BANK POLICY INSTITUTE, PAIGE PIDANO PARIDON

Proposal and Comment Information

Title: Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks; Bank Holding Companies (Reg O and Y), R-1896

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Submitter Information

Organization Name: Bank Policy Institute

Organization Type: Organization

Name: Paige Pidano Paridon

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Please see attached on behalf of BPI. This comment addresses the valuation methodology for derivatives exposures to insiders and affiliates. We are separately submitting a comment letter regarding all other aspects of the Regulation O NPR.

November 4, 2026

Via electronic submission

Benjamin W. McDonough
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: **Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks; Bank Holding Companies (RIN 7100–AH27)**

Ladies and Gentlemen:

The Bank Policy Institute ("BPI")[1] is writing in response to the notice of proposed rulemaking issued by the Board of Governors of the Federal Reserve System regarding "Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks; Bank Holding Companies."[2] This comment addresses the potential adoption of a new valuation methodology for derivative contracts with insiders under Regulation O and with affiliates pursuant to section 23A of the Federal Reserve Act and its implementing regulation, Regulation W, as well as certain other derivative valuation issues. We are submitting a separate comment addressing the other proposed changes to Regulation O.

The proposal would adopt a valuation methodology for credit exposure arising from a bank's derivatives transactions with insiders that would depart significantly from both current practice under Regulation O and the valuation methodology permitted for purposes of section 23A of the Federal Reserve Act and Regulation W for derivatives transactions: the bank's current exposure to the derivative counterparty.[3] The proposal would instead tie the Regulation O (and potentially, Regulation W) valuation methodology for derivative credit exposure to the valuation methodologies permitted under the risk-based capital rules, which include not only current exposure but also measures of potential future exposure ("PFE").[4] The proposal would therefore adopt a new standard for valuing derivatives transactions for purposes of Regulation O, and the proposal notes that the Board may consider adopting this new standard for Regulation W. This new standard is likely to unnecessarily increase costs significantly and potentially force significant changes to existing booking models for firms that reflect the current exposure as the relevant credit exposure measure consistent with the 2020 joint prudential

[1] The Bank Policy Institute is a nonpartisan public policy, research and advocacy group that represents universal banks, regional banks, and the major foreign banks doing business in the United States. The Institute produces academic research and analysis on regulatory and monetary policy topics, analyzes and comments on proposed regulations, and represents the financial services industry with respect to cybersecurity, fraud, and other information security issues.

[2] 91 Fed. Reg. 49,526 (Aug. 4, 2026).

[3] *See* OCC, Federal Reserve Board, FDIC, FCA, FHFA, Final Rule, "Margin and Capital Requirements for Covered Swap Entities," 85 Fed. Reg. 39,754, 39,764 (July 1, 2020).

[4] 91 Fed. Reg. at 49,534.

regulator final rule establishing Margin and Capital Requirements for Covered Swap Entities ("Uncleared Swaps Margin Rule") for inter-affiliate derivatives transactions.[5] Under that rule, banks are required to mitigate their derivatives credit exposure by exchanging variation margin equal to the sum of fair values across derivatives payable and receivable less any variation margin received, with variation margin exchanged daily so as to substantially mitigate inter-affiliate credit risk and obviate the need for inclusion of a measure of PFE.

Including PFE when measuring derivative credit exposure is not only inconsistent with current practice and regulatory policy, it is also inconsistent with sections 22(h) and 23A of the Federal Reserve Act and inappropriate for their distinct purposes. Unlike the capital rules, which are designed to ensure banks have capital to absorb unexpected losses under a range of possible future scenarios, these statutes are designed to measure compliance at a specific point in time and for their own specific purposes. In addition, these changes could result in material changes to exposure amounts that, if extended to Regulation O and/or Regulation W, could result in significantly increased compliance and funding costs for banks as well as other negative implications for banking organizations and financial markets that the Federal Reserve has not grappled with in the proposal. Therefore, the Federal Reserve should not adopt these proposed changes to Regulation O or propose similar changes to Regulation W. Instead, the Federal Reserve should explicitly endorse the continued use of current exposure as the appropriate measure of derivative credit exposure for purposes of both Regulation O and Regulation W.

Should the Federal Reserve nevertheless adopt the proposed changes in any final revisions to Regulation O, the Federal Reserve should consider any changes to Regulation W separately and in light of Regulation W's own statutory purpose and only after undertaking empirical analyses of the likely impact of any changes on bank derivatives activities and the markets and customers those activities support. We acknowledge that Regulation O and Regulation W share certain operational concepts and that greater consistency between them can, where appropriate, promote clarity and reduce unnecessary compliance burdens. However, as discussed further in this letter, Regulation O and Regulation W ultimately are rooted in distinct statutory authorities and purposes. Regulation O is designed to prevent insider abuse by limiting preferential extensions of credit to a bank's insiders, whereas Regulation W is focused on protecting the safety and soundness of banks by limiting their exposure to affiliates. Given their distinct purposes and consequences, the application and interpretation of the two regulations should not be automatically linked.

Concepts from one regulation should only be incorporated into the other where there is a sound conceptual basis for doing so, and alignment should not be an end in itself. Otherwise, alignment could lead to unforeseen and unintended consequences with respect to the application of both regulations. Banks have long-standing and separate controls and procedures built around each existing framework, and changing definitions and methodologies in either regulation for the sole purpose of alignment would increase compliance burdens without meaningfully reducing the risks that the frameworks are intended to mitigate. Any changes should be targeted at specific, well-supported enhancements. In addition, the Federal Reserve should ensure that any linkages it codifies between the two regulations enhance clarity of the two regulations, rather than create additional complexity.

[5] OCC, Federal Reserve Board, FDIC, FCA, FHFA, Final Rule, "Margin and Capital Requirements for Covered Swap Entities," 85 Fed. Reg. 39,754, 39,759 (July 1, 2020).

I. Background

Section 22(h) of the Federal Reserve Act and its implementing regulation, Regulation O, are intended to "prevent insiders from self-dealing by using their positions and leverage to procure loans on more preferential terms or conditions than would otherwise be available to other customers of the bank . . . "[6] To achieve this aim, the statute and regulation restrict the amount and terms of extensions of credit from a member bank to its executive officers, directors, and principal shareholders and to any company controlled by these individuals or entities (collectively, "insiders").[7] Section 22(g) of the Federal Reserve Act imposes additional limitations on extensions of credit made by member banks to their executive officers.[8] An "extension of credit" includes, among other things, the making or renewing of any loan, granting a line of credit, or entering into any similar transaction.[9] Regulation O implements sections 22(g) and 22(h).[10]

Section 614 of the 2010 Dodd-Frank Act amended section 22(h) of the Federal Reserve Act to include as an extension of credit to an insider "having credit exposure to the person arising from a derivative transaction (as defined in section 5200(b) of the Revised Statutes of the United States (12 U.S.C. 84(b))) … between the member bank and the person."[11] In the intervening fifteen years, the Federal Reserve has made no public interpretation of this phrase in the context of section 22(h), whether by rule, guidance or other public statement.

