



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ
GENERAL COUNSEL

November 5, 2012

Andrew S. Baer, Esq.
General Counsel
Morgan Stanley Bank, N.A.
1221 Avenue of the Americas
New York, NY 10020

Dear Mr. Baer:

This is in response to the request by Morgan Stanley Bank, N.A. (“MS Bank”), Salt Lake City, Utah, for the view of staff of the Federal Reserve Board about how to determine, for purposes of sections 23A and 23B of the Federal Reserve Act and the Board’s Regulation W, the value of transactions that involve the novation from MS Bank’s affiliates to the bank of foreign exchange (FX) derivatives between the affiliates and unaffiliated third-party clients.

Section 23A and Regulation W place quantitative and qualitative restrictions on covered transactions between a bank and its affiliates. In general, section 23A and Regulation W limit the total amount of covered transactions between a bank and any single affiliate to 10 percent of the bank’s capital stock and surplus, and limit the total amount of covered transactions between a bank and all its affiliates to 20 percent of the bank’s capital stock and surplus.¹ In addition, section 23A and Regulation W prohibit a bank from purchasing low-quality assets from an affiliate² and require that a covered transaction between a bank and an affiliate be on terms that are consistent with safe and sound banking practices.³ The statute and regulation also require a bank to secure certain covered transactions with prescribed amounts of collateral.⁴ Section 23B generally requires

¹ 12 U.S.C. § 371c(a)(1); 12 CFR 223.11 and 223.12. Section 23A and Regulation W contain certain exceptions to these limits not relevant here.

² 12 U.S.C. § 371c(a)(3) and 12 CFR 223.15.

³ 12 U.S.C. § 371c(a)(4) and 12 CFR 223.13.

⁴ 12 U.S.C. § 371c(c) and 12 CFR 223.14.

that transactions between a bank and its affiliates be on terms that are at least as favorable to the bank as the terms of comparable transactions between the bank and a third party.⁵

Through the novation process as proposed by MS Bank, the bank would succeed to the rights and obligations of its affiliate in derivative contracts between the affiliate and its counterparties, and the affiliate would be relieved of these rights and obligations. The bank does not anticipate paying or receiving any consideration for the novation of any derivative transaction, though all collateral held or posted by the affiliate related to the transaction would be transferred to the bank. After each proposed novation, the counterparty to the derivative contract would face MS Bank and not the affiliate with which the counterparty initially entered into the contract.

The proposed novations are covered transactions under section 23A and Regulation W because MS Bank's acquisition of the FX derivative transactions constitutes a purchase of assets by MS Bank.⁶ Regulation W defines the "purchase of an asset" as the acquisition by a bank of an asset from an affiliate in exchange for cash or any other consideration, including an assumption of liabilities.⁷

Under the novated derivative contract, the bank would have the right to receive payments from the counterparty (an asset) as well as the liability to make payments to the counterparty (which is considered by Regulation W to be

⁵ 12 U.S.C. § 371c-1(a). Effective July 21, 2012, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") revised section 23A to include as a covered transaction the credit exposure of a bank to an affiliate arising from a derivative transaction with the affiliate. Dodd-Frank Act §608(a)(1)(B) (codified at 12 U.S.C. § 371c(b)(7)(G)).

⁶ In addition, the proposed novation would be a covered transaction under the attribution rule contained in Section 23A. Under section 23A and Regulation W, a transaction between a bank and a third party is deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate. 12 U.S.C. § 371c(a)(2) and 12 CFR 223.16(a). The assumption by the bank of the obligation to make payments to the counterparty under the novated derivative contract benefits the bank's affiliate by relieving the affiliate of the obligation to make those payments.

⁷ 12 CFR 223.3(dd); 12 CFR 223.3(h)(3).

payment for the corresponding right to receive future payments – the asset). Following the transaction, MS Bank would be subject to both counterparty credit risk (i.e., the risk that the counterparty does not perform its obligations under the contract) and market risk (i.e., the risk that the contract decreases in value from the perspective of MS Bank) for the novated derivative contract.

Sections 23A and 23B of the Federal Reserve Act and Regulation W allow covered transactions between a bank and an affiliate so long as the transactions are within certain quantitative limits, noted above, and meet certain qualitative requirements. MS Bank has requested advice on how to determine the covered transaction amount for FX derivative transactions under its proposed novation process.

