Regulatory brief

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Credit exposure: Affiliate transaction rule in sight

Various provisions of the Dodd-Frank Act require banks to incorporate credit exposures from derivatives and securities financing transactions when calculating prudential limits. The Office of the Comptroller of the Currency (OCC) recently became the first federal regulator to establish final rules in this area – in this instance, for calculating these exposures for Federal lending limit purposes.[1]

The Federal Reserve Board (FRB) has yet to propose how to calculate these same types of credit exposures for purposes of limits on bank transactions with affiliates. It is our view that this rule will be proposed this fall given the FRB's heightened focus (as evidenced by various recent public pronouncements) on completing an expanded prudential framework for large bank holding companies.

While the OCC's approach is instructive, it is unclear to what extent the FRB will follow suit. Given the perceived greater risks arising from bank transactions with affiliates and the stricter limits and mandatory collateral requirements of the FRB's Section 23A and its Regulation W, we expect that the FRB would apply similar methods used by the OCC but will tend to be more conservative in its interpretation, and less flexible in application. As further described below, were the FRB to follow suit in its definition of credit exposure, the result would be a significant change in practice for calculating credit exposure in derivative transactions between a bank and its affiliates.

The OCC final rule itself includes many technicalities, many of which we do not attempt to address, but the rule should prompt some institutions to assess the availability and reliability of their data for limit measurement and monitoring purposes. In addition, the dynamic nature of the OCC rule is important. Several of its key provisions incorporate by reference current provisions of the OCC's and FDIC's capital rules. These references will ultimately be updated by the OCC to reflect the new Basel III capital rules that were recently approved by the three agencies, and which contain transition provisions and dynamic qualifying capital elements that may result in volatility when monitoring lending limit compliance.[2]

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[1] See 78 FR 37930 (June 25, 2013).

[2] For advanced approaches institutions, the Basel III capital rules will become effective January 1. 2014; for other institutions, the Basel III capital rules will become effective January 1, 2015. See PwC's *Financial Services Regulatory Brief: Basel III Capital Rules finalized by Federal Reserve – But much more to come for the big banks* (July 2011).

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In this **Financial Services Regulatory Brief**, we highlight the key decisions made by the OCC that formed its final rule, analyze the rule's highlights, and link the final rule to some possible expectations for the upcoming FRB affiliate transaction proposal.

Federal and state lending limits (sections 610 and 611 of Dodd-Frank)

Section 610 of Dodd-Frank amends the Federal lending limits to expand the definition of "loans and extensions of credit" to include any credit exposure to an entity arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction or securities borrowing transaction between a national bank and that entity. This new definition also applies to all savings associations. US branches and agencies of foreign banks must also comply with the national bank lending limit – a foreign bank aggregates exposure at all of its US branches and agencies and applies that aggregate amount against the US dollar equivalent of the parent foreign bank's capital.

Section 610 was effective on July 21, 2012, but the OCC extended that date to January 1, 2013 in an interim final rule issued in June of 2012. The OCC later extended the effective date to July 21, 2013 and then to October 1, 2013 in the final rule.

While the OCC's final rule does not apply to state-chartered banks,[3] Section 611 of Dodd-Frank states that an insured state bank may engage in derivative transactions only if home State legal lending limits take into consideration credit exposure to derivatives transactions. Section 611 became effective January 21, 2013. To comply, states have either amended state law or determined that state law already took into consideration derivatives exposure.[4] Note that there is no requirement that State legal lending limits take into consideration credit exposure from securities financing transactions.

[3] The rule does apply to state-chartered savings associations regulated by the Federal Deposit Insurance Corporation (FDIC).

[4] For example, the New York State Legislature amended the New York Banking Law regarding loan limits in July 2011 to authorize the Superintendent of the New York State Department of Financial Services (DFS) to determine the manner and extent to which credit exposures arising from derivatives transactions will be taken into account for statutory loan limits. On July 8, 2013 the DFS issued an emergency regulation implementing the Superintendent's authority. See *Explanatory All Institutions Letter* of the DFS (July 8, 2013).

