

**Call Between Staff of the Federal Reserve Board  
and Morgan Stanley  
August 12, 2016**

**Participants:** Sean Campbell and Anna Harrington (Federal Reserve Board)

Andrew Baer, Priya Bindra and Andrew Nash (Morgan Stanley)

**Summary:** Staff of the Federal Reserve Board had a call with representatives of Morgan Stanley to discuss the proposed rule for single counterparty credit limits implementing section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The representatives discussed the application of the proposed rule to joint ventures as described in further detail in the attached comment letters.

Attachments



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June 3, 2016

Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, NW  
Washington, DC 20551  
Attention: Robert deV. Frierson, Secretary  
**Docket No. R—1534; RIN 7100 AE-48**

Re: Comments in Response to the Notice of Proposed Rulemaking –  
Single Counterparty Credit Limits for Large Banking  
Organizations

Ladies and Gentlemen:

The Clearing House Association L.L.C., the American Bankers Association, The Financial Services Roundtable, the Securities Industry and Financial Markets Association and the International Swaps and Derivatives Association, Inc. (collectively, the “**Associations**”)<sup>1</sup> appreciate the opportunity to comment on the Board of Governors of the Federal Reserve System’s (the “**Federal Reserve**”) notice of proposed rulemaking implementing single counterparty credit limits (“**SCCL**”) for domestic and foreign bank holding companies with total consolidated assets of \$50 billion or more (the “**Reproposal**”).<sup>2</sup> The Reproposal would implement Section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“**Dodd-Frank**”), which requires the Federal Reserve to prescribe standards that limit “the risks that the failure of any individual company could pose” to such bank holding company or to a systemically important nonbank financial company.

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<sup>1</sup> See Annex A for descriptions of Associations.

<sup>2</sup> 81 Fed. Reg. 14,328 (March 16, 2016). The introduction and commentary included in the Reproposal are referred to herein as the “**Preamble**”, and the proposed rules set forth in the Reproposal are referred to herein as the “**Proposed Rules**”.

The Reproposal is in many ways a substantial improvement to the Federal Reserve's initial 2011 proposed SCCL rulemaking (the "**2011 Proposal**"), including, most notably, the more risk-sensitive measurement methodologies for derivatives and other transactions that adhere more closely to the risk-based capital rules' exposure amounts<sup>3</sup> and the exemptions for exposures to certain sovereign issuers and qualifying central counterparties ("**QCCPs**"). These are important improvements, and we urge their retention in the final SCCL rule.

Notwithstanding this progress, however, the Reproposal contains significant flaws and weaknesses that would make the SCCL framework needlessly difficult to operationalize and inaccurate in application. These elements should be redressed in any final SCCL rule in a way that carefully evaluates each of them on a cost-benefit basis. In particular, the Reproposal would:

- Establish an SCCL framework that is operationally complex and in some respects unworkable, particularly with respect to the aggregation of entities that comprise a "covered company" and a "counterparty", which would contribute little, if at all, to the policy objective of limiting undue concentrations of credit risk;
- Overstate the credit risk associated with, and therefore potentially unnecessarily restrict, securities financing and certain other transactions, which could have substantial unintended negative consequences for markets; and
- Impose more stringent restrictions on certain covered companies, such as through a more stringent SCCL limit, without a sound analytical basis for doing so.

We urge the Federal Reserve to revise these and other components of the Reproposal discussed below to ensure that any final SCCL rule imposed under Section 165(e) of Dodd-Frank is appropriately tailored to achieve its prudential purpose, imposes operational burdens only where necessary to achieve the financial stability objectives that underlie the SCCL, uses reasonable measurement methodologies that are a realistic reflection of risk, and only varies in application where there are reasonable and substantiated reasons for doing so.

In reality, exposures to most counterparties most of the time will not approach a covered company's credit limit. Covered companies should be devoting their resources to identifying and monitoring those that do, rather than continuously tracking down remote connections among counterparties to which the covered company has *de minimis* exposure, and about which the covered company has limited information to analyze.

Many of our recommendations are designed to simplify the Reproposal. This includes suggestions to align the SCCL rules with related regulatory regimes where appropriate and avoid the creation of unnecessary gaps between the existing credit risk management frameworks of covered companies and the SCCL. In particular, we urge

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<sup>3</sup> Regulation Q, 12 C.F.R. Part 217.

alignment of various aspects of the Reproposal with the risk-based capital rules and the Office of the Comptroller of the Currency's ("OCC") lending limits<sup>4</sup> that have been in place and "operationalized" for many years by national bank subsidiaries of bank holding companies subject to the SCCL and that resolve many of the same granular issues the SCCL is meant to address. We also urge alignment with the Basel Committee's own Large Exposures Framework (the "**Basel Large Exposure Framework**"), where appropriate as a U.S. policy matter. We also suggest a number of changes intended to provide a more risk-based approach to identifying and measuring certain exposures subject to the SCCL.

The letter is organized as follows:

- Part I provides an executive summary of our comments;
- Part II highlights aspects of the Reproposal that are needlessly complex and often unworkable and identifies, for each, a clearer and less burdensome alternative approach that would achieve the Reproposal's policy objectives;
- Part III describes aspects of the Reproposal that misstate the actual risks of certain transactions and exposures and identifies alternative measurement methodologies that, while still prudentially conservative, would measure the risk of these transactions and exposures in a more appropriate and risk-sensitive manner;
- Part IV identifies our concerns with the conceptual, analytic, and quantitative reasoning on which the Reproposal's more stringent application to certain bank holding companies ("**BHCs**") is based;
- Part V describes concerns regarding the proposed implementation time frame and other compliance requirements; and
- Part VI provides certain additional technical comments and suggestions for improving the quality, coherence and clarity of the SCCL framework.

## **I. Executive Summary**

This executive summary provides an overview of our key recommendations, which are focused on creating an SCCL framework that would improve the overall effectiveness of the final regulation without undermining the intended prudential benefits of the SCCL. In this vein, we urge the Federal Reserve to consider the scope and design of the final SCCL rule against the backdrop of other post-crisis regulatory reforms. As noted in the Preamble, prior to the financial crisis, the U.S. regulatory approach to credit exposure limits was more limited, addressed only some of the interconnectedness among large financial companies and did not apply at the consolidated holding company level. Since that time, however, the Federal Reserve has enacted or proposed other enhanced micro- and macro-prudential rules that have the same

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<sup>4</sup> 12 U.S.C. § 84; 12 C.F.R. Part 32.

objective underlying many elements of the Reproposal of making financial institutions (particularly the largest institutions) sufficiently resilient to withstand the “failure of an individual company,” including the GSIB capital surcharge, Dodd-Frank Title II, U.S. Single Point of Entry, resolution planning, the ISDA resolution stay protocol, TLAC and the risk-based capital rules’ provisions requiring banking institutions to deduct from their own capital their holdings of capital securities of non-consolidated financial institutions (proposed by the TLAC rules to be expanded to cover holdings of non-consolidated financial institutions long-term debt), to name just a few. Elements of the GSIB surcharge alone are designed to reduce interconnectedness among financial institutions, and together with these other reforms reduce substantially the probability and potential systemic impact of the failure of a systemically important financial institution.

Our specific recommendations for addressing our remaining concerns are informed by the following general principles: (i) incorporate, and, as appropriate, enhance the risk measurement methodologies developed under the U.S. risk-based capital framework to ensure that any rule to implement the SCCL is risk-sensitive and accurately assesses the *amounts* of any exposures; (ii) take into account the interplay between the SCCL and other post-crisis financial regulatory reforms that, like the SCCL, are also designed to address counterparty credit risks so that any rule to implement the SCCL is prudentially coherent—i.e., should be crafted so as to reflect the prudential regulatory context in which the SCCL would operate and not developed in a vacuum; (iii) craft a clear and consistent risk-based framework that is not so complex, granular or rigid as to make it difficult for covered companies to provide economically beneficial products and services to customers; (iv) refrain from creating any new limitations on exposures that are critical to the proper functioning of banking and financial markets; and (v) encourage risk management practices that enhance the safety and soundness of covered companies.

With these principles and objectives in mind, we urge the Federal Reserve to modify the Reproposal as follows:

*Improvements to the Scope of the SCCL Framework and the Treatment of Certain Counterparties and Exposures*

- **Define “covered company” based on financial reporting consolidation, consistent with the regulatory capital rules’ approach to scope.**
- Defining “covered company” by reference to the GAAP financial reporting-based regulatory consolidation group would bring within the scope of the SCCL those exposures that truly put a covered company’s capital at risk, as has long been recognized under the U.S. regulatory capital standards, an approach we believe is consistent with that of the Basel Large Exposure Framework. The use of the Bank Holding Company Act of 1956 (the “**BHC Act**”) standard of control, which has a wholly separate purpose of ensuring legal and structural separation, would introduce significant complexity into a covered company’s management of its credit limits to capture exposures that are not likely to be material to a covered company. Indeed, all true economic

exposures will be more accurately captured under the financial reporting consolidation approach as either part of the covered company or as *counterparty* exposures, whereas the BHC Act definition of “covered company” could counterintuitively result in some entities being included as part of both the covered company and the counterparty.

- At a minimum, if the covered company definition is not aligned with the GAAP-based financial reporting consolidation standard, the final SCCL rule should revert to the simple percentage ownership test included in the 2011 Proposal and provide exemptions for registered investment companies and their foreign equivalents, certain Volcker Rule covered funds, certain merchant banking portfolio companies, companies acquired in the ordinary course of collecting a debt previously contracted, Small Business Investment Companies and community development investments.
- **Define “counterparty” with respect to a company based on financial reporting consolidation and apply the control relationship test only if the aggregate net exposure to a counterparty exceeds 5 percent of a covered company’s eligible capital base.**
  - Aggregation of connected counterparties based on financial reporting consolidation would capture true connected exposure risks that are at the heart of Section 165(e)’s purpose to mitigate the risk that the “failure of an individual company” could pose to a covered company while mitigating the significant practical limits on obtaining information on ownership status beyond the financial consolidation group. Any meaningful potential linkages between entities that are not members of the same financial reporting consolidation group as to which a covered company has a material exposure for purposes of the SCCL limits should be addressed through the control relationship and economic interdependence tests, as appropriate.
  - Applying the highly subjective, fact- and labor-intensive control relationship test only to exposures exceeding 5 percent of the eligible capital base—a meaningful and objective materiality threshold which is also used for purposes of the so-called economic interdependence test—would capture aggregate exposures that would even approach a covered company’s limit and ensure that resources are devoted to identifying the relationships between counterparties that are most likely to raise the systemic concerns that the SCCL is meant to address.
- **Exclude natural persons from the SCCL altogether or include them only subject to a 5 percent threshold of the eligible capital base.** Natural persons should not be subject to the SCCL framework because in virtually every case a natural person, even when aggregated with the person’s immediate family, would not approach 25 percent of a covered company’s eligible capital base. Collecting the information that would be required to monitor exposures to natural persons

and developing the systems to monitor and track these relationships across millions of individual customers may not even be possible, and certainly cannot be justified on a cost-benefit basis. Because it is nearly inconceivable that exposures to individuals would ever approach the credit limits, failure to exempt them from the final SCCL rule would divert significant compliance resources to monitoring exposures that cannot possibly pose the types of systemic interconnectivity risks that Dodd-Frank was meant to address.

- **Modify the look-through requirement for securitization vehicles, investment funds or other SPVs in a risk-sensitive manner to ensure that the requirement can, in fact, be operationalized.** A more risk-based approach to the look-through would address the remote possibility that underlying exposures may have a material impact on a Large Covered Company when aggregated with the Large Covered Company's other exposures without sacrificing the prudential or risk mitigation benefits of the look-through or imposing unnecessary costs. In addition to other recommendations in Section II.D.3 to modify or clarify the mechanics of the look-through:
  - The final SCCL rule should exempt from the look-through requirement exposures, including retail asset-backed securities, pools of finance receivables in which the underliers are comprised of small business borrower receivables, and commercial mortgage-backed securities because it is extremely unlikely that any of the underliers would materially contribute to a covered company's exposure to a given counterparty given the granular nature of the underliers. In addition, investment funds registered under the Investment Company Act of 1940 (or governed by similar legislation in other jurisdictions) should be exempt based on their stringent diversification requirements to which they are subject.
  - The scope of the look-through requirement should be clarified to apply only to exposures arising from cash investments in a securitization vehicle, investment fund or other SPV and synthetic positions, such as derivative contracts or other instruments, that mirror the economics of a cash investment that are held in the banking book and exposures arising from extensions of credit and liquidity facilities that mimic the risks of such cash investments and that exceed 0.25 percent of a Large Covered Company's eligible capital base.
- **Eliminate the third-party exposure requirement altogether or limit the type of exposure subject to the requirement and use a 0.25 percent threshold of the eligible capital base.** If not eliminated, the third party exposure requirement in Section 252.75(c) should apply only to third parties that provide credit support or liquidity facilities to a securitization vehicle, investment fund or other SPV and should apply only where the Large Covered Company's investment exceeds 0.25 percent of the Large Covered Company's eligible capital base, consistent with the look-through requirement.

- **Require aggregation of states and their political subdivisions only if they are economically interdependent, subject to the 5 percent threshold of the eligible capital base.** A covered company should use the economic interdependence test to determine if it must aggregate its exposures to a State with exposures to its political subdivisions and should only be required to perform this analysis after its exposure to a State or a political subdivision on its own exceeds 5 percent of the covered company's eligible capital base. The Reproposal provides no basis for the automatic aggregation of states and their political subdivisions, ignores the discrete and diverse credit profiles that exist among a State and its subdivisions and is at odds with historical default experience. At a minimum, municipal revenue bonds should not be aggregated as they are contractually supported by a specific stream of revenue, which is expressly recognized in Chapter 9 of the Federal Bankruptcy Code.
- **Extend the carve-out for exposures to zero risk weight foreign sovereigns to their zero risk weight public sector entities.** The carve-out for exposures to zero risk weight foreign sovereigns should be extended to their zero risk weight public sector entities because they similarly pose little risk of default and would align the treatment of such PSE with the determination of risk weights under the risk-based capital rules.

*Improvements to the SCCL Framework's Measurement of Risk Exposure*

- **Allow covered companies to calculate SFT exposures using any methodology permitted for risk-based capital purposes, at least until a risk-sensitive standardized approach is implemented.** Given the widely recognized flaws inherent in the Reproposal's measurement methodology, which is based on the existing and highly risk-insensitive Comprehensive Approach, a covered company should be permitted to measure SFT exposures using any methodology permitted for risk-based capital purposes, consistent with the SCCL's approach for measuring derivative exposures. This recommendation would encompass any future revisions to the risk-based capital rules as a result of the Basel Committee's proposed revision of the Comprehensive Approach, subject to an appropriate implementation period. In light of the critical role of securities lending in the broader U.S. securities markets, flaws in the SFT measurement methodology that have the potential to cause covered companies to pull back from this activity as a result of a significant overstatement of risk could have real market consequences.
- **Apply the same CCFs to unfunded, off-balance sheet commitments as under the risk-based capital rules.** The final SCCL rule should apply the same CCFs to unfunded, off-balance sheet commitments under the SCCL as are applied under the risk-based capital rules, rather than the proposed uniform 100 percent CCF to all such commitments regardless of contractual provisions, to better reflect actual economic exposure. We see no reason, based on banking organizations' actual experiences or otherwise, to diverge in this context from the existing regulatory regime that would justify the cost of imposing a different standard, including the

disincentive it would provide covered companies to provide large lines of credit to corporate borrowers.

- **Eliminate the eligible protection provider and maturity mismatch adjustment requirements for trading book positions.** Credit and equity derivatives that are covered positions under the market risk capital rule (“**Covered Positions**”) should not be subject to the maturity mismatch adjustment and eligible protection provider requirements. The application of these banking book concepts is not straightforward in a trading book with dynamic exposures and hedges and generally more liquid positions. In this context, the source of the equity or credit derivative is less important if the counterparty risk is appropriately captured. Restricting, via the eligible protection provider requirement and the maturity mismatch adjustment, the ability of otherwise eligible credit and equity derivatives to reduce gross exposure could place unnecessary additional strains on market liquidity.
- **Measure the net credit exposure amount of equity exposures that are Covered Positions subject to the market risk capital rule in a manner consistent with the calculation of specific risk for risk-based capital purposes.** Equity derivatives that are covered positions under the market risk capital rule should be calculated as part of a covered company’s net long or net short position with respect to a given issuer in a manner more generally aligned with how exposure amounts are calculated for such positions under the market risk capital rule. This approach—rather than the approach under the Reproposal to treat equity derivatives in a manner equivalent to instruments designed to offer credit protection—is consistent with the applicable risk-based capital rules and the Basel Committee’s Large Exposure Framework.

*Improvements to the More Stringent Treatment of Certain Covered Companies*

- **Eliminate the 15 percent inter-GSIB limit in the absence of a compelling analytical basis.** Before proceeding with the application of the lower 15 percent inter-GSIB limit to major covered companies, the Federal Reserve should properly account for the probability of a G-SIB default—taking into account the impact of key components of regulatory reforms aimed specifically at addressing both the probability and impact of a G-SIB default.

*Implementation Period in Line with the Considerable Operational Complexity Associated with Preparing for the Requirements of the Final SCCL Rule*

- **Extend the compliance period to two years from the date the reporting template is finalized for all covered companies, or three years if retail exposures are not excluded from the SCCL framework.**
- Two years from the date the SCCL reporting form is finalized is the bare minimum of time that covered companies would need to develop the

necessary infrastructure. SCCL compliance will entail the deployment of significant resources and development of entirely new systems and procedures, which will be highly dependent on the final rule and the Federal Reserve's reporting requirement. This is particularly the case given that much of the information necessary to comply with the Proposed Rules' requirements is not publicly available and the broad-based application of the Reproposal touches virtually every business of a covered company.

- If retail exposures are not exempted from the scope of the final SCCL rule, a minimum of three years from the finalization of the SCCL reporting forms would be necessary to develop and implement systems capable of tracking and calculating exposures to millions of individual customers, their immediate family members, and any other entities a covered company may be required to aggregate.

*Elimination of or Revisions to the Application of the Final U.S. SCCL Rule to FBOs*

- **Do not apply the SCCL separately to the combined U.S. operations of a FBO.** The combined U.S. operations of foreign banking organizations ("FBOs") already subject to a comparable home country regime should not need to comply with the final U.S. SCCL rule to avoid subjecting the combined U.S. operations of FBOs unnecessarily to a host of overlapping regimes that are designed to address the very same issues.
- At a minimum, to the extent FBOs are subject to the final SCCL rule, they should be treated consistently throughout, including by basing the size-based tailoring of the compliance requirements solely on U.S. assets of FBOs and eliminating the "cross trigger" on the exposure limits of an IHC and the combined U.S. operations of the parent FBO.

*Other Technical Issues*

- **Address other concerns and technical issues to increase clarity and make the final SCCL rule more workable.** We also recommend a number of other technical changes and clarifications necessary to operationalize the SCCL, including:
  - Broadening the cure period in the Proposed Rules to mitigate potential disruptions to proper market functioning. In addition, we recommend the inclusion of appropriate transition periods if an exposure or counterparty loses its exemption under the SCCL.
  - Clarifying that the daily compliance requirement for Large Covered Companies is based on the most recent information with respect to counterparties that is available to the Large Covered Company, consistent

with its internal risk management processes and not on information that is updated on a daily basis.

**II. The Reproposal’s definitions of “covered company” and “counterparty” and its “look-through” approach are unworkable and introduce considerable complexity that is unnecessary to achieve the objectives of the SCCL.**

**A. The covered company definition, like the regulatory capital rules’ approach to scope, should adopt GAAP financial reporting consolidation as the test for entities included as part of the covered company. That approach would more accurately reflect the entities likely to put a covered company at risk as a result of counterparty failure.**

The Reproposal would define a covered company to include all entities the covered company directly or indirectly controls under the BHC Act, and would therefore encompass all entities as to which the covered company: (i) directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the entity, (ii) controls in any manner the election of a majority of the directors or trustees of the entity or (iii) exercises a controlling influence over the management or policies of the entity.<sup>5</sup> Reliance on the BHC Act definition of “control” would subject exposures to the SCCL that do not put a covered company at risk and require a covered company to subject to its credit limit entities over which it does not exercise operational control.<sup>6</sup>

Using financial reporting consolidation under U.S. GAAP as the standard, which is the basis on which risk-based and total assets are determined under the regulatory capital rules (both risk-based and leverage), would address these concerns while still meeting the policy objectives of the SCCL. Indeed, the use of a GAAP-based regulatory capital perimeter as the relevant regulatory consolidation group for SCCL purposes would capture precisely the types of risk at which the SCCL is directed and provide a workable standard for covered companies that has already been implemented in practice. Benefits of this alternative approach include the following:

- Reference to the GAAP-based regulatory consolidation group would align a covered company’s eligible capital base with the entities subject to a common risk exposure limit.<sup>7</sup> These are the entities with exposures which actually put the covered company’s capital at risk, as has long been recognized under the regulatory capital standards and reflected in their reliance on that perimeter as the basis for prudential bank regulation. Indeed it is difficult to understand

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<sup>5</sup> 12 U.S.C. § 1841(a)(2).

<sup>6</sup> 81 Fed. Reg. at 14,346.

<sup>7</sup> GAAP-based financial reporting consolidation, which is the basis used for regulatory capital purposes, is also the appropriate standard for aggregation of counterparty exposures. *See* Part II.C, *infra*.

how the exposures of entities that are deemed to pose no material risk of loss under the bank regulatory capital framework could be viewed as doing precisely that under the SCCL framework. The Federal Reserve has applied the other enhanced prudential standards of Section 165 on the basis of GAAP financial reporting consolidation, and there is no reason to deviate in the context of Section 165(e), which similarly does not amend the BHC Act.<sup>8</sup>

- A BHC Act standard would impose significant compliance costs to capture risks that are not likely to be material to a covered company. A covered company does not have the same type of operational control over, and does not monitor each exposure of, a BHC Act subsidiary that is not consolidated as it does over a subsidiary subject to GAAP financial reporting consolidation. The marginal costs of constructing the operational frameworks to comprehensively monitor and control the exposures of a subsidiary that is not consolidated within the GAAP financial reporting consolidation group for SCCL compliance purposes are considerable, yet the incremental risk mitigation benefits are limited—which explains precisely why this has never been required for regulatory capital purposes.
- Using a BHC Act standard is not necessary to “avoid evasion of the rule’s purposes.”<sup>9</sup> The risk that a covered company could use a subsidiary that is not consolidated for GAAP financial reporting purposes to incur exposures on its behalf is limited by the degree of operational control the covered company would have over such subsidiary. Any remaining evasion concerns can be addressed through a reservation of authority by the Federal Reserve to designate companies as part of the covered company.

**1. The exposures of a covered company should be determined by reference to the GAAP-based regulatory consolidation group.**

The GAAP-based regulatory consolidation group should be used to define a “covered company” because it would be consistent with the Basel Large Exposure Framework<sup>10</sup> and include in the scope of the SCCL the exposures that truly put a covered company at risk. In addition, it would avoid introducing unnecessary and distracting operational complexity without meaningfully increasing the risk of evasion. First, requiring a covered company to include in its exposures only the exposures of entities in

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<sup>8</sup> To the extent the Federal Reserve considers the term “unaffiliated” in Section 165(e) to be defined by reference to the “affiliate” definition in the BHC Act under Dodd-Frank Section 2(1), using a different standard to define the scope of “covered company” is clearly within the authority of the Federal Reserve to exempt exposures from Section 165(e).

<sup>9</sup> 81 Fed. Reg. at 14,331.

<sup>10</sup> Basel Committee on Banking Supervision, *Supervisory Framework for Measuring and Controlling Large Exposures*, at ¶ 12 (Apr. 2014), available at <http://www.bis.org/publ/bcbs283.pdf>. (“The application of the large exposures framework at the consolidated level implies that a bank must consider all exposures to third parties across the *relevant regulatory consolidation group* . . . .” (emphasis added)).

the GAAP-based regulatory consolidation group, whose assets are included in the denominators of its regulatory capital ratios, would capture those positions most likely to pose the risks Section 165(e) was designed to capture—namely, those that flow directly through the BHC’s capital accounts. The impact of a failure of a counterparty on a consolidated subsidiary of a covered company is fully reflected in the covered company’s financial statements, including its capital (and hence regulatory capital).

In contrast, the BHC Act control definition, which is exceedingly broad and focused more on the powers-related and structural limitations of the BHC Act and not on economic risk, would impute to covered companies the exposures of a wide range of entities that pose no meaningful risk of loss to the covered company. As discussed further in Parts II.A.2 and II.C, this overly broad definition also creates operational issues.<sup>11</sup> Furthermore, in those instances in which a covered company has only a minority interest in another entity and accounts for its investment using the equity method, losses that that entity incurs as a result of its borrowers’ and counterparties’ defaults do not flow through on a dollar-for-dollar basis to the financial statements and capital accounts (including regulatory capital) of the covered company but instead flow through only to the extent of the covered company’s proportionate exposure reflected through equity accounting adjustments. Including the exposures of such a subsidiary as though they were direct exposures of the covered company could result in the inclusion of an exposure that is in excess of the maximum potential loss a covered company could potentially suffer. For example, if the covered company has a \$30 equity investment in the subsidiary and the subsidiary has a \$50 exposure to a counterparty, the maximum loss a covered company would suffer if the counterparty failed is \$30 but it must include a \$50 exposure for purposes of the SCCL. Such a result artificially exaggerates the covered company’s actual exposure to the counterparty and lowers the covered company’s permissible exposure to the counterparty. Finally, because of the breadth of the concept of controlling influence in the BHC Act control definition, exposures to entities in which the covered company lacks any economic interest at all could be required to be aggregated with the covered company’s exposures.