Valuation of Novated FX Derivative Transactions

Based on all the facts and circumstances and staff's understanding of the novations as proposed by MS Bank, staff would not recommend that the Board find MS Bank to be in violation of the quantitative limits in sections 23A and Regulation W if the FX derivative transactions are within the quantitative limits noted above using the valuation methodology described below and the novations otherwise meet the terms of sections 23A and 23B and Regulation W.⁸ Staff has considered this approach only in the context of FX derivatives and only in the context of the structure for novations proposed by MS Bank. Other types of derivatives or other novation structures may merit different valuations. We would expect MS Bank to calculate the covered transaction amount on a daily basis for all FX derivative transactions that have been novated from an individual affiliate and remain outstanding as of the end of the day,⁹ and as further described below, periodically report its compliance to the Federal Reserve Bank of New York.

In order to account for the full risk exposure of MS Bank resulting from the novations, the bank should apply the quantitative limit of section 23A for any single affiliate to the sum of:

⁸ This discussion presumes that MS Bank conforms to the qualitative and other requirements contained in sections 23A and 23B and Regulation W in carrying out its proposed approach to novations.

⁹ As a result, the covered transaction amount could change for the bank after the novations occur.

- (i) The aggregate amount of all payments made by MS Bank to or for the benefit of the affiliate in connection with any novation;
- (ii) The aggregate absolute value of the negative current exposure of all novated derivative contracts or novated “derivative netting sets”¹⁰ that have negative current exposure as of the time of novation;
- (iii) A “counterparty credit risk measure” (as defined below) for all novated derivative contracts or novated derivative netting sets with each individual counterparty; and
- (iv) A “market risk measure” (as defined below) for all derivative contracts and derivative netting sets that have been novated from that affiliate to MS Bank.

The covered transaction amount for all derivatives that are novated from an individual affiliate may be reduced by the sum of:

- (i) The aggregate amount of all payments made from the affiliate to MS Bank in connection with any novation;
- (ii) The aggregate amount of any “qualifying collateral or margin”¹¹ held by MS Bank (transferred from a counterparty whether at the time of novation or thereafter or from the affiliate to MS Bank at novation) with respect to a novated derivative contract or derivative netting set; and

¹⁰ A “derivative netting set” means all derivative contracts with an individual counterparty that are governed by contractual arrangements that constitute a “qualifying master netting agreement” as defined in 12 CFR part 225, appendix G, § 2. The current exposure of a derivative netting set with an individual counterparty may be calculated on a net basis with respect to all contracts within that derivative netting set.

¹¹ For this purpose, “qualifying collateral or margin” means collateral or margin in the form of either (i) cash or (ii) obligations of the United States or its agencies, or obligations fully guaranteed by the United States or its agencies as to principal and interest, provided that the collateral or margin legally secures a party’s obligations under the relevant transaction(s) and is identified as such. This reduction in the covered transaction amount for this collateral or margin is limited to the valuation for novated FX derivative transactions described in this letter, and does not change any collateral requirements or other provisions of Regulation W.

- (iii) The aggregate amount of any qualifying collateral or margin previously posted by the affiliate to a counterparty with respect to a novated derivative contract or derivative netting set so long as the affiliate transfers to the bank all current and future rights to the collateral.

Counterparty credit risk measure

Counterparty credit risk is valued similarly to the treatment of OTC derivatives under the Board's risk-based capital rules. Under this valuation methodology, the counterparty credit risk measure for a derivative contract or derivative netting set with each individual novated counterparty would equal the exposure at default amount of the contract or netting set as calculated in accordance with (i) in the case of an individual derivative contract, 12 CFR part 225, appendix G, § 32(c)(5), and (ii) in the case of a derivative netting set, 12 CFR part 225, appendix G, § 32(c)(6), with the exception that such calculation may not be modified by paragraph (c)(7) of that section.

Market risk measure

The market risk measure is valued similarly to the capital charge for the market risk of a derivative under the Board's market risk rule.¹² Because the Board recently amended its market risk rule effective on January 1, 2013, this calculation will change at year end.¹³ Specifically, the market risk measure for all derivative contracts and derivative netting sets that are novated to MS Bank from an individual affiliate would:

- (i) Before January 1, 2013, equal the product of (A) the value-at-risk ("VaR") estimate for the portfolio as calculated by the bank under the existing market risk capital rule and (B) a factor of nine;¹⁴
- (ii) On and after January 1, 2013, equal the product of (A) the sum of

¹² See 12 CFR part 225, appendix E.