The proposal would require banks to use "any method it is authorized to use under the Federal banking agencies' risk-based capital rule" to establish the value of credit exposures arising from derivatives transactions.[12] The proposal provides no explanation of why the proposed new approach was chosen or how that approach is consistent with the statutory language and policy purposes of section 22(h). Instead, the proposal simply states that tying the valuation methodology to the capital rules would "leverage the significant consideration given to the valuation of derivative transactions generally for purposes of regulatory capital requirements," and "allow banks to rely on their existing systems and processes for calculating regulatory capital requirements to ensure compliance with Regulation O, minimizing cost to the banks."[13]

In the proposal, the Federal Reserve also notes that "[g]iven the similarities in the amendments made by the Dodd-Frank Act to sections 22(h) and 23A, the Board is considering whether any valuation methodologies in the proposed rule for Regulation O should also be used to value those same credit exposures for purposes of section 23A and the Board's Regulation W." It also notes that "[t]he adoption

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[6] FDIC, Risk Management Manual of Examination Policies. Section 22.1: Examination Documentation Modules, "Regulation O: Loans to Executive Officers, Directors, and Principal Shareholders of Banks," at 1 (Oct. 2022), https://www.fdic.gov/risk-management-manual-examination-policies/regulation-o-loans.

[7] 12 U.S.C. 375b.

[8] 12 U.S.C. 375a.

[9] 12 U.S.C. 375b(9)(D)(i)(I); 12 CFR 215.3.

[10] 12 CFR part 215.

[11] *See* Dodd-Frank Act § 614(a).

[12] 91 Fed. Reg. at 49,534.

[13] *Id*.

of a methodology to value credit exposures for purposes of section 23A and Regulation W would occur in a separate rulemaking." Regulation W implements sections 23A and 23B of the Federal Reserve Act, which are intended to "limit the risks to a member bank from transactions with affiliates and limit the ability of a member bank to transfer its Federal subsidy to affiliates."[14] The potential extension of this valuation methodology to Regulation W appears to reflect the fact that section 608 of the Dodd-Frank Act amended section 23A of the Federal Reserve Act by similarly adding to the list of covered transactions "a derivative transaction, as defined in paragraph (3) of section 5200(b) of the Revised Statutes of the United States (12 U.S.C. 84(b)), with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate."[15] As we noted previously, the consideration of any potential changes in methodology regarding derivatives exposure should be considered independently with respect to each statutory provision and not tied together due to historic practice that no longer makes sense in light of the evolution in the banking system since the enactment of the relevant sections of the Federal Reserve Act. Any proposed changes should also only be finalized after the Federal Reserve has considered empirical analyses of the likely impact of any changes on bank derivatives activities and the markets and customers those activities support.

Because the risk-based capital rule methodologies the proposal would incorporate by reference include not only current exposure but also a measure of PFE, they would result in higher calculated "credit exposure" amounts than using current exposure alone. Under the current capital rules, there are three methods for calculating the counterparty credit-risk exposure amount of a derivative transaction: (i) a "current exposure methodology" ("CEM"), which includes both current exposure and a blunt proxy for PFE; (ii) a "standardized approach for counterparty credit risk" methodology ("SA-CCR"), which includes current exposure and a formula-based measure of PFE, both multiplied by an "alpha factor" of 1.4 for non-commercial end-user counterparties; and (iii) an "internal model methodology" ("IMM"), which uses a sophisticated model that effectively captures elements of both current exposure and PFE.[16] Under a pending March 2026 proposal to revise the risk-based capital rules, however, the latter (IMM) option would be eliminated, and CEM would not be available for use by Category I and II banks.[17] As a result, Category I and II banks' only option under the capital rules and thus under Regulation O (and potentially Regulation W) would be SA-CCR; all other banks would be permitted to use ***either*** CEM or SA-

[14] Board of Governors of the Federal Reserve System, Final rule, "Transactions Between Member Banks and Their Affiliates," 67 Fed. Reg. 76,560 (Dec. 12, 2002).

[15] *See* Dodd-Frank Act § 608.

[16] *See* OCC, Federal Reserve Board, FDIC, Final Rule, "Regulatory Capital Rules: Regulatory Capital and Standardized Approach for Risk-Weighted Assets," 91 Fed. Reg. 15,332, 15,344 (Mar. 27, 2026); 12 C.F.R. §§ 3.34, 217.34, 324.34; *see also* OCC, Federal Reserve Board, FDIC, Final Rule, "Regulatory Capital Rule: Category I and II Banking Organizations, Banking Organizations with Significant Trading Activity, and Optional Adoption for Other Banking Organizations," 91 Fed. Reg. 14,952, 14,963–64 (Mar. 27, 2026). The current exposure methodology calculates exposure as the current credit exposure plus the Potential Future Exposure. 12 C.F.R. §§ 3.34(b), 217.34(b), 324.34(b). SA-CCR calculates the exposure as 1.4 multiplied by the sum of replacement cost and the Potential Future Exposure. 12 C.F.R. §§ 3.132(c)(5)(i), 217.132(c)(5)(i), 324.132(c)(5)(i). The 1.4 multiplier is removed for netting sets where the counterparty is a commercial end-user. 12 C.F.R. §§ 3.132(c)(5)(iv), 217.132(c)(5)(iv), 324.132(c)(5)(iv).

[17] See OCC, Federal Reserve Board, FDIC, Final Rule, "Regulatory Capital Rule: Category I and II Banking Organizations, Banking Organizations with Significant Trading Activity, and Optional Adoption for Other Banking Organizations," 91 Fed. Reg. 14,952, 14,958 (Mar. 27, 2026). The CEM and SA-CCR approaches would remain generally unchanged under the March 2026 proposed revisions to the capital rules.

CCR. Given the purpose of Regulation O to prevent improper insider transactions, authorizing different banks to use different exposure methodologies would not further this purpose. Rather, using current exposure would measure credit exposure consistently to insiders across all institutions for the purpose of guarding against insider self-dealing or preferential treatment.

Whether by express incorporation of the risk-based capital rules or other means, adding any measure of PFE in the measurement of derivative credit exposure for purposes of either section 22(h) or 23A would be inappropriate in light of the policy purposes of those statutes, which differ greatly from those of the bank capital framework. The methodologies used to determine exposure from derivatives transactions in the Regulation O and Regulation W contexts should be tailored for the respective purposes of those regulations. The inclusion of a measure of PFE in determining derivatives credit exposures is unnecessary to meet Regulation O's and Regulation W's distinct policy objectives.

Even absent adding a measure of PFE, using SA-CCR to measure credit exposure for purposes of Regulations O or W would be inappropriate. SA-CCR applies an "alpha factor" of 1.4 for derivatives with non-commercial end-user counterparties to both its replacement cost (i.e., current exposure) and PFE components, automatically increasing the estimate of credit exposure that its formula otherwise produces by 40%. This alpha factor thus further increases the current and PFE exposure amounts, the latter of which is itself not based on actual credit exposure. The alpha factor was "introduced under Basel II to address the perceived shortcomings of IMM, including model risk, wrong way risk, and stressed parameters,"[18] and was set by the Basel Committee for IMM in 2005, based on studies dating back to 2003.[19] The Basel Committee concluded that "to be consistent with the Revised Framework for credit risk, the [exposure at default] for instruments with [counterparty credit risk] must be determined conservatively and conditionally on a 'bad state' of the economy. To accomplish such conditioning in a practical, pragmatic, and conservative manner, the IMM and [standardised method] scale [expected positive exposure] using multipliers, termed "alpha" and "beta", respectively. Both alpha and beta are set at 1.4, but supervisors have the flexibility to raise either parameter in appropriate situations."[20] The alpha factor of 1.4 was then simply "carried over" into SA-CCR "from the alpha value set by the Basel

[18] ISDA, ABA, BPI, SIFMA, and FIA, "U.S. SA-CCR Proposed Rulemaking Meeting with U.S. Banking Agencies" (April 2019), https://www.fdic.gov/system/files/2024-07/2019-exposure-amount-derivative-contracts-3064-ae80-staff-015-01.pdf.

