Chapman and Cutler LLP

Chapman Client Alert

April 22, 2016

Current Issues Relevant to Our Clients

Potential Impact of Proposed Federal Reserve Single Counterparty Credit Limits on Securitizations

On March 4, 2016 the Board of Governors of the Federal Reserve System (the *"Fed"*) issued a Notice of Proposed Rulemaking (*"NPR"*) re-proposing a rule that would establish credit limits for single counterparties of U.S. bank holding companies (*"U.S. BHCs"*), foreign banking organizations (*"FBOs"*), and U.S. intermediate holding companies of an FBO, with $50 billion or more of consolidated assets. The re-proposed rule contains specific provisions for determining counterparty limits for securitization vehicles, investment funds and other special purpose vehicles (collectively, *"SPVs"*).

Section 165(e) of the Dodd-Frank Act directs the Fed to promulgate rules requiring large U.S. BHCs and FBOs to limit their credit exposures to unaffiliated counterparties. The Fed originally proposed single counterparty credit limits for U.S. BHCs, FBOs and IHCs in December 2011 and December 2012. Those proposals also contained proposed provisions for determining counterparty limits for SPVs. These provisions were substantially different from the proposed treatment of SPVs in the re-proposal, which more closely tracks the Supervisory Framework for Measuring and Controlling Large Exposures (the *"BCBS Large Exposure Framework"*) issued by the Basel Committee on Banking Supervision (*"BCBS"*) in April 2014. The general provisions of the re-proposed rule have also been substantially modified to take into consideration the BCBS Large Exposure Framework, revised lending limits that apply to national banks, and industry comments.

The re-proposed rule contains requirements for aggregating related counterparties as a single counterparty and for determining the amount of an exposure that are beyond the scope of this alert.

Comments must be submitted on the re-proposed rule by June 3, 2016.

A copy of the re-proposed rule can be found here.

What banking organizations are covered by the re-proposed rules?

The re-proposed rule applies to the following entities with at least $50 billion of consolidated assets: (1) U.S. BHCs (that are not IHCs), (2) the combined U.S. operations of FBOs, and (3) IHCs (collectively, *"Covered Companies"*). Counterparty limits differ for three different tiers of banking organizations: Covered Companies that are not Large or Major Covered Companies, Large Covered Companies, and Major Covered Companies.

"Major Covered Companies" are (1) U.S. BHCs (other than IHCs) that are Globally Systemically Important BHCs (*"GSIBs"*) using the Fed's "method 1" framework for determining the GSIB capital surcharge, (2) FBOs with consolidated assets of $500 billion or more, and (3) IHCs with consolidated assets of $500 billion or more.

"Large Covered Companies" are Covered Companies of any type that are not Major Covered Companies with $250 billion or more of consolidated assets or $10 billion or more of on-balance sheet foreign exposures.[1]

What are the counterparty limits that apply to different categories of Covered Companies?

Major Covered Companies. For a Major Covered Company that is a U.S. BHC or IHC, the exposure limit is 15% of tier 1 capital for a Major Counterparty and 25% of tier 1 capital for all other counterparties. For a Major Covered Company that is an FBO (with respect to combined U.S. operations), the exposure limit is 15% of worldwide tier 1 capital for a Major Counterparty and 25% of worldwide tier 1 capital for all other counterparties.

Large Covered Companies. For a Large Covered Company that is a U.S. BHC or IHC, the exposure limit is 25% of tier 1 capital for all counterparties. For a Large Covered Company that is an FBO, the exposure limit for its combined U.S. operations is 25% of worldwide tier 1 capital for all counterparties.

All Other Covered Companies. For any other Covered Company that is a U.S. BHC or IHC, the exposure limit for all counterparties is 25% of total regulatory capital plus allowance for loan and lease losses that is not included in tier 2 capital. For any other Covered Company that is an FBO, the exposure limit for its combined U.S. operations is 25% of worldwide total regulatory capital for all counterparties.

"Major Counterparties" are defined in the re-proposed rule as Major Covered Companies, FBOs and IHCs (and their respective subsidiaries) that would have the characteristics of or be indentified by the Fed as GSIBs based upon the BCBS global criteria or the Fed's Regulation Q, and non-bank financial companies supervised by the Fed (that is, those non-bank financial companies designated as systemically important financial institutions by the Financial Stability Oversight Council).

The credit limits in the re-proposed rule apply only to unaffiliated counterparties of the Covered Company. Credit exposures include extensions of credit, repurchase and reverse repurchase transactions, guarantees and letters of credit, derivatives, and any other transaction that the Fed determines to be a credit transaction.

When would the re-proposed rule be effective?

The re-proposed rule would be effective within one year following its effective date for all Major Covered Companies and Large Covered Companies and within two years following its effective date for all other Covered Companies.