The OCC's three alternatives for calculating derivatives credit exposure

In its final rule, the OCC provides three alternatives that may be used by a bank to calculate credit exposure on derivatives transactions (except for credit derivatives):

- The Model Method. The Model Method provides that counterparty credit exposure is measured by adding the current credit exposure (the greater of zero, or the mark-to-market (MTM) value of the transaction) and the potential future credit exposure (PFE) of the transaction. To use this method, a bank must calculate the PFE using either (i) an internal model that has been approved in writing by the appropriate federal banking agency (AFBA) for purposes of Section 32(d) of the advanced approaches capital rules,[5] or (ii) any other appropriate model which has been approved in writing by the AFBA for lending limit purposes. If, after receiving AFBA approval, a bank makes a substantive revision to the model, it must be approved again by the AFBA before it may be used for lending limit purposes.

  The OCC specifically noted that it will not allow the use of a provisional model while regulatory approval is pending. Under the Model Method approach, a bank may net exposures of derivative transactions that are subject to the same master netting agreement.

- Conversion Factor Matrix Method. Under the Conversion Factor Matrix Method, the credit exposure arising from a derivatives transaction is equal to – and remains fixed at – the PFE of the derivative transaction, as determined at execution of the transaction by reference to a simple look up table (i.e., Table 1 in the final rule). The OCC has clarified this calculation to provide that the PFE of the derivatives transaction under this method equals the product of the notional amount of the derivative transaction and a fixed multiplicative factor determined by reference to Table 1.

- Current Exposure Method. Responding to the public comments received on the interim final rule, the OCC eliminated a proposed Remaining Maturity Method in favor of the Current Exposure Methodology (CEM). CEM is used under the Federal Banking Agencies' current regulatory capital rules (both Basel I and Basel II), and the

[5] The OCC noted that technically the AFBA does not separately approve the use of a bank's model but instead approves the bank's exit from parallel run and its use of the Advanced Approaches for which the bank has developed a model. The OCC confirmed this approval to exit from parallel run constitutes approval for purposes of the model alternative.

proposed Advanced Approaches Basel III rules. Under the CEM, a bank calculates the credit exposure for derivative transactions by adding the current exposure (greater of zero or MTM) and the PFE (calculated by multiplying the notional amount by a specified conversion factor which varies based on the type and remaining maturity of the contract) of the derivative transactions. The CEM incorporates additional calculations for netting arrangements and collateral and uses multipliers that are more tailored to computing the PFE.

Unless required to use a specific method by the AFBA, a bank may choose which of these methods it will use. In its interim final rule, the OCC had indicated that once a bank chose a method, a bank must use the same method for all derivative transactions. However, the OCC clarified in its final rule that the AFBA may at its discretion permit a bank to use a specific method to calculate credit exposure and that this method may apply to specific transactions if the AFBA finds such method is consistent with safety and soundness.

Special rules for credit derivatives

The final regulation includes a special rule for calculating the credit exposure of credit derivatives, a transaction in which a bank buys or sells credit protection against loss on a third-party reference entity.

The final rule requires banks to enter into an "effective margining agreement" in order to use the Model Method to calculate counterparty exposure arising from a credit derivative transaction. For a bank that uses a model, an "effective margining arrangement" means a master legal agreement governing transactions between a bank and a counterparty that requires the counterparty to post, on a daily basis, variation margin to fully collateralize that amount of the bank's net credit exposure that exceeds $25 million created by the derivative transactions covered by the agreement. The $25 million threshold was a significant increase from the interim final rule which had a threshold of $1 million. The OCC increased the threshold in order to allow banks with such agreements to use the Model Method without having to modify or renegotiate the agreements.

A bank which is a protection purchaser that uses one of the non-model methods for derivative transactions, or that uses a model without entering into an effective margining agreement with its counterparty, must calculate the counterparty credit exposure arising from credit derivatives by adding the net notional value of all protection purchased from the counterparty across all reference entities.

A bank that is a protection seller calculates the credit exposure to a reference entity arising from credit derivatives by adding the notional value of all protection sold on that reference entity. However, the protection seller can reduce its exposure to the reference entity by the amount of any "eligible credit derivative" which is defined as a single-name credit derivative or standard non-tranched index credit derivative that meets certain requirements, and which is purchased on that entity from an "eligible protection provider" (as defined in Section 32.2(o) of the interim final rule which includes a list of eligible banking and financial entities).