[19] ISDA, FIS, "SA-CCR: Why a Change is Necessary," https://www.isda.org/a/ziDDE/isda-sa-ccr-briefing-paper-final1.pdf.

[20] Basel Committee on Banking Supervision, "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects" (July 2005), at 5, https://www.bis.org/publications/200507-standards-application-basel-ii-trading-activities-and-treatment-double-default-effects.pdf. The Report further states that "The alpha multiplier provides a means of conditioning internal estimates of EPE on a "bad state" of the economy consistent with the determination of credit risk under the Revised Framework. In addition, it acts to adjust internal EPE estimates for both (1) correlations of exposures across counterparties exposed to common risk factors and (2) the potential lack of granularity across a firm's counterparty exposures. The alpha multiplier is also viewed as a method to offset model error or estimation error. Feedback from the industry based on its own analysis and supervisors' simulations suggest that alphas may range from approximately 1.1 for large global dealer portfolios to more than 2.5 for new users of derivatives with concentrated exposures and little or no current exposure in their book. Supervisors have decided to require institutions to use a supervisory specified alpha factor of 1.4, with the ability to estimate an alpha that is specific to the bank's own portfolio, subject to supervisory approval and a floor" that supervisors set at 1.2. *Id*. at 10.

Committee for the" IMM.[21] Indeed, the "alpha factor of 1.4 was never designed to apply to a standardised methodology, but rather to account for model risk and severe market moves that could affect the use of an internal model to calculate exposures. If recalibrated accurately with a larger pool of counterparties and risk factors, ISDA analysis suggests the alpha value should fall to 1.01."[22] Furthermore, the alpha factor of 1.4 "does not reflect the current market environment, particularly in light of larger portfolio diversification effects, and wider clearing and margining practices."[23]

This history highlights that the alpha factor was designed for reasons entirely unique to the capital framework and was never informed by any Regulation O (or Regulation W) considerations. Nor would its inclusion further the purposes of Regulations O or W. The SA-CCR methodology that requires an adjustment to the current and future exposures upwards by 40% arbitrarily bears no relationship whatsoever to the language or purpose of Regulations O and W, and therefore its usage to value derivative exposures for purposes of those regulations would be arbitrary and capricious. Those regulations are designed to capture *actual* credit exposure to another person at an *actual* point in time and then require that such exposure be collateralized and/or limited as to quantity at that same moment in time. Increasing the current exposure by the alpha factor is unnecessary and inappropriate for purposes of Regulations O and W, as is the inclusion of PFE (and the increase of PFE by the alpha factor, as discussed further herein).

For the reasons described herein, the Federal Reserve should therefore reaffirm that current exposure, and current exposure alone, is the appropriate measure of credit exposure arising out of a derivative transaction for purposes of both Regulation O and Regulation W.

II. Current exposure is the appropriate measure for measuring "credit exposure" arising from a derivative transaction under both Regulation O and Regulation W.

The statutory language added to both sections 22(h) and 23A refers to the "credit exposure" that a bank actually "has" as a result of, or arising from, a derivative transaction with an insider or affiliate. Consistent with the purposes of these statutes, the requirements they impose are based on specific, point-in-time measurements of extensions of credit to insiders or affiliates. Therefore, banks must monitor these exposures and comply with their obligations regarding such exposures, as measured at a specific point in time. Credit exposure from a derivative transaction at a specific moment in time is commonly referred to as "current exposure." This exposure is commonly measured as the current mark-to-market ("MTM") of the derivative transactions in the netting set, offset by any variation margin posted by the owing party to secure those payment obligations. Thus, banks generally calculate derivatives exposure, including to insiders and affiliates for purposes of Regulations O and W, as the sum of fair values across derivatives payable and receivable offset by variation margin received/posted.

Indeed, five federal agencies, including the Federal Reserve, have already publicly recognized that current exposure – and current exposure alone – is the appropriate measure of derivative credit exposure for purposes of inter-affiliate derivatives. The Uncleared Swaps Margin Rule exempted inter-

[21] Basel Committee on Banking Supervision, "The standardised approach for measuring counterparty credit risk exposures" (March 2014 (rev. April 2014)), at 1, https://www.bis.org/publications/201403-standards-standardised-approach-measuring-counterparty-credit-risk-exposures.pdf.

[22] *Id*.

[23] *Id.*

affiliate derivatives from the requirement to exchange initial margin, which the agencies describe as "a risk management tool designed to mitigate a covered swap entity's exposure to market risk associated with a counterparty's default by requiring a counterparty to obtain and provide financial collateral equal to the [PFE] the covered swap entity would face if the counterparty defaults."[24] Furthermore, in the preamble to that rule, ***the Federal Reserve expressly affirmed that, for purposes of section 23A*** and the requirements applicable thereunder to inter-affiliate derivatives***, "bank-affiliate derivatives generally can be valued at the bank's current exposure to the affiliate***."[25] Under that rule, covered swap entities must exchange variation margin daily, including with affiliates, which mitigates credit risk arising from derivatives transactions between the parties.[26] The capital rules require PFE to account for a close-out period: the capital rules assume that terminating the contracts, liquidating collateral and closing out the relevant contracts will take some period of time in the event of a counterparty default. However, because the Uncleared Swaps Margin Rule requires daily exchange of variation margin and the greater transparency around inter-affiliate exposures, the need to recognize exposure due to a closeout window is unnecessary.

Thus, the Federal Reserve concluded that to comply with section 23A, "a bank must collect 23A-compliant variation margin from its affiliates to cover its current exposure on bank-affiliate derivatives, but generally is not required to collect initial margin to cover the bank's potential future exposure on the transactions."[27] Consistent with the final approach adopted in the Uncleared Swaps Margin Rule by five federal agencies and the Federal Reserve's complementary position articulated in the preamble to that rule, "current exposure" as applied in Regulation O and Regulation W should be calculated as the sum of the fair value of derivatives across derivatives payable and receivable less any variation margin received in the form of cash or U.S. government securities, without inclusion of a measure of PFE.[28]

a. <u>Including a measure of PFE, whether by incorporation of the risk-based capital rule methodologies or otherwise, would be inconsistent with the policy purposes of section 22(h).</u>

As used in section 22(h), "credit exposure" to a person arising from a derivative transaction should include only existing, actual exposure a bank has to that person at the moment the exposure is measured and should not include PFE. As the Federal Reserve and other banking agencies have acknowledged elsewhere, the "potential future exposure of a derivative contract reflects the possibility

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[24] 85 Fed. Reg. at 39,759. The rule requires covered swap entities not only to exchange variation margin with affiliates, but also to calculate the initial margin amount for certain affiliates and collect initial margin if the aggregate amount of initial margin across those affiliates exceeds 15% of the covered swap entity's tier 1 capital.

[25] 85 Fed. Reg. at 39,764 (emphasis added).

[26] *See*, *e.g.*, 12 CFR § 237.4. Indeed, the OCC recently issued two interpretive letters granting relief to two institutions from the requirement to exchange IM once the aggregate amount of IM exceeds 15% of the institution's tier 1 capital set forth in the Uncleared Swaps Margin Rule. In those letters, the OCC recognized that "[i]nteraffiliate swaps are valuable in managing market and credit risk across complex banking organizations" and recognized that "several other regulatory safeguards—including variation margin and affiliate transaction restrictions—help to mitigate potential affiliate-related risks." *See* Letter from Will Giles, Principal Deputy Chief Counsel, Office of the Comptroller of the Currency, to Colin D. Lloyd (Sept. 3, 2026). *See also* Letter from Will Giles, Principal Deputy Chief Counsel, Office of the Comptroller of the Currency, to Adam Lee (Sept. 15, 2026).