Second, the operational challenges, and in some cases impossibility, of aggregating exposures of entities that are not part of the GAAP-based regulatory consolidation group, together with the other considerations discussed below, far outweigh any marginal benefit of using the Reproposal’s broader test. Indeed, GAAP

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<sup>11</sup> Specifically, the “controlling influence” test of the BHC Act definition of “control” raises several issues. First, it would capture exposures of entities with voting equity stakes as little as 5 percent, and in some cases, exposures to entities with no loss transference to the covered company whatsoever. Second, the systems and processes required to capture such exposures for purposes of the SCCL would require significant development resources with little risk mitigation benefit. Third, the “facts and circumstances” basis and dynamic nature of the controlling influence test raises the possibility of introducing volatility into the SCCL. Finally, the controlling influence test serves policy objectives that are distinct from the SCCL, namely (i) ensuring that entities that acquire control of banking organizations have the financial and managerial strength, integrity, and competence to exercise that control in a safe and sounder manner, and (ii) limiting the mixing of banking and commerce. At a minimum, the final SCCL rule should adopt a bright-line standard similar to the one used in the 2011 Proposal as it would be easier to implement as well as more risk-sensitive and stable.

consolidation requirements are generally focused on presenting “a single economic entity”<sup>12</sup> and already take into account the ability of an investor to “control the operations or assets of the investee.”<sup>13</sup> Operational control is even less likely as the voting stake declines below 25 percent. As a practical matter, a covered company that owns less than 50 percent of the voting power of a company may have limited, if any, operational control of such entity. It is for these reasons that both the Basel Large Exposure Framework<sup>14</sup> as well as the European Union Capital Requirements Regulation (“**EU CRR**”) have taken approaches consistent with use of the GAAP-based regulatory consolidation group to define covered companies.<sup>15</sup>

Although it is true that the BHC Act definition of control has been operationalized by covered companies for the basic purpose of facilitating compliance with the Act’s Sections 3 and 4, its further operationalization for application in the very different context of the SCCL, to the extent achievable at all, would involve considerable expense and complexity. While a covered company can, of course, identify in the ordinary course its BHC Act subsidiaries and periodically provides a list of those subsidiaries to the Federal Reserve on Form FR Y-10, it will nevertheless often be difficult if not impossible for a covered company to “monitor and control”<sup>16</sup> each and every credit exposure of all of its BHC Act subsidiaries. There are fundamental differences between how a bank holding company interacts with and oversees a company within the GAAP-based regulatory consolidation group and over which it has day-to-day operational control and one in which it has only a minority investment but that it nonetheless controls for BHC Act purposes. If a bank holding company financially consolidates and has operational control over a company (thus a member of the GAAP-based regulatory consolidation group), the company generally will be fully integrated into the bank holding company’s enterprise-wide policies, procedures, control framework, business strategies, liquidity and capital management strategy, information technology systems, and management information

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<sup>12</sup> ASC 810-10-10-1.

<sup>13</sup> See ASC 810-10-15-10. Under GAAP consolidation, a covered company first tests for whether an entity is a variable interest entity (“**VIE**”); if it is, the covered company would consolidate the entity if it has the power to direct the most significant economic activities of the VIE. ASC 810-10-15-4. If an entity is not a VIE, then a covered company generally consolidates the entity if it holds a majority voting interest. ASC 810-10-15-18. Both of these tests—economic control over VIEs and majority voting control for non-VIEs—are better proxies for economic exposure and operational control than the BHC Act definition of control contained in the Reproposal.

<sup>14</sup> Basel Committee on Banking Supervision, *Supervisory Framework for Measuring and Controlling Large Exposures*, at ¶ 12 (Apr. 2014), available at <http://www.bis.org/publ/bcbs283.pdf>. (“The application of the large exposures framework at the consolidated level implies that a bank must consider all exposures to third parties across the *relevant regulatory consolidation group* . . . .” (emphasis added)).

<sup>15</sup> The consolidation standards in the EU CRR, which implements the EU large exposures framework in Part Four, are largely based on accounting consolidation but do include a reservation of authority for supervisors to determine the appropriate approach in certain, complex situations. Regulation 2013/575/EU of the European Parliament and of the Council Art. 11 ¶ 1; Art. 18 ¶ 7 (Jun. 26, 2013).

<sup>16</sup> 81 Fed. Reg. at 14,331.

systems. While a bank holding company may have governance rights, protective covenants, and access to information to ensure that its responsibilities under the BHC Act (particularly with respect to permissible activities) are fulfilled for an unconsolidated company that is “controlled” only within the meaning of the BHC Act, the unconsolidated company is unlikely to be integrated into the bank holding company in the same way. Indeed, monitoring for compliance with the BHC Act can more readily be satisfied through covenants, and the static nature of the requirements can be monitored in a straightforward manner. By contrast, the dynamic nature of the SCCL’s requirements cannot readily be satisfied through covenants and would require operationally intensive monitoring efforts. Accordingly, the covered company will face challenges in monitoring and controlling all credit exposures of such entity to all of the entity’s counterparties. As a result, a covered company may, in practice, need to set a credit limit for itself that is well below the actual limit imposed by the rule.

Moreover, some of the limits on a covered company’s operational control over investments arise from requirements imposed under other regulations. For example, a covered company generally is prohibited from routine management or operation of a portfolio company it holds under merchant banking authority,<sup>17</sup> which by definition is a company that is not engaged in financial activities, yet under the Reproposal, the covered company would need to factor the portfolio company’s dynamic exposures into its credit limit regardless of the nature or size of those exposures.

Finally, the evasion concern raised in the Preamble does not dictate incorporation of the BHC Act control standard.<sup>18</sup> Most importantly, the actual risk to which the covered company is exposed—*i.e.*, its exposure as a minority investor in the entity—would still be fully captured by the SCCL by treating the entity as a counterparty, with an exposure amount generally equal to the market value of the equity securities. In addition, if a covered company’s interest in another entity is a minority interest, as is the case under discussion here, by definition the rewards, as well as risks of that entity’s exposures to its borrowers and/or counterparties, are largely for the account of others. Moreover, as discussed above, because a covered company that is deemed to control a subsidiary under the BHC Act’s “controlling influence” test may have little (if any) day-to-day operational control over the entity, a covered company would not have the ability or opportunity to force the entity to incur or divest exposures as a means of evading the SCCL requirements.

To the extent evasion nonetheless remains a concern, the final SCCL rule could include an explicit reservation of authority to address such concerns, similar to the reservation of authority in Section 252.76(b)(3) of the Reproposal. In fact, the GAAP-

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<sup>17</sup> 12 C.F.R. § 225.171.

<sup>18</sup> 81 Fed. Reg. at 14,331. The Reproposal specifies that a bank holding company should be able to monitor and control its credit exposures on a consolidated basis, including the credit exposures of its subsidiaries, and that by applying the single counterparty credit limits in the proposed rule to bank holding companies on a consolidated basis, which would include the credit exposures of their subsidiaries, would help to avoid evasion of the rule’s purposes.

based regulatory consolidation group in the regulatory capital rules already contains an embedded reservation of authority permitting the Federal Reserve to require a banking organization to treat an entity as if it were consolidated on its balance sheet for regulatory capital purposes.<sup>19</sup> Reliance on reservation of authority is a more tailored solution to address any residual evasion concerns than the use of the BHC Act's definition of "control."

**2. If the "covered company" definition is not based on GAAP financial reporting consolidation, the final SCCL rule should provide exemptions for registered investment companies, foreign public funds, Volcker Rule covered funds operated pursuant to the asset management exemption and certain merchant banking portfolio companies.**

We recommend that the categorical exemptions below be granted in the final SCCL rule where such funds or investments are not consolidated by the covered company for financial reporting purposes in light of the regulatory regime to which these entities are subject, which largely eliminates any evasion concerns.<sup>20</sup> These exemptions from the "covered company" definition are necessary whether or not the Federal Reserve were to include all sponsored funds in the definition of a covered company (*see* Part II.A.4 below).

- Registered investment companies and foreign public funds. A covered company may sponsor a fund pursuant to a written plan for the fund to become a registered investment company. In such circumstances, the sponsor may hold a significant equity stake for a period of time during the so-called seeding period. Under the Reproposal's definition of "control", a covered company potentially could be required to aggregate the fund's positions based, for example, on the temporary equity ownership.<sup>21</sup> However, given the temporary nature of the seeding period,<sup>22</sup> such exposures are more properly

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<sup>19</sup> *See, e.g.*, 12 C.F.R. § 217.1(d) (5) ("The Board may determine that the risk-based capital treatment for an exposure or the treatment provided to an entity that is not consolidated on the Board-regulated institution's balance sheet is not commensurate with the risk of the exposure and the relationship of the Board-regulated institution to the entity. Upon making this determination, the Board may require the Board-regulated institution to treat the exposure or entity as if it were consolidated on the balance sheet of the Board-regulated institution for purposes of determining the Board-regulated institution's risk-based capital requirements and calculating the Board-regulated institution's risk-based capital ratios accordingly. The Board will look to the substance of, and risk associated with, the transaction, as well as other relevant factors the Board deems appropriate in determining whether to require such treatment."). The credit exposures of a non-GAAP-consolidated "subsidiary," to the extent the covered company has legally guaranteed those exposures, are an example of a situation where this reservation of authority could be appropriately applied.

<sup>20</sup> *See, e.g.*, 12 C.F.R. § 248.10(c)(1), (12).

<sup>21</sup> The Reproposal would also require aggregation in such situation under the "control relationship" test. *See* Section 252.76(b), 81 Fed. Reg. at 14,332.

<sup>22</sup> The Federal Reserve has recognized that the seeding period for an entity that is a registered investment company or foreign public fund may take up to three years and would not advise treating such a fund

excluded from the SCCL to avoid introducing unnecessary volatility into the framework or discouraging covered companies from sponsoring such funds. The Volcker Rule, recognizing that such funds pose little or no risk to their sponsor, provides an exemption from the definition of “covered fund” and “banking entity” for vehicles formed and operated pursuant to a written plan to become a registered investment company.<sup>23</sup> A similar exemption would be appropriate in the final SCCL rule to avoid aggregating exposures during the temporary seeding period. There is little policy concern with applying an exemption in the context of the SCCL since such funds are subject to a robust regulatory regime. For the same reasons, the exemption should also be available for foreign public funds, which similarly are exempt from the Volcker Rule.<sup>24</sup>

- Volcker Rule-covered funds operated pursuant to the asset management exemption. A covered company may be deemed to control, for BHC Act purposes, a covered fund that it sponsors under the Volcker Rule’s asset management exemption.<sup>25</sup> Under the Reproposal, a covered company would be required to aggregate the exposures of the covered fund with its own exposures. However, the Volcker Rule provides an exemption from the definition of “banking entity” for a vehicle that is a covered fund.<sup>26</sup> Moreover, under the Volcker Rule’s asset management exemption, the covered company would be prohibited from extending credit to the covered fund and from guaranteeing, assuming, or otherwise insuring the obligations of the covered fund.<sup>27</sup> Given these prohibitions, it would be impossible for the exposures of the covered fund to become exposures of the covered company. Furthermore, the risk to the covered company arising out of any direct exposure that a covered company may have to the covered fund through an investment in the

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as a banking entity during the seeding period. See Board of Governors of the Federal Reserve System, *Volcker Rule: Frequently Asked Questions*, Question 16 (Mar. 4, 2016), available at <http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#16>.

<sup>23</sup> 12 C.F.R. § 248.10(c)(1), (12); Board of Governors of the Federal Reserve System, *Volcker Rule: Frequently Asked Questions*, Question 5 (Mar. 4, 2016), available at <http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#5>.

<sup>24</sup> The Federal Reserve has recognized other governance structures abroad and stated that it would not advise that a foreign public fund be deemed a banking entity solely by virtue of its relationship with the sponsoring banking entity where the foreign public fund meets the requirements of section 248.10(c)(1) and the sponsoring banking entity’s relationship with the foreign public fund meets the requirements of 248.12(b)(1) of the Volcker Rule. See Board of Governors of the Federal Reserve System, *Volcker Rule: Frequently Asked Questions*, Question 16 (Mar. 4, 2016), available at <http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#14>.

<sup>25</sup> 12 C.F.R. § 248.11(a).

<sup>26</sup> 12 C.F.R. § 248.2(c)(2)(i).

<sup>27</sup> 12 C.F.R. § 248.14(a).

covered fund is already addressed by the requirement to deduct such investment from the covered company's tier 1 capital.<sup>28</sup>

- Merchant banking investments. By definition, investments held under the merchant banking authority must be in entities that are engaged in nonfinancial activities.<sup>29</sup> As a result, there is a fundamental difference in nature between the types of transactions a covered company would enter into and those of a merchant banking portfolio company. In addition, because of the nonfinancial nature of a portfolio company's operations, there generally would be little opportunity for a covered company to coerce its merchant banking portfolio company to enter into transactions aimed at circumventing the SCCL. Finally, the prohibition on routine management of portfolio companies by bank holding companies reduces the opportunity for evasion.
- DPC holdings. Interests in companies held as a result of the acquisition of shares in the ordinary course of collecting a debt previously contracted ("DPC") are generally not integrated in covered companies' systems and must be divested within specified time periods under other federal regulations.<sup>30</sup> Developing the capability to monitor exposures of companies held under DPC authority for this purpose when a covered company would be divesting within a short period would be an unnecessary diversion of a covered company's SCCL compliance efforts.
- SBIC and Community Development Investments. Interests in Small Business Investment Companies ("SBICs")<sup>31</sup> and community development investments should also be excluded from the "covered company" definition. Including these entities within the scope of a covered company's SCCL would mean that the entities would need to have or be in a position to develop systems to monitor their credit exposures on a daily basis as a result of their inclusion as part of a covered company. The requirement to build a monitoring system across these types of entities could discourage covered companies from investing in them, potentially depriving these companies of an important source of funding.

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<sup>28</sup> 12 C.F.R. § 248.12(d).

<sup>29</sup> 12 U.S.C. § 1843(k)(4)(H).

<sup>30</sup> 17 C.F.R. § 255.10(a)(2)(iii), (c)(8)(iii).

<sup>31</sup> SBICs are investment funds licensed and regulated by the U.S. Small Business Administration that are eligible for certain benefits if they comply with certain regulatory restrictions. Banks (and by extension bank holding companies) have the authority under the Small Business Investment Act of 1958 to invest in SBICs, subject to certain quantitative limits and as investments designed primarily to promote the public welfare under 12 § USC 24 (Eleventh). As with community development investments, SBICs are specifically excluded from the Volcker Rule. *See* 12 U.S.C. § 1851(d)(1)(E).

**3. Sponsored funds should not be included as part of the covered company, and the definition of “subsidiary” should not be expanded to include any investment fund or vehicle advised or sponsored by a covered company.**

The Preamble specifically asks whether the proposed definition of a “subsidiary” should be expanded to include “any investment fund or vehicle advised or sponsored by a covered company.”<sup>32</sup> We strongly oppose this suggestion. As an initial matter, each sponsored or advised fund is a separate legal entity that is distinct from its sponsor or adviser. The sponsor or adviser has no claim on the fund’s assets nor may it use the fund’s assets for its own benefit, and the fund’s shareholders—not the sponsor or adviser—bear the risk of investment losses and the benefits of any investment gain. Furthermore, since the entire purpose of an investment fund is to permit investors to obtain exposures to a specific market segment or investment strategy, investors understand that they bear performance risk and that there is no broad-based expectation of support.

Accordingly, a sponsored or advised fund should not be included in the definition of a subsidiary, absent a legally binding obligation by the covered company to support the fund. Any argument in favor of an expansive definition of the term “subsidiary” is based on the flawed premise that a covered company would *voluntarily* (and without a legal obligation) provide support to a sponsored or advised fund in the event of financial need, even though history shows that such “step-ins” have only occurred in specific, limited instances, such as during the financial crisis, and, even during the crisis, were not a wide spread phenomenon and have been mitigated by many post-financial crisis reforms.<sup>33</sup> Furthermore, such an argument ignores the regulatory scheme which governs investment funds, and could in fact trigger an expectation of sponsor support that does not exist in practice, thus undermining one of the major features of recent regulatory reforms.

During the financial crisis, there was pressure to step-in and provide support for money market mutual funds (“**MMMMF**”) as a result of the use of a fixed net asset value (“**NAV**”) which imposes an implicit “floor” on the fund that certain sponsors felt pressured to support. However, other types of investment funds do not have an implicit floor, thereby all but eliminating the primary rationale for sponsor support. Furthermore, expectations of sponsor support are also constrained by the ability of an investment fund to limit withdrawals and to postpone redemptions during periods of economic stress.

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<sup>32</sup> 81 Fed. Reg. at 14,331.

<sup>33</sup> See Letter from The Clearing House to the Basel Committee on Banking Supervision, dated March 17, 2016, regarding the Consultative Document entitled *Identification and Measurement of Step-in Risk*; Letter from the Global Financial Markets Association, the CRE Finance Council, CREFC Europe, and the Real Estate Roundtable to the Basel Committee on Banking Supervision, dated March 17, 2016, regarding the Consultative Document entitled *Identification and Measurement of Step-in Risk*.

Since the financial crisis, significant measures have been taken to further strengthen the resilience of investment funds. In the case of MMMFs, the SEC has implemented a series of reforms, notably a requirement for all institutional, non-government MMMFs to make use of a floating NAV.<sup>34</sup> In addition, the SEC has proposed a rule that would require open-ended funds generally to maintain a liquidity risk management program, including a minimum portion of net assets that can be converted to cash within three business days, thus minimizing the risk of disruption in stressed conditions.<sup>35</sup> Finally, as indicated above, under the Volcker Rule's asset management exemption, a covered company is prohibited from extending credit to a covered fund and from guaranteeing, assuming, or otherwise insuring the obligations of that covered fund.<sup>36</sup>

Similarly, prudential regulations and accounting requirements for covered companies already substantially address step-in risk. Under GAAP, the Financial Accounting Standards Board provides guidance on whether an implicit interest in a variable interest entity exists, including when a reporting entity may be required to protect an investor in a legal entity from absorbing losses by that legal entity.<sup>37</sup> In addition, the Federal Reserve's Comprehensive Capital Analysis and Review ("CCAR") process already requires BHCs to identify and assess risks, including off-balance-sheet exposures that only materialize under stressful conditions. These measures are more than sufficient to address any possible residual step-in risk. More broadly, we do not believe that Section 165(e) was intended by Congress as a substitute for SEC regulation of investment funds through the implementation of a requirement that would expand the SCCL framework to include sponsored or advised funds.

**B. The definition of "counterparty" with respect to a company should be based on financial reporting consolidation, and the control relationship or economic interdependence tests should apply only if an exposure exceeds 5 percent of a covered company's eligible capital base.**

The Reproposal's definition of "counterparty" would encompass a company and all persons of or as to which the company: (i) owns, controls, or holds with power to vote 25 percent or more of a class of voting securities; (ii) owns or controls 25 percent or more of the total equity; or (iii) consolidates for financial reporting purposes.<sup>38</sup> In addition, a

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<sup>34</sup> See Money Market Fund Reform, SEC Release No. IC-29132 (Feb. 23, 2010), 75 Fed. Reg. 10,060 (adopting release), available at <http://www.sec.gov/rules/final/2010/ic-29132fr.pdf>; Money Market Fund Reform; Amendments to Form PF, SEC Release No. 33-9616 (Jul. 23, 2014), 79 Fed. Reg. 47,736 (adopting release), available at <https://www.sec.gov/rules/final/2014/33-9616.pdf>.

<sup>35</sup> SEC, *Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release; Proposed Rule*, 80 Fed. Reg. 62,287 (Oct. 15, 2015).

<sup>36</sup> 12 C.F.R. § 248.14(a).

<sup>37</sup> ASC 810-10-22-50 to -54.

<sup>38</sup> Section 252.71(e)(2).

covered company would be required to aggregate counterparties connected by the existence of a control relationship.<sup>39</sup> A final layer of complexity would be added for the counterparties to which a covered company has exposures that exceed 5 percent of its eligible capital base through the application of the economic interdependence test.<sup>40</sup> As described below, this definition would raise practical concerns regarding gaps in the information required to aggregate counterparties, result in complex “multi-to-one” mapping issues and present inaccurate depictions of economic connectedness that are based on the existence of a broadly defined “control relationship.” A financial reporting consolidation standard would solve these concerns, but still capture the overwhelming majority of exposures that are likely to be economically connected.

**1. Financial reporting consolidation captures a substantial majority of counterparties that are economically interconnected and therefore is an appropriate starting point for aggregating counterparties.**

The Associations understand that meaningfully monitoring and reducing systemic risk may require aggregation of exposures across certain related counterparties. The “connected counterparty” framework set out in the Reproposal, however, goes far beyond what is necessary to capture connected exposure risks and would present significant, and, in some cases, insurmountable, operational challenges.

The purpose of Section 165(e) is to mitigate the risk that the “failure of an individual company” could pose to a covered company by limiting the credit exposure a covered company may have “to any unaffiliated company.” The counterparty definition

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<sup>39</sup> A control relationship would be determined based on the following factors: (i) the presence of voting agreements; (ii) the ability of one counterparty to significantly influence the appointment or dismissal of another counterparty’s administrative, management or governing body, or the fact that a majority of members of such body have been appointed solely as a result of the exercise of the first counterparty’s voting rights; and (iii) the ability of one counterparty to exercise a controlling influence over the management or policies of another counterparty. Section 252.76(b).

<sup>40</sup> A determination as to whether two counterparties are economically interdependent would be based on: (i) whether 50 percent or more of one counterparty’s gross revenue or gross expenditures are derived from transactions with the other counterparty; (ii) whether one counterparty (counterparty A) has fully or partly guaranteed the credit exposure of the other counterparty (counterparty B), or is liable by other means, and the credit exposure is significant enough that counterparty B is likely to default if presented with a claim relating to the guarantee or liability; (iii) whether 25 percent or more of one counterparty’s production or output is sold to the other counterparty, which cannot easily be replaced by other customers; (iv) whether the expected source of funds to repay any credit exposure between the counterparties is the same and at least one of the counterparties does not have another source of income from which the extension of credit may be fully repaid; (v) whether the financial distress of one counterparty (counterparty A) is likely to impair the ability of the other counterparty (counterparty B) to fully and timely repay counterparty B’s liabilities; (vi) whether one counterparty (counterparty A) has made a loan to the other counterparty (counterparty B) and is relying on repayment of that loan in order to satisfy its obligations to the covered company, and counterparty A does not have another source of income that it can use to satisfy its obligations to the covered company; and (vii) any other indicia of interdependence that the covered company determines to be relevant to this analysis. Section 252.76(a)(2).

and related aggregation requirements in the Reproposal, however, are inconsistent with both the letter and intent of Section 165(e) and would require aggregation of a wide range of exposures that, though related because of the relationships among third parties, do not represent a single concentration risk to an event of default at a particular individual counterparty. The Reproposal also diverges from international standards and standards in other jurisdictions—the Basel Large Exposure Framework uses a 50 percent threshold for counterparty aggregation<sup>41</sup> and the EU CRR aggregates counterparties based on accounting standards<sup>42</sup>—but provides no explanation for why a different standard is necessary here.

Furthermore, the Reproposal would mandate aggregation of counterparty exposures that may not have any indicia of economic connection. Even to the extent that a counterparty's performance could be affected by the financial condition of its shareholders, such indirect risks are merely *potential* exposures. Assuming neither a covered company nor its counterparty has entered into any transactions directly with the counterparty's shareholders, such shareholder distress would not, on its own, have any effect on the covered company. The Reproposal also increases the likelihood of “multi-to-one” mapping by requiring a covered company to aggregate its entire exposure to a given entity with its exposures to multiple, separate groups of connected counterparties. In perhaps the most extreme example, if an entity were one-fourth owned by four separate companies, any exposures to such entity would need to be aggregated with the covered company's counterparty exposure to each of the entity's four one-fourth owners.<sup>43</sup> Furthermore, if such a counterparty's voting rights and equity ownership interests were not aligned, a covered company's exposures to it may need to be aggregated with more than four entities.

The Reproposal's approach also raises practical concerns as the information necessary to determine ownership status below a financial consolidation standard simply may not be available for some counterparties. It is unlikely, as just one example, that a covered company would be able to determine on the basis of publicly available information whether a given counterparty's voting equity interest constitutes a separate class of securities if that interest votes together on some issues but separately on others. A counterparty may simply refuse to provide such granular information because of the sensitivity of the information being shared. Furthermore, other regulatory regimes to which certain entities are subject as described above would not require regulated entities to request such sensitive information, and, as such, risks placing covered companies at a

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<sup>41</sup> Basel Committee on Banking Supervision, *Supervisory Framework for Measuring and Controlling Large Exposures*, at ¶ 22 (Apr. 2014), available at <http://www.bis.org/publ/bcbs283.pdf>.

<sup>42</sup> Regulation 2013/575/EU of the European Parliament and of the Council Art. 4 ¶ 37 (Jun. 26, 2013).

<sup>43</sup> Although guidance issued by the Committee of European Banking Supervisors (now the European Banking Authority) on the large exposures framework included in the Capital Requirements Directive (CRD) explicitly contemplates multi-to-one mapping, the CRD framework only applies automatic aggregation at 50 percent/accounting consolidation, thus mitigating the issue. See Committee of European Banking Supervisors, *Guidelines on the Implementation of the Revised Large Exposures Regime* (Dec. 2009).

competitive disadvantage relative to their counterparts that are not under a similar obligation.

We urge the Federal Reserve to adopt a financial consolidation standard, as it would address these concerns. Not only would aggregation based on financial reporting consolidation be tailored to encompass truly *connected* exposure risks—as the likelihood of actual economic dependence between counterparties is much higher when an entity is consolidated for financial reporting purposes—it would also be practical to implement. In addition, adopting a financial consolidation standard would more closely align with international standards and allow covered companies with global footprints to establish compliance mechanisms that can be used across jurisdictions in which they operate.

**2. Like the economic interdependence test, the control relationship test should be applied in a risk-sensitive manner only to exposures exceeding 5 percent of a covered company's eligible capital base. In addition, the economic interdependence test should not apply across public sector entities, private sector entities and natural persons.**

The two additional, independent counterparty aggregation requirements in Section 252.76 of the Reproposal—the economic interdependence test in Section 252.76(a) and the control relationship test in Section 252.76(b)—add significant complexity to the analysis a covered company must undertake and are not necessary to meet the objectives of Section 165(e). We recognize, however, that the Federal Reserve may prefer to maintain consistency with the Basel Large Exposure Framework. If so, the control relationship test should be implemented in a manner that prioritizes identification of sources of exposure that in the aggregate may pose a risk to the covered company that might otherwise escape detection over identifying any possible connection among counterparties regardless of the size of the covered company's potential exposure. To mitigate operational complexities, we recommend that the control relationship test, like the economic interdependence test,<sup>44</sup> be subject to a threshold of 5 percent of a covered company's eligible capital base.<sup>45</sup>

The absence of such a *de minimis* standard for the control relationship test means that a covered company would need to investigate—for each and every counterparty, including for those with smaller, otherwise *de minimis* exposures—whether such counterparty is connected with any other entity to which the covered company has a credit exposure by the presence of voting agreements, the ability to select the majority of the members of a governing body, or the ability to exercise a controlling influence over such other entity.<sup>46</sup> Evaluating each of these factors would require a covered company to conduct significant due diligence and would almost certainly require information that is

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<sup>44</sup> Section 252.76(a).

