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BANKING

Expert Analysis

OCC and Federal Reserve Diverge On Calculation of Credit Exposure

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In late June, the Office of the Comptroller of the Currency (OCC) released an interim final rule[1] implementing the changes mandated by Section 610 of the Dodd-Frank Wall Street Reform and Consumer Protection Act to the national bank (and savings association) lending limits (Lending Limit Release). Section 610 expands the definition of "loans and extensions of credit" to include "credit exposure" from repurchase and reverse repurchase transactions and securities lending and borrowing transactions (collectively, "securities financing transactions") and derivative transactions.

The Lending Limit Release is the second agency rulemaking to define "credit exposure" arising from securities financing and derivative transactions. In December 2011, the Board of Governors of the Federal Reserve System proposed rules implementing, among other things, Section 165 of Dodd-Frank. The proposed rules limit the credit exposure a large bank holding company (generally with more than $50 billion in assets) or another non-bank company that is deemed to be "systemically significant" (together, "Covered Companies") may have with any single counterparty (the so-called single counterparty credit limit or SCCL) (hereinafter, the Federal Reserve's proposed rules are referred to as the Proposed SCCL Rules).[2]

Different Approaches

Although in different contexts, both the Federal Reserve and the OCC are required by Dodd-Frank to define "credit exposure" for derivative transactions and securities financing transactions to help address concentration risk. The central issue in determining the appropriate measure of credit exposure for these types of transactions is whether the potential future exposure (PFE) relating to such transactions, which reflects the potential for fluctuation in the value of the transaction over its life, should be included in the calculation of exposure and, if so, how to estimate the PFE. Both the Federal Reserve and the OCC have taken the position in their proposals that credit exposure for such transactions should include an estimate of PFE. The Federal Reserve has proposed a standardized, risk-insensitive measure that, if implemented as proposed, could result in significant disruptions in the derivative and securities financing markets. The OCC's Lending Limit Release introduces a more flexible, models-based alternative to measuring such exposures.

The underlying purpose of the SCCL, not surprisingly, is to "limit the risks that the failure of any individual firm could pose to a [C]overed [C]ompany."[3] The Federal Reserve's approach to SCCL establishes limits in two tiers. The first tier is a general limit on a Covered Company's credit exposure to any single counterparty of 25 percent of the Covered Company's capital stock and surplus. A second tier exists that limits credit exposure between "major" Covered Companies (i.e., those with Covered Companies with more than $500 billion in global assets) to 10 percent of any major Covered Company's capital stock and surplus.

The Proposed SCCL Rules' definition of credit exposure is broad, and that definition, as well as the Proposed SCCL Rules more broadly, has been subject to criticism for being overly broad and prescriptive. For example, the calculation of derivative exposures under the Proposed SCCL Rules, which has garnered significant industry attention, does not allow for the use of internal models that generally use a more risk-sensitive approach to calculating exposure but instead requires the use of the more prescriptive current exposure method.[4] Critics have expressed concern that the Proposed SCCL Rules, if implemented in their current form, would significantly reduce liquidity and would precipitate a massive restructuring of Covered Companies' positions in order to bring exposures within the limits required by the Proposed SCCL Rules.[5]

The Lending Limit Release, in many cases, represents a significant departure from the Federal Reserve's approach in the Proposed SCCL Rules. The OCC's approach to credit exposure is less burdensome and provides significantly more flexibility than the Proposed SCCL Rules, including by permitting banks to measure such exposures using supervisor-approved internal models and treating exposures that come to exceed the lending limit at some point after inception as nonconforming transactions that a bank must bring back into compliance rather than as automatic violations. In addition, for each type of transaction, the Lending Limit Release includes an alternative measurement approach that allows a bank to lock in the exposure amount at inception of the exposure, although the alternative approaches generally would result in conservative estimates of the exposure amount.

In the Lending Limit Release, the OCC states that it reviewed comments received by other agencies in response to rulemakings to implement provisions of Dodd-Frank that raise similar issues, including comments on the Proposed SCCL Rules. Indeed, the OCC's approach to defining "credit exposure" for this purpose responds to many of the concerns expressed by commenters on the Proposed SCCL Rules. In particular, the OCC's approach provides banks with flexibility in calculating compliance with the lending limit rules rather than imposing a one-size-fits-all approach and, by permitting banks to use supervisor-approved internal models, would allow banks that have already developed such models to continue to use these more risk-sensitive methods of measuring credit exposure arising from derivatives or securities

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financing transactions and to rely on the systems they currently use for credit risk management purposes to maintain compliance with the lending limit rules.[6]

Other Distinctions

Other notable distinctions between the Lending Limit Release and the Proposed SCCL Rules include:

• **Credit derivatives.** Similar to the Proposed SCCL Rules, when a bank sells protection on a reference asset in the form of a credit derivative, it must treat the notional protection sold as an exposure to the reference asset. If the bank purchases credit derivatives that meet certain eligibility criteria on the same reference asset, it may reduce the amount of its exposure to the reference asset. Unlike the Proposed SCCL Rules, a bank may only use an eligible credit derivative to reduce its exposure to a reference asset on which it has sold credit protection rather than to reduce exposures on other transactions (such as a loan or debt security), and the OCC requests comment on whether this is appropriate.

