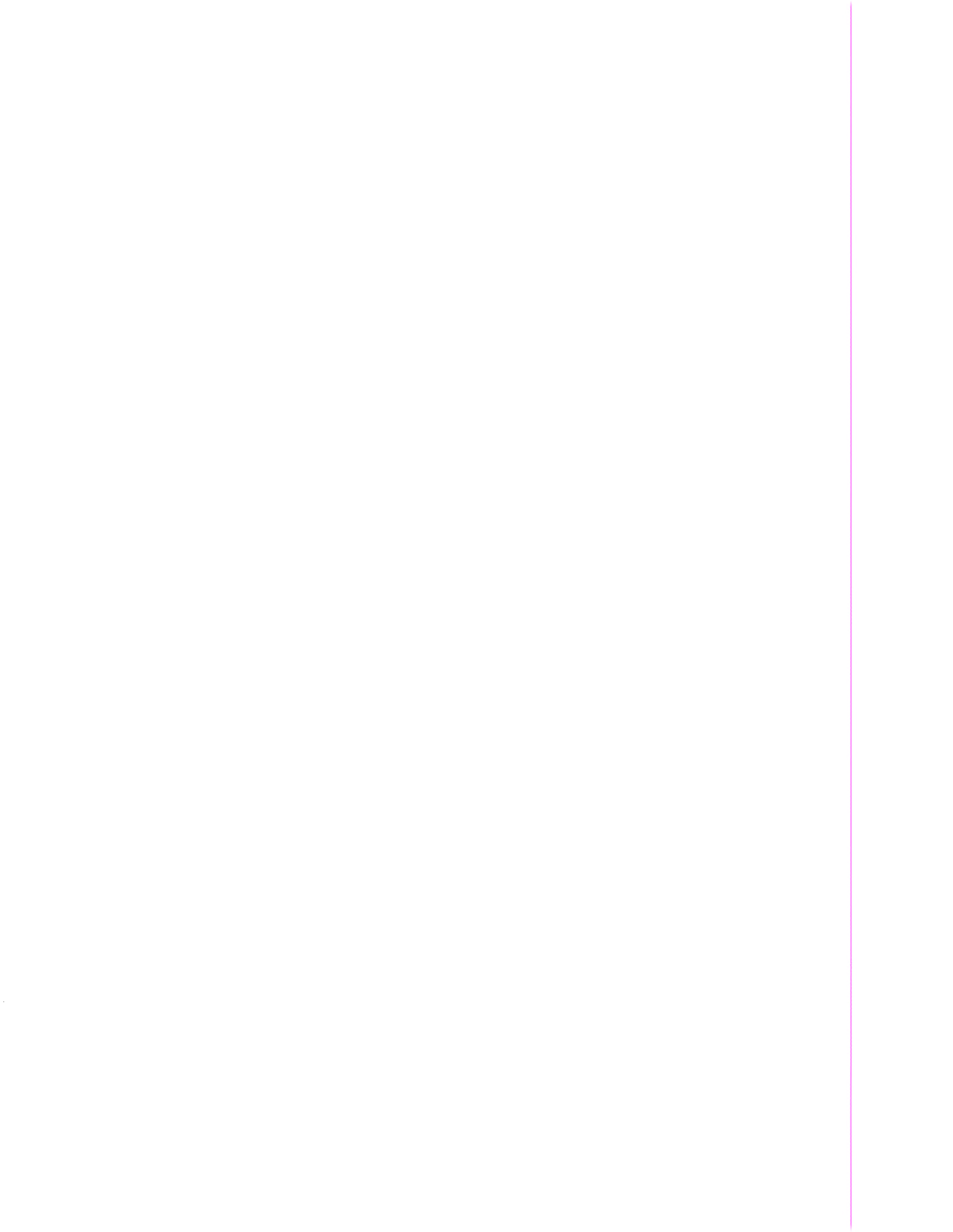
Attached are a memorandum to the Board and a draft Federal Register notice of proposed rulemaking that would impose single-counterparty credit limits on large U.S. bank holding companies and foreign banks.

Section 165(e) of the Dodd-Frank Act prohibits a U.S. bank holding company or the U.S. operations of a foreign banking organization with $50 billion or more in total consolidated assets ("covered company") from having credit exposure to any unaffiliated company that exceeds 25 percent of the covered company's capital stock and surplus. The statute also authorizes the Board to impose a lower limit if necessary to mitigate financial stability risks. In 2011 and 2012, the Board proposed and received comments on rules to implement the section 165(e) credit exposure limits. In response to those comments and to the release of a related international standard regarding credit exposure limits for global banks, staff developed the draft proposed rule, which would establish single-counterparty credit limits for covered companies.