[27] 85 Fed. Reg. at 39,764.

[28] *See*, e.g., 12 CFR § 237.4.

of changes in the value of the derivative contract over a specified period."[29] It does not reflect the current value of a derivative contract, nor does it reflect the amounts that one party actually owes the other at any given time – in other words, it does not reflect the first party's actual "credit exposure" to the other. Rather, it is a measure of the possibility of changes in one or both of those things over a hypothetical future period, and of the hypothetical impact of such changes on the terms of the contract and the obligations among the parties. Thus, "credit exposure" that a bank has to a person arising from a derivative transaction should not include any measure of PFE, because any "exposure" captured in such measure does not actually exist at that time, and, in fact, may never exist.

As noted, section 22(h) restricts the amount and terms of extensions of credit from a member bank to insiders in order to "protect banks against potential harm from the conflicts of interest of, and self-dealing by, insiders who are in a position to put their personal or business self-interest ahead of the interests of the banks."[30] To achieve that purpose with respect to derivatives transactions with insiders, a bank must objectively determine its actual exposure to an insider at a specific point in time to which the requirements and limitations of the statute apply. Because the current MTM of a derivative, offset by any variation margin, captures the economic exposure between the bank and the insider at a specific point in time, it sufficiently measures that exposure for purposes of applying the requirements of Regulation O to that exposure to protect against the risks the regulation aims to mitigate. Current exposure accurately reflects the bank's exposure and is consistent with the structure and purpose of Regulation O as a point-in-time regulatory compliance requirement designed to guard against insider self-dealing.

Including a measure of PFE is not appropriate for calculating derivative credit exposure for Regulation O, as it does not capture the bank's actual exposure to an insider at a specific point in time. Rather, PFE is a forward-looking estimate of a potential increase in a bank's credit exposure to a counterparty during a period of extreme market stress. The fact that the proposal would permit banks to calculate derivative credit exposure using any methodology under the capital rules, each of which includes a measure of current exposure plus a measure of PFE, calculated differently under each methodology, demonstrates that PFE does not reflect actual exposure at a given time. Indeed, measures of PFE are inherently a reflection of (i) subjective assumptions about what hypothetical future changes are sufficiently "possible" such that they should be considered, (ii) the choice of a future time period over which those changes should be taken into account, and (iii) hypothetical assumptions about the impact of those particular changes over that particular time period on the terms of the derivative contract. Put very simply, PFE does not measure one party's actual credit exposure to another; it is instead a calibrated estimate of what one party's credit exposure *might* be in a particular future state of the world. How much a derivative's value might theoretically fluctuate has no bearing on whether an insider transaction was conducted under preferential terms.

[29] OCC, Federal Reserve Board, FDIC, Final Rule, "Standardized Approach for Calculating the Exposure Amount of Derivative Contracts," 85 Fed. Reg. 4362, 4366 (Jan. 24, 2020).

[30] Federal Reserve, Staff Memo on Proposed Rule to Modernize Regulation O (Bank Lending to Insiders), at 2 (June 30, 2026), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20260731b1.pdf.

i. <u>The capital requirements that include a measure of PFE serve a different purpose than Regulation O.</u>

Although other regulatory requirements imposed on banks related to their derivatives transactions include measures of PFE, the policy purposes of those requirements differ from those of Regulation O. The capital rule framework is intended to be a risk-measurement framework under which a firm is required to hold loss-absorbing capacity for potential future loss outcomes across a range of scenarios. By the very nature of commercial banking, the amount of capital held is a fraction of all potential future losses, requiring a measure of conservatism in the valuation approach. For example, the capital framework deliberately uses a more conservative, forward-looking and hypothetical measure of exposure for derivatives and therefore includes PFE in this measurement. This different approach is consistent with the capital framework's focus on protecting banks against failure in the event of losses of any origin by ensuring that they hold sufficient capital to absorb potential unexpected losses during a period of severe systemic stress. For derivatives, the capital framework is calibrated such that a bank will hold sufficient capital to absorb potential losses if a counterparty defaults on a derivative.

To provide this forward-looking protection, the primary capital rule valuation methodologies incorporate the PFE concept, which operates as an add-on to current credit exposure. Importantly, the federal banking agencies have consistently described the PFE as an ***add-on*** to the current credit exposure that is tailored to the needs of the capital rule.[31] In other words, PFE is not part of the current credit exposure but is added to that exposure when determining capital requirements. These features are designed for a capital framework intended to protect against future losses. However, this is not well suited to Regulation O's distinct purpose of limiting and imposing requirements on concrete, existing extensions of credit to insiders to protect banks from the risks of preferential treatment of insiders.

Similarly, single counterparty credit limits ("SCCL")[32] applicable to large banking organizations and systemically important nonbank financial companies[33] and the Office of the Comptroller of the Currency's lending limits applicable to banks include requirements and limitations related to derivatives exposures to counterparties.[34] Those regimes include measures of PFE in calculating those limits.[35]

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[31] *See, e.g.,* OCC, Federal Reserve Board, FDIC, "Risk-Based Capital Standards: Derivative Transactions," 60 Fed. Reg. 46,170 (Sept. 5, 1995) (" The credit equivalent amount of an off-balance-sheet interest rate or exchange rate contract (rate contract) is determined by adding together the current replacement cost (current exposure) of the contract and an estimate of the possible increase in future replacement cost (potential future exposure, also referred to as the add-on) in view of the volatility of the current exposure of the contract.").

[32] Section 165 of the Dodd-Frank Act authorized the Federal Reserve to impose heightened standards on systemically important nonbank financial companies and large bank holding companies to "prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions." Section 165(e)(2) required the Federal Reserve to establish regulations limiting the credit exposure of such entities to any unaffiliated company to "limit the risks that the failure of any individual company could pose to" such entities. Such credit exposure includes "counterparty credit exposure to the company in connection with a derivative transaction." 12 USC 5365(e)(2).

[33] 12 USC 5365(e)(3).

[34] However, we note that some states' lending limits only require banks to measure their current exposure from derivatives transactions. *See*, *e.g.*, N.Y. Comp. Codes R. & Regs. tit. 3, ch. I, pt. 117 - Lending Limits: Inclusion of Credit Exposures Arising from Derivative Transactions; MA Gen L ch 167E § 6 (2025), "Limitations on Obligations."

[35] While we cite the examples of SCCL and OCC lending limits to illustrate the distinct objectives and methodologies of different prudential regulatory standards, we note that exposure methodologies used in these frameworks are

Those limits, however, are intended to manage safety and soundness and broader financial stability concerns that could arise from concentrations of credit risk to any borrower or counterparty; therefore, those measures include PFE. For example, the SCCL rule was adopted as part of the post-crisis reform mandated by the Dodd-Frank Act designed to enhance financial stability. Section 165(e) of the Act required the Board to establish single-counterparty credit limits for large U.S. and foreign banking organizations and nonbank financial companies, "in order to limit the risks that the failure of any individual firm could pose to these firms."[36] On adoption of the final rule, then-Vice Chair for Supervision Quarles stated that the final rule "addresses an important contributing factor to the financial crisis: contagion caused by interconnectivity among large banks" and is "a useful complement to the ***principal*** protections against contagion: the robust capital and liquidity positions of the financial system today."[37] Similarly, the OCC's lending limits help enhance the safety and soundness of national banks by promoting diversification of credit exposures. The difference in purpose between Regulation O and the SCCL and the OCC's lending limits supports a difference in approach, and a simpler point-in-time, mark-to-market measure of credit exposure is sufficient to mitigate the risks of potential harm from self-dealing by insiders.