<sup>45</sup> See Section 252.76(b).

<sup>46</sup> *Id.*

not public or otherwise readily available, particularly in the case of counterparties that are not publicly reporting companies and are not in regulated industries. For example, evaluation of whether one counterparty exercises a “controlling influence” over another would require a detailed facts-and-circumstances-based analysis of such entities’ relationships, which may not be possible based on available information or captured by existing information systems in place at covered companies or, for that matter, counterparties. Indeed, for smaller counterparty relationships, the lack of publicly available information and the expense associated with obtaining the level and detail of necessary information may outweigh the potential profitability of the relationship, such that a covered company would choose to limit smaller counterparty exposures as a general matter in order to avoid the operational complexity associated with compliance for such exposures. Finally, applying a control relationship test as proposed without the 5 percent of the covered company’s eligible capital base threshold potentially would divert supervisory resources to addressing control questions for *de minimis* exposures rather than advancing the policy goal of limiting material economic exposure.

Our recommendation would require a covered company to determine whether a counterparty—defined by a financial consolidation standard—to which the covered company has a net aggregate exposure that exceeds 5 percent of the covered company’s eligible capital base must be aggregated with other entities with which the counterparty has a control relationship. The use of a 5 percent of a covered company’s eligible capital base threshold would be unlikely to result in “missed” concentration risk since it would apply well below any counterparty exposure limit in the Reproposal. In addition, to address any evasion concerns, the Federal Reserve could reserve authority to designate companies as part of a particular counterparty.

In addition, the final SCCL rule should clarify that the economic interdependence test should generally be applied only to persons and entities within, and not across, three discrete universes: public sector entities, private sector entities and natural persons unless a covered company otherwise would aggregate a person or entities across those universes for its own internal risk management purposes. The economic interdependence test includes requirements that will require covered companies to make subjective judgments, for example, whether the financial distress of one counterparty “is likely” to impair another counterparty’s ability to pay its liabilities when due or whether production or output sold to a counterparty can “easily be replaced” by others. We expect that covered companies will need to develop reasonable proxies to determine compliance with these standards given that many of the standards are more akin to guidance than objective measures that can be implemented in a consistent manner across covered companies. The subjective nature of many of the requirements already will be difficult to implement within each of the three universes we have identified. Many, if not most, of these standards would be impossible, or at least impracticable, to implement across the natural person, public entity and private entity universes, and could lead to absurd results, such as aggregating the exposures to individual persons employed by, and private contractors providing services to, a municipality where the covered company has exposures to the corresponding State’s general obligation bonds. This cannot be the intended result. Our

proposal is the most straightforward solution to make the aggregation requirements practical to operationalize.

**C. In the absence of financial consolidation-based “covered company” and “counterparty” definitions, the final SCCL rule needs to address the complexities and unintended consequences that arise when a particular entity is within the scope of both the “covered company” and “counterparty” definitions, such as a joint venture.**

If the final SCCL rule does not adopt the financial consolidation-based definitions of “covered company” and “counterparty”, it must clarify how entities that are “controlled” by a covered company and “controlled” or otherwise required to be aggregated with a counterparty are treated. Congress implicitly recognized the difference in risk posed by an affiliate and that posed by a non-affiliate. Indeed, Congress limited credit exposures “to any *unaffiliated* company. . .” when establishing the maximum statutory credit exposure limit under Dodd-Frank.<sup>47</sup> The Reproposal’s discrete treatment of covered company aggregation and counterparty consolidation does not address the potential for overlap between the two—that is, those involving jointly owned companies. Scenarios involving jointly owned entities under the “covered company” and “counterparty” definitions in the Reproposal raise issues in three different contexts: (i) inter-affiliate exposures, (ii) outward-facing exposures of the jointly owned entity, and (iii) third party treatment of exposures to the jointly owned entity.

Covered companies participate in joint ventures for a number of reasons. In many jurisdictions, law or regulation may prohibit a foreign bank from operating a wholly owned subsidiary in the local market. In these cases, a foreign bank is effectively required to partner with a local financial institution to offer its products and services in the local market, or to facilitate foreign investors’ access to the market. In other cases, banks may have different regional focuses, core competencies, client relationships, or other relative strengths that can be effectively combined in a joint venture; in these cases, joint ventures provide a vehicle for banks to combine their respective capabilities in a joint venture structure. It is important that the Federal Reserve address these issues in the final SCCL rule to ensure that covered companies can, as a practical matter, continue to enter into these arrangements in light of the importance of jointly owned entities to the operations of many covered companies, which provide demonstrable public benefits.<sup>48</sup>

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<sup>47</sup> Dodd-Frank Section 165(e)(2) (emphasis added).

<sup>48</sup> The Federal Reserve has recognized in various contexts that joint ventures may produce public benefits that outweigh possible adverse effects. *See, e.g.*, Federal Reserve System, Order Approving Investment in a Company that Performs Trust Company Activities re: Bank One Corporation’s acquisition of 50 percent of the voting interests in EquiServe Limited Partnership (Nov. 16, 1998) (finding that “the performance of the proposed activity by the joint venture can reasonably be expected to produce benefits to the public that would outweigh any possible adverse effects under the proper incident to banking standard of section 4(c)(8) of the BHC Act”), available at <https://www.federalreserve.gov/boarddocs/press/bhc/1998/19981116/>; Federal Reserve System, Order Approving Notices to Conduct Certain Data Processing and Other Nonbanking Activities re: six Southeast banking organizations acquisition of more than 5 percent of the voting shares of a new

First, it is possible—by a broad reading of the text of the Reproposal in conjunction with BHC Act definitions—that a covered company could be required to aggregate inter-affiliate exposures to its own subsidiary with its exposures to a counterparty, where that subsidiary is jointly owned by the covered company and an unaffiliated counterparty, such that the jointly owned entity is separately deemed to be part of the counterparty group as a “subsidiary”, as reflected in Annex B, illustration A as exposure “1a.” Moreover, if a jointly owned entity were financially consolidated by an unaffiliated counterparty but also considered a “subsidiary” of the covered company, the jointly owned entity’s inter-affiliate exposures to its own financial consolidation group (the counterparty) would be deemed covered company exposures to the counterparty, as reflected in Annex B, illustration A as exposure “1b.” It is also possible that the exposures of a jointly owned entity financially consolidated by a counterparty group to another subsidiary within that same counterparty group would be aggregated with the covered company’s exposures to the counterparty, insofar as (i) the jointly owned entity is considered a “subsidiary” of the covered company and (ii) the other entity within the counterparty group is a “subsidiary” of the unaffiliated counterparty, as reflected in Annex B, illustration A as exposure “1c.”

Second, with respect to the outward-facing exposures of the jointly owned entity, a jointly owned entity that is included as part of a counterparty could be forced to consider the exposures of the covered company that is its part-owner when its outward-facing exposures—that is, the exposures of the jointly owned entity to third parties—must be aggregated with the covered company’s exposures, as reflected in Annex B, illustration B.

Finally, with respect to third party treatment of exposures to the jointly owned entity, under the Reproposal any covered company facing a jointly owned entity may be required to treat jointly owned entities as part of two or more separate “counterparty” consolidation groups, resulting in “double-counting” of the exposure to the jointly owned entity, as reflected in Annex B, illustration C.

We urge the Federal Reserve to adopt a three-part solution to resolve the irrational complexities presented by each of these scenarios that includes (i) a narrow exemption limited to jointly owned entities that are subject to prudential regulation that would address all three issues cited above using specific exemptions from the definition of “counterparty” and “covered company” that, in each case, would be subject to a set of very specific conditions, (ii) a clear definition for the term “unaffiliated counterparty” that could be used for any type of jointly owned entity so long as the entity is consolidated for financial reporting purposes by at least one of the joint owners, and (iii) a bright-line, default approach for any entity that clarifies the statutory intent that an entity that is a subsidiary of a covered company for purposes of the final SCCL rule cannot also be a counterparty of that covered company.

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company that would engage in certain nonbanking activities related to the operation of ATM and POS networks (Dec. 9, 1996) (finding that JV would offer benefits to consumers and smaller financial institutions), available at <https://www.federalreserve.gov/boarddocs/press/bhc/1996/199612092/>.

The revisions in this first technical solution below are intended to exclude from the definitions of “counterparty” and “covered company” certain entities that are jointly owned in a manner that would solve for each of the three sets of unintended consequences of the Reproposal described above. These exclusions would be narrowly tailored and would be available only if the jointly owned entity is subject to direct regulation as a broker-dealer, bank or investment adviser and an unaffiliated bank holding company or foreign banking organization owns, controls or holds more than 50 percent of a class of voting securities of the jointly owned entity and consolidates the entity for financial reporting purposes. Pursuant to this technical solution, the definition of “counterparty” would be drafted to ensure that the exposures of the jointly owned entity would be aggregated only with a bank holding company or foreign banking organization that owns, controls or holds with power to vote more than 50 percent of a class of voting securities of the entity and that consolidates the entity for financial reporting purposes by any covered company (including a covered company that is not an owner of the jointly owned entity). The “covered company” definition would be revised so that a covered company that is a joint owner of the entity that is more than 50 percent owned or financially consolidated with a bank holding company or foreign banking organization would treat its exposures to the entity as counterparty exposures (and not as part of the covered company).

The first technical solution we propose would require the following revisions to the definitions contained in the Proposed Rules:

- “*Counterparty* means . . . (2) [w]ith respect to a company, the company and all persons that that counterparty (i) owns, controls or holds with power to vote 25 percent or more of a class of voting securities of the person; (ii) owns or controls 25 percent or more of the total equity of the person; or (iii) consolidates for financial reporting purposes, as described in § 252.72(d), collectively, provided that, neither paragraph (e)(2)(i) nor (e)(2)(ii) shall include a person if (A) such person is a broker-dealer, investment adviser or bank that is directly regulated by a home country supervisor represented on the Basel Committee on Banking Supervision and is not a securitization vehicle, investment fund or other special purpose vehicle, as those terms are used in 12 C.F.R. § 252.75, (B) a bank holding company or foreign banking organization subject to the Bank Holding Company Act of 1956, in either case that is unaffiliated with the counterparty, owns, controls, and holds with power to vote more than 50 percent of a class of voting securities of the broker-dealer, investment adviser or bank, (C) such bank holding company or foreign bank consolidates the broker-dealer, investment adviser or bank for financial reporting purposes, and (D) the covered company includes its credit exposures to such broker-dealer, investment adviser or bank in its credit exposures to such bank holding company or foreign bank.”
- “*Covered company* means any bank holding company . . . and all of its subsidiaries other than any company that is otherwise a subsidiary of the covered company if (i) such company is a broker-dealer, investment adviser or

bank that is directly regulated by a home country supervisor represented on the Basel Committee on Banking Supervision and is not a securitization vehicle, investment fund or other special purpose vehicle, as those terms are used in 12 C.F.R. § 252.75, (ii) a bank holding company or foreign banking organization subject to the Bank Holding Company Act of 1956, as amended, in either case that is unaffiliated with the covered company, owns, controls, or holds with power to vote more than 50 percent of a class of voting securities of the broker-dealer, investment adviser or bank, (iii) such bank holding company or foreign bank consolidates the broker-dealer, investment adviser or bank for financial reporting purposes, and (iv) the covered company includes its credit exposures to such broker-dealer, investment adviser or bank in its credit exposures to such bank holding company or foreign bank.”

This technical solution would correct for all three types of issues set forth above with respect to jointly owned entities—inter-affiliate exposures, outward-facing exposures and third party treatment of exposures. This is the broadest of the three elements of the solution and for that reason is also the most limited—available only for jointly owned banks, broker-dealers and investment advisers. By limiting the exemption to entities subject to other prudential regulation, the possibility that these entities could incur exposures on behalf of the covered company to allow the covered company to evade the rule is significantly reduced, if not eliminated.

Second, for other types of jointly owned entities—or as an alternative in the event the solution set forth above is not adopted—we urge the Federal Reserve to define and clarify the term “unaffiliated counterparty” in the final SCCL rule, by looking to the company with which the joint owner is financially consolidated. More specifically, we propose that the term “unaffiliated counterparty” be defined to:

- Exclude any company that is a subsidiary of the covered company, if that subsidiary is financially consolidated by that covered company; and
- For purposes of a covered company’s subsidiary’s credit exposures as a subsidiary of the covered company, exclude any company that (i) financially consolidates such subsidiary, (ii) is treated by the covered company as part of the same counterparty as such company that financially consolidates such subsidiary, or (iii) is an affiliate of such subsidiary that is financially consolidated by the covered company, in each case so long as the covered company includes its credit exposures to that subsidiary in the covered company’s credit exposures to the unaffiliated counterparty that financially consolidates such subsidiary.

Although, unlike the first element of the solution set forth above, this clarification would not resolve all three types of issues with respect to jointly owned entities, it would at least mitigate the first issue with respect to inter-affiliate exposures (the exposures reflected in Annex B, illustration A, 1a, 1b and 1c) involving a jointly owned entity, which create particularly anomalous and, we believe, unintended results.

Finally, for jointly owned entities that are not subject to prudential regulation or financially consolidated with any of the entity's joint owners—or for covered companies that need only a simple and straightforward way of addressing joint ownership—we recommend that the final SCCL rule clarify that any entity that is part of the covered company under the final SCCL rule by definition cannot also be a counterparty of that covered company. This reading is consistent with Section 165(e)'s language, which limits exposures only to an “unaffiliated company.”

**D. The Reproposal's “look-through” requirement is unlikely to identify significant concentrations and would introduce operational complexities that can be addressed by a more risk-sensitive modified “look-through” approach.**

Under the Reproposal, a covered company with \$250 billion or more in total consolidated assets or \$10 billion or more in on-balance-sheet foreign exposures (“**Large Covered Company**”) would be required to calculate its gross credit exposure to each issuer of assets held by a securitization vehicle, investment fund or other special purpose vehicles (“**SPV**”) to which the Large Covered Company has an exposure if it is unable to demonstrate that its gross credit exposure to each issuer, based on only the exposures arising from its investment in such securitization vehicle, investment fund or other SPV, is less than 0.25 percent of the Large Covered Company's eligible capital base.<sup>49</sup> If a Large Covered Company is required to conduct such a “look-through” and is unable to identify each issuer of assets of the securitization vehicle, investment fund or other SPV, then the Large Covered Company must attribute its gross credit exposure to a single unknown counterparty.<sup>50</sup> The unknown counterparty would then be subject to the general credit exposure limits under the Reproposal.<sup>51</sup>

While the Associations acknowledge the need to mitigate potential risks associated with underlying exposures of securitization vehicles, investment funds or other SPVs, Large Covered Companies would face numerous challenges in implementing the Reproposal's requirements. Although the threshold of 0.25 percent of a Large Covered Company's eligible capital base is designed to eliminate look-through requirements which could be “unduly burdensome”,<sup>52</sup> we believe further tailoring is warranted. There are significantly less burdensome ways to address the remote possibility that underlying exposures may have a material impact on a Large Covered Company's single-counterparty concentration risk that do not sacrifice the prudential or risk mitigation benefits of the look-through approach in the Reproposal.

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<sup>49</sup> Section 252.75(a)(3).

<sup>50</sup> Section 252.75(b)(2).

<sup>51</sup> *Id.*

<sup>52</sup> 81 Fed. Reg. at 14,342.

There are three aspects of the look-through approach that are particularly problematic and unnecessarily burdensome:

- First, the look-through approach applies to all securitization vehicles, investment funds and other SPVs regardless of their purpose or the nature of their underliers. Many securitization vehicles, investment funds or other SPVs will have a large number of underliers, each of which is extremely unlikely to materially contribute to the Large Covered Company's exposure to a particular counterparty. For example, the "issuer" of assets in the context of securitization vehicles other SPVs with retail underliers, such as credit card or auto loan receivables, or residential mortgage backed securities, are natural persons, and it would be inconceivable that a Large Covered Company would have exposures to an individual obligor that approach the relevant credit limit.<sup>53</sup>
- Second, based on language in the Preamble<sup>54</sup> and in Section 252.73(b)<sup>55</sup> the look-through approach potentially would apply to a very broad range of relationships between a Large Covered Company and a securitization vehicle, investment fund or other SPV, such as derivative transactions and servicing functions. Based on this reading, the look-through approach would require a Large Covered Company to evaluate *all* of its exposures to all securitization vehicles, investment funds or other SPVs and analyze the underlying assets of each securitization vehicle, investment fund or other SPV to which it has an exposure to determine whether it must apply the look-through. It is not entirely certain whether this was intended in view of the use of the word "invests" in the text of Section 252.75(a)(2)(i),<sup>56</sup> which suggests a more limited scope than all exposures.

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<sup>53</sup> Please refer to our proposal with respect to exposures to natural persons set forth in Part II.F.

<sup>54</sup> "Under the proposed rule, covered companies that have \$250 billion or more in total consolidated assets or \$10 billion or more in total on-balance-sheet foreign exposures would be required to analyze their credit exposure to the issuers of the underlying assets in an SPV *in which the covered company invests or to which the covered company otherwise has credit exposure.*" 81 Fed. Reg. at 14,342 (emphasis added).

<sup>55</sup> "A covered company that has \$250 billion or more in total consolidated assets or \$10 billion or more in total on-balance-sheet foreign exposures shall calculate its gross credit exposure for *investments in and exposures to* a securitization vehicle." 81 Fed. Reg. at 14,352 (emphasis added).

<sup>56</sup> "If a covered company can satisfy the requirements of paragraph (a)(3) of this section, a covered company must calculate its gross credit exposure to each securitization vehicle, investment fund, and other special purpose vehicle *in which it invests* pursuant to § 252.73(a), and the covered company is not required to calculate its gross credit exposure to each issuer of assets held by a securitization vehicle, investment fund, or other special purpose vehicle." 81 Fed. Reg. at 14,354 (emphasis added).

- Third, there are a number of practical challenges with the look-through mechanics:
  - Principally, a Large Covered Company may not have access to information regarding the securitization vehicle, investment fund or other SPV's underlying assets—at least not at the frequency and level of granularity required by the Reproposal. The Reproposal would require exposure limits to be calculated daily,<sup>57</sup> but in practice, data on underliers may only be reported monthly or quarterly. For example, the SEC's disclosure requirements for securitization vehicles under Regulation AB and its recent amendments do not require real-time disclosure of portfolio positions and instead require that issuers provide periodic disclosure only for “significant obligors” that represent at least 10 percent of the relevant asset pool.<sup>58</sup> This informational challenge is particularly acute if a Large Covered Company's exposure is not an investment—for example, if the Large Covered Company has derivative or securities financing transaction (“SFT”) exposure to a securitization vehicle—in which case the Large Covered Company may not have access to the same type of information that an investor would have about the underliers of the securitization vehicle.
  - In addition, even if the required information is available on a daily basis, requiring a look-through to every single underlier of the securitization vehicle, investment fund or other SPV rather than just to those that exceed the 0.25 percent of the Large Covered Company's eligible capital base threshold would significantly increase the amount of resource-intensive work needed to comply with the requirement, with little clear benefit to risk management. The nature of securitization vehicles, investment funds or other SPVs do not lend themselves to concentrated exposure and the Federal Reserve could address evasion concerns by retaining the authority to designate such exposures as connected. As discussed in our recommendations below, application of the 0.25 percent of the Large Covered Company's eligible capital base threshold in this context may facilitate reliance on a securitization vehicle, investment fund or other SPV's prospectus because the prospectus may contain guiding principles as to what the

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<sup>57</sup> See Section 252.78(a). While not all covered companies would be required to demonstrate compliance on a daily basis, all companies would need to have systems in place to permit daily calculations. 81 Fed. Reg. at 14,344. Our general recommendations regarding compliance and monitoring are in Section VI.G.

<sup>58</sup> 17 C.F.R. §§ 229.1101(k); 1112. Under Regulation AB II, issuers will be required to provide periodic asset-level disclosures concurrent with Form 10-D filings, for a specific and limited list of asset classes, which are tied to a securitization vehicle's distribution dates. 79 Fed. Reg. 57,184, 57,243 (Sep. 24, 2014).

largest type of exposure can be within a fund and thereby reduce the operational burden on the covered company if such maximum exposure is less than the 0.25 percent of the Large Covered Company's eligible capital base threshold.

The foregoing problems will be compounded rather than mitigated by the Reproposal's concept of a "single, unknown counterparty."<sup>59</sup> The likely informational gaps and friction in identifying particular issuers of assets underlying securitization vehicles, investment funds or other SPVs will almost certainly result in Large Covered Companies attributing these exposures to a single, unknown counterparty when the 0.25 percent of a Large Covered Company's eligible capital base threshold has been met.<sup>60</sup> If a Large Covered Company is required to do so across multiple securitization vehicles, investment funds or other SPVs, attribution of exposures to the single, unknown counterparty may become the rule rather than the exception, with the size of the exposure to such unknown counterparty potentially approaching the applicable SCCL despite the lack of any reason to believe or evidence that the exposures being aggregated are at all related. Such an outcome may result in fewer Large Covered Company investments in securitization vehicles, investment funds and other SPVs, which are critical instruments for the efficient functioning of credit markets.<sup>61</sup>

As discussed further below, our recommendations include:

- Exemptions from the look-through requirement for exposures to certain categories of securitization vehicles, investment funds and other SPVs altogether based on their structure, the granular nature of their underliers or the regulatory regime to which they are subject;
- Requiring the look-through only in cases of exposures arising from a Large Covered Company's investment in a securitization vehicle, investment fund or other SPV. At a minimum, exemptions are necessary for exposures relating to services provided under a Custody Service Level Agreement or equivalent arrangement; and

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<sup>59</sup> See Section 252.75(b)(2).

<sup>60</sup> The Reproposal is unclear as to whether the attribution to the single, unknown counterparty would be the covered company's entire exposure to a securitization vehicle, investment fund or other SPV or merely the portion that it is unable to link back to an individual issuer of assets. See 81 Fed. Reg. at 14342 ("If a covered company with \$250 billion or more in total consolidated assets or \$10 billion or more in total on-balance-sheet foreign exposures would be required to apply the look-through approach, but is unable to identify an issuer of assets underlying a securitization vehicle, investment fund or other SPV, the covered company would be required to attribute *the exposure* to a single 'unknown counterparty.'") (emphasis added). We assume that only the component that cannot be attributed to an underlying issuer would be attributed to the single unknown counterparty and urge the Federal Reserve to confirm that understanding in the final SCCL rule.

<sup>61</sup> For example, studies have shown that securitization markets can reduce the cost of credit for borrowers. See, e.g. Taylor D. Nabauld & Michael S. Weisbach, Did Securitization Affect the Cost of Corporate Debt?, National Bureau of Economic Research (March 2011).

- Modifying the mechanics of the look-through approach to (i) apply only to exposures that exceed the 0.25 percent of the Large Covered Company's eligible capital base threshold, (ii) permit reliance on prospectus information in conducting the look-through and (iii) clarify that look-through on a monthly and "event dates" basis is sufficient.

**1. Exempt exposures to certain categories of securitization vehicles, investment funds and other SPVs altogether based on their structure, the granular nature of their underliers or the regulatory regime to which they are subject.**

Certain categories of securitization vehicles, investment funds or other SPVs by their nature are unlikely to result in exposures to underliers that approach the relevant limits under the SCCL framework, even when aggregated with other exposures to the same counterparty. Although the 0.25 percent of a Large Covered Company's eligible capital base threshold may alleviate this concern for certain securitization vehicle, investment fund or other SPV exposures, its main operational benefit is in forgoing the look-through when a Large Covered Company's aggregate exposure to the entire securitization vehicle, investment fund or other SPV, which is easily calculated, is less than the 0.25 percent of a Large Covered Company's eligible capital base threshold.<sup>62</sup> However, in certain cases, a Large Covered Company may have exposures to a securitization vehicle, investment fund or other SPV that exceed this 0.25 percent of a Large Covered Company's eligible capital base threshold, in which case the Large Covered Company would not be able to avail itself of the benefits of the 0.25 percent of a Large Covered Company's eligible capital base threshold, despite the fact that the underliers, when aggregated with a Large Covered Company's other exposures, would never reach the SCCL exposure limits. We recommend that any category of securitization vehicle, investment fund or other SPV that contains a large number of individual positions, consistent with the concept of a "well diversified portfolio" in the risk-based capital rules,<sup>63</sup> be exempt from this requirement, because they are not likely to result in material economic exposures when aggregated with a Large Covered Company's other exposures, the burden of conducting the look-through would be

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<sup>62</sup> "A covered company's exposure to each underlying asset in a securitization vehicle, investment fund or other SPV necessarily would be less than 0.25 percent of the covered company's eligible capital base where the covered company's entire investment in the securitization vehicle, investment fund or other SPV is less than 0.25 percent of the covered company's eligible capital base." 81 Fed. Reg. n.79 at 14,342.