The proposed rule is tailored to the systemic footprint of covered companies. For example, covered companies with less than $250 billion in total assets and less than $10 billion in foreign exposure would be permitted to use a broad capital base of total regulatory capital, would be required to demonstrate compliance on a quarterly basis, and would be given two years from the effective date of the rule to come into compliance. Covered companies above these thresholds would be required to use the narrower capital base of tier 1 capital, would be required to demonstrate compliance on a monthly basis, and would be given one year to come into compliance. Moreover, U.S. global systemically important banks and the largest foreign banks would be subject to a tighter 15 percent of capital limit with respect to counterparties that are systemically important financial institutions.

The Committee on Bank Supervision has been briefed on the draft proposed rule and has approved moving forward. With that agreement, I believe the attached materials are ready for the Board's consideration at an open Board meeting on March 4.

Attachments



TO: Board of Governors

FROM: Staff[1]

DATE: February 26, 2016

SUBJECT: Proposed rules to implement single-counterparty credit limits in section 165(e) of the Dodd-Frank Act

ACTIONS REQUESTED: Approval to invite public comment on draft proposed rules to implement the single-counterparty credit limits required under section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), and the attached draft Federal Register notice. Staff also requests authority to make technical changes (for example, to conform to Federal Register standards and correct non-substantive errors in the documents) to the attached documents.

EXECUTIVE SUMMARY:

- Background: Section 165(e) of the Dodd-Frank Act limits the credit exposure that U.S. and foreign bank holding companies with $50 billion or more in total consolidated assets ("covered BHCs"), as well as certain nonbank financial companies, may have to an unaffiliated company to a maximum of 25 percent of capital stock and surplus. In 2011 and 2012, the Board proposed and received comments on rules to implement the section 165(e) credit exposure limits. In response to those comments and to the release of a related international standard regarding credit exposure limits, staff developed the draft proposed rules, which would establish single-counterparty credit limits for covered BHCs.
    - The draft proposed rules would apply to covered BHCs on a consolidated basis, including any subsidiary.
    - The draft proposed rules would not at this time apply to any nonbank financial company that the Financial Stability Oversight Council ("FSOC") has designated for supervision by the Board. The draft Federal Register notice states that the Board would apply similar requirements to these companies separately by rule or order at a later time.
- Credit exposure limits: The draft proposed rules would apply three increasingly stringent credit exposure standards to account for the increased risk to the financial system of interconnectedness among the largest and most complex financial firms:
    - A domestic BHC, foreign banking organization, and U.S. intermediate holding company ("IHC") with total consolidated assets of $50 billion or more would be prohibited from having aggregate net credit exposure to a single counterparty in

[1] Mr. Alvarez, Ms. Schaffer, Mr. McDonough, Mss. Nardolilli and Chang (Legal Division), and Messrs. Gibson, Van Der Weide, Campbell, and Bleicher (Division of Banking Supervision and Regulation).

excess of 25 percent of the company's total regulatory capital plus allowance for loan and lease losses ("ALLL"). This is the limit set by section 165(e);

- A domestic BHC, foreign banking organization, and U.S. IHC with total consolidated assets of $250 billion or more, or $10 billion or more in on-balance-sheet foreign exposures, would be prohibited from having aggregate net credit exposure to a single counterparty in excess of 25 percent of the company's tier 1 capital; This tighter limit relies on authority granted to the Board by section 165(e) to set stricter limits; and

- A "major covered company" – defined as any domestic BHC that is a global systemically important banking organization ("G-SIB"), as well as any foreign banking organization or U.S. IHC with total consolidated assets of $500 billion or more – would be prohibited from having aggregate net credit exposure to a "major counterparty" in excess of 15 percent of the major covered company's tier 1 capital. A "major counterparty" would include all major covered companies, any other foreign banking organization that has the characteristics of a G-SIB, and any nonbank financial company designated by FSOC for supervision by the Board.

- Counterparties: The draft proposed rules would define a counterparty to include an unaffiliated company, natural person (and the person's immediate family), U.S. State, and any foreign sovereign entity that is assigned a risk weight greater than zero under the Board's capital rules.[2]

- Credit exposures: The credit exposure limits in the draft proposed rules would apply to (i) extensions of credit; (ii) repurchase or reverse repurchase agreements; (iii) securities lending or securities borrowing transactions; (iv) guarantees, acceptances, and letters of credit; (v) the purchase of, or investment in, securities issued by the counterparty; (vi) credit exposures in connection with certain derivative transactions; and (vii) any transaction that is the functional equivalent of the above as well as any similar transaction that the Board determines to be a credit transaction.

  - The credit exposure limits would apply to aggregate net credit exposures, which would reflect mitigants such as guarantees and collateral, rather than aggregate gross credit exposure.