Including all of the same components as included in the capital framework or SCCL regime, such as a PFE charge, in the calculation of exposures does not sufficiently justify the proposed change, as sections 22(h) and (g) and Regulation O prescribe other effective means for reducing insider-related risks. In particular, Regulation O separately requires that all extensions of credit to insiders be made on substantially the same terms as those prevailing for comparable transactions with non-insiders and generally requires board approval,[38] which independently protects against preferential treatment to insiders regardless of the valuation methodology used. These other requirements of Regulation O help mitigate the risks of self-dealing by insiders, including with respect to derivatives transactions, without the need for a PFE measure.

Furthermore, banks have developed comprehensive governance and risk-management regimes to monitor transactions with insiders and manage any conflicts of interest, whereas the SCCL and bank lending limits tend to rely solely on measures of credit exposure to further their aims. For all these reasons, the Federal Reserve should explicitly endorse the use of current credit exposure as the relevant credit exposure measure by adopting the same language as used in the preamble to the Uncleared Swaps Margin Rule in the codified regulation.[39]

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also implicated by the Agencies' March 2026 capital proposal. BPI and its member firms reserve judgment on how specific methodologies incorporated in final capital rules may or may not be suitable to support SCCL and OCC lending limits frameworks.

[36] See 12 U.S.C. 5365(e)(1).

[37] Board of Governors of the Federal Reserve System, Opening Statement on the Single-counterparty Credit Limit Final Rule by Vice Chairman for Supervision Randal K. Quarles (June 14, 2018) (emphasis in original), https://www.federalreserve.gov/newsevents/pressreleases/quarles-statement-20180614.htm.

[38] 12 C.F.R. §§ 215.4(a)(1)(i); 215.4(b)(1); *see also* 91 Fed. Reg. at 49,564.

[39] We note that, for a bank that provides significant clearing and settlement services, together with ancillary services such as foreign exchange derivatives, Regulation O's lending limit could constrain such a bank's commercial transactions with a fund complex, especially if Regulation O includes a PFE measure for derivatives. A lending limit constraint could require such a bank to unwind longstanding, pre-existing lending relationships with a fund complex, causing potential disruptions to the fund and its investors.

b. <u>Including a measure of PFE, whether by incorporation of the risk-based capital rule methodologies or otherwise, would be inconsistent with the policy purposes of section 23A.</u>

Regulation W implements sections 23A and 23B of the Federal Reserve Act, which are intended to "limit the risks to a member bank from transactions with affiliates and limit the ability of a member bank to transfer its Federal subsidy to affiliates."[40] Section 23A seeks to achieve these goals by, among other things, limiting a bank's "covered transactions" with any single "affiliate" to no more than 10 percent of the bank's capital stock and surplus, and transactions with all affiliates combined to no more than 20 percent of the bank's capital stock and surplus. "Covered transactions" include purchases of assets from an affiliate, extensions of credit to an affiliate, investments in securities issued by an affiliate, guarantees on behalf of an affiliate, and certain other transactions that expose the member bank to an affiliate's credit or investment risk. As noted, section 608 of the Dodd-Frank Act amended section 23A by adding to the list of covered transactions "a derivative transaction . . . with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate."[41]

Like Regulation O, the requirements and limitations imposed by Regulation W are designed to apply to actual covered transactions with affiliates at a specific point in time. In the context of derivatives with affiliates, the purposes of Regulation W would best be served by applying the regulation's requirements to a bank's actual exposure to an affiliate at a specific point in time. Because the current credit exposure valuation captures the present-day economic exposure between the bank and the affiliate, it sufficiently protects against the risks that Regulation W aims to mitigate. As noted previously with respect to Regulation O, although other regulatory requirements imposed on banks related to their derivatives transactions include measures of PFE, such as the capital requirements, the policy purposes of those requirements differ from those of Regulation W. The capital framework deliberately uses a more conservative, forward-looking and hypothetical measure of exposure for derivatives and therefore includes PFE in this measurement. This different approach is consistent with the capital framework's focus on protecting banks against failure in the event of losses of any origin by ensuring that they hold sufficient capital to absorb potential unexpected losses during a period of severe systemic stress. For purposes of Regulation W, however, the current credit exposure valuation captures the present-day economic exposure between the bank and the affiliate and thus sufficiently protects against the risks that Regulation W is designed to mitigate.

Further, the primary purpose and effect of many inter-affiliate trades is specifically to facilitate an efficient central risk management model and to ***reduce systemic risk***; they are not executed to benefit affiliates at below-market cost or to transfer the benefits of the federal safety net to such affiliates. Inter-affiliate derivative transactions are an important part of the way that banking organizations operate their businesses, manage market and credit risks and serve their customers and should therefore be encouraged. Central risk management is impractical to achieve for a global banking organization in many cases without the extensive use of inter-affiliate derivatives. For example, customer-facing transactions may be required by local law to be booked in a separate, locally licensed entity, which must then enter into a back-to-back transaction with the central risk management entity.

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[40] Board of Governors of the Federal Reserve System, Final rule, "Transactions Between Member Banks and Their Affiliates," 67 Fed. Reg. 76,560 (Dec. 12, 2002).

[41] *See* Dodd-Frank Act § 608.

In addition, Regulation W, like Regulation O, includes other risk mitigating requirements imposed on banks for inter-affiliate derivatives that obviate the need to include a PFE measure for derivatives exposure. Regulation W limits banks' covered transactions with affiliates to no more than 10 percent of the bank's capital stock and surplus, and transactions with all affiliates combined to no more than 20 percent of the bank's capital stock and surplus.[42] Regulation W also imposes collateral requirements on bank-affiliate credit transactions and, pursuant to section 23B of the Federal Reserve Act, requires that covered transactions occur on market terms; that is, on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with unaffiliated companies.[43] For example, in the preamble to the Uncleared Swaps Margin Rule, the Board recognized that in many cases, it is "reasonable to conclude that a bank-affiliate swap with no initial margin requirement is at least as favorable to the bank as a comparable bank- nonaffiliate swap with two-way initial margin requirements."[44] Indeed, as noted previously, it is standard market practice for banks and their counterparties, including affiliates, to exchange daily variation margin to manage point-in-time counterparty credit risk, thereby eliminating the need to include a measure of PFE to address potential future valuation changes.[45] Regulation W also requires all transactions between a member bank and its affiliates to be on terms and conditions that are consistent with safe and sound banking practices.[46]

Further, banks employ comprehensive policies and systems to manage the risks associated with transactions with affiliates and to monitor compliance with the requirements of Regulation W, rather than relying solely on quantitative limits to do so (e.g., as in the case of the SCCL regime).

Finally, the methodology of valuing credit exposures for Regulation W purposes will have an immediate financial impact on a bank. In the context of Regulation O, certain transactions between a bank and its directors and principal shareholders are subject to overall limits based on the bank's capital but otherwise can be entered into with prior approval by the bank's board of directors. A calculation that increases the amount of credit exposure may subject more transactions to the board approval requirement but would not prohibit them. In contrast, an increase in credit exposure of credit transactions with affiliates under Regulation W results in a dollar-for-dollar increase in the amount of cash or U.S. government securities collateral that must be collected from affiliates. Therefore, as noted previously, any proposed change in measuring credit exposure to affiliates arising from derivatives transactions must be separately proposed for public comment, and the Federal Reserve must consider the potential implications of such a change separately and based on empirical analyses, with respect to Regulation W and not as part of its consideration of the proposed change to Regulation O.

c. PFE under SA-CCR is inappropriate for Regulation O and Regulation W.