• **Nonconforming transactions.** Under the Lending Limit Release, a credit exposure arising from a derivative or securities financing transaction that is measured under the internal model method and that exceeds the lending limit after inception of the transaction, will not be deemed a violation and instead will be treated as nonconforming if the extension of credit was within the legal lending limit at the time it was made. A bank must use reasonable efforts to bring the nonconforming transaction into compliance with the lending limit, subject to safety and soundness considerations, but no timeframe is specified.[7] Under the Proposed SCCL Rules, exceeding the applicable limit would be an immediate violation for any type of transaction, which means that a company subject to the limit would need to maintain a significant buffer at all times.

• **Contingent exposure to a derivative clearinghouse.** In the Lending Limit Release, the OCC requests comment on whether a bank's contingent obligation under derivative clearinghouse rules to advance funds to a guaranty fund should be subject to the lending limits and, if so, how it should be measured. Such exposures would be covered under the Proposed SCCL Rules.

The different approaches to measuring the same credit exposures taken by the OCC and the Federal Reserve raise the question as to whether, and to what extent, the Lending Limit Release will influence the Federal Reserve's final rule implementing the SCCL. In addition to defining "credit exposure" for purposes of the SCCL, the Federal Reserve must also define "credit exposure" for purposes of Section 23A of the Federal Reserve Act, which restricts "covered transactions" between a depository institution and its affiliates. Section 23A was amended by Section 608 of Dodd-Frank to include among the list of "covered transactions" derivative transactions and securities financing transactions to the extent such transactions result in a depository institution having "credit exposure" to an affiliate.

Assuming the SCCL is implemented basically as is, Covered Companies that are bank holding companies and their bank subsidiaries likely will face a number of challenges as they will be required to comply with two different regimes: one (the Proposed SCCL Rules) for the bank holding company, on an enterprise-wide, aggregated basis and one (the Lending Limit Release) for bank subsidiaries of the bank holding company. Furthermore, these bank subsidiaries, because they are subject to the SCCL via their Covered Company parent, effectively could have a reduced lending limit at the bank level because the same exposures would have to be measured under the less risk-sensitive approach under the Proposed SCCL Rules.

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Even if the Proposed SCCL Rules and the Lending Limit Release do converge, there will undoubtedly continue to be distinctions that must be carefully evaluated and implemented by bank compliance departments. Lawyers with bank clients, and especially those with large bank holding company clients, should watch closely for developments in this area.

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1. Published at 77 Fed. Reg. 37265 (June 29, 2012). The lending limits applicable to national banks and federal and state chartered savings associations (collectively, banks) generally limit the total loans and extension of credit from a bank to a person to 15 percent of the unimpaired capital and unimpaired surplus ("capital") of the bank, with an additional 10 percent of capital available if the loan is fully secured by readily marketable collateral. As a result of Dodd-Frank, banks must include exposures from derivative and securities financing transactions within the applicable limit.

2. Published Jan. 5, 2012 in the Federal Register at 77 Fed. Reg. 594. Comments on the Proposed SCCL Rules were due in April.

3. Id. at 612.

4. The current exposure method is calculated as the current exposure (greater of mark-to-market or zero) plus potential future exposure (notional x conversion factor) and includes the recognition of some netting if the transaction is subject to a qualifying master netting agreement and permits adjustment for financial collateral.

5. See, e.g., the comment letter on the Proposed SCCL Rules by The Clearing House Association LLC, the American Bankers Association, the Financial Services Forum, The Financial Services Roundtable and the Securities Industry and Financial Markets Association, dated April 27, 2012 (available at http://www.theclearinghouse.org/index.html?f=073837).

6. In order to measure credit exposure from credit derivatives under the internal model approach, the bank must have a margining agreement in place that requires daily posting of variation margin to fully collateralize the bank's net exposure in excess of $1 million under the agreement, which may not be consistent in all cases with how those arrangements are structured today.

7. Although the credit exposure of a derivative transaction measured under the remaining maturity approach also may fluctuate over time, they are not included in the list of nonconforming transactions and, therefore, could automatically trigger a violation if they exceed the lending limits (unless the excess is attributable to a factor that would otherwise fit within the definition of nonconforming transaction, such as a decline in the bank's capital).