<sup>63</sup> See, e.g., 12 C.F.R. § 217.210(e), FN 33 (defining a well-diversified portfolio as one that contains a large number of individual equity positions, with no single position representing a substantial portion of the portfolio's total fair value); EBA, *Final Draft Implementing Technical Standards, On appropriately diversified indices under Article 344(1) of Regulation 575/2013* (Dec. 17, 2013), available at <https://www.eba.europa.eu/documents/10180/529485/EBA-ITS-2013-10+%28Diversified+indices%29.pdf>. (recognizing the concept of "appropriately diversified" with respect to identifying such indices for the purposes of calculating the capital requirements for equity risk according to the standardized rules and that such indices need not be broken down into their constituent equities but rather can be treated as if they were individual equities).

substantial and the nature of the underliers indicates there would be no concern that Large Covered Companies would use the exemption to evade the SCCL by shifting large exposures into these vehicles, including:<sup>64</sup>

- Retail asset-backed securities, including securitization vehicles, investment funds or other SPVs backed by credit card receivables, auto loans, student loans, unsecured consumer loans and residential mortgages, because the underlying borrowers are natural persons or small and medium enterprises. As a general matter, all exposures to natural persons should be exempt from the SCCL given the low probability that such exposures would ever approach the limits set forth in the Reproposal.<sup>65</sup> If the final SCCL rule nonetheless continues to apply to such exposures, retail securitization vehicles or SPVs should be exempt.
- Pools of finance receivables in which the underliers are comprised of small business borrower receivables (such as dealer floor plans and equipment lease and loans), as well as trade receivables.
- Commercial mortgage backed-securities because the underlying assets are cash flows related to physical properties with little likelihood of overlap across a bank's lending portfolio.

In addition, exposures to investment funds registered under the Investment Company Act of 1940 or governed by substantially equivalent legislation in other jurisdictions should also be exempt from this requirement. Such funds are subject to stringent diversification and asset quality requirements, thereby limiting the probability of economic correlation with the Large Covered Company's other exposures.<sup>66</sup> As an example, a diversified company's holdings of the securities of a single issuer may not exceed 5 percent of the value of the total assets of its holdings. This limit makes it much less likely that any of the exposures of such funds would materially increase a covered company's exposure concentration to any given issuer. These funds are also subject to ongoing regulatory oversight. Additionally, the fiduciary duty and independence requirements imposed on such fund's directors should minimize or eliminate concerns about such funds being used to evade the SCCL otherwise applicable to the Large Covered Company investor.<sup>67</sup> As such, there should be limited concern that a Large Covered Company would be able to take advantage of this exemption to circumvent its exposure limits.

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<sup>64</sup> While our list of recommendations is comprised of fixed income instruments, this same principle could be applied to portfolios of equity underliers as well, consistent with its use in the risk-based capital rules.

<sup>65</sup> See Part II.F, *infra*.

<sup>66</sup> 15 U.S.C. § 80a-5(b)(1).

<sup>67</sup> See 15 U.S.C. §§ 80a-10(a); 80a-2(a)(3), (19); 80a-35(a).

**2. Require the look-through only in cases of exposures arising from a Large Covered Company's investment in a securitization vehicle, investment fund or other SPV or extensions of credit and liquidity facilities with similar risk profiles to investments. At a minimum, exemptions are necessary for exposures relating to services provided under a Custody Service Level Agreement or equivalent arrangement.**

Consistent with the Basel Large Exposure Framework, the look-through requirement should be limited to a Large Covered Company's (i) cash investments in a securitization vehicle, investment fund or other SPV and synthetic positions, such as derivative contracts or other instruments, that mirror the economics of a cash investment that are held in the banking book and (ii) exposures arising from extensions of credit and liquidity facilities that mimic the risks of such cash investments. Including a broader range of exposure types, such as those arising from underwriting, market making or payment, clearing and settlement ("PCS") activities, would create significant operational complexities with minimal corresponding risk mitigation benefits. For example, a custodial service provider may generate exposures due to the provision of overdraft services or a Large Covered Company acting as underwriter may have a temporary exposure to a securitization vehicle, investment fund or other SPV during an offering period. Such exposures would occur on an infrequent basis, would be for a short duration and would not be expected to produce material economic correlations with other exposures the Large Covered Company may have. Yet if the scope of the look-through is not limited to investments and equivalent positions, a Large Covered Company that engages in these activities would need to expend significant resources developing systems and procedures to perform the look-through analysis for these exposures that, as a practical matter, would almost never present material credit risk. As such, we recommend that the Federal Reserve narrow the scope of the look-through in a risk-sensitive manner by focusing on this more limited universe of exposures that are most likely to generate material exposures that are the focus of Section 165(e).

At a minimum, if the look-through approach is required to apply more broadly, exemptions would be required for exposures to securitization vehicles, investment funds or other SPVs relating to the provision of services under a Custody Service Level Agreement or equivalent arrangement.<sup>68</sup> While such exposures are always short-dated in duration and generally small relative to the size of the securitization vehicle, investment

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<sup>68</sup> As an alternative, the exemption for such exposures could leverage the analogous definition of operational deposit requirements set forth in the Liquidity Coverage Ratio ("LCR"): "Operational deposit means unsecured wholesale funding or a collateralized deposit that is necessary for the Board-regulated institution to provide operational services as an independent third-party intermediary, agent, or administrator to the wholesale customer or counterparty providing the unsecured wholesale funding or collateralized deposit." 12 C.F.R. § 249.3. The LCR recognizes the ancillary nature of such deposits and that the customer's "primary purpose" is to obtain operational services provided by a covered company. Similarly, exposures stemming from the provision of operational services to a securitization vehicle, investment fund or other SPV are ancillary in nature and should also be exempt from the SCCL.

fund or other SPV, such exposures may surpass the 0.25 percent of the Large Covered Company's eligible capital base threshold and trigger a look-through under the Reproposal. These ancillary exposure types, such as those that may arise out of the provision of custodial and other operational services to a fund, should be exempt as the covered company is not seeking to take on credit risk and the primary purpose of the related services is not to extend credit. Furthermore, in the instances where such ancillary exposures arise they would almost never generate material economic exposures when aggregated with the Large Covered Company's other positions.

**3. Modify the mechanics of the look-through approach to (i) apply only to exposures that exceed the 0.25 percent of a covered company's eligible capital base, (ii) permit reliance on prospectus information in conducting the look-through and (iii) reduce the look-through frequency to monthly and "event dates."**

The mechanics of the look-through approach should be modified by using a risk-based approach to identify credit concentrations in securitization vehicle, investment fund or other SPV underliers.

First, we recommend that the final SCCL rule adopt the "partial" look-through approach contained in the Basel Large Exposure Framework. Under this approach, in cases where a Large Covered Company's securitization vehicle, investment fund or other SPV exposure does exceed the 0.25 percent of the Large Covered Company's eligible capital base threshold and a look-through is required, the look-through would identify only those underlying assets for which the underlying exposure value is equal to or above the 0.25 percent of the Large Covered Company's eligible capital base threshold.<sup>69</sup> The European Banking Authority also adopted this identification approach in its Regulatory Technical Standards, which assign exposures to an "unknown client" only if information about the issuer is missing *and* the exposure exceeds the 0.25 percent of the Large Covered Company's eligible capital base threshold.<sup>70</sup> This is a significant improvement

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<sup>69</sup> Basel Committee on Banking Supervision, *Supervisory Framework for Measuring and Controlling Large Exposures*, at ¶ 74 (Apr. 2014), available at <http://www.bis.org/publ/bcbs283.pdf>.

<sup>70</sup> European Banking Authority, *EBA Final Draft Regulatory Technical Standards, On the determination of the overall exposure to a counterparty or connected counterparties in respect of transactions with underlying assets under Article 390(8) of Regulation (EU) No 575/2013* (Dec. 5, 2013), available at [https://www.eba.europa.eu/documents/10180/513001/EBA-RTS-2013-07+\(Determination+of+exposures+\).pdf](https://www.eba.europa.eu/documents/10180/513001/EBA-RTS-2013-07+(Determination+of+exposures+).pdf) ("EBA RTS"). These standards provide specifically that:

- (1) where an exposure value is smaller than the 0.25 percent *de minimis* threshold, the covered company need not apply the look-through approach and can assign exposure to the transaction as a "separate client", therefore only limiting its exposure to the transaction itself, and
- (2) where an exposure value is equal to or larger than 0.25 percent *de minimis* threshold, the covered company must apply the look-through approach to identify the obligors of all credit risk exposures underlying the transaction, determine the exposure value and add it to the counterparty or connected counterparties; only then—if it is not possible or feasible to look-through some (or all) of the underlying assets of a given transaction—would the institution be required to assign its

from the full look-through requirement contemplated by the Reproposal because it would reduce the number of exposures added to the “unknown” counterparty and would be consistent with the 0.25 percent Large Covered Company’s eligible capital base threshold, which implicitly recognizes that exposures below this level are unlikely to produce a material economic exposure when aggregated with a Large Covered Company’s other positions. There is little concern that this modification would permit a Large Covered Company to avoid compliance with the Reproposal’s exposure requirements as a result of the generally diversified nature of securitization vehicle, investment fund or other SPV underliers and the fact that large underliers that exceed the 0.25 percent of a Large Covered Company’s eligible capital base threshold would be captured by the modified look-through approach. A Large Covered Company would not be able to engage in potentially abusive transactions by shifting large exposures to a securitization vehicle, investment fund or other SPV that may otherwise exceed the applicable limit since securitization vehicles, investment funds and other SPVs generally do not take on such concentrated positions and any sizeable position would likely exceed the 0.25 percent of the Large Covered Company’s eligible capital base threshold and be subject to look-through and aggregation.

Second, Large Covered Companies should be able to meet this requirement by relying upon information contained in a securitization vehicle, investment fund or other SPV’s prospectus or similar document. These documents contain guiding principles as to what the largest type of exposure can be within a fund and may be a logical complement to the modified “look-through” approach if a securitization vehicle, investment fund or other SPV’s maximum exposure limit falls below the 0.25 percent of the Large Covered Company’s eligible capital base threshold. This approach would be an efficient way to deal with the operational burden created by the look-through since there would appear to be no benefit from having a Large Covered Company complete the resource-intensive steps required by the look-through if a securitization vehicle, investment fund or other SPV is prohibited from taking on exposures that would approach the limits set forth in the SCCL and would be consistent with approaches in other jurisdictions.<sup>71</sup>

Third, the look-through requirement should be undertaken at less frequent intervals than the generally applicable daily compliance requirement given the operationally intense nature of the analysis.<sup>72</sup> Review on a monthly basis (or when asset-level disclosures are publicly filed) using the most recently available information using the most recently available information, subject to an additional “event date” trigger, is sufficient given the diverse nature of securitization vehicle, investment fund or other SPV underliers and the low probability of a substantial change in a securitization vehicle, investment fund or other SPV’s positions on any given day. The “event date”

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exposure to those unidentified underlyings to the “unknown client”, to which the large exposures limit applies in the same way that it applies to any other counterparty or connected counterparties.

<sup>71</sup> Reliance on information in a prospectus is permitted under the EU CRR for exposures in the form of units or shares in collective investment undertakings. See Regulation 2013/575/EU of the European Parliament and of the Council Art. 132 ¶ 5 (Jun. 26, 2013).

<sup>72</sup> Our general compliance and monitoring recommendations are described in Part VI.G.

requirement would include new credit transactions or the publication of asset additions by a securitization vehicle, investment fund or other SPV. This would be largely consistent with the approach taken by the European Banking Authority (“EBA”).<sup>73</sup>

**E. Section 252.75(c)’s “third party exposure” requirement should be eliminated or, at a minimum, limited to specified types of third parties and subject to the 0.25 percent of the Large Covered Company’s eligible capital base threshold.**

The Reproposal would also require a Large Covered Company to identify third parties whose failure or distress would likely result in a loss in the value of the Large Covered Company’s investment in or exposure to a securitization vehicle, investment fund or other SPV.<sup>74</sup> This requirement would impute additional exposures to a covered company without considering the actual amount of risk to which the covered company is exposed as a result of such exposures. Just as important, the requirement simply cannot be operationalized as proposed.

There are three primary challenges to implementing such a requirement:

- The universe of such third parties is not limited in any way and may include entities that would be impractical or impossible for a covered company to identify;
- Even assuming relevant third parties can be identified, the covered company would need to determine the exact nature of the relationship between the third party and the securitization vehicle, investment fund or other SPV in order to assess the impact the third party’s failure or distress would have on the covered company’s investment in or exposure to the securitization vehicle, investment fund or other SPV; and
- The requirement merely references a “loss” to the covered company’s investment in the securitization vehicle, investment fund or other SPV, without reference to the materiality of such an investment relative to the covered company’s capital.

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<sup>73</sup> In response to comments that the requirement would effectively require the analysis of thousands of underlying exposures for highly granular transactions or exposures of immaterial size, drawing on information from a wide variety of dispersed sources, received in various formats and from multiple companies, the EBA made clear in its final Regulatory Technical Standards its view that—although under Article 395(3) of the CRR institutions must comply with the large exposures limits at all times—to meet this requirement an institution need only monitor the changes in the underlying assets of a transaction on a “regular basis.” More specifically, the EBA provides that for “dynamic portfolios”, for which the relative portions of underlying assets as well as the composition of a transaction itself can change over time, it is sufficient for an institution to monitor the composition of a transaction “at least monthly.” EBA RTS, at 58.

<sup>74</sup> Section 252.75(c).

To mitigate these challenges, the Associations strongly recommend that this requirement either be eliminated altogether or significantly refined to capture a more meaningful and realistically identifiable set of third party exposures. At a minimum, we recommend that (i) this requirement apply only to third parties providing credit support or liquidity facilities to a securitization vehicle, investment fund or other SPV, and (ii) exposures be allocated to such parties only in the event that the Large Covered Company's exposure to the securitization vehicle, investment fund or other SPV exceeds the same 0.25 percent of a Large Covered Company's eligible capital base threshold applicable to the look-through test. Even with these limitations on the scope and materiality of the relevant third party exposures, compliance still could be only on a reasonable "best efforts" basis because Large Covered Companies will lack access to current information.

Without a limit on the type of third-party exposures, Large Covered Companies would have to consider an overly broad universe of entities with a role in the SPV market, the identity of whom may be impossible to ascertain. For example, the identity of currency or interest rate swap providers may not be known to the Large Covered Company, particularly if their services are in a different denominated portion of a tranche than the Large Covered Company's position. Furthermore, it is standard practice that such providers may be easily substituted in the event of default and thus their failure would not pose a significant risk to a securitization vehicle, investment fund or other SPV or, indirectly, to a Large Covered Company. The possibility of evasion stemming from this modification seems remote because a Large Covered Company generally would not have any role in the selection of such service providers and could not use this exemption to shift exposures to stay within the SCCL's limit.

To the extent this requirement is retained in the final SCCL rule, the analysis should be required only for economic exposures that are potentially material. By imposing this requirement only on investments that exceed the 0.25 percent of a Large Covered Company's eligible capital base threshold applicable to the look-through test, the extent of the overstatement of economic exposure is mitigated and the operational burden is reduced. As a starting point, it is important to recognize that this requirement overstates a Large Covered Company's exposure to the securitization vehicle, investment fund or other SPV. For example, if a Large Covered Company has a \$100 exposure to a securitization vehicle, investment fund or other SPV and identifies a credit provider whose failure or distress may result in a loss of its position, the Reproposal would require the Large Covered Company to allocate this same \$100 exposure to two different parties: \$100 of exposure to the securitization vehicle, investment fund or other SPV *and* \$100 of exposure to the third-party credit provider to the securitization vehicle, investment fund or other SPV. Despite the fact that the absolute most the Large Covered Company stands to lose in the event of a default by *both* the securitization vehicle, investment fund or other SPV *and* the third-party credit provider is limited to its \$100 investment, the \$100 exposure is allocated twice. For example, if a Large Covered Company extends a loan to an investment fund, it would typically record that transaction, thereby creating an exposure to the fund. It is unclear how the Large Covered Company would then capture its exposure to the third-party credit provider when no transaction with such third party is

recorded in the Large Covered Company's books. Furthermore, the Reproposal does not contain any threshold and refers only to the loss of the covered company's investment. As a conceptual matter, this standard is inappropriate because it implies that the mere possibility of a loss of any magnitude is something that should be protected against, yet the potential for a loss is inherent in any investment. By focusing on the loss to the Large Covered Company and imposing the same 0.25 percent of a Large Covered Company's eligible capital base threshold from the look-through approach, this approach would capture material economic exposures while minimizing the overstatement of economic risk and alleviating unnecessary operational burden.

**F. Exposures to natural persons should not be subject to the credit exposure limits, or, at a minimum, should be subject to the aggregation requirement only if a covered company's direct lending exposure to a single natural person on its own exceeds 5 percent of the covered company's eligible capital base.**

The definition of "counterparty" under the Reproposal includes natural persons, and further requires that exposures to an individual be aggregated with exposures to members of such individual's "immediate family."<sup>75</sup> It is nearly inconceivable that exposures to individuals would ever approach the credit limits, and it would be impossible for such exposures to pose the types of systemic interconnectivity risks that Dodd-Frank was meant to address, that is 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* ...."<sup>76</sup> In fact, the statutory language of Section 165(e) prohibits covered companies from having credit exposure to "any unaffiliated *company*" that exceeds 25 percent of the capital stock and surplus, which indicates that Congress did not intend for exposures to natural persons to be subject to the SCCL. While Section 165(e) does permit the Federal Reserve to establish a "lower amount" than the 25 percent set forth in the statute, inclusion of natural persons would be an expansion of the SCCL's scope and not merely a reduction of the 25 percent statutory limit.

Moreover, the inclusion of natural persons as counterparties subject to the SCCL framework, particularly given the absence of any materiality threshold, would require devotion of significant resources to ensure compliance notwithstanding the likely negligible benefits of monitoring credit exposures to individuals under the SCCL framework. The Reproposal would require covered companies to monitor and calculate their daily exposure to millions of individual customers and also to determine whether each individual customer has any "immediate family"<sup>77</sup> members (including, for example, adult children residing in the individual's home) whose exposures a covered company

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<sup>75</sup> Section 252.71(e)(1).

<sup>76</sup> See Dodd-Frank Section 165(a)(1) (emphasis added).

<sup>77</sup> *Immediate family* means the spouse of an individual, the individual's minor children, and any of the individual's children (including adults) residing in the individual's home. Section 252.71(s).

would be required to aggregate. This would in turn require a covered company to collect extensive documentation from all retail consumers doing business with the covered company when a relationship is established (and potentially on a regular basis) just to comply with the aggregation requirement. This would include, for example, information such as the name and social security numbers of a spouse, any minor children and any adult children residing in the individual's home. In addition, the Reproposal does not appear to exclude natural persons from the economic interdependence and control relationship tests, which as discussed in Part II.B.2, would present significant complications. Indeed, it may not be possible for a covered company to design a system, even within a two year compliance time frame and sparing no cost, that can identify such relationships and track such exposures for every individual customer.

Concerns about risks stemming from exposures to individuals are already adequately, and more appropriately, addressed under the applicable national bank or state lending limit rules<sup>78</sup> and existing risk management systems. In light of such extant prudential regulation limiting lending to individual borrowers and the likely impossibility of designing meaningful SCCL compliance systems that capture exposures to individuals, it is unwarranted under any reasonable cost-benefit analysis to require covered companies to develop and maintain the mechanisms for tracking exposures to individuals under the SCCL framework.

At a minimum, we recommend that any compliance requirement under the SCCL framework with respect to exposures to individuals be subject to a materiality threshold, set at 5 percent of a covered company's eligible capital base. The exposures used as a basis for determining whether the 5 percent of the covered company's eligible capital base threshold is exceeded would include only direct lending exposure by the covered company to an individual without reference to exposures to such individual's immediate family members or entities connected by control relationships or economic interdependence. This approach would avoid the need to engage in the full, resource-intensive analysis of identifying individuals that may require aggregation.

**G. States and their political subdivisions should be aggregated only if they are economically interdependent. At a minimum, municipal revenue bonds should not be subject to aggregation.**

The "counterparty" definition for States under the Reproposal includes "all of its agencies, instrumentalities, and political subdivisions (including any municipalities)", an overly inclusive standard that requires automatic aggregation of all public exposures at a State-wide level irrespective of the absence of any economic interdependence.<sup>79</sup> This would include credit exposures to the State and its agencies as well as exposures to cities, towns, school districts, public colleges and universities, fire districts, and other public authorities (including public housing and transportation authorities), among others. The Reproposal fails to present any rationale for this automatic aggregation and its uniform

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<sup>78</sup> For national banks, 12 C.F.R. Part 32.

<sup>79</sup> Section 252.71(e)(3).

treatment of such diverse and discrete exposures is unnecessary and not supported by historical experience. A finding of actual economic interdependence, based on application of the factors set forth in the Reproposal, should be made before aggregation is required.

Treating a State and all its political subdivisions as a monolithic entity for the purposes of the SCCL framework ignores the variations in creditworthiness across sub-State entities. Credit rating agencies recognize that the credit risk of different municipalities within a given State should be assessed independent of the credit risk of other municipalities within the State and from the credit risk of the State itself. As one example, following the Mammoth Lakes, Stockton and San Bernardino bankruptcy filings, Moody's reviewed its ratings for each of 32 different California cities.<sup>80</sup> While the majority were on review for downgrade, the ratings for the general obligations bonds of Los Angeles and San Francisco were on review for upgrade. These ratings reflect the heterogeneous credit profiles of municipalities due to a range of factors, including differences in existing debt outstanding, tax bases, and other sources of revenue.

The aggregation of all such sub-State public entities with the State itself appears to be based on an inaccurate assessment of the economic and legal relationship between political subdivisions or entities and the State in which they are located. While it would generally be expected that most state agencies would be aggregated with the State, as they operate from a single budget and the relationship would likely be captured by applying the economic interdependence test, political subdivisions of a given State generally have their own tax bases and budgets that are largely independent of the State and its agencies, and in most cases application of the economic interdependence test appropriately would not result in the aggregation of these entities. As one illustration, since 1970 there have been only 95 municipal defaults recorded by Moody's, all of which occurred at the municipal level without a corresponding default at the State level.<sup>81</sup> Furthermore, similar to the discussion in Part II.A.4 above regarding "step-in" risk for sponsored funds, the premise that a State will "step-in" and support a failing municipality, thus jeopardizing its own economic stability, has not been borne out historically. One particularly notable example is the bankruptcy of the city of Detroit in 2013, in which the largest ever municipal bankruptcy filing by the largest city in the State did not pose a meaningful risk to the economic stability of the State of Michigan as a whole as the liabilities of the city were resolved solely at the municipal level without meaningfully threatening the economic viability of the State.

We urge the Federal Reserve to eliminate automatic aggregation of exposures between States and their political subdivisions and instead rely on the economic interdependence test in the Reproposal to determine when such exposures should be aggregated. Further, this analysis should be required only when an exposure exceeds 5

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<sup>80</sup> Moody's Investor Service, *Rating Action: Moody's reviews ratings of 32 California cities; nine pension bonds downgraded* (October 9, 2012).

<sup>81</sup> Moody's Investors Service, *Special Comment: U.S. Municipal Bond Defaults and Recoveries, 1970-2014*, Appendix A (July 24, 2015).

percent of a covered company's eligible capital base, in line with the Reproposal's approach to aggregation based on economic interdependence. Using the economic interdependence test for aggregation of State and sub-State exposures would align treatment of public exposures with the general SCCL framework more broadly, be consistent with actual historical default correlations and risk at the State and sub-State level and reflect the general economic relationships between States and their political subdivisions.<sup>82</sup> In addition, because this approach would align more closely with applicable OCC lending limits,<sup>83</sup> covered companies would be able to leverage similar analyses already being performed.

At a minimum, we recommend that municipal revenue bonds be excluded from the aggregation requirement. Municipal revenue bonds, which are generally issued to finance public works, are supported directly by the revenues that are derived from the relevant project, and bondholders are contractually limited from having any claim on the issuer's other resources as the bonds represent a pledge of special revenues that enjoy special treatment under Chapter 9 of the Federal Bankruptcy Code.<sup>84</sup> Indeed, the yield premium traditionally associated with revenue bonds relative to general obligation bonds indicates that investors expect the contractual limitation on the source of repayment revenues will be respected.<sup>85</sup> Furthermore, the Federal Reserve recently drew a distinction between the credit quality of revenue bonds and that of general obligation bonds by limiting eligibility for classification as high quality liquid assets to general obligation bonds.<sup>86</sup> Given this clear delineation of the repayment obligation, requiring aggregation of the municipal revenue bond exposure with exposures to the State in which

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<sup>82</sup> Given the complexities of the economic interdependence as formulated in the Reproposal discussed in Part II.B.2 above, the unique facts and circumstances likely to arise in the context of exposures to States and their political subdivisions may require the use of proxies for the standards identified in the economic interdependence test.

<sup>83</sup> The OCC lending limits require aggregation for extensions of credit made to a "common enterprise." The test to determine whether a common enterprise exists is substantially similar to the economic interdependence test set forth in the Reproposal. 12 C.F.R. § 32.5(c). Moreover, the OCC lending limits go further and exempt loans to or guaranteed by general obligations of a State or political subdivision. 12 C.F.R. § 32.3(c)(5).

<sup>84</sup> Municipal revenue bonds are deemed to generate "special revenues" under Chapter 9. 11 U.S.C. § 902(2). Chapter 9 exempts claims payable from special revenues from the automatic stay and clarifies that such claims are not treated as having recourse against the debtor. 11 U.S.C. §§ 922(d); 927.

<sup>85</sup> During 2015 this premium was an average of 53 basis points for an index of revenue bonds relative to an index of general obligation bonds based on data compiled by The Bond Buyer, *available at* [http://www.bondbuyer.com/apps/custom/msa\\_search.php?product=bbi\\_history&coll=1&col3=1&start\\_date=01%2F01%2F2015&end\\_date=12%2F31%2F2015&submit=GO](http://www.bondbuyer.com/apps/custom/msa_search.php?product=bbi_history&coll=1&col3=1&start_date=01%2F01%2F2015&end_date=12%2F31%2F2015&submit=GO).

<sup>86</sup> In explaining its nuanced treatment of municipal revenue bonds, the Federal Reserve noted that "[d]uring a period of significant stress, the credit quality of revenue bonds tends to deteriorate more significantly than general obligation bonds, and thus, the liquidity of revenue bonds is not as reliable as that of general obligation bonds during a period of market stress." Federal Reserve System, *Liquidity Coverage Ratio: Treatment of U.S. Municipal Securities as High-Quality Liquid Assets*, 81 Fed. Reg. 21,223, 21,226.

the issuing municipality is located—or other municipalities within the State—would inappropriately aggregate exposures with little, if any, correlated risk of default.

