Chapman and Cutler LLP

Chapman Client Alert

May 3, 2016 Current Issues Relevant to Our Clients

Potential Impact of Proposed Federal Reserve Single Counterparty Credit Limits on Municipal Obligation Holders

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 (*"IHCs"*), with $50 billion or more of consolidated assets. The re-proposed rule defines a counterparty, with respect to a State, as the State and all of its agencies, instrumentalities, and political subdivisions (*including any municipalities* (emphasis added)) collectively. As a result, certain banks holding obligations of a State may be required to aggregate their credit exposure to the State with their exposure to all of the municipalities and other governmental bodies located within that State for purposes of complying with the limits.

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 defined Counterparty with respect to a State to include municipalities of the State.

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.

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 identified 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 a State and Municipalities within a State be treated under the Proposed Rule?

The re-proposed rule defines a counterparty, with respect to a State, as the State and all of its agencies, instrumentalities, and political subdivisions (*including any municipalities* (emphasis added)) collectively. As a result, the State and any governmental entity within the State may potentially be aggregated as a single counterparty for purposes of the limits. The proposed rule does not distinguish between different kinds of municipal entities (e.g., the municipality itself versus the various enterprise systems that a municipality may own and operate), so a Covered Company may need to aggregate any and all municipal and quasi-municipal credit exposure within a State with its direct credit exposure to that State for purposes of the credit limits.

A State-wide conduit issuing authority (which may be issuing debt solely on behalf of non-governmental borrowers such as non-profit educational and healthcare organizations) would be a particularly interesting example to consider in relation to this broad definition. Another instance that may be open to interpretation is whether a Covered Company with no direct credit exposure to a given State, but with some direct credit exposure to various municipal entities of that State, would need to aggregate those municipal exposures as a single counterparty. The phrase "With respect to a State" at the beginning of the "State" prong of the definition may leave open the possibility that if the State itself is not a counterparty of the Covered Company then its various municipal entities are not aggregated as a single counterparty for purposes of the single counterparty limits.

What else is relevant to this analysis?

A conservative reading of the "State" prong of the Counterparty definition under the proposed rule would aggregate credit exposure to every municipal and quasi-municipal issuer in each State as a single counterparty. That approach deserves careful consideration because it's not clear that the credit risk of a given State is strongly positively correlated with the credit risk of every municipality (or even a majority of municipalities) within that State. Similarly, it's not clear that the credit risk of a given municipality is strongly positively correlated with that of another municipality within the same State. The Fed may also wish to consider whether different kinds of municipal entities deserve different treatment under the proposed rule. For example, if a municipal credit exposure is secured by a pledge of special revenues that enjoys special treatment under Chapter 9 of the federal bankruptcy code, perhaps that credit exposure should be viewed differently than a general obligation of a municipal entity that is not secured by a pledge of special revenues.

The NPR does not provide a rationale for aggregating municipal credit exposure with that of the State in which it's located, so we are left to speculate about the reason or motivation for such a broad definition of Counterparty with respect to a State. The Fed plainly appreciates the nuances of municipal credit characteristics, as evidenced by its recent adoption of a final rule to amend the LCR rule to include certain U.S. municipal securities as HQLA.[1] Perhaps the Fed will ultimately draw finer distinctions with respect to municipal counterparties and the credit exposure they present for Covered Companies as it has done with SPVs for purposes of Securitizations.[2]

What happens next?

Banks should carefully examine their credit exposures to States and their municipalities to determine whether the proposed single counterparty credit limits may present an issue for them. Several industry groups are preparing comments to the NPR, and interested banks may wish to participate in the comment process individually or through a trade association.

For More Information

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

1 In the release relating to the final rule, the Fed acknowledged certain differences between revenue bonds and general obligation bonds (including the treatment of special revenues in a bankruptcy); see related Client Alert here.

2 See related Client Alert here.

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