[42] 12 CFR 223.11, 223.12.

[43] 12 CFR 223.14, 223.51.

[44] 85 Fed. Reg. at 39,764.

[45] Banks have adopted standard risk-mitigating practices for inter-affiliate derivative transactions. Generally, banks enter ISDA Master agreements and Credit Support Annexes to those contracts with affiliates, as they would with third parties. The ISDA Master Agreement governs the rights and responsibilities of over-the-counter derivatives transactions, and the Credit Support Annexes to those contracts establish terms of the collateral arrangement between two counterparties.

[46] 12 CFR 223.13.

The details of how counterparty credit-risk exposure is calculated for derivatives under SA-CCR provide a powerful illustrative example of how conceptually inappropriate PFE is in the context of Regulations O and W. PFE under SA-CCR is prescribed by regulators, highly conservative, and calibrated to periods of extreme market stress. Under SA-CCR, a party must calculate and include (i) replacement cost (i.e., current exposure) and (ii) potential future exposure, as determined under a specific formula. That PFE formula in turn is based on: (i) the notional amount of the contract, as multiplied by a specified supervisory duration adjustment (the "adjusted notional"); (ii) a "supervisory delta" adjustment, which estimates potential changes in the value of the derivative relative to the value of its underlying(s); (iii) a "maturity factor," which reflects a specified margin period of risk that varies depending on whether the derivative is subject to a variation margin agreement; and (iv) a "supervisory factor," which reflects potential volatility based on the asset class of the derivative. The resulting PFE number is thus, of course, highly sensitive to any change in one or more of these elements, each of which reflects particular assumptions about what may happen in the future and how such changes would affect the obligations of the parties.

i. <u>Increasing PFE under SA-CCR based on an "alpha factor" would be arbitrary and capricious for purposes of Regulation O and Regulation W.</u>

As noted previously, when calculating a credit-risk exposure amount to non-commercial end-user counterparties, SA-CCR applies an "alpha factor" of 1.4 to both its replacement cost (i.e., current exposure) and PFE components, automatically increasing the estimate of credit exposure that its formula otherwise produces by 40%. As discussed, the alpha factor was designed for reasons entirely unique to the capital framework and was never informed by any Regulation O (or Regulation W) considerations. Nor would its inclusion further the purposes of Regulation O or Regulation W, which are designed to capture *actual* credit exposure to another person at an *actual* point in time and then require that such exposure be collateralized and/or limited as to quantity at that same moment in time. Thus, the use of SA-CCR – which not only inappropriately includes a measure of PFE that is based on a range of supervisory assumptions about future changes and their impact on the derivative that is already calibrated to a stress period – but then inflates that exposure by the alpha factor – is inappropriate for purposes of Regulations O and W and such use in either regulation would be arbitrary and capricious.

d. <u>Other risk-mitigating requirements imposed on banks for inter-affiliate derivatives obviate the need to include a PFE measure for derivatives exposure.</u>

As described previously, banks must hold capital against the value of credit exposures arising from derivatives transactions, including inter-affiliate derivatives transactions. Under the capital rules (including under both the current rules and the revisions proposed in March 2026), banks must hold capital against a measure of derivatives exposure that includes a forward-looking assessment of potential future risk, which is intended to mitigate risks to the stability of the bank and potential financial stability concerns. The capital framework is calibrated such that a bank will hold sufficient capital to absorb potential losses if a counterparty defaults on a derivative. To provide this forward-looking protection, the primary capital rule valuation methodologies incorporate the PFE concept, which operates as an add-on to current credit exposure. Because banks must hold capital against this potential future exposure, it is unnecessary to include a PFE measure for 23A/B and Regulation W purposes.

As noted, banks mark derivatives exposure to market daily, including with affiliates, and exchange variation margin. In addition, under the resolution plan requirements imposed by the Dodd-Frank Act, the largest banking organizations have developed, consistent with guidance issued by the

Federal Reserve and FDIC, Single Point of Entry ("SPOE") resolution plans that are designed such that neither a bank entity nor its sister affiliates would enter insolvency proceedings, even if the parent holding company were to fail.[47] Under the rules and guidance that apply to large banking organizations that have adopted an SPOE strategy, a bank subsidiary of an SPOE filer must have sufficient capital and other loss-absorbing resources to enable it to meet well-capitalized standards (inclusive of capital required to be held in respect of PFE on inter-affiliate derivatives exposures) even after the failure of the parent BHC. By incorporating the need to satisfy existing capital standards at the bank level on a post-failure basis, resolution-related standards already are designed such that a bank will have sufficient capital relative to inter-affiliate derivatives exposures, even in the event of the BHC's failure. Consequently, extending PFE as an exposure measure to Regulation W would be both redundant and unnecessary to serve the objectives of section 23A and Regulation W in light of these already existing standards.

A broad set of already existing requirements imposed on banking organizations are designed to mitigate the risk of loss to the bank that may arise from derivatives exposure to affiliates, including the risk of potential future losses to the bank. Inclusion of a measure of PFE in credit exposure from derivatives to affiliates under Regulation W would thus be duplicative and unnecessary to mitigate those risks. Further, imposing such a requirement would have significant detrimental knock-on effects for banking organizations that the Federal Reserve has not addressed in the proposal, as described below.

III. <u>The proposal does not sufficiently justify the proposed valuation methodology</u>.

Under the Administrative Procedure Act, as interpreted by courts, an agency's action must be justified based on the relevant facts.[48] The justifications offered for aligning the derivative exposure methodology with the capital rules do not provide sufficient support for the proposed changes. First, the proposal erroneously states that "banks and their insiders rarely engage in derivatives transactions or securities financing transactions."[49] Notwithstanding this characterization, banks do regularly engage in derivatives transactions with insiders, particularly principal shareholders and their related interests.

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[47] U.S. GSIBs have each adopted an SPOE resolution strategy, under which only the parent holding company enters resolution proceedings, the firm's losses are absorbed by shareholders and other total loss-absorbing capacity ("TLAC") creditors, and the bank and other material subsidiaries are recapitalized and continue as going concerns or are wound down in an orderly manner outside of resolution. By design, SPOE (and the framework around it, including secured support agreements and applicable capital and liquidity triggers) mitigates the risk of a default that could trigger the termination and closeout of derivatives exposures by providing the bank and its affiliates with the resources to continue to meet their obligations during the resolution period, such that the derivatives remain margined and current in this process. Additionally, the Federal Reserve Board, OCC, and FDIC adopted rules to "facilitate the orderly resolution of a failed GSIB by limiting the ability of the firm's QFC counterparties [including affiliates] to terminate such contracts immediately upon entry of the GSIB or one of its affiliates into resolution." *See* Board of Governors of the Federal Reserve System, Final Rule, "Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions," 82 Fed. Reg. 42882, 42883 (Sept. 12, 2017), https://www.govinfo.gov/content/pkg/FR-2017-09-12/pdf/2017-19053.pdf and 12 CFR 371.

[48] *See Michigan v. EPA*, 576 U.S. 743, 750–52 (2015) (stating that "agency action is lawful only if it rests on a consideration of the relevant factors" and "an agency may not entirely fail to consider an important aspect of the problem when deciding whether regulation is appropriate") (internal quotations omitted).

[49] 91 Fed. Reg. at 49,533.

Therefore, the valuation methodology is both practically significant and an area where banks have developed compliance infrastructure, creating meaningful reliance interests.

In this regard, the Federal Reserve has not explained why it is proposing to import derivative exposure methodology from the capital rules to Regulation O or Regulation W, other than to assert that banks already use those methodologies for capital purposes and their incorporation would therefore reduce the burden of calculation. That statement does not attempt to justify *why* the use of that methodology is appropriate in the context of Regulation O or Regulation W, which, as discussed previously, have very different purposes from the capital framework. The Federal Reserve has not provided any explanation or analysis of why it believes it is appropriate to include PFE when calculating derivative credit exposure, either as a matter of statutory construction or policy; it is thus exceedingly difficult for us to comment on whether such explanation or analysis is reasonable. Similarly, the Federal Reserve has not provided any explanation or analysis of why the specific elements of the risk-based capital rules' approach – for example, SA-CCR's inclusion of PFE, its detailed formula for calculating PFE, and its automatic 40% upward adjustment to both current exposure and PFE amounts – are an appropriate measure of derivative credit exposure for purposes of Regulation O and/or Regulation W, making it nearly impossible for us to comment on whether such explanation or analysis is reasonable. Nor does the Federal Reserve explain why it proposes to delegate interpretive authority of the Federal Reserve Act – over which the Federal Reserve has sole authority – to multiple agencies, both international and domestic. The capital rules have traditionally been established through an international consultative process and through interagency rulemaking with the FDIC and OCC. Instead of the Federal Reserve interpreting the Federal Reserve Act, according to its text and purposes, this change would have the effect of delegating interpretation of sections 22(h) and 23A to an interagency and international process established for entirely unrelated reasons.

Further, ***changes in policy*** must be explained and justified,[50] and a more detailed justification is required in cases where a change reflects reliance interests.[51] The proposal does not acknowledge that the proposed valuation methodology is a departure from the methodology that the Federal Reserve has previously affirmed is appropriate to use in the section 23A/Regulation W context, and that banks are currently using for 22(h) and (g)/Regulation O purposes, or explain why that methodology is insufficient. In its 2020 swaps margin rule, the Federal Reserve stated that credit exposure arising from bank-affiliate derivatives generally can be valued for section 23A purposes at the bank's current exposure to the affiliate — i.e., current mark-to-market exposure only, without adding PFE. The Federal Reserve's statement in 2020 notably included no qualification that the Federal Reserve may adopt a different interpretation in a future Regulation W rulemaking. With this statement coming ten years after passage of the Dodd-Frank Act, with Federal Reserve staff being well aware of the market uncertainties caused by the absence of any rule on the definition of "credit exposure" of derivatives, banks rationally assumed they could rely on this statement accompanying a final rule in a notice-and-comment rulemaking and that the question was settled. If the approach to derivative credit exposure proposed for Regulation O

[50] *Encino Motorcars, LLC v. Navarro*, 579 U.S. 211, 212 (2016) (holding that "[a]gencies are free to change their existing policies, but in explaining its changed position, an agency must be cognizant that longstanding policies may have engendered serious reliance interests that must be taken into account") (internal quotations omitted); *Am. Fed'n of Gov't Emps. v. FLRA*, 25 F.4th 1, 5 (D.C. Cir. 2022).

[51] *Encino Motorcars, LLC*, 579 U.S. at 222; *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 516–17 (2009); *FDA v. Wages and White Lion Investments*, L.L.C., 604 U.S. 542, 568 (2025).

were applied in the Regulation W context, this would mark a significant and highly consequential reversal of the Federal Reserve's interpretation of section 23A.

The Federal Reserve has not conducted any assessment of the implications such a shift in methodology would produce, in either the Regulation O or the Regulation W context. Because PFE represents a modeled estimate of potential future exposure rather than an actual current credit exposure, including it in the calculation of covered transactions in Regulation W could require banking organizations to reserve liquidity against exposures that may never materialize. This could materially increase the amount of capital and liquidity dedicated to internal affiliate transactions, limiting the efficiency of centralized risk management and hedging activities. Banking organizations may be forced to restructure otherwise prudent internal risk transfers or utilize more costly third-party alternatives, potentially reducing market efficiency and increasing operational complexity. The reduction of inter-affiliate derivatives transactions due to the inclusion of PFE in the exposure calculation would result in the trapping of liquidity internally between affiliated parties above and beyond any other applicable liquidity requirements. Banking organizations likely would have to maintain the value of that measure in cash to ensure that such amount would be exempted from the 23A quantitative limits. These cash holdings also could reduce the availability of high-quality liquid assets of the parent holding company and affect the organization's liquidity coverage ratio calculations. Further, this cash would have to be maintained in a segregated earmarked deposit account, decreasing available resources to engage in other market activities, such as participating in the U.S. Treasury markets. Given that SA-CCR PFE was developed as a prudential capital measure and not as a measure of actual extensions of credit, importing that methodology into the Regulation W framework would represent a significant departure from the historical purpose and structure of Regulation W, which was designed to limit actual credit exposure to an affiliate.

Other key elements of the proposal are equally unexplained. The Federal Reserve has not identified any observed risks to banking organizations or losses they have incurred as a result of the longstanding use of the current exposure method to measure derivatives exposure to insiders and affiliates or why a shift to the capital methodology is necessary or appropriate. Nor has it addressed why the other requirements of Regulation O and Regulation W, as well as other regulatory requirements under different authorities, as described previously, do not sufficiently address the supposed risks the Federal Reserve is attempting to mitigate by proposing to include, for the first time, a measure of PFE in calculating derivatives exposures to insiders or affiliates.

Further, the proposal explains that using the capital framework to calculate derivatives exposure for Regulation O would ease banks' compliance obligations for purposes of Regulation O as banks already calculate this exposure for capital purposes. Although banks already calculate derivatives exposures using the capital rules' methodologies, they have in place separate policies and procedures for Regulation O and Regulation W compliance based on the use of current credit exposure. Requiring banks to use the capital rules' methodologies for Regulation O and/or Regulation W purposes would increase costs and burden on banks, as they already have the appropriate systems in place to continue using current credit exposure.

IV. Additional Valuation Recommendations

In calculating current exposure from derivative transactions with insiders and affiliates, we recommend the following amendments for purposes of determining credit exposure from derivatives for Regulation O and Regulation W.

a. <u>The Federal Reserve should allow banks to net exposures from equity derivatives and total return swaps for the purposes of valuation.</u>

The proposal would treat equity derivatives and total return swaps as functionally equivalent to a guarantee for purposes of valuing exposures to both the counterparty and the underlying obligor on the instruments.[52] The proposed valuation could mean that exposures from these products could not be netted and that for purposes of Regulation O and, if also applied to Regulation W, banks would be required to hold financial collateral against 100% of the notional component referencing the affiliate security to the extent the bank is "short" the exposure or providing downside protection. This framework is at odds with how markets products are managed by financial institutions, in which firms actively hedge and manage their overall exposure through a series of offsetting transactions to reduce their overall exposure to the instrument or affiliate security. For example, a standard booking model recognized under the OCC's derivatives licensing framework is that the national bank is perfectly matched on the transaction with two identical offsetting transactions that result in no net risk exposure. These hedging techniques have long been recognized by the agencies in multiple frameworks. For example, the OCC's derivatives licensing framework, Regulation Y, the Volcker Rule, and the Capital Rules all recognize, and in most cases require, the substantial benefits of risk reduction techniques, such as hedging derivatives exposure through offsetting transactions.

Preventing banks from netting exposures arising from equity derivatives and total return swaps against other derivative exposures increases the burden of providing such products and potentially reduces their ability to engage in this kind of transaction with market participants. We further note that because Regulations O and W would treat one side of the transaction punitively (i.e., where the member bank is paying downside protection on the instrument), the framework would have the perverse incentive of disincentivizing banks from actively hedging the instrument if the hedge would be treated as a guarantee, notwithstanding that all the frameworks above would permit, and in some cases, require, that the original exposure be hedged. We therefore recommend that the Federal Reserve allow firms to net all long and short exposures to the extent such netting is consistent with the agencies' derivatives and market risk frameworks and held in a bona fide market making or hedging capacity under the Volcker Rule.

b. <u>The Federal Reserve should apply the proposed requirement for a bank to decompose a basket or index for which it provides credit protection to identify specific insider exposures only when the basket or index is sufficiently small or concentrated</u>.

The Proposal states that "[w]here the securities issued by a bank's insider(s) represent only a portion of the reference assets [in an equity derivative or total return swap], the valuation would be limited to the amount of the guarantee provided by the bank with respect to the obligations of its insider(s)."[53] We note that banks are among the largest market participants in derivatives involving credit protection on broad-based baskets and indices consisting of large numbers of constituent securities. In these cases, decomposing the basket or index to isolate exposure to insiders or affiliates would be complex and burdensome and contrary to how such products are viewed by our customers

[52] 91 Fed. Reg. at 49,534.

[53] 91 Fed. Reg. at 49,534.

(i.e., broad based baskets and indices are viewed as exposure to the component itself, not the individual constituents). Broad based baskets and indices are designed to mirror a recognized exposure or benchmark to a broader sector of the market rather than exposure to a particular set of companies or sectors.

Likewise, to the extent such a framework is extended to Regulation W, it would potentially balloon the types of covered transactions that banking organizations would be required to treat as a guarantee (i.e., the pro rata notional of such transaction that references an affiliate would require dollar for dollar collateral). For example, many of the Bank Policy Institute's members are constituents of the S&P 500 index along with countless other indices and although such members are only a small portion of the index, given the size of the market for index products and the fact that the framework does not currently recognize bona fide hedging techniques, the resulting covered transactions or insider exposure on the component referencing the security could be very large and would require dollar-for-dollar collateral notwithstanding that banks view themselves as actively hedged on the transactions (often through an identical, offsetting derivative). This could disintermediate banks, the largest market participants, from basket and index derivative products. In addition, there is limited risk of a bank offering preferential treatment to insiders or affiliates in the context of providing broad-based credit protection, given that the purpose of the relationship is to provide protection against the whole basket or index. The proposed treatment of baskets and indices is thus unduly burdensome and unnecessary to serve the purposes of Regulation O or Regulation W. The proposal also would not appropriately recognize diversification and hedging in respect of index positions as provided in aspects of the capital rules.[54]

The Federal Reserve should require decomposition of a basket or an index only when that basket or index is sufficiently small or concentrated; for instance, decomposition could be required for an index that would be a "narrow-based security index" as defined in the Commodity Exchange Act or Securities Exchange Act, or falls below a threshold number of constituent securities. At a minimum, the Federal Reserve should allow netting of such exposures, for the reasons discussed previously.

c. <u>The Federal Reserve should clarify that CDS and TRS transactions will not be treated as "synthetic asset purchases" for purposes of Regulation W.</u>

The preamble states that "credit derivatives in which a bank provides credit protection to an affiliate and similar equity derivatives or total return swaps (whether funded or unfunded) subject the bank to similar risk of loss as if the bank had purchased the reference asset itself. As a result, the proposed methodology would treat this synthetic asset purchase similarly to Regulation O's valuation of an asset purchase by a member bank from an affiliate by valuing the transaction at the greater of (i) the total notional exposure or (ii) the maximum potential loss to the member bank on the transaction."[55] However, cash settled CDS and TRS provided to an affiliate (that do not reference an affiliate security) are not viewed as synthetic asset purchases for Regulation W purposes because these instruments present credit and market risk. This proposed methodology regarding CDS and TRS should not be extended to

[54] *See, e.g.*, 12 C.F.R. §§ 3.22(h), 217.22(h), 324.22(h) (calculation of net long position under the deductions framework); 12 C.F.R. §§ 3.210, 217.210, 324.210 (calculation of specific risk for purposes of the market risk capital framework).

[55] 91 Fed. Reg. at 49,534.

Regulation W because it is contrary to the statutory language and the longstanding treatment of such products as derivatives rather than purchases of assets.

Should the Federal Reserve treat those derivatives as asset purchases, sub-investment grade CDS/TRS could be considered "low-quality assets" under Regulation W, which would greatly limit banks' ability to provide CDS and TRS to affiliates. Banks are the largest market intermediaries in CDS transactions and use CDS and TRS to hedge risk efficiently and cost-effectively, freeing up space to offer more credit to their customers while mitigating risk and meeting stringent capital requirements. Many of these transactions are prudentially managed by the bank with an offsetting transaction with its affiliate, which, under this framework, could be prohibited notwithstanding the overall risk reduction of the transaction and the fact that the derivative is not legally an asset purchase.

CDS and TRS can allow banks more flexibility to serve their customers' credit needs by permitting them to offset risk using their affiliates as a source of strength. Limiting banks' ability to use these tools could reduce banks' capacity to extend credit. Therefore, these instruments should not be treated as asset purchases for purposes of Regulation W.

d. <u>The Federal Reserve should not automatically link the Regulation W methodology for valuing securities financing transactions ("SFTs") to the methodology proposed or adopted for purposes of Regulation O.</u>

As discussed above, sections 22(h) and 23A of the Federal Reserve Act have different statutory purposes, which should be taken into account when making changes to Regulations O and W. We have expressed our views with respect to the valuation of SFTs under Regulation O in the companion letter we are submitting, and we note that our comments with respect to Regulation O should not be assumed to apply in the context of Regulation W. The definitions of certain types of SFTs differ between section 22(h) and section 23A, further supporting the importance of considering the methodology used for valuing SFTs independently with respect to each statute. The methodology used for valuing SFTs should be aligned across Regulations O and W only if there is a clear reason for doing so, and whatever approach the Federal Reserve proposes to use for the purposes of Regulation W should be grounded in an analysis of Regulation W-specific considerations. BPI will provide further comments on the Regulation W approach for valuing SFTs should the Board raise this issue in any future Regulation W proposal.

V. <u>Conclusion</u>

Requiring a valuation methodology for derivatives with insiders or affiliates that includes a measure of PFE would not further the purposes of sections 22(h) and 23A of the Federal Reserve Act and would have significant negative consequences for banking organizations and financial markets more broadly. The Federal Reserve should not adopt these proposed changes to Regulation O (or propose similar changes to Regulation W) and instead should explicitly endorse the continued use of the current credit exposure valuation for derivatives transactions for purposes of both Regulation O and Regulation W.

We would welcome the opportunity to discuss our comments with you further. Please contact Paige Paridon at (703) 887-5229 or paige.paridon@bpi.com to schedule time to discuss or with any questions.

Respectfully submitted,

Paige Pidano Paridon
EVP, Senior Associate General Counsel &
Co-Head of Regulatory Affairs
Bank Policy Institute