Chapman and Cutler LLP

Chapman Client Alert

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Current Issues Relevant to Our Clients

Impact of Federal Reserve Single Counterparty Credit Limits on Securitizations

On June 14, 2018 the Board of Governors of the Federal Reserve System (the *"Fed"*) issued a final rule (*the "final rule"*) that establishes credit limits for single counterparties of U.S. bank holding companies (*"U.S. BHCs"*) and foreign banking organizations (*"FBOs"*) with $250 billion or more in global assets, and U.S. intermediate holding companies of covered FBOs with $50 billion or more of consolidated assets. *In an important change, while the final rule retains provisions applicable to FBOs, an FBO that is subject to single counterparty credit limit regulation in its home country on a consolidated basis consistent with the BCBS Large Exposure Framework can comply with the final rule by certifying to the Fed that it in compliance with those home country SCCL limits.* The final 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 and issued a re-proposed rule in March of 2016 (the *"re-proposed rule"*). The provisions for determining counterparty limits for SPVs in the re-proposed rule and in the final rule closely track 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 SPE provisions in the final rule have been significantly modified in response to industry comments on the re-proposed rule. Chapman and Cutler LLP represented the Structured Finance Industry Group in developing its comments on the re-proposed rule. A copy of the SFIG comment letter can be found here.

The final 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.

A copy of the final rule can be found here.

What banking organizations are covered by the rule?

The final rule applies to the following entities (1) U.S. BHCs (that are not IHCs) with $250 billion or more of assets, (2) the combined U.S. operations of FBOs with $250 billion or more of global assets (*"Covered FBOs"*),[1] and (3) IHCs of Covered FBOs with $50 billion or more of assets (collectively, *"Covered Companies"*). The re-proposed rule would have applied to each of the foregoing categories of entities that had $50 billion or more of assets. The minimum combined asset threshold for U.S. BHCs and FBOs was increased from $50 billion as a result of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018, which raised the minimum threshold of ultimate application of Section 165 of the Dodd-Frank Act to bank holding companies with $250 billion or more in consolidated assets.

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

Single-Counterparty Credit Limits Applicable to U.S. BHCs

Category of U.S. BHC	Applicable Credit Exposure Limit
Covered U.S. BHCs that are not Major Covered Companies	25 percent of the Covered Company's tier 1 capital
U.S. BHCs that are GSIBs using the global methodology (Major Covered Companies)	15 percent of the Major Covered Company's tier 1 capital for exposures to Major Counterparties 25 percent of the Major Covered Company's tier 1 capital for all other counterparty exposures

Single-Counterparty Credit Limits Applicable to the Combined U.S. Operations of FBOs	
Category of FBO	**Applicable Credit Exposure Limit**
Combined U.S. operations of FBOs with total consolidated global assets that equal or exceed $250 billion but are not Major FBOs	25 percent of the FBO's tier 1 capital
Top tier FBOs that are GSIBs using global methodology (Major FBOs)	15 percent of the Major FBO's tier 1 capital for exposures to Major Counterparties 25 percent of the Major FBO's tier 1 capital for all other exposures

Single-Counterparty Credit Limits Applicable to U.S. IHCs	
Category of U.S. IHC	**Applicable Credit Exposure Limit**
U.S. IHCs that have total consolidated assets of at least $50 billion but less than $250 billion	25 percent of the IHC's total regulatory capital plus the balance of its allowance for loan and leases losses (ALLL) not included in tier 2 capital under the capital adequacy guidelines
U.S. IHCs that have $250 billion or more in total consolidated assets but are not Major U.S. IHCs	25 percent of the IHC's tier 1 capital
U.S. IHCs that have $500 billion or more in total consolidated assets (Major U.S. IHCs)	15 percent of the IHC's tier 1 capital for exposures to Major Counterparties 25 percent of the IHC's tier 1 capital for all other exposures

"Major Counterparties" are defined in the final 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 final rule apply only to unaffiliated counterparties of the Covered Company.[2] 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 will the final rule be effective?

The final rule will be effective on January 1, 2020 for Major Covered Companies and major FBOs and on July 1, 2020 for all other Covered Companies.

How would the credit exposure to an SPV be treated under the final rule?

Covered Companies treat the SPV as their counterparty in a securitization transaction. In addition, Covered Companies are required to determine additional exposures 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 relevant capital base, then the exposure in the relevant securitization transaction is treated solely as an exposure to the SPV. If not, then the Covered Company must also recognize a credit exposure to each underlying issuer with an exposure of 0.25% or more of the Covered Company's tier 1 capital.

This "partial look through" approach described above is a significant change to the re-proposed rule in response to industry comments. Under the re-proposed rule, if only one exposure to each underlying issuer in a securitization transaction was greater than 0.25% of the Covered Company's tier 1 capital, then an additional exposure had to be recognized to *every* underlying issuer in the transaction, even those with exposures that were less than 0.25% of the Covered Company's relevant capital base.

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.

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 would have required Covered Companies (as defined in the re-proposed rule) to recognize exposures to all 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 size of such additional exposures would have equaled the total size of the securitization exposure of the Covered Company to the SPV in the securitization transaction.

The text of the re-proposed rule cited 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 included asset originators and liquidity providers as examples of such third parties.

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

In response to industry comments, the final rule would only require a Covered Company to recognize an additional third party exposure if the third party provides credit or liquidity support to the SPV. Further, such exposures are limited to the dollar amount of the actual third party exposure, regardless of the size of the related securitization exposure.

Must compliance with the rule still be tested daily?

Yes, however, while this created substantial concerns for the industry as it related to the re-proposed rule, most of these concerns related to the lack of current information. The preamble to the final rule indicates that Covered Companies may rely in good faith on the most recently available information and that Covered Companies are allowed to fill in any missing information to the best of their ability (in a reasonable manner using such recent information). This should address many of the industry concerns with daily testing.

How are retail exposures treated under the final rule?

One request from the industry was to exempt retail exposures from the scope of the look-through provision of the rule due to both the difficulty in obtaining information with respect to these assets and the unlikelihood given their granular nature that these exposures would exceed the applicable counterparty limits. While the Fed did not provide for an exclusion, it noted in the preamble to the final rule that it may be possible to ascertain that a transaction does not contain any exposures greater than 0.25% of capital "based on the characteristics of the SPV without having to measure any specific exposure within the SPV."

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 $250 billion in worldwide assets is covered by the rule if it is not complying through Fed certification as described above 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 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.

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1 As noted above, FBOs that certify that they are in compliance with home country SCCL limits are deemed to be in compliance with the final rule.

2 Importantly for many banks sponsoring asset-backed commercial paper conduits, while the concept of affiliation in the re-proposed rule was derived from the Bank Holding Company Act, the term affiliate in the final rule is derived from applicable financial accounting principles. No ABCP conduits that we are aware of are treated as Bank Holding Company Act affiliates by their sponsor banks, but many if not most ABCP conduits are affiliates of their sponsors for accounting purposes. This means that under the final rule, exposures of banks to their ABCP conduits that are accounting affiliates would not be covered by the final rule.

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