How would the credit exposure to an SPV be treated under the re-proposed rule?

Covered Companies that are not Major Covered Companies or Large Covered Companies would treat the SPV as their counterparty in a securitization transaction. The Fed may determine that such a smaller Covered Company must apply the "look-through approach" described below after notice and an opportunity for hearing.

Major Covered Companies and Large Covered Companies are required to determine their exposure to each issuer of assets that underlies the Covered Company's "investment" in the SPV using a "look-through approach." If the Covered Company can determine that its exposure to each underlying issuer in a securitization transaction is less than 0.25% of the Covered Company's tier 1 capital, then the exposure in the relevant securitization transaction is treated as an exposure to the SPV. If not, then the Covered Company must recognize credit exposure to each underlying issuer instead of the SPV.[2]

If the Covered Company cannot determine its credit exposure to an underlying issuer, then the Covered Company must attribute that exposure (together with any other undetermined issuer exposures) to a single "unknown entity." If the Covered Company has imposed a credit concentration limit on the size of its credit exposure to an individual entity, such limit could presumably be used to demonstrate that the Covered Entity cannot have an exposure to any underlying issuer equal to or greater than 0.25% of the Covered Company's tier 1 capital. The potential exposure would, however, need to be computed based on the Covered Company's potential maximum exposure to the underlying issuer and not any borrowing base or similar limit that would reduce the overall amount of credit extended to an SPV but that would not reduce the potential size of the exposure in the underlying asset pool.

This approach is substantially identical to the look-through approach taken in the BCBS Large Exposure Framework. In contrast, the Fed's original proposed rule would not have required a look-through. Instead, the original proposed rule would have given the Fed discretion to look through an SPV to underlying asset issuers on a case-by-case basis, but only if the SPV failed certain discrete concentration tests (such as having 20 or fewer underlying exposures).

How is the exposure amount to an underlying asset issuer or unknown counterparty determined?

Where the interests of all investors in an SPV are *pari passu*, the gross exposure to the asset issuer or unknown issuers (treated as a single entity) is equal to the Covered Company's pro rata share multiplied by the value of the assets of the relevant issuer or entity that are held in the structure.

Where the interests of all investors in an SPV are not *pari passu*, the gross exposure to the asset issuer or unknown issuers (treated as a single entity) is equal to the lower of the value of the tranche in which the Covered Company is invested or the value of the assets attributable to the relevant issuer or entity multiplied by the Covered Company's pro rata share of the tranche.

This approach is identical to the approach for determining the exposure to underlying issuers in the BCBS Large Exposure Framework.

When must a Covered Company recognize an exposure to a third party with a contractual or other business relationship with an SPV?

Again consistent with the BCBS Large Exposure Framework, the re-proposed rule requires Major Covered Companies and Large Covered Companies to recognize exposures to third parties with contractual or other business relationships with

SPVs where the failure or material financial distress of that third party would cause a loss in the value of the Covered Company's investment in or exposure to the SPV.

The text of the re-proposed rule cites fund managers and protection providers as examples of third parties whose distress could lead to a loss. In the preamble to the re-proposed rule, the Fed also includes asset originators and liquidity providers as examples of such third parties.

This third party exposure would be *in addition to* any exposure to the SPV or underlying asset issuer otherwise required by the re-proposed rule.

If an FBO covered by the rule has an IHC, does the FBO include the IHC's exposures in its exposure limits?

Yes. An FBO with $50 billion in worldwide assets is covered by the rule and would have all its US exposures included, even those exposures that are separately limited for its IHC. Thus, the IHC would have an exposure limit, and the exposures of the IHC would be included in determining the total US exposures of the FBO.

Do the proposed exposure limits replace lending limits that apply to US banks and FBOs?

No. U.S. banks and the U.S. branches of foreign banks will continue to be subject to lending limits. In general, such lending limits to unaffiliated counterparties are 15% of total capital. The proposed exposure limits apply to the consolidated exposures of U.S. BHCs, IHCs, and FBOs. The lending limits only apply to banks, including U.S. branches of foreign banks.

For More Information

If you would like further information concerning the matters discussed in this article, please contact your primary Chapman attorney.

1 The re-proposed rule does not use this term, but instead consistently refers to Covered Companies with $250 billion or more of consolidated assets or $10 billion or more of on-balance sheet foreign exposures (the criteria doe banking bank holding companies required to determine risk-based capital using Basel III advanced approaches). For ease of reference, we follow other commentators referring to such Covered Companies as "Large Covered Companies."

2 The text of the re-proposed rule is not completely clear on this point, but it is our understanding that the Fed intended the underlying issuers to replace the SPV as "counterparties" when and exposure to an underlying issuer could exceed the 0.25% of tier 1 capital threshold.

Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®