**H. Exposures of foreign sovereign entities that are not assigned a zero percent risk weight under Regulation Q should be aggregated only if they are economically interdependent.**

The final SCCL rule should not subject foreign sovereign entities that are not assigned a zero percent risk weight under Regulation Q to automatic aggregation with their agencies and instrumentalities, or with public sector entities (“PSEs”). As with the proposed automatic aggregation standard for U.S. States, such an approach is not adequately tailored to reasonably capture default risk correlation. We therefore recommend that the final SCCL rule not require aggregation of all such exposures absent the covered company making a determination that the entities meet the “economic interdependence” test, including the 5 percent of a covered company’s eligible capital base threshold.

**I. Exposures of foreign political subdivisions should be aggregated only if they are economically interdependent.**

The final SCCL rule should not subject a foreign political subdivision to automatic aggregation with its agencies or instrumentalities, PSEs or its political subdivisions.<sup>87</sup> As with the proposed automatic aggregation standard for U.S. States, such an approach is not adequately tailored to reasonably capture default risk correlation. We therefore recommend that the final SCCL rule not require aggregation of all such exposures absent the covered company making a determination that the entities meet the “economic interdependence” test, including the 5 percent of a covered company’s eligible capital base threshold.

**J. The carve-out for exposures to zero risk weight foreign sovereigns should also extend to zero risk weight public sector entities of exempt sovereigns.**

The Reproposal’s definition of “counterparty” does not include zero risk weight foreign sovereigns (and thus exempts them from the SCCL framework),<sup>88</sup> but does not extend such exemption to zero risk weight PSEs of zero risk weight foreign sovereigns. Such exposures should also be exempt from the SCCL framework, because they similarly pose little risk of default. Extending this exemption would align the treatment of such PSEs with the determination of risk weights under 12 C.F.R. 217.32(e)(3) of the risk-

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<sup>87</sup> We note that the Reproposal is unclear on this point. The Preamble indicates that a counterparty would be defined to include “certain foreign sovereign entities (including their agencies, instrumentalities and political subdivisions).” 81 Fed. Reg. 14,331. However, Section 252.71(e)(4) defines counterparty for purposes of foreign sovereign entities not assigned a zero percent risk weight under Regulation Q as “the foreign sovereign entity and all of its agencies and instrumentalities (but not including any political subdivision).” Our recommendations would resolve this ambiguity.

<sup>88</sup> See Section 252.71(e).

based capital rules, which allows a Federal Reserve-regulated institution to assign a zero percent risk weight to a foreign PSE to the extent that the PSE's home country supervisor allows it. We believe a similar approach is appropriate here.

**III. All exposure measurements should be risk-sensitive and generally conform to the methodologies, principles and definitions of the risk-based capital rules.**

We appreciate the Federal Reserve's general approach of aligning the exposure measurement methodologies with the risk-based capital rules. The objective of measuring exposures under the risk-based capital rules (before applying risk-weights to the exposures) and under the SCCL (before applying percentages to limit exposures to counterparties) is the same—to accurately assess the *amount* of the exposure. One should not be more or less conservative than the other—both should strive for accuracy. Overall, the Reproposal's result is a more risk-sensitive and appropriate methodology than the 2011 Proposal, particularly the measurement of derivative exposures, which permits covered companies to leverage existing, risk-sensitive approaches already employed in risk-based capital calculations. We urge that the same approach be adopted for SFTs and credit conversion factors (“CCFs”).

**A. SFT exposures should be calculated using any methodology currently permitted for risk-based capital purposes, at least until a sufficiently risk-sensitive standardized approach is implemented.**

The Reproposal's methodology for measuring SFT exposures is based on the existing, highly risk-insensitive Comprehensive Approach, which produces inaccurate exposures multiples higher than the actual economic risk. This approach substantially overstates SFT exposures due to several methodological limitations,<sup>89</sup> including (i) the use of standardized haircuts that are applied to loan and collateral positions independently and with unreasonably conservative assumptions, (ii) the failure to recognize the benefit of correlation between loan and collateral positions, (iii) the failure to recognize the impact of portfolio diversification benefits and (iv) the imposition of a standardized haircut for cross-currency transactions which substantially overstates volatility for most currency pairs. Quantitative analysis demonstrates significant divergence between covered companies' own estimates of SFT exposures and the supervisory exposure method.

These methodological limitations—retained in the Reproposal—could very well lead to significant credit constraints and associated limits on the ability of covered companies to provide services, particularly within the securities lending markets. In particular, agent lenders may be limited in their capacity to facilitate the flow of securities between lenders and borrowers. Given that roughly 56 percent of securities loans are equity products,<sup>90</sup> the majority of securities lending transactions will be subject

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<sup>89</sup> See Section 252.74(b).

<sup>90</sup> Securities Lending, Market Liquidity and Retirement Savings: The Real World Impact, Finadium LLC (Nov. 2015) at 2 (hereinafter “**Securities Lending Market Study**”).

to the highest additional haircut possible under Section 252.74(b). Moreover, the effects of these added haircuts will not be sufficiently mitigated by the collateral received, since that collateral is also subject to a pre-determined haircut. Covered companies are most likely to be credit constrained when transacting with major counterparties in the securities lending market. Indeed, because these major counterparties are frequent participants in these SFTs, the 15 percent credit limit on exposures between major counterparties may result in credit constraints and real market impacts.<sup>91</sup>

To put these constraints in context, it is important to understand the critical role of securities lending in the broader U.S. securities markets.

- First, securities lending serves as an important contribution to market liquidity. A sample of trading in 2015 indicated that short sales represent approximately one-third of U.S. equity market volumes, which would not be possible without a well-functioning securities lending market to enable sellers of securities to cover their delivery obligations.<sup>92</sup> In addition to contributing to liquidity, empirical data suggests that short selling plays an important role in reducing spreads, increasing price discovery, mitigating the rise of market bubbles and facilitating both market making and risk management activities.<sup>93</sup>
- Second, the ability to borrow securities is critical to the timely delivery of securities as securities loans are often used to cover settlement failures.
- Third, securities loans are increasingly being used to facilitate so-called “collateral upgrades” in which investors and financial intermediaries requiring high quality liquid assets for derivative transactions borrow them by exchanging other assets.<sup>94</sup>
- Finally, securities lending provides an important source of uncorrelated, incremental revenue for institutional investors that must meet target returns in order to adequately meet the needs of individual retirees.<sup>95</sup>

A robust securities lending market is essential to the healthy and efficient functioning of many aspects of the broader U.S. securities markets. Regulatory initiatives that could (and in this case are likely to) reduce the size and scope of securities lending activities must be approached with utmost caution. The additional layers of conservatism introduced by the Reproposal in measuring net exposures arising from securities lending diverges from the way in which such exposures are measured for risk-

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<sup>91</sup> See Section 252.72(c).

<sup>92</sup> Securities Lending Market Study at 9.

<sup>93</sup> Securities Lending Market Study at 7-10.

<sup>94</sup> Securities Lending Market Study at 5.

<sup>95</sup> Securities Lending Market Study at 12.

based capital purposes and unnecessarily undermines a critical function in the U.S. financial system.

We believe the Reproposal's departure from the risk-based capital methodologies for measuring securities lending exposures is unwarranted. We therefore urge the Federal Reserve to permit covered companies to calculate SFT exposures using any methodology that they are permitted to use for risk-based capital purposes, consistent with the Reproposal's approach for measuring derivatives exposure.<sup>96</sup> This would produce exposure amounts much closer to the underlying economic risks because risk-based capital rules permit covered companies, in applying supervisory-approved internal methodologies, to take into account the type of collateral securing a loan as well as the correlation between loaned securities and non-cash collateral and diversification benefits not recognized in the Reproposal. As these models are already used to calculate regulatory capital requirements, they have been subject to supervisory review and auditor evaluation. In addition, this approach has already been endorsed in the OCC lending limits.<sup>97</sup>

The Basel Committee has recognized many of the shortcomings in the Comprehensive Approach, on which the proposed methodology is largely based, and is seeking to address these shortcomings in a recently released proposal, which would generally provide a more granular assessment of credit risk than the current Comprehensive Approach.<sup>98</sup> Our recommendation to permit covered companies to use any method permissible under the risk-based capital rules would encompass any revisions to the risk-based capital calculations as a result of the Basel Committee's proposed revised version of the Comprehensive Approach, if such revisions are incorporated into the U.S. risk-based capital rules. Under the Basel Committee proposal, a covered company would be permitted to recognize the benefits associated with netting long and short positions, which in turn would allow for long position haircuts to offset those of short positions.<sup>99</sup> This approach is simple and conservative as it relies on only three inputs while limiting the weight of net exposures to 40 percent of the calculation. The other 60 percent is designed to approximate the impact of portfolio diversification on a market-wide basis. Furthermore, regulatory arbitrage is prevented with respect to the diversification benefit by eliminating any security from the netting set the value of which is less than 10 percent of the value of the largest security in the netting set.<sup>100</sup> This approach is nonetheless risk-sensitive relative to the Reproposal because it incorporates netting, diversification and correlation benefits excluded from the Reproposal.

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<sup>96</sup> See Section 252.73(a)(11).

<sup>97</sup> 12 C.F.R. § 32.9(c)(1)(i)(A).

<sup>98</sup> See Basel Committee on Banking Supervision, Revisions to the Standardised Approach for Credit Risk: Standards – Second Consultative Document at 19 (Dec. 2015), available at <http://www.bis.org/bcbs/publ/d347.pdf>.

<sup>99</sup> See *id.* The specific formula is weighted 40 percent to net exposure, which reflects the effect of netting long and short positions, and 60 percent to gross exposure, which does not reflect such netting.

<sup>100</sup> *Id.* at 20.

We recognize that if a new measurement methodology is incorporated into risk-based capital rules, the final SCCL rule may also be amended to reflect that change, perhaps even to establish such methodology as the sole permissible methodology for measuring SFT exposures. The incorporation of a new measurement methodology would be the subject of a separate notice and comment rule-making under applicable administrative law, and covered companies would need an implementation period adequate to put any later-adopted approach into operation.

**B. The CCFs applied to unfunded, off-balance-sheet commitments should be the same as under the risk-based capital rules, and the final SCCL rule should allow covered companies to reduce an exposure if the unused portion of a committed credit line is secured by any “eligible collateral.”**

The Reproposal would apply a 100 percent CCF to unfunded off-balance-sheet commitments when calculating a covered company’s gross credit exposure.<sup>101</sup> By contrast, the standardized approach under the risk-based capital rules uses: (i) a 0 percent CCF for the unused portion of a commitment that is unconditionally cancelable, (ii) a 20 percent CCF for a commitment with an original maturity of one year or less that is not unconditionally cancelable and (iii) a 50 percent CCF for a commitment with an original maturity of more than one year that is not unconditionally cancelable.<sup>102</sup> The SCCL’s 100 percent CCF assigned to all unfunded off-balance-sheet commitments, regardless of the other characteristics of such commitments, would significantly overstate the potential exposure from such lending commitments and fails to accurately reflect banking organizations’ actual experiences with many commitments. The Reproposal’s analytical and quantitative bases for establishing a 100 percent CCF for all unfunded off-balance sheet commitments is unclear, as no data supporting the proposed CCF is included in the Reproposal.

In particular, the Associations believe that the proposed 100 percent CCF for unconditionally cancelable commitments is inappropriate in light of the fact that banking organizations are permitted to eliminate these exposures entirely at any time, and, with respect to retail commitments (*i.e.*, credit cards and home equity lines of credit), have in fact done so in the past.<sup>103</sup> Historical data demonstrate that banking organizations have

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<sup>101</sup> Section 252.73(a)(8) provides that the amount of gross credit exposure of a covered company to a counterparty with respect to a credit transaction in the case of committed credit lines is equal to the face amount of the credit line.

<sup>102</sup> 12 C.F.R. § 217.33(b). The supplementary leverage ratio for advanced approaches banks uses these same CCFs with one exception—it applies a minimum CCF of 10 percent, with the consequence that a 10 percent CCF applies to commitments that are unconditionally cancelable. 12 C.F.R. § 217.10(c)(4)(H).

<sup>103</sup> The Clearing House Association, *Comments in Response to Consultative Documents – Revisions to the Standardised Approach for Credit Risk and Capital Floors: The Design of a Framework Based on Standardised Approaches* (March 26, 2015), at 13-14, available at <https://www.theclearinghouse.org/~media/files/association%20related%20documents/20150326%20letter%20to%20base1%20on%20standardized%20approach.pdf>.

unilaterally cancelled these commitments and eliminated the risk during periods of stress. For example, the Federal Reserve Bank of New York Quarterly Report on Household Debt and Credit shows that limits on credit card lines of credit fell by 12 percent during the recent recession in the United States.<sup>104</sup> This overstatement would serve as a disincentive to providing large lines of credit to corporate borrowers. Not only are lines of credit important sources of liquidity in the economy generally, studies have suggested that they may be especially beneficial to large, public corporations—the very types of counterparties likely to be adversely affected by the Reproposal’s treatment of unfunded commitments.<sup>105</sup> Because the application of a 100 percent CCF in all cases would grossly overstate the actual credit exposure for those lines of credit that are either unconditionally cancelable or of shorter durations, the impact of any such contraction would be most substantial on these products. At the least we urge the Federal Reserve not to apply a CCF to unconditionally cancelable commitments that is higher than the 10 percent minimum CCF used in the supplementary leverage ratio and noted above.

By contrast, the variable CCF approach under the risk-based capital rules is more tailored and better captures the level of risk posed by different types of off-balance-sheet commitments. The Reproposal’s 100 percent CCF would also be inconsistent with other metrics that incorporate the Basel III total leverage exposure measure, including the GSIB surcharge and the Financial Stability Board’s (“FSB”) proposed total loss absorbing capacity (“TLAC”) standards.<sup>106</sup> In addition, the Basel Large Exposure Framework applies the Basel Standardized Approach’s CCFs for purposes of calculating single counterparty credit exposure.<sup>107</sup> We therefore recommend that in the final SCCL rule the Federal Reserve apply the same CCFs for unfunded off-balance-sheet commitments with those CCFs applicable under the risk-based capital rules, consistent with the approach in the Basel Large Exposure Framework. Again, the objective in establishing exposure amounts for both the SCCL and risk-based capital rules is the same—accurately estimating the size and likely occurrence of the off-balance sheet credit

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<sup>104</sup> Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit, at 7 (November 2014), available at [http://www.newyorkfed.org/householdcredit/2014-q3/data/pdf/HHDC\\_2014Q3.pdf](http://www.newyorkfed.org/householdcredit/2014-q3/data/pdf/HHDC_2014Q3.pdf).

<sup>105</sup> Christopher M. James, Visiting Scholar at the Federal Reserve Bank of San Francisco, *Economic Letter: Credit Market Conditions and the Use of Bank Lines of Credit* (Aug. 31, 2009), available at <http://www.frbsf.org/economic-research/publications/economic-letter/2009/august/credit-market-bank-lines-credit>.

<sup>106</sup> The long-term debt components of the Federal Reserve’s TLAC proposal, in Sections 252.62 and 252.162 of the proposed TLAC rules, tie to designated percentages of risk-weighted assets, using the capital rules’ CCF percentages as noted above. 80 Fed. Reg. 74,962 (Nov. 30, 2015).

<sup>107</sup> We are aware that under the Basel Committee’s Revisions to the Standardised Approach for credit risk, a uniform CCF of between 50 and 75 percent would be applied to all wholesale commitments regardless of maturity unless they otherwise qualify for a lower CCF. However, such an approach would still apply a lower CCF to unconditionally cancelable retail commitments, and, moreover, the uniform CCF under the Basel Committee’s revised Standardised Approach would not be 100 percent. Basel Committee on Banking Supervision, *Revisions to the Standardised Approach for Credit Risk: Standards – Second Consultative Document* ¶¶ 64-74 (Dec. 2015), available at <http://www.bis.org/bcbs/publ/d347.pdf>.

exposure. Aligning the treatment of CCFs under the SCCL and the risk-based capital rules in this context, as the Reproposal does for derivatives, would better reflect both actual exposures and the benefit of credit lines as financial tools for market participants. At a minimum, we urge the Federal Reserve to clarify that a credit facility that is unconditionally cancelable by the covered company would not be considered a committed credit facility for purposes of the SCCL. This would be consistent with the treatment of unconditionally cancelable commitments under the risk-based capital rules and with the proposed definitional changes related to committed credit facilities for purposes of the LCR and the Federal Reserve's recently proposed NSFR.<sup>108</sup>

In addition, the Reproposal provides that the exposure may only be reduced by the unused portion of the credit extension if the used portion is at all times fully secured by specifically enumerated qualifying collateral rather than by any "eligible collateral" (as defined in the Reproposal).<sup>109</sup> This would exclude many types of investment grade debt securities, publicly traded equity securities and publicly traded convertible bonds, to the extent such obligations are not directly and fully guaranteed by the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") while under conservatorship or receivership of the U.S. government or issued by a U.S. government-sponsored enterprise. These exclusions are unnecessary, as the definition of "eligible collateral" already is sufficiently narrow and any concerns with its scope could be addressed by imposition of appropriate haircuts. Furthermore, the addition of yet another definition of collateral would needlessly complicate a covered company's ability to operationalize the requirement by developing dual systems to track collateral based on its underlying purpose. We therefore recommend that the final SCCL rule allow covered companies to reduce an exposure if the unused portion of a committed credit line is secured by any "eligible collateral." Applying the same standard for eligible collateral throughout the SCCL framework would simplify the framework and avoid complexity where it is unnecessary to achieve the financial stability objectives that underlie the SCCL.<sup>110</sup>

**C. The Reproposal's approach to derivative exposure valuation appropriately permits the use of risk-sensitive measurement methodologies and should only incorporate a new standardized approach after careful study and review.**

We support the Reproposal's alignment of the permissible approaches to calculating credit exposures arising from derivatives transactions with the approaches

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<sup>108</sup> See Department of the Treasury: Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, *Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements*, 81 Fed. Reg. 35,124, 35,129 (Proposed 12 C.F.R. §249.3) (June 1, 2016).

<sup>109</sup> Section 252.74(g); Section 252.71(k).

<sup>110</sup> Our recommendation for the definition of eligible collateral in the SCCL framework is contained in Part VI.D.

permitted under the risk-based capital rules (12 C.F.R. Part 217, subpart D and E),<sup>111</sup> including the ability to calculate derivatives exposures using the internal model method (“**IMM**”). The Preamble notes that the Federal Reserve may also consider the inclusion of the revised standardized approach (“**SA-CCR**”) that was finalized by the Basel Committee in March 2014.<sup>112</sup>

At this point it would be premature to include any specific tie-in to SA-CCR in the final SCCL rules, as SA-CCR has not yet been proposed in the United States for incorporation into the U.S. risk-based capital rules. Rather, if and when SA-CCR has been implemented under the U.S. risk-based capital rules, the potential impact of a concomitant change in the SCCL methodology should be evaluated through a separate notice and comment rulemaking. Such rulemaking should include a review of the impact of SA-CCR on the SCCL exposure measurements and whether any corresponding adjustment to the calibration of the SCCL’s limits would be required. In addition, any future shift to a new calculation methodology would necessitate appropriate implementation periods that take into account the complexity of moving to a new measurement methodology.

**D. The inclusion of purchased credit and equity derivatives when calculating net exposure from Covered Positions should not be subject to requirements to apply adjustments for maturity mismatches or limited to credit and equity derivatives purchased from an eligible protection provider.**

Covered Positions are risk-managed on a net basis with neither long nor short exposure enjoying a fixed definition of position or hedge.<sup>113</sup> The concept of a gross exposure with protection applied to arrive at a net exposure is not straightforward in the trading book. Positions are taken and adjusted with subsequent transactions as trading book risk is managed. The banking book ideal of an original held position and a matched hedge is not reflected in the more dynamic trading book. The initiation of a position could just as well be a purchased credit or equity derivative with a cash position providing closure as the reverse. Permitting only those credit and equity derivatives purchased from eligible protection providers to reduce a gross exposure, in addition to conflicting with the very nature of trading book positions, impacts the utility of derivatives purchased from protection providers that do not meet the eligibility criteria.

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<sup>111</sup> Section 252.73(a)(11).

<sup>112</sup> See Basel Committee on Banking Supervision, *The Standardised Approach for Measuring Counterparty Credit Risk Exposures* (Mar. 2014, rev. Apr. 2014), available at <http://www.bis.org/publ/bcbs279.htm>; 81 Fed. Reg. at 14,337.

<sup>113</sup> Under the market risk capital rule, banking organizations are required to use either a standardized or internal models method for measuring specific risk. The rules specify that if a banking organization uses internal models to measure the specific risk of a portfolio, it must capture all material components of specific risk for the debt and equity positions in the portfolio; if this requirement is not met, and for portfolios for which specific risk is not measured using internal models, banking organization must separately calculate a specific-risk add-on for the portfolio under the standardized method. 12 C.F.R. §§ 217.207(b)-(c); 217.210.

This unnecessary restriction is likely to further reduce liquidity and concentrate exposure with market participants who enjoy the eligible protection provider designation, in other words – the banking sector.

While it might be reasonable in the banking book to restrict the ability of credit and equity derivatives to reduce gross exposure if they are not purchased from eligible protection providers or if they do not have appropriate maturity, it does not make sense to do so in the trading book. The banking book, by definition, consists of “stickier” exposures, which banks intend to or might have to hold for some period of time, such as credit exposures arising from their lending or derivatives business. While hedges for banking book exposures may be matched to specific exposures for their duration and are less likely to be executed dynamically, trading book positions are dynamic, fluid and not meant to be held for any time certain. Given the reduced ability of covered companies to shed the original exposure of banking book positions, there exists some argument that hedges of such exposures that will reduce gross exposure ought to meet certain higher requirements. As a result, in the risk-based capital rules, hedges reducing capital requirements in the banking book must be purchased from eligible protection providers and are subject to haircuts for maturity mismatches. Such requirements do not apply in the trading book where exposures and hedging are much more dynamic, generally more liquid and the source of credit or equity derivatives is less important so long as the associated counterparty risk is captured.<sup>114</sup> In the trading book, maturity of purchased protection is also less important as positions change frequently, are often not held to maturity and additional, extending protection can and will be purchased if and when necessary.

Restricting, via the eligible protection provider requirement and the maturity mismatch adjustment, the ability of credit and equity derivatives to reduce gross exposure would:

- Provide an inaccurate view of a covered company’s economic risk. Of particular note, such restrictions would have the potential to impact the amount of risk-shifting observed for Covered Positions, in cases where a credit or equity derivative with a financial institution as a reference entity is purchased from a financial institution (so, ordinarily triggering a requirement to risk shift) but either the protection provider is not an eligible protection provider or the full notional of the derivative is not risk-shifted because both the gross exposure reduction and the resulting risk-shifting is reduced by a maturity mismatch haircut. This will have an effect contrary to what the Reproposal sets forth as an objective of and rationale for mandatory risk shifting from the application of collateral – to observe risk connections. The proposed limitations would actually obscure risk connections that exist in the real world.

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<sup>114</sup> 12 C.F.R. Part 217, Subpart F.

- Force covered companies to manage to an unrealistic picture of economic risk; and
- Require covered companies to develop a new mechanism to import the maturity mismatch concept to trading book positions even though the assignment of the maturity mismatch adjustment to such positions would necessarily be arbitrary.

To address these concerns, we urge the Federal Reserve to eliminate the “eligible protection provider” and maturity mismatch requirements<sup>115</sup> for otherwise eligible credit derivatives and equity derivatives that are Covered Positions. In addition, the definition of “eligible credit derivative” should not require that such protection be purchased solely from eligible guarantors when such protection is a Covered Position. There are other protections that mitigate against counterparty risk other than a limiting “eligible protection provider” definition, including, for example, that these positions generally are entered into with a counterparty with which the covered company has a qualified master netting agreement that includes daily variation margin requirements. In addition, we recommend that the maturity mismatch adjustment not apply to credit and equity derivatives used to reduce gross exposure in the trading book.

**E. Net credit exposure amounts on equity exposures that are Covered Positions subject to the market risk capital rule should be determined in a manner consistent with the calculation of specific risk for risk-based capital purposes.**

Under the Reproposal, a covered company would be required to treat equity derivatives in the same manner as instruments designed to offer credit protection, categorizing equity derivatives as either sold or purchased protection and requiring risk-shifting under 252.74(e) to the derivative counterparty when a derivative exposure offsets a long equity exposure. This methodology diverges from both the Basel Committee’s Large Exposure Framework<sup>116</sup> and the large exposure limits of the EU CRR,<sup>117</sup> under

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<sup>115</sup> Section 252.74(e)(2) provides that a covered company must include in the calculation of its exposure to an eligible protection provider the notional amount of the protection purchased “as adjusted by the maturity mismatch adjustment approach of Section 217.36(d) of the Federal Reserve’s Regulation Q, as applicable...” We understand the “as applicable” to mean if the maturity mismatch would be applicable under the risk-based capital rules. The maturity mismatch haircut in 217.36(d) does not apply to trading book positions and would not be applicable. If our understanding is correct, we recommend that the similar language in Section 252.74(e)(1)(ii) be modified to include “as applicable” after the reference to the Federal Reserve’s Regulation Q. If our understanding is not correct and the “as applicable” refers instead to whether the maturity mismatch haircut is applicable as described in Section 252.74(e)(1)(ii), then we urge the Federal Reserve to modify the application of the maturity mismatch haircut in 217.36(d) to apply only to circumstances in which it is applicable under the risk-based capital rules, that is, to positions in the banking book.

<sup>116</sup> Basel Committee on Banking Supervision, *Supervisory Framework for Measuring and Controlling Large Exposures*, at ¶ 36, n.12 (Apr. 2014), available at <http://www.bis.org/publ/bcbs283.pdf>.

<sup>117</sup> Regulation 2013/575/EU of the European Parliament and of the Council Art. 204 ¶ 1; Art. 399 ¶ 2 (Jun. 26, 2013).

which equity derivatives are not equated with credit derivatives. Rather, under these international standards and rules for large exposure limits, net exposure amounts on equity positions that are subject to applicable regulatory capital rules for market risk positions are calculated on a basis that is more generally aligned with how exposure amounts are calculated for such positions under applicable market risk capital rule.

The Reproposal provides no explanation for diverging from international standards in this regard, and we are aware of no statutory or prudential justification for such divergence. Indeed, this divergence is particularly counterintuitive, since the risk that the Reproposal seeks to mitigate with respect to equity exposures would be fully captured when a BHC calculates its net exposure amount on an equity position for purposes of determining the specific risk of equity positions that are Covered Positions subject to the market risk capital rule.<sup>118</sup>

More specifically, when a covered company holds an equity position, it is subject to both general market risk and the specific risk of that position. General market risk (*i.e.*, the risk of loss that could result from broad market movements, such as changes in the general level of equity prices)<sup>119</sup> represents a covered company's exposure to the market as a whole, while specific risk (*i.e.*, the risk of loss on the position that could result from factors other than broad market movements, such as event risk, default risk, and idiosyncratic risk)<sup>120</sup> represents the covered company's exposure to a specific issuer of an equity instrument. With regards to an equity exposure, the risk that the Reproposal seeks to mitigate—*i.e.*, the risk to a covered company arising from an individual company's failure<sup>121</sup>—is the specific risk of an equity position.

For purposes of determining the specific risk of an equity position under the market risk capital rule standardized measurement approach that must be used for portfolios for which specific risk is not measured or adequately captured using internal models, a banking organization must look across its portfolio of equity instruments issued by a given party and equity derivatives referencing that issuer and may net long and short cash and derivative positions in identical issues (or identical indices) to calculate a single net long or short position with respect to that issuer.<sup>122</sup> This net position is the banking organization's exposure amount for purpose of determining its specific risk to the issuer, including the risk to the banking organization that could arise from the issuer's default or failure. Given the existence of this well-tested methodology for calculating the net

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<sup>118</sup> 12 C.F.R. §§ 217.207, 217.210.

<sup>119</sup> 12 C.F.R. § 217.202(b).

<sup>120</sup> *Id.*

<sup>121</sup> “Section 165(e) of Dodd-Frank authorizes the Board to establish single-counterparty credit limits for bank holding companies with total consolidated assets of \$50 billion or more (covered companies) and foreign banking organizations with total consolidated assets of \$50 billion or more, and any U.S. intermediate holding company (covered entities), in order to limit the risks that the failure of any individual firm could pose to a covered company.” 81 Fed. Reg. at 14,328.

<sup>122</sup> 12 C.F.R. § 217.207.

exposure amount on cash and derivative equity positions, it is difficult to understand why the Reproposal would diverge from international standards and introduce a new methodology that would inappropriately treat equity derivatives in a manner equivalent to instruments designed to offer credit protection, categorize equity derivatives as either sold or purchased protection and require risk-shifting to the derivative counterparty when a derivative exposure offsets a long equity exposure.

We therefore urge the Federal Reserve to permit a covered company to calculate its net credit exposure arising out of such positions in a manner consistent with how a covered company would calculate its net long or short position with respect to a given issuer for purposes of determining the specific risk add-on under the market risk capital rule, as applicable. Namely, for purposes of calculating its net credit exposure arising out of equity instruments issued by that counterparty and equity derivatives referencing that issuer that are Covered Positions subject to the market risk capital rule, a covered company should be permitted to net long and short cash and derivative positions in identical issues or identical indices to calculate a single net long position. Furthermore, a covered company's net credit exposure to a counterparty arising out of such equity positions should equal the market value of that net long position.<sup>123</sup> Such an approach would be more consistent with applicable risk-based capital rules and with the Basel Committee's Large Exposure Framework and would also reduce operational complexity by allowing covered companies to use existing systems and methodologies that already capture the very risk intended to be captured by the SCCL.

**IV. The Reproposal's application of more stringent credit limits to major covered companies is flawed, unsupported by either the Reproposal or the accompanying White Paper, and ignores recent regulatory reforms that mitigate the same risks at which the more stringent limit would be directed.**

The Reproposal would impose a more stringent credit limit of 15 percent of tier 1 capital on exposures between a major covered company and a major counterparty.<sup>124</sup> Although we appreciate the Federal Reserve's concern regarding a "heightened degree of credit risk and greater potential for heightened financial instability" when considering exposures between global systemically important banks ("GSIB"),<sup>125</sup> the analysis in the Reproposal and accompanying White Paper do not demonstrate that, taking into account other regulatory initiatives addressing the increased systemic significance of the largest covered companies, the more stringent standards are warranted. While we recognize that the lower 15 percent inter-GSIB limit is based on the standard in the Basel Large Exposure Framework,<sup>126</sup> we do not believe that justifies its adoption in the United States

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<sup>123</sup> Consistent with the Basel Committee's Large Exposure Framework, a net short position should not result in a net credit exposure. Basel Committee on Banking Supervision, *Supervisory Framework for Measuring and Controlling Large Exposures*, at ¶ 59 (Apr. 2014), available at <http://www.bis.org/publ/bcbs283.pdf>.

<sup>124</sup> Section 252.72(c).

<sup>125</sup> 81 Fed. Reg. at 14,334.

<sup>126</sup> See Basel Large Exposure Framework at ¶¶ 16, 90-92.

if not otherwise supported and sensible. As a legal matter, the Basel Large Exposure Framework does not bind the Federal Reserve in any way. As a policy matter, application of a limit on inter-GSIB exposures at any level below 25 percent would be unwarranted.

The White Paper that accompanies the Reproposal (the “**SCCL White Paper**”) focuses on the default correlation between a GSIB and another GSIB (as compared to a non-financial company), concluding from that analysis that a more stringent limit is appropriate for inter-GSIB exposures because, in essence, a GSIB counterparty is more likely to fail at the same time a lending GSIB suffers financial stress than is a non-GSIB counterparty. That analysis, however, does not take into account in any meaningful way either the relative probability of a GSIB default or the expected impact of such default. This is particularly striking in light of the many regulatory reforms aimed specifically at addressing those very concerns, many of which have been implemented in a more conservative manner in the United States than required by the corresponding international framework. Collectively, these GSIB-specific regulatory measures were implemented for the specific purpose of reducing both the probability of default and loss-given-default of GSIBs relative to non-GSIBs, given the greater systemic costs associated with their failure. Accordingly, the SCCL is itself in many ways duplicative of these other reforms, as it shares their overall objective: “to limit the risks that the failure of any individual company could pose to a nonbank financial company supervised by the Federal Reserve or a BHC [with \$50 billion or more in total consolidated assets].”<sup>127</sup> This redundancy is only more pronounced in the context of the lower inter-GSIB limit.

The duplicative effect of the post-crisis reforms, and thereby the inappropriateness of a more stringent inter-GSIB limit, is well illustrated by the SCCL White Paper itself. In particular, the SCCL White Paper assumes that all GSIBs have the same systemic cost of failure and therefore the same capital surcharge, which is at odds with the expected impact framework laid out in the GSIB surcharge calibration white paper that accompanied the release of the final rule implementing the GSIB capital surcharge.<sup>128</sup> Indeed, the entire purpose of that framework is to reduce the probability of a GSIB’s failure relative to that of a non-GSIB by requiring it to hold greater amounts of capital.<sup>129</sup> As shown in the TCH Research Note “Overview and Assessment of the

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<sup>127</sup> Dodd-Frank Section 165(e)(1).

<sup>128</sup> See Board of Governors of the Federal Reserve System, *Calibrating the GSIB Surcharge* (Jul. 20, 2015), available at <http://www.federalreserve.gov/aboutthefed/boardmeetings/gsib-methodology-paper-20150720.pdf>.

<sup>129</sup> Moreover, since Dodd-Frank was enacted, the level of capital that all banks must hold has increased significantly. In addition to the GSIB surcharge, the Federal Reserve’s robust stress-testing processes under CCAR, the Capital Plan Rule and DFAST ensure that U.S. GSIBs in particular have sufficient capital to endure severely adverse market and economic conditions at least as and likely even more adverse than the 2007-2009 financial crisis. 12 C.F.R. § 225.8; see, e.g., Federal Reserve Board, Comprehensive Capital Analysis and Review 2015: Summary Instructions and Guidance at 12, 27 (2014) (“Eight BHCs with substantial trading or custodial operations will be required to incorporate a counterparty default scenario component into their supervisory adverse and severely adverse stress scenarios. Like the global market shock, this component will only be applied to the largest and most

Methodology Used by the Federal Reserve to Calibrate the Single-Counterparty Credit Limit” (the “**TCH Research Note**”), a credit limit consistent with the currently applicable GSIB surcharge framework, and the reduction in GSIB probability of default that framework implies, would be a limit equal to more than 100 percent of tier 1 capital for five of the eight GSIBs, and in no case less than 25 percent.<sup>130</sup>

Finally, the Reproposal’s more stringent inter-GSIB limit wholly ignores other key regulatory reforms enacted for the purpose of ensuring that GSIBs can be resolved in a manner that avoids negative systemic consequences and taxpayer exposure. These important reforms alone render any more stringent inter-GSIB limit wholly inappropriate, as their effect is to make any credit losses on exposures to a GSIB particularly unlikely. Most notably:

- Dodd-Frank Title II. The Orderly Liquidation Authority provided under Title II of Dodd-Frank is a central example of the reforms that have addressed systemic risk in the event of default. As noted in the Orderly Liquidation Authority adopting release, “[w]ith the enactment of the Dodd-Frank Act, Federal regulators have the tools to resolve a failing financial company that poses a significant risk to the financial stability of the United States. . . in a

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complex BHCs, in line with the Federal Reserve’s higher expectations for those BHCs relative to the other BHCs participating in CCAR . . . The Federal Reserve has differing expectations for BHCs of different sizes, scope of operations, activities, and systemic importance in various aspects of capital planning. In particular, the Federal Reserve has significantly heightened expectations for BHCs that are subject to the Federal Reserve’s Large Institution Supervision Coordinating Committee (LISCC) framework.” (“**CCAR 2015 Instructions**”).

More rigorous leverage ratios, including the supplementary and enhanced supplementary ratios, also meaningfully constrain banking organizations’ ability to hold shorter-duration assets. 12 C.F.R. §§ 217.10(c)(4); 217.1(f)(4); 217.2; 217.11(a)(4)(2). This helps to ensure that in times of economic stress, banking organizations will have sufficient resources available to absorb unexpected losses that may not be adequately captured by the risk-based regulatory capital regime. As demonstrated in the TCH Research Note, the greater the level of loss absorbency that banks are required to hold, the less need there is for a more stringent SCCL.

<sup>130</sup> See The Clearing House, *Overview and Assessment of the Methodology Used by the Federal Reserve to Calibrate the Single-Counterparty Credit Limit* (Jun. 2016), available at [https://www.theclearinghouse.org/~media/TCH/Documents/20160603\\_TCH\\_Research\\_Note\\_SCCL.pdf](https://www.theclearinghouse.org/~media/TCH/Documents/20160603_TCH_Research_Note_SCCL.pdf). As noted above, the more stringent inter-GSIB credit limit of 15 percent is consistent with the standard in the Basel Large Exposure Framework. An alternative to avoid this inconsistency with the expected impact framework presented in the context of the GSIB surcharge—without eliminating the 15 percent inter-GSIB credit limit as introduced under the Basel Large Exposure Framework—would be to lower the GSIB surcharge. For example, one approach would be to lower the weight assigned to the interconnectedness factor to recognize the inter-GSIB credit limit of 15 percent of tier 1 capital. Based on the analysis in the TCH Research Note, if the GSIB surcharge took into account the 15 percent inter-GSIB credit limit, a GSIB would be required to hold only roughly one half of the amount of common equity tier 1 capital that would be required under the GSIB surcharge as currently calibrated.

way that addresses the concerns and interests of legitimate creditors while also protecting broader economic and taxpayer interests.”<sup>131</sup>

- U.S. Single Point of Entry (“SPOE”). The U.S. SPOE strategy developed by the FDIC to implement Title II is targeted at “provid[ing] stability to financial markets by allowing vital linkages among the critical operating subsidiaries of the firm to remain intact and preserving the continuity of services between the firm and financial markets that are necessary for the uninterrupted operation of the payments and clearing systems, among other functions.”<sup>132</sup> In combination with the FSB TLAC proposal (described below), SPOE “should permit a large, consolidated entity that owns banks or broker-dealers to continue to function even if the ultimate holding company ceases to be viable and must be recapitalized or wound down.”<sup>133</sup>
- Resolution Planning. Dodd-Frank Section 165 also requires a covered company to submit a resolution plan providing detailed information to the applicable federal bank regulatory agencies to assist in rapid and orderly resolution of the banking organization in the event of its material financial distress or failure.<sup>134</sup> Such plans function as a complement to the SPOE strategy by providing prudential regulators with the information necessary for an orderly liquidation under Dodd-Frank Title II. Moreover, a covered company is required to identify its major counterparties in its resolution plan, along with an analysis of the impact on the covered company of the failure or material financial distress of each such counterparty.<sup>135</sup>
- ISDA Resolution Stay Protocol. The ISDA Resolution Stay Protocol<sup>136</sup> significantly improves the resolvability of global banking organizations by preventing a destabilizing run by derivatives counterparties on an operating subsidiary when its parent enters a bankruptcy or Title II resolution.<sup>137</sup> The protocol addresses the risk that “counterparties of the foreign subsidiaries and branches of GSIBs [with] contractual rights and substantial economic incentives to accelerate or terminate those contracts as soon as the U.S. parent GSIB enters [resolution]” would exercise these rights, which could, in turn, “render a resolution unworkable by resulting in the disorderly unwind of an

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<sup>131</sup> Orderly Liquidation Authority, 76 Fed. Reg. 4,207, 4,208 (Jan. 25, 2011).

<sup>132</sup> Single Point of Entry Strategy, 78 Fed. Reg. 76,614, 76,615 (proposed Dec. 18, 2013).

<sup>133</sup> Governor Jerome H. Powell, Speech at the Stern School of Business, New York University, New York, NY: Financial Institutions, Financial Markets, and Financial Stability at 3 (Feb. 18, 2015), available at <http://www.federalreserve.gov/newsevents/speech/powell20150218a.pdf>.

<sup>134</sup> Dodd-Frank Section 165(e)(1).

<sup>135</sup> 12 C.F.R. § 243.4(e)(10), (11).

<sup>136</sup> 2014 ISDA Resolution Stay Protocol, published November 4, 2014 by the International Swaps and Derivatives Association, Inc., available at <http://assets.isda.org/media/f253b540-25/958e4aed.pdf>.

<sup>137</sup> *Id.*

otherwise viable foreign subsidiary and the disruption of critical intra-affiliate activities that rely on the failing subsidiary.”<sup>138</sup> The protocol supports orderly resolution by contractually barring closeouts as part of the cross-border application of special resolution regimes applicable to certain financial companies.<sup>139</sup> The protocol is currently the subject of a proposed rulemaking by the Federal Reserve.<sup>140</sup>

- **TLAC.** The Federal Reserve’s proposed implementation of TLAC and long-term debt requirements<sup>141</sup>—the U.S. version of the FSB’s international standard<sup>142</sup>—ensures that “[GSIBs] finally have the quantum of total loss absorbing capacity that extensive analysis shows balances the benefit of greater resilience against the higher funding costs for the banks that results from the removal of public subsidies.”<sup>143</sup> In the United States and other countries that employ a SPOE resolution regime, TLAC will ensure that there are sufficient loss-absorbing resources available to fully recapitalize any failed (material) subsidiary even under extreme loss assumptions.<sup>144</sup> In addition, the Federal Reserve’s TLAC proposal would expand upon the risk-based capital rules’ provisions requiring banking institutions to deduct from their own capital their holdings of capital securities of non-consolidated financial institutions to also require deductions for unsecured long-term debt.<sup>145</sup> The

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<sup>138</sup> Testimony of Governor Daniel K. Tarullo, Federal Reserve Board of Governors, before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Sept. 9, 2014), *available at* <http://www.federalreserve.gov/newsevents/testimony/tarullo20140909a.htm>.

<sup>139</sup> 2014 ISDA Resolution Stay Protocol, published November 4, 2014 by the International Swaps and Derivatives Association, Inc., *available at* <http://assets.isda.org/media/f253b540-25/958e4aed.pdf>.

<sup>140</sup> Federal Reserve System, *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* (May 3, 2016) *available at* <https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160503b1.pdf>.

<sup>141</sup> Federal Reserve, *Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies; Proposed Rule*, 80 Fed. Reg. 74,926 (Nov. 30, 2015).

<sup>142</sup> Financial Stability Board, “Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution” (November 10, 2014), *available at* <http://www.financialstabilityboard.org/2014/11/adequacy-of-loss-absorbing-capacity-of-global-systemically-important-banks-in-resolution/>.

<sup>143</sup> October 12, 2014, Annual G30 International Banking Seminar, Remarks given by Mark Carney, Governor of the Bank of England, “Regulatory work underway and lessons learned.”

<sup>144</sup> The Clearing House, February 2, 2015 Letter re: Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banking Groups in Resolution – Consultative Document, *available at* <https://www.theclearinghouse.org/issues/banking-regulations/international-regulation/financial-stability-board/20150202-joint-letter-to-fsb-on-tlac-proposal>.

<sup>145</sup> 80 Fed. Reg. at 74,950.

rationale for this proposed requirement is aimed squarely at “reducing the risk of contagion.”<sup>146</sup> Importantly, the TLAC regime will also include so-called “clean holding requirements”, which will effectively prohibit any GSIB from taking on material counterparty exposures at the holding company level, and thereby limiting such exposures to the operating subsidiary level. Collectively, these components of the TLAC regime will not only reduce the likelihood of credit losses related to GSIB exposures, but will also make such exposures less likely to contribute to systemic risk.

Relative to the underlying purpose of the SCCL and the potential policy case for a more stringent inter-GSIB limit, the cumulative impact of these capital resolution reforms cannot be overstated. To the extent a GSIB may have credit risk exposure to a counterparty GSIB, each of the following is true:

- Both the exposed GSIB and the counterparty GSIB’s probability of default will be substantially reduced by the additional capital each is required to hold under the GSIB surcharge;
- The exposure itself is likely to be to the material operating subsidiaries of the counterparty GSIB, and not its holding company; and
- Even in the event of the counterparty GSIB’s failure, the material operating subsidiaries to which the GSIB is exposed will be recapitalized via the bail-in of substantial amounts of additional TLAC, and *thereby remain open, solvent, and performing on its obligations to the exposed GSIB.*

Simply put, the notion that inter-GSIB risk exposures—protected as they are by this powerful and uniquely applicable series of risk mitigants—could somehow warrant a more stringent limit than exposures not so protected is patently unreasonable

**V. The proposed one year implementation period should be extended to a minimum of two years, beginning upon finalization of the SCCL reporting forms, or three years if exposures to natural persons are not excluded from the final SCCL rule.**

The Reproposal provides for a compliance period of one year for Large Covered Companies,<sup>147</sup> but this is insufficient given the extraordinary complexity of implementation. In addition, the Reproposal would impose a broad range of new requirements for covered companies that do not necessarily align with similar requirements in other contexts, including the risk-shifting requirement, the need to consider the impact of third parties on securitization vehicles, investment funds or other SPVs and the attribution of certain securitization vehicle, investment fund or other SPV exposures to a single, unknown counterparty. This complexity will prolong all stages of

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<sup>146</sup> *Id.*

<sup>147</sup> Section 252.70(g)(2).

covered company implementation, from system design through the development of comprehensive policies and procedures. Furthermore, this complexity will be magnified if the Federal Reserve does not exempt natural persons from the scope of the rule as discussed in Part II.F. In the absence of such an exemption a covered company would need to calculate its exposure to millions of individual customers and determine whether each customer has immediate family members. Efforts to complete this work would face obstacles from the infrastructure of covered companies as they traditionally maintain discrete platforms for retail and wholesale clients, and effective communication between the two would require substantial modifications. In addition, a longer implementation period would allow covered companies to leverage the continued adoption of the legal entity identifier which continues to be rolled out in various regulations worldwide and would improve standardization of SCCL output.<sup>148</sup> The implementation schedule should therefore be a minimum of two years for all covered companies if exposures to natural persons are exempt from the final SCCL rule and three years if exposures to natural persons are included in the final SCCL rule.

Moreover, many facets of the Reproposal will require the development of bespoke systems to address the SCCL's new requirements. Although the extent of the required systems development will ultimately depend on the final SCCL rule and corresponding reporting template, we anticipate new systems or significant adaptation of existing systems will be required, at a minimum, for the following purposes:

- Development of monthly reports to demonstrate compliance with the single-counterparty credit limits;
- Tracking of exposure shifts associated with collateral, guarantees, and credit and equity derivatives;
- Attribution of securitization vehicle, investment fund or other SPV exposures to the issuer of underlying assets; and
- Modifications to, or a development of, systems to account for the new definitions that would be introduced under the Reproposal, including the "control" and "counterparty" definitions, as well as aggregation requirements for non-U.S. sovereigns and U.S. States.

Not only would a covered company need to build or modify all of the above systems, development of each system would be a lengthy, multi-step process. Such development would necessarily include, at a minimum:

- Extensive project planning, including allocation of budget resources for deployment on SCCL development, establishment of a management team, a review of the final SCCL rule, translation into internal MIS user requirements

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<sup>148</sup> For example, several European Securities and Markets Authority regulations requiring implementation of the LEI have implementation deadlines in January 2018. *LEI Uses*, THE LEGAL ENTITY IDENTIFIER REGULATORY OVERSIGHT COMMITTEE, <http://www.leiroc.org/lei/uses.htm> (last visited May 30, 2016).

and conversion of MIS user requirements into detailed technological specifications (3 months);

- Redeployment of existing resources and acquisition of new resources, including technology development resources, subject matter experts across multiple lines of business (6 months);
- Software coding development inclusive of aggregation system development, new data requirements imposed by reporting forms, and interface protocols for all systems of record (12 months);
- Quality assurance testing across all affected systems followed by separate quality assurance testing of the SCCL system, which cannot be performed concurrently (3 months);
- End-user testing (1 month);
- Adjustments to development based on feedback received during testing (3 months); and
- Final review and approval by the various lines of business and control groups followed by a development “freeze” prior to actual roll out and implementation (2 months).

In all, this means implementation would take a minimum of 30 months, assuming the above aggressive timetable. This means that work would need to begin even before our proposed two-year implementation period begins and, consequently, before the reporting form, or possibly even before the SCCL rule, is finalized. As a result, the timeline also will be affected by “corrections” that will have to be implemented to accommodate changes to systems that covered companies begin to build before the exact reporting requirements are known. Based on the complexity of the development work, the sheer number of systems required and parallel regulatory initiatives, a compliance period of one year for the SCCL is unrealistic. A longer compliance period would not conflict with the Basel Large Exposure Framework implementation timeline of January 1, 2019.<sup>149</sup>

In addition to covered company implementation considerations, the compliance period must also account for the potential impact the SCCL may have on existing market dynamics, particularly in light of the SCCL’s new and untested elements. Covered companies will need time not only to assess their potential overages under the SCCL, but will also need to work with clients and trading counterparties to adjust positions and develop new transactional patterns. It is critical that this not occur over a compressed time period to avoid unnecessary dislocation or unintended pressures on asset classes or counterparties more likely to be affected by the SCCL.

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<sup>149</sup> Basel Committee on Banking Supervision, *Supervisory Framework for Measuring and Controlling Large Exposures*, at ¶ 93 (Apr. 2014), available at <http://www.bis.org/publ/bcbs283.pdf>.

For the reasons described above, to the extent there will be anything more than a very short gap between the effective date of the final SCCL rule and the finalization of associated reporting forms,<sup>150</sup> the compliance period should be based on finalization of the reporting forms rather than the effective date of the final SCCL rule. Much of the system development described above would be dependent on the types of output and analysis the Federal Reserve will require of covered companies. For example, if the Federal Reserve expects a covered company to provide a summary of underlying positions of a top counterparty under the SCCL, the relevant system would need to be built to accommodate this requirement. As such there is a limited amount of implementation work a covered company can undertake until the reporting requirements have been finalized. Not only would it be inefficient for a covered company to layer on new requirements midway through development, doing so could be disruptive of the implementation process and jeopardize compliance with the Federal Reserve's deadline. We therefore urge the Federal Reserve to begin the compliance period, of, at a minimum, two years, as discussed above, when reporting forms have been finalized.

## **VI. Recommendations to address other concerns and technical issues**

### **A. FBO Issues**

The inclusion of foreign banking organizations (“**FBOs**”) already subject to comparable SCCL regimes is inconsistent with principles of national treatment and competitive equality and should not be included in the scope of the final SCCL rule, though of course the U.S. intermediate holding company (“**IHC**”) would nonetheless remain subject to the SCCL. To the extent FBOs are subject to the final SCCL rule, they should be treated consistently throughout. The application of the SCCL under the Reproposal to the combined U.S. operations of an FBO in cases where the FBO is already subject to a regime consistent with the Basel Large Exposure Framework is unnecessary, imposes significant additional burdens, and disregards the principles of national treatment and competitive equality, which are embedded in Section 165 of Dodd-Frank. Because the combined U.S. operations of the FBO already are subject to a comparable home country regime as part of the consolidated FBO, applying the regime again at the level of the combined U.S. operations alone adds no real risk-mitigating benefit. It would, however, impose significant costs and introduce compliance complexities because the FBO would be forced to comply with a host of regimes that are designed to address the very same issues—(1) exposure limits imposed by home country regimes; (2) U.S. federal and/or state lending limits that would apply to U.S. bank subsidiaries and branches; (3) an exposure limit that would apply to the combined U.S. operations of such FBO under the Reproposal; and (4) a separate exposure limit that would apply to the IHC of such FBO under the Reproposal. The Reproposal provides no justification for this layering on of overlapping requirements.

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<sup>150</sup> The Preamble indicates that the Federal Reserve plans to develop such reporting forms but does not provide information as to when they will be made available to covered companies. 81 Fed. Reg. at 14,344.

**1. If the SCCL is imposed separately on the combined U.S. operations of an FBO, the size-based tailoring of the compliance requirements should be based solely on U.S. assets and major FBOs should be identified based on their GSIB status.**

The Reproposal would apply increasingly stringent credit limits as the size of a subject BHC increases, as measured by total consolidated assets, with the most stringent limits and compliance obligations applicable to FBOs and U.S. IHCs with \$500 billion or more in total consolidated assets.<sup>151</sup> Under this standard, an FBO would be placed into a “covered category” based on its global total consolidated assets regardless of the size of its U.S. operations. The more stringent limits are meant to reflect the potential impact on U.S. financial stability of the covered company, but, in the case of FBOs, the asset measure would over-estimate U.S. impact. The proposed framework makes no allowance for this.