In response to comments urging the OCC to allow banks to purchase credit protection, such as a default or total return swap, to reduce all type of credit exposure to a borrower, the OCC agreed that to a certain extent credit protection purchased should be allowed to offset other types of exposure. Specifically, the OCC added a new provision which excludes from the lending limits rule that part of a loan or extension of credit for which a bank has purchased protection that meets certain requirements provided the total amount of the exclusion does not exceed 10% of the bank's capital and surplus.

Credit exposure for securities financing transactions

The interim final rule provided banks with two options – the Model Method and the non-Model Method – for determining the credit exposure of securities financing transactions, defined as repurchase agreements, reverse repurchase agreements, securities lending transactions, and securities borrowing transactions. The final rule retains the Model Method and renames the Non-Model Method as the Basic Method. However, in response to comments, the OCC added a third alternative – the Basel Collateral Haircut Method.

The Model Method. Under the Model Method, a bank may calculate the credit exposure of a securities financing transaction using either (i) an internal model the use of which has been approved in writing by the AFBA for purposes of Section 32(b) of the advanced approaches capital rules, provided that the bank provides prior written notice to the AFBA of the model's use for lending limit purposes or (ii) any other appropriate model the use of which for lending limit purposes has been approved in writing by the appropriate AFBA. If a bank makes a substantive revision after receiving AFBA approval, the use of the model must be approved by the AFBA before it may be used for calculating lending limits. As with the model approach for derivatives, the OCC indicated it would not allow the use of a provisional model.

The Basic Method. Under the Basic Method, the calculation of credit exposure is based on the type of securities financing transaction at issue.

- *Reverse Repurchase Agreement*. Under the Basic Method, credit exposure is equal and remains fixed as the product of the haircut associated (under the collateral haircuts table) with the collateral received and the amount of cash transferred.
- *Repurchase Agreement*. The Basic Method provides that credit exposure is equal to and remains fixed at the difference between the market value of securities transferred less cash received (the net current credit exposure.)
- *Securities Borrowing Transaction*. If the collateral is cash, treat the same as a reverse repurchase transaction above. If collateral is securities, the credit exposure is equal to and remains fixed at the product of the higher of the two haircuts associated with the securities and the higher of the two par values of the securities.
- *Securities Lending Transaction*. If the collateral received is cash, the Basic Method would treat it the same as repurchase transaction, meaning treat the credit exposure as equal to and remaining fixed at the net current credit exposure. If the collateral is securities, the credit exposure for lending limits is equal to and remains fixed at the product of the higher of the two haircuts associated with the two securities and the higher of the two par values of the securities.

The Basel Haircut Method. Commenters on the interim final rule had requested that the OCC permit banks to measure credit exposure of securities financing transactions by applying the standard supervisory haircuts for such transactions using the current risk-based capital rules of the AFBA's capital rules or the proposed Basel III Advanced Approaches rules once finalized (collectively, the Basel Collateral Haircut Approach) as an additional non-model approach. Commenters noted that under the Basel Collateral Haircut Approach, exposure value changes as the market value of the securities changes, while under the Basic Method in the final rule, exposure remains fixed at the inception of the securities financing transaction. The OCC agreed with these commenters and included this additional method of measuring credit exposure for securities financing transactions, named in the rule as the Basel Collateral Haircut Method.

Exposures to central counterparties

Under the interim final rule, exposures to central counterparties are credit exposures subject to lending limits. Industry commenters to the interim final rule recommended that the OCC either exclude these exposures from an institution's lending limits or assign the exposures a higher lending limit. This recommendation was based on Title VII of Dodd-Frank which mandates over time the migration of most standardized derivatives to be cleared through central counterparties to reduce systemic risk.