  - The draft proposed rules would apply a "risk-shifting" approach to a credit exposure involving certain credit risk mitigants, such as collateral or guarantees. Under this approach, a reduction in the exposure amount to a counterparty relating to an eligible credit risk mitigant generally would result in a dollar-for-dollar increase in exposure to the collateral issuer or credit protection provider, as applicable.

- Exemptions: The draft proposed rules would provide exemptions or exclusions for credit exposures to (1) the U.S. government (including U.S. government agencies as well as Fannie Mae and Freddie Mac, while in conservatorship); (2) foreign sovereign entities that are

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[2] See 12 CFR part 217, subpart D.

assigned a zero percent risk weight under the Board's capital rules; (3) trade exposures to qualifying central counterparties; and (4) the Federal Home Loan Banks.

- Impact Analysis: Staff estimates that the total amount of excess credit exposure of domestic covered BHCs under the proposal would be less than $100 billion, and that the overwhelming majority of this excess credit exposure would be credit exposure by major covered companies to major counterparties. Staff believes that firms could largely eliminate this excess exposure amount without materially disrupting their activities.

DISCUSSION:

Background

The Board originally issued proposed rules to implement section 165(e) for domestic BHCs with total consolidated assets of $50 billion or more in 2011 ("the original domestic proposal"), and for foreign banking organizations with total consolidated assets of $50 billion or more in 2012 ("the original FBO proposal," and together with the original domestic proposal, "the original proposals").[3] A summary of comments on the original proposals is attached as an appendix to this memorandum. Following the release of these proposals by the Board, the Basel Committee on Banking Supervision ("BCBS") adopted a related international standard for controlling large exposures of internationally active banking organizations (the "international standard").

Summary of the Proposal

Proposal for Domestic Banking Organizations

Overall Limits

The original domestic proposal would have established a two-tier framework of single-counterparty credit limits. Under that proposal, a domestic BHC with $50 billion or more in total consolidated assets ("covered company") generally would have been prohibited from having aggregate net credit exposure to a single counterparty in excess of 25 percent of the BHC's total regulatory capital plus ALLL. In addition, a covered company with $500 billion or more in total consolidated assets would have been prohibited from having aggregate net credit exposure to another banking organization with $500 billion or more in total consolidated assets, or to a

[3] See 77 Federal Register 594 (January 5, 2012); 77 Federal Register 76627 (December 28, 2012).

nonbank financial company designated by the FSOC for Board supervision, in excess of 10 percent of the covered company's total regulatory capital.

This draft proposal would establish three increasingly stringent single-counterparty credit limits. As a baseline standard, and similar to the original proposal, a covered company with $50 billion or more in total consolidated assets would be prohibited from having aggregate net credit exposure to a single counterparty in excess of 25 percent of the BHC's total regulatory capital plus ALLL. A new second category of limits would apply to covered companies with $50 billion or more in total assets that either have $250 billion or more in total consolidated assets or $10 billion or more in cross-border exposures. These firms would be prohibited from having aggregate net credit exposure to a single counterparty in excess of 25 percent of their tier 1 capital. Tier 1 capital represents, on average, about 82 percent of total regulatory capital plus ALLL for these firms.

The third category of limits would apply to major covered companies. A major covered company would be prohibited from having aggregate net credit exposure in excess of 15 percent of its tier 1 capital to any entity that is a major counterparty. A "major counterparty" would be defined as a domestic or foreign G-SIB or a nonbank financial company that has been designated by the FSOC for supervision by the Board. The following table summarizes the proposed single-counterparty credit limits for covered companies:

<u>Proposed Single-Counterparty Credit Limits for Covered Companies</u>

Category of Covered Companies	**Applicable Credit Exposure Limit**
Covered companies that have less than $250 billion in total consolidated assets and less than $10 billion in on-balance-sheet foreign exposures	Aggregate net credit exposure to a counterparty cannot exceed 25 percent of a covered company's total regulatory capital plus ALLL
Covered companies that have $250 billion or more in total consolidated assets or $10 billion or more in on-balance-sheet foreign exposures, but are not major covered companies	Aggregate net credit exposure to a counterparty cannot exceed 25 percent of a covered company's tier 1 capital
Major covered companies	Aggregate net credit exposure to a <u>major counterparty</u> cannot exceed 15 percent of a major covered company's tier 1 capital

Category of Covered Companies	Applicable Credit Exposure Limit
	Aggregate net credit exposure to other counterparties cannot exceed 25 percent of a major covered company's tier 1 capital

Definitions of "Subsidiary" and "Counterparty"

Under the draft proposed rules, a covered company would be required to aggregate any of its and its subsidiaries' exposures to the same counterparty. For these purposes, a "subsidiary" would mean a company that is directly or indirectly controlled by the specified company for purposes of the Bank Holding Company Act of 1956, 12 U.S.C. 1841 et seq ("BHC Act").[4] A "counterparty" would include a company; natural person (including a natural person's immediate family); U.S. state (including all of its agencies, instrumentalities, and political subdivisions); and foreign sovereign entities that are not assigned a zero percent risk weight under the Board's capital rules. A credit exposure to a counterparty also would include a credit exposure to any person with respect to which the counterparty (1) owns, controls, or holds with power to vote 25 percent or more of a class of voting securities; (2) owns or controls 25 percent or more of the total equity; or (3) consolidates for financial reporting purposes.

The requirements in section 165(e) operate as a separate and independent limit from the investment securities limits and lending limits in the National Bank Act and Federal Reserve Act, and a domestic covered BHC must comply with all of the limits that are applicable to it and its subsidiaries. A covered company would be required to ensure that it does not exceed the single-counterparty credit limits when all the credit exposures on the organization are consolidated. Because the draft proposed rules would impose limits on credit transactions by a covered BHC on a consolidated basis, including its subsidiary depository institutions, the draft proposed rules may affect the amount of loans and extensions of credit that would otherwise be consistent with a subsidiary depository institution's lending limits.

In addition, a covered company would be required to aggregate exposures to counterparties that are "economically interdependent." Two counterparties would be deemed

[4] See proposed rule § 252.71(cc); see also section 252.2(g) of the Board's Regulation YY (12 CFR 252.2(g)).

economically interdependent when the failure or distress of one of the counterparties would cause the failure or distress of the other counterparty. The proposal lists several factors that covered companies must consider when assessing whether counterparties are economically interdependent. This assessment would only be required when a covered company's exposure to one of the counterparties exceeds 5 percent of the covered company's eligible capital.[5]

Calculation of Exposure Amounts

As noted above, the draft proposed rules would impose limits on the amount of "aggregate net credit exposure" that a covered company may have to a counterparty. To calculate its aggregate net credit exposure to a counterparty, a covered company would first calculate its "gross credit exposure" resulting from credit transactions with that counterparty. The covered company would then reduce the gross credit exposure amount based on certain forms of credit risk mitigation – namely, eligible collateral, certain types of guarantees, certain types of credit and equity derivatives, and certain other hedges.

Under the original domestic proposal, covered companies would have been required to calculate credit exposure from derivatives transactions with a counterparty using the "Current Exposure Method" ("CEM") from the Board's standardized risk-based capital rules for BHCs. Under the draft proposed rules, covered companies would instead be permitted to calculate their potential future exposure to derivatives counterparties using any methodology that they are allowed to use under the risk-based capital rules. These methodologies would include CEM for all covered companies and the internal models methodology for covered companies subject to the Board's advanced approaches risk-based capital rules.[6]

Under the draft proposed rules, a covered company generally would measure credit exposure to a counterparty in a securities financing transaction as the value of any cash and securities transferred to that counterparty minus the value of any cash and securities received

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[5] For covered companies with less than $250 billion in total consolidated assets, and less than $10 billion in on-balance-sheet foreign exposures, "eligible capital" would refer to the company's total regulatory capital stock and surplus plus ALLL. For domestic covered BHCs above these thresholds, "eligible capital" would refer to the company's tier 1 capital.

[6] 12 CFR part 217, subparts D and E. This draft proposal cites the BCBS's recent issuance of a final revised standardized approach ("SA-CCR") for measuring credit exposure to a derivatives counterparty, and notes that the Board may consider incorporating SA-CCR into single-counterparty credit limit requirements at such time as the Board incorporates SA-CCR into the risk-based capital rules.

from that counterparty as collateral, adjusted in the same manner as under the risk-based capital rules.[7] The draft proposed rules also seek comment on several alternative approaches that could be used to measure credit exposure from securities financing transactions.

The draft proposal would also make several changes relative to the original domestic proposal with respect to the treatment of credit risk mitigants. Under the original proposal, a covered company would have had the option to reduce its gross credit exposure to a counterparty on the basis of eligible collateral securing that exposure, and if it did elect to so reduce its exposure to the counterparty, would have been required to recognize a dollar-for-dollar increase in its exposure to the issuer of the eligible collateral. Under the revised proposal, to help prevent arbitrage and promote monitoring of a covered company's credit exposures, a covered company would be required to reduce its exposure to the original counterparty based on eligible collateral, and to recognize a dollar-for-dollar increase in exposure to the collateral issuer.

With respect to eligible guarantees and eligible credit and equity derivatives, the original proposal would have required a covered company to reduce its gross credit exposure to a counterparty based on such guarantees and derivatives, and to recognize a dollar-for-dollar increase in its exposure to the relevant protection provider. The approach in the revised proposal is generally similar. However, where a covered company uses credit or equity derivatives to hedge an exposure to a non-financial entity where that exposure is subject to the Board's market risk capital rules, the covered company would be permitted to measure credit exposure to protection providers using any counterparty credit risk methodology authorized under the risk-based capital rules. For credit and equity derivatives, this would include CEM for all covered companies and approaches that rely on internal models for covered companies subject to the Board's advanced approaches risk-based capital rules.

Treatment of Special Purpose Vehicles

The revised proposal also includes a specific framework for measuring credit exposures that arise in the context of investments in securitizations, investment funds, and other special purpose vehicles (collectively, "SPVs"). A covered company generally would have to recognize an exposure to an SPV equal to the value of its investment in the SPV. In addition, if a covered company with total consolidated assets of $250 billion or more, or $10 billion or more in on-

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[7] See discussion of securities financing transactions in the "Net Credit Exposure" section of the draft preamble.

balance-sheet foreign exposures cannot demonstrate that its exposure to each underlying investment in an SPV is smaller than 0.25 percent of the BHC's eligible capital base, the BHC would be required to apply a "look-through" approach. The look-through approach would require the BHC to recognize an exposure to each issuer of the assets that the SPV holds. Such covered companies would also be required to recognize exposures to relevant third parties (e.g., credit enhancement providers) whose failure or distress would likely result in a reduction in the value of the BHC's investment in the SPV.

Exemptions and Exclusions

The original proposed rules provided an exclusion for exposures to the U.S. government (including federal government agencies), as well as an exemption for exposures to Fannie Mae and Freddie Mac while in conservatorship. The draft proposed rules would maintain both. In addition, the draft proposed rules would include an exemption for exposures to foreign sovereign governments that receive a zero percent risk weight under the Board's standardized risk-based capital rules (12 CFR part 217, subpart D), exposures to the Federal Home Loan Banks, and trade exposures to qualifying central counterparties. A foreign sovereign government receives a zero percent risk weight under the capital rules if the sovereign has a country risk classification of 0 or 1 from the Organization for Economic Cooperation and Development, indicating that there is a high probability that the sovereign will continue to service its external debt. For the purposes of the exemption for trade exposures to qualifying central counterparties, a qualifying central counterparty would include a central counterparty that is a designated financial market utility ("FMU") under Title VIII of the Dodd-Frank Act; and, if not located in the United States, a central counterparty that is regulated and supervised in a manner equivalent to a designated FMU, as well as a central counterparty that meets certain prudential standards specified in the Board's capital rules.[8] "Trade exposures" to a qualifying central counterparty would include any credit exposure arising from the cleared portfolio and pre-funded default fund contributions. Exempt trade exposures would not include, for example, a loan from a covered company to any central counterparty that is unrelated to that covered company's clearing activity with that central counterparty.

[8] See definition of "qualifying central counterparty" in the Board's risk-based capital rules (12 CFR 217.2).

Tailoring

The draft proposal is designed to be less stringent for those BHCs whose failure or distress would be less likely to pose a risk to U.S. financial stability. As noted above, only major covered companies would be subject to a 15 percent limit on exposures to major counterparties. For covered companies with less than $250 billion in total consolidated assets, and less than $10 billion in on-balance-sheet foreign exposures, single-counterparty credit limits would be based on total regulatory capital rather than tier 1 capital. Such firms would not be subject to the more specific requirements regarding exposures related to investments in SPVs that apply to larger firms. In addition, such firms would be provided a two-year compliance period (compared with a one-year period for larger firms) and would have to demonstrate compliance with single-counterparty credit limits on a quarterly basis (compared with a monthly basis for larger firms).

Proposal for Foreign Banking Organizations

The single-counterparty credit limit proposal for foreign banking organizations builds on the enhanced prudential standards adopted by the Board in February 2014 for foreign banking organizations with $50 billion or more in total consolidated assets.[9] Under that rule, a foreign banking organization with U.S. non-branch assets of $50 billion or more is required to form an IHC to hold its interests in U.S. bank and nonbank subsidiaries. A U.S. IHC will be subject to enhanced prudential standards on a consolidated basis, including risk-based and leverage capital requirements, liquidity requirements, and risk management standards. Certain enhanced prudential standards also will apply to a foreign banking organization's "combined U.S. operations," which would include a foreign banking organization's U.S. branches and agencies as well as its U.S. subsidiaries.

Like the enhanced prudential standards for foreign banking organizations that the Board has previously adopted, the single-counterparty credit limits in this proposal would apply only to foreign banking organizations with $50 billion or more in total worldwide consolidated assets. For such organizations, the limits would apply separately to both the U.S. IHC and the foreign banking organization's combined U.S. operations including the IHC (each a "covered entity"). More specifically, single-counterparty credit limits for a U.S. IHC would limit the U.S. IHC's

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[9] 79 Federal Register 17240 (March 27, 2014).

aggregate net credit exposure to another counterparty relative to the U.S. IHC's eligible capital. Single-counterparty credit limits for a foreign banking organization's combined U.S. operations (which includes a U.S. branch or agency of the foreign bank, as well as its IHC) would limit the aggregate net credit exposure of the combined U.S. operations to another counterparty relative to the foreign bank parent's eligible capital.

Similar to the proposal for domestic banking organizations, single-counterparty credit limits for foreign banking organizations would fall into three tiers of increasing stringency. As a baseline, the U.S. IHC and combined U.S. operations of a foreign banking organization (with $50 billion or more in total worldwide consolidated assets) would be prohibited from having aggregate net credit exposure to a single counterparty in excess of 25 percent of the U.S. IHC's or foreign bank parent's total regulatory capital, respectively. The second category of single-counterparty credit limits would apply to intermediate holding companies and the combined U.S. operations of foreign banking organizations with $250 billion or more in total consolidated worldwide assets or $10 billion or more in on-balance-sheet foreign exposures.[10] These entities would be prohibited from having aggregate net credit exposure to a single counterparty in excess of 25 percent of the U.S. IHC's consolidated tier 1 capital or 25 percent of the foreign bank parent's worldwide consolidated tier 1 capital. The third category of single-counterparty credit limits would apply to intermediate holding companies and the combined U.S. operations of foreign banking organizations with $500 billion or more in total consolidated assets. These entities would be prohibited from having aggregate net credit exposure to a major counterparty in excess of 15 percent of the U.S. IHC's consolidated tier 1 capital, or 15 percent of the foreign bank parent's worldwide consolidated tier 1 capital.[11] The following table summarizes the single-counterparty credit limits for covered entities:

[10] For these purposes, the calculation of "foreign exposure" would exclude exposures of the intermediate holding company or combined U.S. operations to both the foreign bank parent and the foreign bank parent's home country sovereign.

[11] As in the domestic proposal, a "major counterparty" would be defined as a domestic or foreign banking organization that is a G-SIB or a nonbank financial company that has been designated for supervision by the Board.

Proposed Single-Counterparty Credit Limits Applicable to Covered Entities

Category of Covered Entities	Applicable Credit Exposure Limit
U.S. intermediate holding companies or foreign banking organizations with less than $250 billion in total consolidated assets and less than $10 billion in on-balance-sheet foreign exposures	Aggregate net credit exposure of a U.S. intermediate holding company cannot exceed 25 percent of the U.S. intermediate holding company's total regulatory capital plus the balance of its ALLL not included in tier 2 capital under the Board's capital adequacy guidelines (12 CFR part 252) Aggregate net credit exposure of a foreign banking organization, with respect to its U.S. combined operations, to a counterparty cannot exceed 25 percent of the foreign banking organization's total regulatory capital on a consolidated basis
U.S. intermediate holding companies or foreign banking organizations with $250 billion or more in total consolidated assets or $10 billion or more in on-balance-sheet foreign exposures	Aggregate net credit exposure of a U.S. intermediate holding company to a counterparty cannot exceed 25 percent of the U.S. intermediate holding company's tier 1 capital Aggregate net credit exposure of a foreign banking organization, with respect to its U.S. combined operations, to a counterparty cannot exceed 25 percent of the foreign banking organization's worldwide tier 1 capital
Major U.S. intermediate holding companies and major foreign banking organizations	Aggregate net credit exposure of a major U.S. intermediate holding company or, with respect to its combined U.S. operations, of a foreign banking organization to a major counterparty cannot exceed 15 percent of the covered entity's tier 1 capital Aggregate net credit exposure of a major U.S. intermediate holding company or, with respect to its combined U.S. operations, of a foreign banking organization to other counterparties cannot exceed 25 percent of the covered entity's tier 1 capital

The proposed single-counterparty credit limits would not apply to exposures of a U.S. IHC or a foreign banking organization's combined U.S. operations to the foreign banking organization's home country sovereign or to the foreign bank parent. In addition, in calculating its net credit exposure to a counterparty, a U.S. IHC and a foreign banking organization's combined U.S. operations would not be permitted to reduce the gross exposure to the counterparty based on collateral issued by, or guarantees or credit or equity derivatives obtained from, the foreign bank parent. The other major elements of the proposed single-counterparty credit limit framework for foreign banking organizations would generally be the same as the proposed requirements for domestic covered BHCs.

Calibration Analysis

Basing single-counterparty credit limits for covered BHCs with $250 billion or more in total consolidated assets or $10 billion or more in total on-balance-sheet foreign exposures on tier 1 capital would be consistent with the post-crisis focus on higher-quality forms of capital and, based on the experience in the crisis whereby market participants significantly discounted the value of capital instruments such as subordinate debt that count in total regulatory capital, would provide a more reliable capital base for the credit limits. In addition, the analysis that follows suggests that using a narrower definition of capital for such covered BHCs could help to mitigate risks to U.S. financial stability.

As described above, the draft proposed rules for domestic and foreign banking organizations would include a tighter 15 percent limit that would apply to exposures of U.S. covered companies, intermediate holding companies with $500 billion or more in total consolidated assets, and the combined U.S. operations of foreign banking organizations with $500 billion or more in total consolidated assets to major counterparties. The draft proposed rules are accompanied by a quantitative analysis ("White Paper") that sets out the rationale for applying a tighter limit to such exposures, and for the specific calibration of the tighter limit in the draft proposed rules. In brief, the principal rationale for applying a tighter limit to exposures of major covered companies to major counterparties is that these exposures are expected to result in a heightened degree of risk to the major covered company compared to otherwise equivalent exposures of major covered companies to other counterparties. This heightened risk arises because major covered companies and major counterparties are engaged in common business lines and have common counterparties and funding sources. This creates a significant degree of

commonality in their economic performance. In particular, factors that would likely cause the distress of a major counterparty would also likely be expected to adversely affect a major covered company.

The White Paper analyzes data on the default correlation between systemically important financial institutions ("SIFIs")[12] as well as data on the default correlation between SIFIs and a sample of non-SIFI companies. The analysis supports the view that the correlation between SIFIs – and hence, the correlation between major covered companies and major counterparties – is measurably higher than the correlation between SIFIs and other counterparties. This finding further supports the view that credit extensions of major covered companies to major counterparties present a higher degree of risk than credit extensions between a major covered company and other counterparties.

The more stringent credit limit of 15 percent is informed by the results of a credit risk model that is described in detail in the White Paper. Data on the correlations described above are used to calibrate a credit risk model that is then used to set the single-counterparty credit limit for exposures of a major covered company to a major counterparty to equilibrate the total risk incurred on such credit extensions with that incurred on credit extensions by a major covered company to a non-major counterparty. The resulting model produces single-counterparty credit limits for exposures of major covered companies to major counterparties in line with the proposed limit of 15 percent.

An additional consideration that is not explicitly considered in the context of the White Paper's credit model is the relative difference in adverse consequences arising from multiple SIFI defaults relative to the default of a SIFI and a non-SIFI counterparty. The financial stability consequences of the default of a SIFI borrower and a resulting default of a SIFI lender are likely greater than the adverse consequences that would result from the default of a single SIFI lender and a single non-SIFI borrower. This consideration supports an appropriate inter-SIFI single-counterparty credit limit that is even lower than that proposed for exposures between non-SIFIs.

Impact Analysis

Board staff have conducted a quantitative impact study to help assess the likely effect of the revised proposal. Based on this study, staff believes firms would be able to comply with the

[12] For purposes of the White Paper, SIFIs include G-SIBs and nonbank financial companies designated by FSOC for supervision by the Board.

proposed framework without materially disrupting their activities. Staff estimates that there would be less than $100 billion in aggregate "excess credit exposure" among all domestic covered BHCs that would be subject to the proposed requirements.[13] The overwhelming majority of the estimated excess credit exposure would be inter-SIFI credit exposure – that is, credit exposure by a major covered company to a major counterparty. Accordingly, the principal effect of the proposal would be to reduce concentrations of credit risk between SIFIs – concentrations that generate outsized levels of systemic risk, as explained in the White Paper and as demonstrated in the financial crisis.

Staff anticipates that U.S. firms would be able to eliminate their excess exposure amounts largely by compressing derivatives trades, collecting more collateral from their counterparties, increasing their use of central clearing with qualifying central counterparties, and rebalancing their portfolios among their counterparties.

Conclusion: Staff recommends that the Board approve the attached rules and invite comment on the proposal. If approved, public comment on the proposed rules would be solicited through June 3, 2016. Staff also requests authority to make minor and technical changes to the draft proposed rules and draft Federal Register notice prior to publication (for example, to address any changes that may be requested by the Federal Register).

Attachment

[13] "Excess credit exposure" refers to the amount of credit exposure that a firm has to its counterparties in excess of what that firm would be permitted to have under the proposed requirements.