The more stringent requirements also affect the compliance obligations an FBO would face.<sup>152</sup> An FBO may be forced to come into compliance with the requirements more quickly and provide more frequent reporting based on the size of its global total consolidated assets, irrespective of the size of its U.S. operations.<sup>153</sup> An additional complicating factor is that under the Reproposal the same banking organization could be considered a “major FBO” (that is, total consolidated assets of the FBO exceed \$500 billion)<sup>154</sup> but not a “major IHC” (that is, total consolidated assets of the IHC do not exceed \$500 billion),<sup>155</sup> resulting in differing compliance responsibilities between the FBO and the IHC.

To address these concerns, we recommend the definition of “major FBO” in the final SCCL rule be based solely on the assets of the FBO’s combined U.S. operations, rather than on its global total consolidated assets. Basing the compliance regime on the size of the FBO’s U.S. footprint should not increase the risk to U.S. financial stability—and certainly not enough to justify potentially subjecting an FBO to the significant burden of complying with multiple, differing requirements in the United States. At a minimum, however, the compliance phase-in and reporting frequency should be based solely on the size of the U.S. IHC (or the combined U.S. operations if the FBO has no IHC).

In addition, under the 2011 Proposal, all major covered companies—both U.S. BHCs and FBOs—would have been determined solely by reference to their asset sizes.<sup>156</sup>

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<sup>151</sup> See Section 252.172.

<sup>152</sup> See Section 252.178(a).

<sup>153</sup> See *id.*, Section 252.170(c).

<sup>154</sup> See Section 252.171(w).

<sup>155</sup> See Section 252.171(x).

<sup>156</sup> Section 252.92(aa) of the 2011 Proposal.

However, under the Reproposal U.S. BHCs are deemed major covered companies based on their GSIB status,<sup>157</sup> while FBOs are deemed to be major covered companies based solely on their size.<sup>158</sup> The determination of GSIB status involves several factors beyond size, including interconnectedness, substitutability, complexity and cross-jurisdictional activity.<sup>159</sup> The Reproposal does not offer an explanation for this discrepancy or why consideration of these additional factors for purposes of calibrating the SCCL is appropriate for U.S. BHCs but not for FBOs. Furthermore, Section 165 mandates the Federal Reserve to establish prudential standards that increase in stringency based on factors other than size, such as the interconnectedness of a company and its importance as a source of credit and liquidity.<sup>160</sup> The failure to consider these additional factors overestimates the importance of FBOs to the U.S. financial system. These effects are amplified by not calibrating the relevant SCCL thresholds for FBOs based on the size of their U.S. operations. We therefore recommend that the major threshold determination for FBOs be aligned with that applicable to U.S. BHCs by reference to an entity's GSIB status.

**2. The “cross trigger” provision should be eliminated because it would place unnecessary credit limits on the combined U.S. operations.**

Section 252.178(c) of the Reproposal imposes a “cross trigger” on the exposure limits of an IHC and the combined U.S. operations of the parent FBO. If either the IHC or the FBO has exceeded its applicable exposure limit to a counterparty, then neither entity can engage in additional credit transactions with such counterparty unless the Federal Reserve determines that such transactions are “necessary and appropriate to preserve the safety and soundness of the foreign banking organization or U.S. financial stability.”<sup>161</sup> To the extent that the SCCL rule continues to separately apply to both the combined U.S. operations of an FBO and its U.S. IHC, the cross trigger provision should be eliminated.

This cross trigger provision is fundamentally inconsistent with a framework that otherwise measures and treats exposures of an FBO and exposures of its IHC separately. The Federal Reserve has provided no explanation for this anomalous treatment. Rather, the Preamble only sets forth a narrative description of the text of the rule without elaboration or support for why such an approach might be beneficial or how it is appropriate.<sup>162</sup>

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<sup>157</sup> Section 252.71(w).

<sup>158</sup> Section 252.172(w).

<sup>159</sup> 12 C.F.R. § 217.404.

<sup>160</sup> 12 U.S.C. §§ 5323(a)(2); 5365(a)(1)(B).

<sup>161</sup> Section 252.178(c).

<sup>162</sup> See 81 Fed. Reg. at 14,347-48.

Given the difference in capital bases between an IHC and the parent FBO, the parent FBO would necessarily have a larger capability for credit exposures to a given counterparty under the Reproposal. In light of the separate capital bases and applications of the SCCL, a breach by the IHC should not limit transactions by the rest of the combined U.S. operations. Furthermore, there is no question of evasion if the FBO's applicable limit could accommodate the additional exposure to the counterparty.

**3. The home country sovereign exemption should be clarified to confirm that it includes the sovereign's agencies and instrumentalities.**

The Reproposal exempts exposures to an FBO or IHC's home country sovereign, regardless of the risk weight assigned to such sovereign under Regulation Q (12 C.F.R. Part 217).<sup>163</sup> The specific exemption language refers generally to exposures to "the foreign banking organization's home country sovereign entity" but does not specify whether home country sovereign entity includes the sovereign's agencies and instrumentalities.<sup>164</sup> The Preamble explains that the home country sovereign exemption is intended to be "consistent with the treatment of credit exposures of covered companies to the U.S. government."<sup>165</sup> Such an approach is consistent with principles of competitive equality, as FBOs will have relationships with their home country sovereigns that may be analogous to the relationship between U.S. BHCs and the U.S. government. For U.S. BHCs, it is clear that neither exposures to the United States nor exposures to its agencies and instrumentalities are subject to the exposures limits, since none of the foregoing appear in the definition of "counterparty."<sup>166</sup> We therefore recommend that the final SCCL rule expressly exempt exposures to the foreign banking organization's home country sovereign entity and all of its agencies and instrumentalities.

**4. The calculation of on-balance-sheet foreign exposures should be clarified to exclude exposures to both the foreign bank parent and the foreign bank parent's home country sovereign.**

The Associations recommend that the final SCCL rule expressly set out the methodology for calculating on-balance-sheet foreign exposures for purposes of determining the set of SCCL compliance requirements the FBO would be subject to, which currently is described only in the memorandum issued in connection with the Reproposal.<sup>167</sup> The Staff Memo explains that the calculation of such exposures

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<sup>163</sup> Section 252.177(a)(4).

<sup>164</sup> *Id.*

<sup>165</sup> 81 Fed. Reg. at 14,347.

<sup>166</sup> *See* Section 252.71(e).

<sup>167</sup> Memorandum from Governor Tarullo to the Board of Governors, Proposed rules to implement single-counterparty credit limits in section 165(e) of the Dodd-Frank Act (the "Staff Memo") (Feb. 26, 2016), available at <http://www.federalreserve.gov/aboutthefed/boardmeetings/sccl-board-memo-20160304.pdf>.

“exclude[s] exposure 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.”<sup>168</sup> This approach is appropriate because it properly reflects that the calculation of foreign exposures is in relation to exposures of the combined U.S. operations and should be set forth in the text of the final SCCL rule.

## **B. Counterparty Issues**

### **1. The final SCCL rule should codify the Federal Reserve’s stated intention to apply the attribution rule only to prevent evasion with an exclusion for ordinary course transactions.**

Section 252.73(c) of the Reproposal imposes the statutory “attribution rule” and requires a covered company to treat any credit transaction with any person as a credit transaction with a counterparty, to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that counterparty. We appreciate the Federal Reserve’s stated intention to avoid interpreting the rule in a manner that would impose an undue burden, such as by requiring firms to monitor and trace proceeds of transactions made in the ordinary course of business.<sup>169</sup> However, that intention is expressed only in the Preamble, which, over time, may not be read together with the final SCCL rule. In addition, the preamble to the 2011 Proposal provided an example of a covered company making a loan to a counterparty that in turn used the loan to purchase goods from a third party as the type of transaction that should not be subject to the attribution rule.<sup>170</sup> The Federal Reserve stated that since the proceeds of the loan with the counterparty are “used for the benefit of, or transferred to, the third party” the attribution rule could be read to mean the covered company has a credit exposure to the third party, but the Federal Reserve recognized the “difficulty in monitoring such transactions and the limited value in tracking such money flows” for purposes of the SCCL.<sup>171</sup> To provide covered companies with greater certainty, we recommend the Federal Reserve codify both its intended scope of the attribution rule and an exception for goods purchased in ordinary course transactions in the final SCCL rule.

The statutory attribution rule has the potential to be read quite broadly. As noted in the preamble to the 2011 Proposal, an overly broad interpretation of the attribution rule would “lead to inappropriate results and would create a daunting tracking exercise.”<sup>172</sup> As covered companies design their compliance systems, it is important that they know the extent of the tracking exercise they need to undertake. Incorporation of an explicit exception for certain ordinary course transactions would be consistent with the approach

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<sup>168</sup> *Id.* at 10 n.10.

<sup>169</sup> 81 Fed. Reg. at 14,337.

<sup>170</sup> Federal Reserve System, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 Fed. Reg., 594, 618 (Jan. 5, 2012).

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

in the OCC lending limits. Under the “direct benefit” in 12 C.F.R. § 32.5(b), which states that a direct benefit exists when either the proceeds of an extension of credit or assets purchased with the proceeds are transferred to another person, specifically excludes proceeds transferred “in a bona fide arm’s length transaction where the proceeds are used to acquire property, goods, or services.” There is a similar exception to the “tangible-economic-benefit rule” in Regulation O for proceeds of an extension of credit that are used “in a bona fide transaction to acquire property, goods, or services from the insider.”<sup>173</sup> These exceptions in analogous or similar contexts reflect an appropriate cost-benefit analysis, which is consistent with the statements in the Preamble.

Indeed, the mere fact that loan proceeds are used to acquire goods does not evidence the degree of economic interdependence that the SCCL is meant to capture, and ordinary course transactions by their very nature should not give rise to anti-evasion concerns. Furthermore, any minimal risk reduction benefit that might stem from such monitoring would be substantially outweighed by the costs associated with such operationally intensive efforts.

## **2. The final SCCL rule should clarify that exposures to Federal Home Loan Banks (“FHLB”) are exempt exposures.**

The Associations recommend that the final SCCL rules expressly provide that a covered company’s exposures to a FHLB are exempt, in addition to the exemption for FHLBs from the definition of “covered company.”<sup>174</sup> The Preamble states that “Section 252.77(b) of the Reproposal would implement section 165(e)(6) of the Dodd-Frank Act, which provides a statutory exemption for credit exposures to the Federal Home Loan Banks.”<sup>175</sup> Similarly, the Staff Memo regarding the Reproposal explains that “. . . the draft proposed rules would include an exemption for exposures to . . . the Federal Home Loan Banks . . . .” The text of Section 252.77(b), however, states only that “For purposes of this subpart, a *covered company* does not include any Federal Home Loan Bank.” (emphasis added).

We support the expansion of the exemption in the 2011 Proposal relating to FHLBs to include an exemption to exposures to a FHLB. First, the language of Dodd-Frank Section 165(e)(6) supports a broad exclusion of FHLBs from the SCCL regime, providing that “[t]his subsection shall not apply to any Federal home loan bank.” This language strongly suggests that the intent was to carve out FHLBs entirely from the SCCL framework, which appears to reflect a Congressional judgment that the significant role that the FHLBs play in housing markets merits an exception to counterparty limits that would effectively constrain that role.<sup>176</sup> Thus, while bank exposures to FHLBs carry

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<sup>173</sup> 12 C.F.R. § 215.3(f)(2).

<sup>174</sup> See Section 252.77(b).

<sup>175</sup> 81 Fed. Reg. at 14,344.

<sup>176</sup> Office of the Comptroller of the Currency: Community Affairs, Fact Sheet: Federal Home Loan Bank Programs for Community Investments (Nov. 2015), available at <http://www.occ.treas.gov/topics/community-affairs/publications/fact-sheets/fact-sheet-fed-home-loan.pdf>.

risk, Congress could reasonably have concluded that the public policy benefits of FHLB funding outweigh that counterparty risk.

In light of the important role of FHLBs in the housing markets and more broadly, it is important that FHLBs be excluded from the SCCL framework completely—as covered companies or as counterparties. Accordingly, we support the exemptions reflected in the rule text and in the Preamble and Staff Memo.

### **3. Identification of Major Counterparties.**

If the concept of “major counterparty” included in the Reproposal is retained in the final SCCL rule, the determination of which entities are “major” should be made by reference to the annual FSB report listing GSIBs identified by the Basel Committee.<sup>177</sup> In addition to increasing harmony with the Basel Committee approach, it would also allow reliance on and integration with pre-existing data sources.

#### **C. Exposure Calculation Issues**

##### **1. The definition of “eligible collateral” should be expanded to conform to the definition of “financial collateral” under the risk-based capital rules.**

The Reproposal restricts the definition of “eligible collateral” to that in which the covered company has a perfected, first priority security interest or legal equivalent thereof and is in the form of (1) cash on deposit with the covered company (including cash held by a third-party custodian or trustee), (2) debt securities (other than mortgage- or asset-backed securities and resecuritization securities, unless those securities are issued by a U.S. government-sponsored enterprise) that are bank-eligible investments and that are investment grade, (3) equity securities that are publicly traded or (4) convertible bonds that are publicly traded. However, this definition of “eligible collateral” is narrower in scope than the definition of financial collateral under the risk-based capital rules.<sup>178</sup> Specifically, financial collateral also encompasses: (1) gold bullion, (2) any long- or short-term debt securities that are not resecuritization exposures and that are investment grade (including mortgage- or asset-backed securities, regardless of the issuer) and (3) money market fund shares and other mutual fund shares if a price of such shares is publicly quoted daily.<sup>179</sup> This difference in scope raises several important issues.

- First, this approach is inconsistent with the Basel Committee’s Large Exposure Framework which includes in its concept of eligible credit risk mitigation any financial collateral qualifying as eligible financial collateral

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<sup>177</sup> Basel Committee on Banking Supervision, *Supervisory Framework for Measuring and Controlling Large Exposures*, at ¶ 90 (Apr. 2014), available at <http://www.bis.org/publ/bcbs283.pdf>.

<sup>178</sup> Section 252.71(k).

<sup>179</sup> 12 C.F.R. § 217.2.

under the standardized approach for risk-based capital requirement purposes.<sup>180</sup> As such, the more restrictive definition in the Reproposal creates concerns regarding competitive equity.

- Second, the existing exposure reporting systems at covered companies were developed and put into operation for regulatory capital purposes are coded to identify “financial collateral”, new programs and systems would be required to distinguish efficiently between “eligible collateral” and “financial collateral” in a manner consistent with the compliance and reporting obligations of the Reproposal. The benefit in the form of reduced risk is unclear as the excluded forms of collateral do not appear to present significant risks and presumably have already been thoroughly vetted by prudential regulators in the risk-based capital context, yet the costs to modify such programs and systems would be substantial.
- Third, any concerns that may exist regarding value retention for certain collateral types as a result of fire sale risk would be more appropriately managed through additional volatility haircuts instead of removing from the scope of Eligible collateral altogether.
- Finally, existing capital reporting requirements, such as FR Y-15,<sup>181</sup> already require banks to report collateral data using the “financial collateral” definition.

Consequently, we recommend that the Federal Reserve conform the definition of “eligible collateral” to the definition of “financial collateral” to minimize inconsistencies across jurisdictions and expenses of adapting existing systems and reporting mechanisms that would likely outweigh any potential reduction of risk.

In addition, the final SCCL rule should clarify that the reference in the definition of “eligible collateral” to “cash on deposit” would include any combination of foreign currency and U.S. dollars held inside or outside the United States. This clarification is important because, for among other reasons, it is not uncommon for customer counterparties outside the United States to purchase derivatives from a U.S. banking organization for which the collateral supporting the transaction is held in the local currency in a deposit account at a third-party custodian outside the United States. As drafted, the Reproposal could be interpreted to require cash on deposit in U.S. dollars and/or in the United States and exclude cash collateral in U.S. dollars or foreign currency held outside the United States.

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<sup>180</sup> Basel Committee on Banking Supervision, *Supervisory Framework for Measuring and Controlling Large Exposures*, at ¶ 36 (April 2014), available at <http://www.bis.org/publ/bcb283.pdf>.

<sup>181</sup> Board of Governors of the Federal Reserve System, Reporting form FR Y-15, available at <https://www.federalreserve.gov/apps/reportforms/reportdetail.aspx?sOoYJ+5BzDaRHakir9P9vg==>.

**2. The final SCCL rule should give equal treatment to all collateral posted to a counterparty that is held in a segregated account at a third-party custodian.**

The Preamble states that the amount of initial margin and excess variation margin posted to a bilateral or central counterparty for cleared or uncleared derivative transactions would be treated as credit exposure to the counterparty unless such margin is held in a segregated account at a third-party custodian.<sup>182</sup> However, the Reproposal does not expressly extend this treatment to other transaction types for which collateral is similarly posted to counterparties and held in segregated accounts at third-party custodians.

We agree that initial margin and excess variation margin that a covered company pledges to a counterparty to a cleared or uncleared derivative transaction that is held in a segregated account at a third-party custodian should not be treated as a credit exposure of the covered company to the counterparty. We do not see, however, why this principle should be limited to collateral pledged in connection with *derivative* transactions. Rather, we urge the Federal Reserve to extend this principle to all transactions in which a covered company has pledged collateral to a counterparty and such collateral is held in a segregated account at a third-party custodian, at least so long as the covered company's rights in the transaction in the event of the counterparty's default or bankruptcy are comparable to those that the covered company would have in a derivative transaction. For example, where a covered company pledges collateral to a counterparty under a transaction that satisfies the definitional and operational requirements of a "repo-style transaction" under Regulation Q, the risks to the counterparty that a covered company is exposed to with respect to such collateral are no greater than the risks a covered company would be exposed to in a derivative transaction with that counterparty. Consequently, any collateral pledged by a covered company to a counterparty, that is in excess of the value of securities or cash received by the covered company from the counterparty, that is held in a segregated account at a third-party custodian should not be treated as a credit exposure of the covered company to the counterparty.

We also note that the Preamble language regarding the treatment of initial margin and variation margin discussed above is not included in the rule text and recommend its inclusion in the final SCCL rule. Similarly, footnote 87 in the Preamble states that "As initial margin and excess variation margin posted to the QCCP and held in a segregated account by a third party custodian are not subject to counterparty risk, these amounts would not be considered credit exposures under the proposed rule."<sup>183</sup> We also urge the Federal Reserve to codify this provision in the final SCCL rule.

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<sup>182</sup> "With respect to cleared and uncleared derivatives, the amount of initial margin and excess variation margin (*i.e.*, variation margin in excess of that needed to secure the mark-to-market value of a derivative) posted to a bilateral or central counterparty would be treated as credit exposure to the counterparty unless the margin is held in a segregated account at a third party custodian." 81 Fed. Reg. at 14,337.

<sup>183</sup> 81 Fed. Reg. at 14,344.

**3. Covered companies should be permitted to exclude any credit exposures to a counterparty deducted from Tier 1 capital as credit exposures for SCCL purposes.**

Under the risk-based capital rules, certain items are required to be fully deducted from common equity tier 1 capital, including certain investments in another financial institution's capital instruments. Additionally, banks must consider threshold deductions for, among other things, significant investments in another unconsolidated financial institution's common stock. Generally, banks must deduct the amount of exposure to these types of assets, by category, that exceeds 10 percent of a base common equity tier 1 capital calculation.<sup>184</sup> By including these deducted exposures in a covered company's gross credit exposure to a given counterparty under the SCCL, the Reproposal fails to recognize that the covered company's regulatory capital considered available to absorb losses—the measure against which its applicable credit limits are measured—has already been reduced by the amount of such exposures. We urge the Federal Reserve to permit a covered company to exclude these deducted exposures from the calculation of its gross credit exposures to the relevant counterparty. This approach would be consistent with the Basel Large Exposure Framework, which provides specifically that an exposure to a counterparty that is deducted from capital generally must *not* be added to other exposures to that counterparty for the purpose of the large exposure limit.

**4. Covered companies should be permitted to net exposures against specific ALLL and thereby recognize that capital has already been designated to absorb losses.**

U.S. GAAP accounting standards and related supervisory policies of the Federal bank regulators<sup>185</sup> require banking organizations to make adequate provision or allowance for loan and lease losses (“ALLL”). The purpose of the ALLL is to reflect estimated credit losses within a bank's portfolio of loans and leases and is presented on the balance sheet as a contra-asset account that reduces the amount of the loan portfolio reported on the balance sheet. The “general” ALLL is an estimate of expected credit losses within the entire portfolio based on historical analysis, while “specific” ALLL is provisioned with respect to a specific counterparty. Because the specific ALLL provision reflects a balance sheet reduction of the value of the asset that has been set aside to absorb expected credit losses for a specific counterparty, the final SCCL rules should permit a covered company to reduce its exposure to that same counterparty by the amount of the specific provisions. This treatment would align with the treatment of an exposure to a counterparty under the Basel Large Exposure Framework, which provides specifically in

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<sup>184</sup> 12 C.F.R. § 217.22. In addition, there is a 15 percent aggregate limit on these three threshold deduction items—the amounts of threshold items not deducted will be assigned a 250 percent risk weight.

<sup>185</sup> See, e.g., Federal Reserve, Bank Holding Company Supervision Manual, Section 2065, available at [http://www.federalreserve.gov/boarddocs/supmanual/supervision\\_bhc.htm](http://www.federalreserve.gov/boarddocs/supmanual/supervision_bhc.htm).

defining exposures as “the accounting value of the exposure” that accounting value is “net of specific provisions.”<sup>186</sup>

**5. Eligible margin loans should not be subject to the risk-shifting requirement.**

The risk-shifting framework in the Reproposal requires that any reduction in the exposure amount to the original counterparty as a result of eligible collateral be accompanied by a dollar-for-dollar increase in exposure to the eligible collateral issuer. This “risk-shifting” to the eligible collateral issuer would introduce a significant and unnecessary operational burden with respect to margin lending accounts, as it would require a covered company to identify each collateral issuer and shift individually relatively small dollar amounts of such exposures to each such collateral issuer for each of these small exposures. Margin loans are typically extended on the basis of the collateral pool in the account and not on the basis of specific collateral, so implementation of this requirement would require the development of new systems to “match” collateral solely for this purpose.

The Federal Reserve’s criteria for eligible margin loans under the risk-based capital rules<sup>187</sup> are designed to ensure an institution’s ability to liquidate a given position within one day, which mitigates significantly the counterparty credit risks the Reproposal aims to limit and thus obviate the need to include such exposures in the risk-shifting framework applicable to such limits. To qualify as an eligible margin loan, an extension of credit must be (i) collateralized exclusively by liquid and readily marketable debt or equity securities, or gold, (ii) marked-to-fair value daily and subject to daily margin maintenance requirements, and (iii) conducted under an agreement that provides the institution the right to accelerate and terminate the extension of credit and to liquidate or set-off collateral promptly upon an event of default.<sup>188</sup> In addition, an institution must conduct a “conduct sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that the agreement underlying the exposure” meets these requirements and is legal, valid, binding and enforceable.<sup>189</sup>

Given the stringent eligibility requirements for “eligible margin loans”, the small dollar amounts involved, and the typically very broad pool of underlying collateral, we respectfully request the Federal Reserve to exclude such exposures from the risk-shift requirement. Relying on existing regulatory safeguards in this context would avoid imposing additional operational burden on covered companies to develop systems to match collateral in a margin loan account with particular loans even though the risk of developing undue concentrations of risk is remote.

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<sup>186</sup> Basel Large Exposure Framework, ¶ 32.

<sup>187</sup> 12 C.F.R. § 217.2.

<sup>188</sup> 12 C.F.R. §§ 217.2; 217.3(b).

<sup>189</sup> 12 C.F.R. § 217.3(b).

**6. Initial and variation margin posted by a protection provider should reduce the amount of the risk-shift where such margin is in a form exempt from the SCCL.**

Under Section 252.73(a)(11) of the Reproposal, a covered company that is required to recognize exposure to an eligible protection provider under 252.74(e) must exclude that transaction with the protection provider for purposes of calculating its gross exposures. Section 252.74(e) then imposes a risk-shift requirement by requiring a reduction in gross credit exposure by the notional amount of any eligible credit or equity derivative from a protection provider. However, the Reproposal does not explicitly address whether the risk-shift should account for any eligible collateral posted by the protection provider, such as in the form of initial or variation margin, as would generally be required for eligible collateral received under Section 252.74(c).

The final SCCL rule should clarify this ambiguity by amending Section 252.74(e) to expressly permit a reduction in the exposure to the protection provider by the value of any collateral received, provided such collateral is in a form exempt from the SCCL.<sup>190</sup> This approach would be consistent with the SCCL's general risk-shift requirement as it would be illogical to permit a reduction of exposure based on collateral received in one context but not in another, particularly if the collateral is posted by the same counterparty. Furthermore, a limitation to encompass only collateral that is exempt from the SCCL is appropriate to minimize the complexity of the framework by reducing the "orders" of risk-shifting. For example, if non-exempt collateral were used to reduce the exposures, this would create a "second order" of risk-shifting: first from the initial gross exposure to the eligible protection provider, then again from the eligible protection provider to the issuer of the collateral received. In practice, most initial and variation margin posted would be in the form of instruments exempt from the SCCL, such as cash or U.S. government securities, so contemplating further risk-shifting would unnecessarily increase the complexity of the framework.