In the final rule, the OCC did not agree that the lending limits rule should exclude credit exposures to central counterparties or central counterparty guaranty funds given the concentrated nature of these exposures. Therefore, the final rule subjects credit exposures arising from derivatives transactions to central counterparties to be included in lending limits. In addition, it includes a special provision that the measure of exposure to a central counterparty must include the sum of the initial margin posted, plus any contributions to a guaranty fund at the time the contribution is made. However, the OCC recognizes that the role of central counterparties in the global market is dynamic and that uncertainties exist as to how the role will evolve. Therefore, the OCC will continue to monitor the role of central counterparties and will revisit the lending limits rule for credit exposures to such entities if necessary.

There is a noteworthy difference between the OCC rule's treatment of exposures to central counterparties and that of the New York State Department of Financial Services (DFS). The DFS guidance allows credit exposures to certain qualifying central counterparties – those determined by the Financial Stability Oversight Council to be systemically important Financial Market Utilities – to be excluded from the lending limit calculation.[6]

Nonconforming loans and extensions of credit

The interim final rule added a new paragraph stating that a credit exposure arising from a derivative transaction or securities financing transaction and determined by a model, will not be deemed a violation of the lending limits and will be treated as nonconforming if the extension of credit was within the bank's legal lending limits at execution and is no longer in conformity because the exposure has increased since execution. In its final rule, the OCC clarified that the provision on nonconforming loans and extensions of credit also applies to transactions calculated using a non-model method. Once a transaction becomes nonconforming, the rule requires institutions to use reasonable efforts to bring it into conformity with the lending limits unless doing so would be inconsistent with safety and soundness. The OCC enforces this provision accordingly.

[6] See Section 117.5 of General Regulations of the Superintendent: "In computing its credit exposures arising from derivative transactions, a bank need not include credit exposures to a qualifying central counterparty that has been designed by the Financial Stability Oversight Council as a financial market utility that is, or is likely to become, systemically important."

Implications for Sections 23A and 23B

Section 608 of Dodd-Frank is somewhat of a companion provision to Section 610, as it requires banks to include within the limits and collateral requirements of Section 23A (of the Federal Reserve Act) credit exposures to an affiliate that arise out of derivatives or securities financing transactions between the bank and affiliate. While Section 608 became effective on July 21, 2012, no official guidance or regulatory proposals have been issued by the FRB interpreting or implementing it. Now that the lending limit rule issued by the OCC is final and the banking agencies have also finalized the Basel III capital rules (which as discussed earlier will be incorporated into the OCC final rule), the stage seems set for the FRB to propose rules implementing Section 608 as well.

While Sections 610 and 608 have a similar purpose of ensuring bank credit exposure to counterparties or affiliates in derivatives and securities financing transactions are included in the respective prudential limits, the FRB and OCC are not required to arrive at the same methods for calculating credit exposure as they are interpreting different statutory provisions with their own history, structure and context. Given the perceived greater risks arising from bank transactions with affiliates and the stricter limits and mandatory collateral requirements of Section 23A, we expect that the FRB may apply similar methods used by the OCC but will tend to be more conservative in interpretation and less flexible in application.

As an important example, affiliate derivative counterparties have been documented with margining agreements to meet the market terms expectations under Section 23B, including daily marks-to-market and two-way collateralization. Subsequently, variation margin under zero threshold margining agreements have been used to meet the expectation for derivative credit exposure as a covered transaction under Section 23A.

Notwithstanding the benefits of netting, use of any of the three methods described above for derivatives to calculate credit exposure under Section 23A would add a PFE element for collateralization, which likely would necessitate active use and monitoring of initial margin; therefore, effectively obligating unobligated funds that affiliates have traditionally pledged and posted with their bank affiliates for operational convenience (and as an abundance of caution) to minimize the risk of any inadvertent rule violations. It is not clear what impact minimum transfer amounts would have on the required level of collateralization of credit exposure as a covered transaction. For example, even with a zero threshold agreement, commonly observed minimum transfer amounts of $500 thousand to $1 million would leave some portion of the calculated credit exposure uncollateralized.

While the OCC's final rule does not apply to transactions with affiliates as defined under Section 23A, if the FRB follows suit in its definition of credit exposure the result would be a significant change in practice for affiliate derivative transactions. We will have our answer when the FRB proposes its rule, which in our view will be this fall.

Additional information

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