Appendix – Summary of Comments on the 2011 and 2012 Proposals

The Board received 48 comments, representing approximately 60 parties, on the original domestic proposal on section 165(e) as it relates to domestic banks and organizations and 35 comments, representing over 45 organizations, on the original FBO proposal as it relates to foreign banking organizations. The comments were received from a wide range of individuals, banking organizations, industry and trade groups representing banking, insurance, and the broader financial services industry, and public interest groups. Board staff also met with industry representatives and government representatives to discuss issues relating to the proposed rules.

Some commenters expressed support for the broader goals of the proposed rules to limit single-counterparty concentrations at large financial companies. Numerous commenters expressed concerns, however, on various aspects of the proposed rule.

In the 2011 proposed rule, the Board proposed to limit the aggregate net credit exposure of a domestic covered BHC to a single unaffiliated counterparty no more than 25 percent of consolidated capital stock and surplus of the domestic covered BHC. The Board further proposed to limit the aggregate net credit exposure of BHCs with over $500 billion in assets to any other unaffiliated counterparty of similar size, or a nonbank financial company designated by FSOC for supervision by the Board, to 10 percent of the capital stock and surplus of the domestic covered BHC.

Several commenters questioned the Board's basis for lowering the 25 percent statutory limit to 10 percent. These commenters generally questioned the financial stability need for the lower limit and questioned whether the 10 percent limit would have disruptive effects, such as reducing market liquidity, decreasing loan capacity, and driving financial services to the shadow banking sector. Several commenters questioned the Board's basis for selecting a $500 billion asset threshold as the cutoff for the lower 25 percent statutory credit limit. Commenters representing the insurance industry criticized the proposed standard because it did not take into account the unique risks of the insurance business. The Board also received several comments that supported imposing the more stringent limits on single-counterparty credit exposures between very large organizations.

Some commenters on the original proposed rule urged the Board to base single-counterparty credit limits on a narrower definition of capital. For example, one commenter noted that a central finding of the financial crisis was that only common equity was reliably loss absorbing, and further observed that the Basel III capital standard reflects this through its redefinition of capital instruments. This commenter also argued that there are advantages to coordinating regulatory capital definitions around a limited number of capital definitions that include only instruments that are reliably loss absorbing.

In its 2011 proposed rule, the Board proposed to exempt credit exposures that were direct claims on, and the portions of claims that were directly and fully guaranteed as to principal and interest by, the United States and its agencies. Many commenters supported expanding this exemption to include creditworthy non-U.S. sovereigns. Several commenters noted that

sovereign entities generally are not regarded as "companies," and the statute covers exposures to companies. Others argued there is no rationale for distinguishing between U.S. and other highly-rated sovereign exposures and that limiting the amount of exposure that a domestic covered BHC can have to a highly-rated sovereign may increase systemic risk by limiting the entities' ability to invest in or accept as collateral instruments issued by such sovereigns. Commenters suggested that exposures to those sovereigns that are assigned a low risk-weight under the Basel Capital rules should be exempt.

Commenters questioned the Board's approach to measuring the exposures resulting from derivatives transactions. Under the proposed rule, a domestic covered BHC generally would have been required to calculate credit exposure to a derivatives counterparty using the CEM. Commenters argued that CEM is insufficiently risk-sensitive and that it overstates the realistic economic exposure of a derivative transaction. Commenters attributed these supposed flaws to the fact that CEM limits the extent to which netting benefits are taken into account in calculating counterparty exposures.

Some commenters also criticized the Board's proposed approach to measuring exposures from securities financing transactions.[14] These commenters argued that the collateral volatility haircuts included in the proposed rule do not recognize the risk-mitigating value of positive correlations between securities on loan and securities received as collateral. These commenters also pointed out that under the Board's risk-based capital rules, collateral volatility haircuts for securities lending and repurchase transactions may be multiplied by the square root of ½ to reflect a five-day liquidation period, rather than the ten-day period for other transaction types.

Many of the comments received concerning the proposed rule for foreign banking organizations were similar to those filed with respect to the domestic proposed rule, especially regarding the proposed rule's treatment of foreign sovereign instruments. Some commenters argued that, in light of the Basel Committee's adoption of a Large Exposures standard that would apply to a foreign banking organization on a consolidated basis, it was unnecessary for the Board to develop single-counterparty credit limits for a foreign banking organization's combined U.S. operations. Some commenters also expressed concerns related to the definition of the relevant capital base for their organizations. For example, some foreign banking organizations that expected to form U.S. IHCs to hold their U.S. subsidiaries were concerned that their relevant capital base would be restricted to the capital of the IHC, and not the relevant consolidated capital level of their entire company.

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[14] "Securities financing transactions" include repurchase agreements, reverse repurchase agreements, securities lending transactions, and securities borrowing transactions.