**7. The use of tier 1 capital as the eligible capital base for Large Covered Companies is inconsistent with the mandate of Section 165(e) of Dodd-Frank.**

Section 165(e) of Dodd-Frank directs the Federal Reserve to issue regulations that prohibit covered companies "from having credit exposure to any unaffiliated company that exceeds 25 percent of the capital stock and surplus (or such *lower* amount as the Board of Governors may determine by regulation to be necessary to mitigate risks to the financial stability of the United States) of the company." The term "capital and surplus" is commonly used as the basis of quantitative limits in U.S. banking law statutes. The

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<sup>190</sup> As proposed, such collateral would include: cash, U.S. government securities, securities of a sovereign receiving a zero percent risk weight, direct claims on and the portions of claims directly and fully guaranteed as to principal and interest by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation while operating under the conservatorship or receivership of the Federal Housing Finance Agency, or any other exemption the Federal Reserve determines is applicable. Section 252.77.

term is used in Section 23A of the Federal Reserve Act,<sup>191</sup> implemented by Regulation W,<sup>192</sup> and Section 22(h) of the Federal Reserve Act,<sup>193</sup> implemented by Regulation O,<sup>194</sup> each of which has been interpreted consistently by the Federal Reserve over the years.<sup>195</sup> In both instances, capital stock and surplus is defined in the implementing regulation to include both tier 1 and tier 2 capital. When Congress used the term “capital and surplus” as the basis of the quantitative single counterparty credit limit to be established in accordance with Section 165(e), it did so in the context of this long history. In this context, the statutory authority to *lower* the amount of the permissible credit exposure simply cannot be read as permission to change the eligible capital base. We recognize that in proposing tier 1 capital as the eligible capital base for Large Covered Companies, the Federal Reserve likely is seeking to align the SCCL with the Basel Large Exposure Framework. In general, and as noted throughout this letter, we generally support alignment with that Framework where possible to promote international consistency. In this case, however, the statutory mandate cannot accommodate the approach in the Basel Large Exposure Framework, and Congressional intent should not be bent to do so.

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<sup>191</sup> 12 U.S.C. § 371c.

<sup>192</sup> “Capital stock and surplus” means the sum of: (1) A member *bank’s tier 1 and tier 2 capital* under the risk-based capital guidelines of the appropriate Federal banking agency ... ; (2) The balance of a member bank’s allowance for loan and lease losses not included in its tier 2 capital under the risk-based capital guidelines of the appropriate Federal banking agency ... ; and (3) The amount of any investment by a member bank in a financial subsidiary that counts as a covered transaction and is required to be deducted from the member bank’s capital for regulatory capital purposes. 12 C.F.R. § 223.3(d) [emphasis added].

<sup>193</sup> In general a member bank may extend credit to any executive officer, director, or principal shareholder, or to any related interest of such a person, if the extension of credit is in an amount that, when aggregated with the amount of all outstanding extensions of credit by that bank to its executive officers, directors, principal shareholders, and those persons’ related interests *would not exceed the bank’s unimpaired capital and unimpaired surplus*. 12 U.S.C. § 375b(5).

<sup>194</sup> A member bank’s unimpaired capital and unimpaired surplus equals: (1) The *bank’s Tier 1 and Tier 2 capital* included in the bank’s risk-based capital under the capital guidelines of the appropriate Federal banking agency, based on the bank’s most recent consolidated report of condition ...; and (2) The balance of the bank’s allowance for loan and lease losses not included in the bank’s Tier 2 capital for purposes of the calculation of risk-based capital by the appropriate Federal banking agency, based on the bank’s most recent consolidated report of condition .... 12 C.F.R. § 215.2(i) [emphasis added].

<sup>195</sup> Similarly, the OCC’s national bank lending limits similarly define “capital and surplus” as “(1) [a] national bank’s or savings association’s *Tier 1 and Tier 2 capital* calculated under the *risk-based capital standards* applicable to the institution ...; plus (2) [t]he balance of a national bank’s or savings association’s allowance for loan and lease losses not included in the bank’s or savings association’s Tier 2 capital, for purposes of the calculation of risk-based capital described in paragraph (c)(1) of this section ...”.

## **D. Compliance and Monitoring Issues**

### **1. A covered company's compliance report should include only exposures that exceed at least 5 percent of its eligible capital base or that rank within its top 20 exposures.**

As the Federal Reserve develops reporting requirements, we urge the Federal Reserve to adopt a risk-based reporting framework as contemplated by the Basel Large Exposure Framework.<sup>196</sup> Specifically, we recommend that the reporting regime requirements be limited to the following:

- All exposures equal to or above 10 percent of a covered company's eligible capital base (although a lower 5 percent of a covered company's eligible capital base threshold may be appropriate, consistent with the "*de minimis*" approach we have recommended for purposes of aggregating certain types of exposures).<sup>197</sup>
- The 20 largest exposures to counterparties, irrespective of the value of such exposures relative to the covered company's eligible capital base.

This approach to reporting would focus on exposures that represent the most significant potential risks to a covered company that Section 165(e) is meant to capture and would also provide the Federal Reserve with only the most important linkages to monitor for systemic risk. A risk-based approach also is important to ensure accuracy. While components of the reporting process would be automated, covered companies would still need to engage in significant manual reviews and quality control checks of the output. The more granular the reporting form, the more resources have to be allocated to support the reporting function that could be better deployed elsewhere.

### **2. The final SCCL rules should clarify that daily compliance is based on the most recent information with respect to counterparties that is available to a covered company, consistent with the covered company's risk management processes.**

The Reproposal would require Large Covered Companies to be in compliance with the SCCL on a daily basis and demonstrate that compliance in monthly reports.<sup>198</sup> All other covered companies would be required to be in compliance on a quarterly basis

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<sup>196</sup> We would also request the Federal Reserve apply universal confidential treatment of any SCCL reports received from covered companies. Disclosure of such data could raise a host of issues, including client confidentiality concerns, potential competitive disadvantages and adverse market effects.

<sup>197</sup> See Parts II.B.2, II.F and II.I of this letter for additional detail on our proposed application of a threshold of 5 percent of the covered company's eligible capital base for the purposes of aggregating certain exposures.

<sup>198</sup> Section 252.78(a).

but “would need to have systems in place that would allow them to calculate compliance on a daily basis.”<sup>199</sup> The Reproposal does not include guidance, however, on whether the daily compliance requirement means that counterparty information must be current on a daily basis.

We assume that the daily compliance requirement is focused on ensuring that a covered company is in compliance with SCCL based on the most recent information available to it. As discussed throughout this letter, much of the information required to perform the proposed aggregation analyses simply is not available to a covered company on a real-time or automatic basis, and in many cases the information is not public.<sup>200</sup> In addition, it is not just a question of collecting the necessary information. Application of aggregation requirements to counterparty relationships necessarily will involve judgment-based determinations that simply cannot be done on a continuous basis, nor would there be sufficient risk-mitigation benefit to requiring it. Just as a covered company’s eligible capital base is determined as of the most recent quarter<sup>201</sup> rather than on a continuously updated basis, the exposures included in the calculation should be based on the covered company’s most recent information on its counterparties. We expect that most covered companies as part of their regular risk management process at a minimum collect the information relevant to the determination of counterparty scope when the counterparty is onboarded, annually, and on the occurrence of a significant event that triggers notice to the covered company under its agreement(s) with the counterparty or that the covered company otherwise is aware of. If a covered company’s supervisor considers the covered company’s framework sufficient for risk management purposes, we do not see a compelling benefit from requiring more frequent updates to the available information.

**3. A cure period should be available in a wider array of circumstances and the scope of permitted activities while in breach should be more risk-sensitive. Short-dated exposures resulting from PCS activities should be exempted and transition periods should be introduced for changes in counterparty status.**

Under the Reproposal, a covered company in breach of an exposure limit would not be subject to enforcement action for a 90 day period if it used reasonable efforts to return to compliance and the breach was solely due to: (i) a decrease in the covered

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<sup>199</sup> 81 Fed. Reg. at 14,344.

<sup>200</sup> See Parts II.B.1, II.D.

<sup>201</sup> We also request the Federal Reserve clarify that reference to “tier 1 capital” is based on a Large Covered Company’s most recent FR Y-9C filing. The Reproposal defines “Capital stock and surplus” as “the sum of the following amounts in each case as reported by the bank holding company on the most recent FR Y-9C report. . .” yet the definition of “tier 1 capital” for Large Covered Companies does not reference the most recent FR Y-9C as the basis for determining a Large Covered Company’s tier 1 capital. Section 252.71. The approach for “capital stock and surplus” in the Reproposal mirrors the requirement in the OCC lending limits, which generally permit banks to use the measure of capital as of the last day of the preceding quarter. 12 C.F.R. § 32.4(a)(1).

company's capital stock and surplus, (ii) the merger of the covered company with another covered company, (iii) a merger of two unaffiliated counterparties, or (iv) any other circumstance the Federal Reserve determines is appropriate.<sup>202</sup> A covered company would be prohibited from engaging in additional credit transactions with the counterparty absent a determination by the Federal Reserve that such credit transactions are necessary or appropriate to preserve the safety and soundness of the covered company or U.S. financial stability.<sup>203</sup>

Although a useful start, this approach is insufficient because it does not make allowances for the full range of circumstances where the cause of the breach is beyond a covered company's control and would not be expected to pose systemic risk (because, for example, it would be of short duration). The approach also does not provide any relief for the friction inherent in securities markets, such as operational failures that may occur during the trade settlement process. Immediately cutting off additional exposure between a covered company and a counterparty could be extraordinarily disruptive to the functioning of securities markets, particularly if a breach were between two major dealers that routinely transact with one another in the ordinary course in a variety of markets, products and customer bases. Indeed, it is highly likely that the application of the approach outlined in the Reproposal in the event of such a breach would negatively impact the ability of the impacted company to clear trades, manage liquidity or properly hedge market exposures. When considered together with the daily compliance requirement, the limited scope of the cure period also fails to account for basic implementation mechanics, such as the time necessary to properly communicate the prohibition on additional credit transactions to affected clients, employees and trading counterparties. As a result, markets will operate under the shadow of potential turmoil should a breach occur and covered companies may impose what would otherwise be unnecessarily conservative internal buffers in an effort to avoid such conflicts.

Finally, the Reproposal does not include automatic transition periods to accommodate a change in a counterparty's status from exempt to non-exempt exposure.

**a. Broader Cure Periods That Automatically Allow for Ordinary Course Activity are Critical to Proper Market Functioning.**

We urge the Federal Reserve to broaden the proposed cure period as follows:

- General Cure Period. The final SCCL rule should broaden the specific scenarios set forth in Section 252.78 to apply to any breach that is beyond the covered company's control and that a covered company reasonably believes it can remediate within a 90 day period. The covered company would be required to report the breach to the Federal Reserve immediately and submit a plan for returning to compliance, but should be permitted to continue to

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<sup>202</sup> Section 252.78(c).

<sup>203</sup> *Id.*

engage in ordinary course transactions with the relevant counterparty without a requirement to obtain pre-approval from the Federal Reserve during the cure period. This standard would balance the need to incentivize covered companies to monitor exposures appropriately while avoiding abrupt and unnecessary disruptions to markets, particularly between major dealers facing breaches of a temporary nature. Any safety and soundness concerns would be mitigated by prudential supervision and monitoring following reporting of the breach by the covered company, supplemented by a covered company's internal policies and procedures. This exemption would therefore serve as a more risk-sensitive and practical approach to dealing with SCCL breaches.

- Cure Period for Breach of Inter-GSIB Limit. Although we continue to believe the lower limit for transactions between major covered companies and major counterparties is inappropriate, as discussed in Part IV, if the Federal Reserve maintains it in the final SCCL rule, exceeding the limit should not constitute an automatic breach.
  - If a breach relates to a major counterparty subject to the 15 percent of tier 1 capital limit but the aggregate exposure to the counterparty is less than the 25 percent of tier 1 capital limit, a covered company should be able to continue transactions in the ordinary course with the major counterparty. This approach would avoid significant market disruptions given the prominent role that GSIBs have in financial markets. For example, if two major dealers were immediately prohibited from transacting with one another, major market dislocations could result due to a significant volume of trade novation requests or a disruption in the flow of market making activities. Even under this more operationally practical and sound standard, the covered company would still need to use reasonable efforts to resolve the breach within the 90 day period. Providing such an exemption would appropriately leverage the differential between the GSIB and non-major counterparty thresholds in a balanced, risk-sensitive manner.

**b. If the Cure Period Provisions are not Broadened as Recommended, a More Limited Cure Period for PCS-Related Exposures is Necessary.**

At a minimum, the final SCCL rule needs to take into account the practical realities of the operations of covered companies in financial markets by carving out short-term exposures related to the provision of payment, clearing and settlement services. Specifically, we recommend an exemption that mirrors the European Union's Capital Requirements Directive ("EU CRD") by granting an exemption for very short-term PCS-related exposures. Under the EU CRD the following PCS-related exemption periods apply:

- In the case of foreign exchange transactions, exposures during the two working days following payment;
- In the case of transactions for the purchase or sale of securities exposures incurred in the ordinary course of settlement during the five working days following payment or delivery of the securities (whichever is earlier);<sup>204</sup> and
- In the case of the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking or financial instruments clearing, settlement and custody services to clients, delayed receipts in funding and other exposures arising from client activity which do not last longer than the following business day.<sup>205</sup>

Such exemptions appropriately recognize the friction inherent in settlement functions that are typically resolved over a very short period of time and thus generally should not be considered part of a covered company's counterparty exposures. In addition, covered companies already have in place internal systems and policies designed to monitor and escalate these types of operational failures in order to mitigate the risk that they persist longer than anticipated. Accordingly, PCS exposures should not contribute to a covered company's credit limit unless and until they have persisted beyond the time periods enumerated in the EU CRD. Not only would this ensure globally consistent regulatory treatment, but it would also remove a potentially volatile component from the SCCL. Such an approach would allow covered companies to focus risk management efforts on exposures of a less transitory nature and provide the Federal Reserve with a more meaningful view into systemic risk.

### **c. Specific Transition Periods.**

We further recommend including appropriate transition periods in the event of changes in a counterparty's status as follows:

- Sovereign exposures, should a sovereign be downgraded by OECD and begin to attract a non-zero risk weight. Failure to provide such a transition period may lead to significant market disruption, particularly as a result of the risk-shifting requirements for collateral, such as for SFTs. Counterparties to SFT transactions will likely favor the use of exempt sovereign instruments to facilitate compliance with the SCCL. However, if an instrument loses its

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<sup>204</sup> Indeed, the Federal Reserve explicitly recognizes this fact in its recently proposed net stable funding ratio, under which it does not recognize trade date payables—established when a covered company buys financial instruments, foreign currencies, and commodities, but the transactions have not yet settled—as a source of stable funding, in recognition of the fact that settlement of these types of funding transactions “generally occur within five business days.” See Department of the Treasury: Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, *Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements*, 81 Fed. Reg. at 35,139 (Proposed 12 C.F.R. §249.104(e)(1)) (June 1, 2016).

<sup>205</sup> O.J. (L 575/2013) 176.

exemption many of these transactions would need to be re-collateralized with other securities in an operationally intensive process. Furthermore, other exposures unrelated to collateral, such as investments in sovereign debt, should be permitted to be rebalanced gradually over time to avoid downward pressure at a time when, presumably, there would already be significant price pressure on the instruments.

- QCCPs, should a CCP lose its QCCP status, making it no longer eligible for exemption. Shifting confirmed trades away from a CCP would be an operationally intensive process requiring collaboration with both the old and new CCPs as well as other clearing members. Such a process would have little precedent and could not be completed effectively in a compressed period of time.
- Exposures to Fannie Mae or Freddie Mac, should either institution no longer remain under the conservatorship or receivership by the U.S. government. If the exemption is to be phased-out in those circumstances, the final SCCL rule should provide a transition period (or a transition period should be established through a new and separate notice and comment rulemaking) to allow covered companies to address large exposures to such entities when conservatorship or receivership ends without being in breach of the SCCL. An appropriate transition period for these exposures would be critical to prevent severe market dislocation and a disruption to the flow of credit to the housing sector. At the end of 2015 Fannie Mae and Freddie Mac had over \$800 billion of debt outstanding,<sup>206</sup> a large percentage of which was held by commercial banks.<sup>207</sup> A drastic change in the status of this amount of debt for purposes of the SCCL would affect many covered companies, and the simultaneous unwinding of such a “crowded trade” could potentially cause a dramatic sell-off and indirectly impact the flow of credit to the housing sector. Furthermore, given that the current average trading volume for these securities is over \$2 billion a day,<sup>208</sup> liquidity concerns may also arise if covered companies making a market in the debt were forced to suddenly curtail their exposures over a short period of time. For these reasons the loss of an exemption for exposures to Fannie Mae and Freddie Mac would have a significant impact on covered companies and financial markets and would need to be appropriately addressed at the time. We would recommend that, at a minimum, existing

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<sup>206</sup> Securities Industry and Financial Markets Association, U.S. Agency Debt Outstanding, *available at* <http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/TA-US-Agency-Debt-Outstanding-SIFMA.xls?n=27870>.

<sup>207</sup> Board of Governors of the Federal Reserve System, Assets and Liabilities in the United States (Weekly) – H.8, *available at* <http://www.federalreserve.gov/releases/h8/current>.

<sup>208</sup> Securities Industry and Financial Markets Association, U.S. Agency Debt Outstanding, *available at* <http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/TA-US-Agency-Trading-Volume-SIFMA.xls?n=52781>.

portfolio holdings should be permitted to run off via contractually scheduled  
amortization of the underlying debt securities

\* \* \*

If the Federal Reserve would like additional information regarding these  
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## ANNEX A

The Clearing House. The Clearing House is a banking association and payments company that is owned by the largest commercial banks and dates back to 1853. The Clearing House Association L.L.C. is a nonpartisan organization that engages in research, analysis, advocacy and litigation focused on financial regulation that supports a safe, sound and competitive banking system. Its affiliate, The Clearing House Payments Company L.L.C., owns and operates core payments system infrastructure in the United States and is currently working to modernize that infrastructure by building a new, ubiquitous, real-time payment system. The Payments Company is the only private-sector ACH and wire operator in the United States, clearing and settling nearly \$2 trillion in U.S. dollar payments each day, representing half of all commercial ACH and wire volume.

The American Bankers Association. The American Bankers Association is the voice of the nation's \$16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard \$12 trillion in deposits and extend more than \$8 trillion in loans.

The Financial Services Roundtable. As advocates for a strong financial future™, FSR represents 100 integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. FSR member companies provide fuel for America's economic engine, accounting directly for \$98.4 trillion in managed assets, \$1.1 trillion in revenue, and 2.4 million jobs.

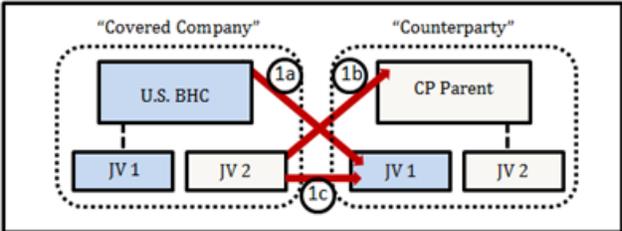
The Securities Industry & Financial Markets Association. SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$20 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

International Swaps and Derivatives Association. Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 67 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, clearing houses and repositories, as well as law firms, accounting firms and other service

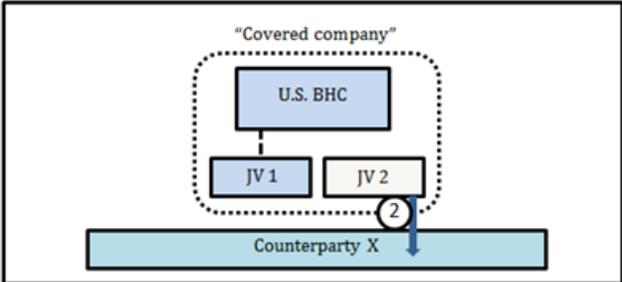
providers. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).

ANNEX B

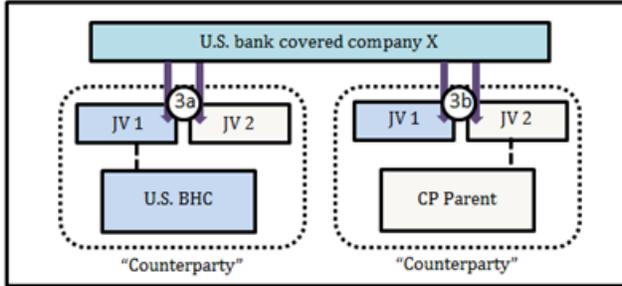
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# Morgan Stanley

June 3, 2016

Robert de V. Frierson  
Secretary  
Board of Governors of the Federal Reserve System  
20th Street and Constitution Avenue NW  
Washington, DC 20551

Re: **Single-Counterparty Credit Limits for Large Banking Organizations, Docket No. R-1534, RIN No. 7100 AE-48.**

Ladies and Gentlemen:

Morgan Stanley appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve System (the “**Board**”) in response to the Board’s notice of proposed rulemaking to implement single-counterparty credit limits (“**SCCL**”) for large U.S. banking organizations (the “**Proposed Rule**”).<sup>1</sup>

Morgan Stanley, a financial holding company supervised by the Board, provides its products and services to a large and diversified group of clients and customers around the world, including corporations, governments, financial institutions and individuals.

We support the adoption of a well-designed SCCL framework as a tool to prevent over-concentration of risk in financial markets. We adopt the recommendations made in the comment letter submitted by The Clearing House Association L.L.C., the American Bankers Association, The Financial Services Roundtable, the Securities Industry and Financial Markets Association, and the International Swaps and Derivatives Association (the “**Associations’ Letter**”) on the Proposed Rule.

Our comments in this letter focus on the treatment of joint ventures in the SCCL framework. Morgan Stanley operates in many markets—including in China, Japan and South Africa—through joint ventures, as do other institutions that would be subject to the Proposed Rule. Often this is because the law in a particular country limits the ownership interests that foreign investors may have in financial institutions in that country. Although the Proposed Rule does not discuss joint ventures, the expansive scope of the Proposed Rule would create many practical problems for normal course joint venture transactions, even where there are no underlying policy concerns with over-concentration of risk in financial markets. In this letter, we recommend modest approaches for tailoring the SCCL framework appropriately to accommodate joint venture structures, while still ensuring that credit limits are applied rigorously against all meaningful unaffiliated counterparty risks.

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<sup>1</sup> 81 Fed. Reg. 14,328 (Mar. 16, 2016).

## 1. Summary of the issue

The Proposed Rule is grounded in two key definitions: “covered company” and “counterparty.” Each covered company—generally speaking, a large U.S. bank holding company—must apply the SCCL framework to limit its credit exposures to any unaffiliated counterparty, which may include other financial institutions, corporate groups, and certain governmental entities.

When determining the scope of covered companies and counterparties, the Proposed Rule includes any other person in which the covered company or counterparty, respectively, owns, controls, or has power to vote 25 percent or more of a class of voting securities of such person.<sup>2</sup> As a result, in a joint venture structure, an entity may be deemed to be part of *both* the covered company and the covered company’s unaffiliated counterparty, if each has at least a 25 percent voting interest in the entity.

By applying a 25 percent voting interest consolidation standard, the Proposed Rule creates three categories of problems for joint ventures. First, a joint venture entity may be simultaneously included in both the “covered company” and the “counterparty” consolidation groups. As a result, the covered company may be forced to treat its inter-affiliate exposures to such entity as exposures to an unaffiliated counterparty group, even where the covered company consolidates and risk manages the entity. Alternatively, when the joint venture partner consolidates and risk manages the entity, the covered company may nonetheless be required to treat the entity as part of its own covered company. In this scenario, the joint venture entity’s inter-affiliate exposures to its own consolidating parent company, and potentially even the entity’s exposures to the covered company’s consolidated subsidiaries, would be deemed credit exposures of the covered company.

Second, the 25 percent voting interest standard requires that the covered company consolidate the external-facing credit exposures of a joint venture entity, even when the covered company has no operational control over the entity and no responsibility for supporting the capital of the entity.

Third, large U.S. bank holding companies that are covered companies under the rule would be required to treat the joint venture entity as simultaneously part of two separate counterparty consolidation groups, even when credit exposures to the joint venture entity have no bearing on credit risk to the non-consolidating joint venture partner.

## 2. Recommended solutions

The Proposed Rule does not discuss joint ventures, and we believe that the issues identified in Part 1 of this letter can be addressed through modest revisions to the SCCL framework that promote the Board’s underlying policy concerns.

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<sup>2</sup> See 12 C.F.R. § 252.171(e)(2)(i) (proposed) (definition of “counterparty”); 12 C.F.R. § 252.171(f) (proposed) (definition of “covered company,” which incorporates the 25 percent voting interest standard through cross-references).

***a. Financial reporting consolidation standard***

The most direct resolution of the joint venture issues would be to adopt financial reporting consolidation principles for determining the scope of the “covered company” and “counterparty.” This approach would be consistent with the large exposure framework of the Basel Committee on Banking Supervision, and would align the SCCL framework with risk management considerations.<sup>3</sup>

***b. Joint venture focus: comprehensive solution***

Alternatively, if the Board elected to maintain the “covered company” and “counterparty” definitions in the Proposed Rule, a clarification could be added to address the issues raised by joint ventures. This approach would resolve all the concerns noted in Part 1 through standards that would require aggregation of a joint venture entity with its consolidating parent company. To avoid arbitrage concerns, the approach we are suggesting would apply only in cases where the joint venture entity is itself a regulated entity subject to effective supervision. Illustrative language demonstrating this approach is included in Part II.C of the Associations’ Letter.

***c. Joint venture focus: inter-affiliate solution***

Finally, the Board could resolve the inter-affiliate issues in isolation and leave the remaining issues for resolution through case-by-case exemptive relief. This approach would address the most glaring operational problems created by the Proposed Rule while avoiding any significant structural changes to the SCCL framework. If the Board takes this approach, we respectfully request that it provide guidance in the final rulemaking describing the process for, and standards governing, exemptive relief requests submitted by covered companies pursuant to 12 C.F.R. § 252.77(c).

This approach could be implemented through a clarification that, for purposes of the SCCL framework, an “unaffiliated counterparty” excludes inter-affiliate exposures from or to a joint venture entity that is deemed to be part of the covered company or counterparty because of the 25 percent voting interest standard, as long as the covered company otherwise applies the SCCL framework to the non-inter-affiliate exposures of the entity. Illustrative language demonstrating this approach is included in Part II.C of the Associations’ Letter.

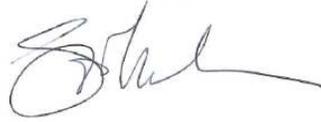
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<sup>3</sup> See Basel Committee on Banking Supervision, *Supervisory framework for measuring and controlling large exposures* (April 2014), ¶¶ 12, 22.

### 3. Conclusion

Morgan Stanley appreciates the opportunity to provide comments to the Agencies on the Proposed Rule. Please do not hesitate to contact us if you have any questions.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Soo-Mi Lee', with a long horizontal flourish extending to the right.

Soo-Mi Lee  
Managing Director