¹³ Risk-Based Capital Guidelines: Market Risk, 77 FR 52587 (August 30, 2012).

¹⁴ The 9x factor that is applicable prior to January 1, 2013 is intended to reflect a value that would be generally equivalent to the market risk measure based on the amended market risk rule that is required after year end 2012.

(1) the VaR-based measure calculated under section 5 of the amended market risk rule and (2) the Stressed VaR-based measure calculated under section 6 of that rule,¹⁵ and (B) a factor of three.

Unless otherwise indicated above,¹⁶ MS Bank would be expected to calculate daily the covered transaction amount for all FX derivative transactions that have been novated from an individual affiliate and remain outstanding as of the end of each day and apply this amount to its quantitative limit for covered transactions with a single affiliate under section 23A and Regulation W. Similar treatment should be applied for the aggregate affiliate limit under section 23A and Regulation W.

Application of Section 23B to Novated FX Derivative Transactions

The proposed novation to MS Bank of FX derivative transactions are also subject to the market-terms requirement of section 23B of the Federal Reserve Act.

We understand that some of the derivative transactions to be novated to MS Bank are expected to have a negative current exposure at the time of the novation (“out-of-the-money derivative contracts or derivative netting sets”). We would expect, consistent with our understanding of general market practice, that as part of the novation to MS Bank by an unaffiliated third party of an out-of-the-money derivative contract or derivative netting set, the bank would receive either payment or collateral in an amount at least equal to that negative current exposure. Accordingly, consistent with section 23B, MS Bank would be expected to accept a novation of an out-of-the-money derivative contract or derivative netting set from an affiliate only if MS Bank receives (i) payment from its affiliate, at the time of novation, at least equal to any negative current exposure, (ii) all current and future rights to qualifying margin or collateral that the bank’s affiliate had previously posted to the counterparty in an amount at least equal to any negative current exposure, or (iii) a combination of payment and rights to posted collateral that fully covers the negative current exposure.

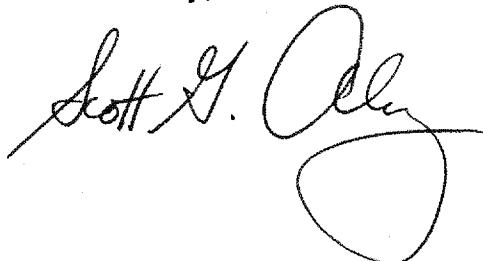
¹⁵ Risk-Based Capital Guidelines: Market Risk, 77 FR 52587 (August 30, 2012).

¹⁶ As described on page 4, the aggregate absolute value of the negative current exposures of all novated derivative contracts or novated derivative netting sets is calculated at the time of the novation.

To ensure compliance with the valuation methodology described in this letter, MS Bank is expected to submit information to the Federal Reserve Bank of New York on a monthly basis that demonstrates how MS Bank valued the FX derivative transactions novated to the bank from each individual affiliate, and that includes a calculation of the bank's remaining quantitative limit available under section 23A and Regulation W for each individual affiliate and for all affiliates in the aggregate. In addition, MS Bank is expected to consult with the Board prior to deviating in any way from this methodology in calculating its covered transaction amount for novated FX derivative transactions. Once the Board issues a final rulemaking modifying Regulation W to incorporate changes made by the Dodd-Frank Act, MS Bank must value any derivative contract it novates from an affiliate pursuant to the terms of the revised Regulation W, as applicable.

This opinion is specifically limited to the facts, understandings and conditions described in this letter. Any change in these facts or understandings could result in a different conclusion and should be reported immediately. If you have any questions regarding this letter, please contact Pamela Nardolilli (202-452-3289) or Sebastian Astrada (202-452-3594) of the Legal Division, or Robert Brooks (202-452-3103) of the Division of Banking Supervision & Regulation.

Sincerely,

A handwritten signature in black ink, appearing to read "Scott G. Oley". The signature is fluid and cursive, with a large, stylized "S" at the beginning and a "J" at the end.

cc: Federal Reserve Bank of New York
Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation