Financial Services Management

Single-Counterparty Credit Limits (SCCLs)

Cite
FRB, Notice of Proposed Rulemaking (NPR),
Single-Counterparty Credit Limits for Bank Holding Companies
and Foreign Banking Organizations

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Impact Assessment

- SCCLs mandate data-aggregation, exposure-tracking systems which large banks have been building for years that nonetheless often remain incomplete. FRB estimates may thus under-estimate long-term realignment in credit markets along with significant reductions in inter-connectedness.
- The FRB estimates only minimal changes in outstanding exposures at affected banks and FBOs, likely due to prolonged advance notice, numerous exemptions, and increased flexibility.
- FBOs face fewer distinctions between U.S. and home-country SCCL requirements unless they are designated GSIBs or the FRB thinks they warrant this status.
- Although applicable only to BHCs and FBOs above $250 billion, the FRB clearly needs to build out rules for companies between $100 billion and $250 billion. This policy is likely to continue as the FRB implements the new thresholds in recent law.
- If Fannie and Freddie exit conservatorship, their SCCL exemption ends. Should this occur without sufficient advance planning, major market disruptions are possible.

Overview

After issuing a proposal in 2011[1] and then another in 2016,[2] the Federal Reserve has finalized standards governing the single-counterparty credit limits

[1] See **SYSTEMIC54**, *Financial Services Management*, January 3, 2012.
[2] See **CONCENTRATION9**, *Financial Services Management*, March 14, 2016.

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(SCCLs) mandated by the Dodd-Frank Act.[3] The final rule also reflects the changes to the threshold at which BHCs are subject to Dodd-Frank systemic regulation mandated by the new financial-reform law.[4] It thus increases the BHC size at which SCCLs are applicable from $50 billion to $250 billion and makes similar changes to the treatment of foreign banking organizations (FBOs) and intermediate holding companies (IHCs) with assets above $50 billion of foreign banks with consolidated global assets above the $250 billion threshold.

The FRB has retained its proposal to make the standards still more stringent for global systemically-important banks (GSIBs) whether the parent company is a U.S. BHC or the foreign parent of an FBO. It has also made clear that some form of SCCLs will be proposed for BHCs and FBOs with assets between $100 billion and $250 billion. As a result, despite the higher applicability limits and substantive changes to the way SCCLs are measured, the rule does not indicate any wholesale retreat by the FRB now from prior policies.

Impact

During the 2008 crisis, systemic stress ricocheted through the financial system in part because large financial institutions had exposures through complex financial instruments not captured by prior loan or investment limits to capture overall concentration risk. As a result, global regulators have implemented credit-exposure limits[5] and Dodd-Frank mandated thresholds that limited SCCLs to no more than 25 percent of capital and surplus for large BHCs and FBOs. The law set this threshold at $50 billion, now increased to $250 billion, and gave the FRB considerable flexibility to set standards below the asset threshold, define capital and exposures, and otherwise set SCCLs.

The final rule makes more use of this discretion than earlier proposals but nonetheless keeps numerous aspects to which the industry objected. For example, although the law as noted allows the limits to be set to "capital and surplus," the rule elects a Tier 1 denominator that is considerably more stringent due to concerns about concentration and contagion risk. The capital-and-surplus denominator remains in OCC's loans-to-one-borrower and FRB's inter-affiliate rules,[6] although the agencies have long planned to revise and tighten these standards. No timing or any near-term prospect for such change has, however, been announced. And, although the final rule does not tighten the 25 percent overall SCCL, it retains a tougher standard for GSIBs on grounds that inter-GSIB exposures are particularly risky. The FRB staff in 2016 completed a white paper showing inter-GSIB correlation risk that support this approach in the final rule.

Based on all of these changes, the Board estimates that the final rule affects no more than $100 billion of now-impermissible exposures largely at the biggest BHCs and FBOs. There thus should be little material impact in the Board's view with regard to credit availability and, given the new transition period (see below) ample time to adjust internal controls.

Because the final rule measures exposures in part through reliance on accounting consolidation, inter-connectedness at the largest banks may well be

[3] See **SYSTEMIC29**, *Financial Services Management*, July 13, 2010.

[4] See **SIFI27**, *Financial Services Management*, June 4, 2018.

[5] See **CONCENTRATION5**, *Financial Services Management*, April 23, 2014.

[6] See *Client Reports* in the **REGW** series.

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better known in advance and thus captured by the Fed's estimate. However, GSIBs are subject to Basel data-aggregation standards[7] that, even now, are largely unimplemented due to limited data. Complex exposures not captured by accounting and those at banking organizations not subject to the GSIB data-aggregation requirements may thus prove elusive. When systems finally develop to capture them in response to this final rule, additional inter-connections may well surface. Barring these could pose additional credit-availability and market-efficiency challenges, as well as promote greater non-bank activities due to their exemption from SCCLs.

Another challenge to estimating the final impact is the scope of the exemptions provided in the final rule for sovereign and related entities. Changes to the zero risk weighting for most sovereigns long contemplated by the Basel Committee could lead to significant restrictions. These would help to cut the "doom loop," but also pose credit-availability and market-efficiency problems.

Changes to sovereign or quasi-sovereign entities also pose future problems. The most immediate of these in the U.S. addresses the housing GSEs. Exposures to Fannie and Freddie in conservatorship are exempted, but any of the pending reforms to these GSEs would terminate this exemption for all but full-faith-and-credit entities. Significant changes in U.S. housing finance and the supply of high-quality liquid assets would result.

What's Next

The FRB unanimously approved this NPR on June 14.[8] The rule is effective sixty days after publication in the *Federal Register*. GSIBs must comply by January 1, 2020; other entities must do so by July 1, 2020. As noted, the FRB plans to consider SCCLs for BHCs with assets between $100 billion and $250 billion and address similar issues for FBOs; no timetable for doing so is provided.

Analysis

A. Limits

These are:

- 25 percent of Tier 1 capital for BHCS above $250 billion based on aggregate net exposures to an unaffiliated single counterparty (see below). The Board reserves its authority to apply SCCLs to smaller BHCs on a case-by-case basis;
- A tougher fifteen percent of Tier 1 limit for exposures by GSIBs to other GSIBs and designated non-bank SIFIs. Foreign GSIBs are defined as those that have the characteristics of global GSIB-designation standards[9] (but do not need also to be so designated since FBOs that would be designated as GSIBs fall under the FRB's

[7] See **RISKMANAGEMENT7**, *Financial Services Management*, January 24, 2013.
[8] See *Client Report* **CONCENTRATION10**, June 14, 2018.
[9] See **CAPITAL180**, *Financial Services Management*, November 16, 2011.

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rules[10]) and IHCs that would also be subject to FRB GSIB designation also are considered GSIBs for purpose of this limit; and

- like-kind limits for FBOs based on combined U.S. operations and their IHCs. SCCLs for IHCs are tailored based on the company's size, with the rules applying to IHCs between $50 and $250 billion even if they are smaller BHCs otherwise not covered by the SCCL standards. Interestingly, IHCs with assets between $50 billion and $250 billion not only come under just the 25 percent standard, but also one based on capital measured by total capital and loan-loss reserves. The Tier 1 capital numerator is reserved for larger IHCs, with the GSIB standard applying to the largest IHCs regardless of whether their parent bank is a GSIB. However, FBOs are deemed in compliance if they certify to the FRB that the parent company complies with the Basel credit-exposure limits.

B. Counterparty Exposures

As noted, counterparties are defined by reference to a company and all of its subsidiaries and affiliates. These are now defined by accounting-consolidation standards, not the BHC Act. Unless exempted (see below), a wide range of exposures to entities and natural persons other than companies are also covered under rules specific to each such counterparty. Investment funds, certain merchant-banking holdings, and other counterparty-related exposures are not aggregated unless they are consolidated for accounting purposes, but exposures in other entities – including special-purpose vehicles (SPVs) are captured in complex ways designed to attribute underlying risk back to potentially large counterparties.

Exposures are as noted measured on an aggregate net basis, with netting allowed to reflect collateral, credit-risk mitigation, and hedges that meet certain standards. In general, eligible collateral tracks standards in the capital rules, as does the definition of an eligible guarantor. Guarantors must for example meet the conditions in the capital rules setting risk parameters and restricting reliance on monoline providers; specific standards also apply to credit default swaps. Exposures netted for one counterparty by third-party actions are shifted to the provider of the credit-risk mitigation and applied on a dollar-for-dollar basis to its SCCL. Derivatives exposures may be calculated based on any methodology permitted in the FRB's advanced-approach capital rules.[11] The proposed application of the standardized approach to securities financing transactions is replaced in the final rule with any methodology allowed under any of the FRB's capital rules (i.e., standard or advanced).[12]

As in the NPR, exposures are aggregated not only to reflect subsidiaries and affiliates, but also other entities to which a counterparty is intertwined (i.e., where its risk depends on actions by the other entity or entities the other company controls). The final rule retains this economic-interdependence approach, despite strong protest about its burden and complexity. However, connected counterparties now must be included only if the initial counterparty has more than five percent of its capital exposed to the intertwined one. Factors defining interdependence are also specified in the final rule, with the Board now also establishing a process through which BHCs can request temporary exemptions from aggregating intertwined exposures. However, a process through which the Board may also order recognition of economic interdependence is also included in the final rule to prevent evasion.

10 See **GSIB7**, *Financial Services Management*, July 23, 2015.

11 See **CAPITAL201**, *Financial Services Management*, July 19, 2013.

12 See **CAPITAL200**, *Financial Services Management*, July 15, 2013.

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Exemptions are provided for:

- Exposures to sovereign entities and their sub-divisions or agencies given a zero risk weighting;
- exposures to the U.S. government that are directly and fully guaranteed with regard both to principal and interest. This exemption applies to Fannie Mae and Freddie Mac while in conservatorship. Exposures to Federal Home Loan Banks are not so favored;
- intraday credit exposures;
- trade exposures to qualified CCPs;
- exposures to the BIS, IMF, and World Bank; and
- credit transactions with the European Commission or ECB.

If credit guarantees or protection are obtained on these exempt exposures, then the SCCLs must be calculated for the provider on the notional exposure as if the exposure were to a non-exempt entity.

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