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Single counterparty credit limits (SCCL) for large banking organizations

March 2016

Executive summary

On Friday, March 4, the Federal Reserve Board of Governors (FRB) approved a second notice of proposed rulemaking (“re-proposal”) to establish single counterparty credit limits (SCCL) for large bank holding companies (BHCs).¹ The re-proposal applies to US BHCs and foreign banking organizations (FBO) with US\$50 billion or more in consolidated US assets, collectively defined as “covered companies,” and sets stricter boundaries for firms with larger systemic footprints. Comments on the re-proposal are due by 3 June 2016. The re-proposal did not provide an official effective date, but compliance will be required within one or two years from the effective date, depending on the size of the institution.

The re-proposal is more closely aligned with the Basel Committee on Banking Supervision’s international standards for measuring and controlling large exposures (BCBS LES – finalized in 2014).² However, it presents some material changes from the original notice of proposed rulemaking (NPR) that reflect evolution in supervisory thinking:

Three-tier limit structure for aggregate net exposures to a single counterparty

A three-tiered limit structure is introduced (increased from two in the original proposal), effectively placing tighter constraints on exposures between the largest and most systemically important counterparties in the top tier by measuring

these exposures against a more limited Tier 1 capital base. This change is offset by a greater percentage limit – 15% instead of 10% of capital for this tier. The three-tier limit framework is intended to scale the constraints to align with the greater systemic risks posed by counterparty interconnectedness between larger firms.

Additional exemptions

Exposures to qualifying central counterparties (QCCPs) and highly rated sovereigns (those with a 0% US Basel III risk weight [RW]) are exempt in the new proposal, which addresses the concern that limits on exposures to QCCPs would create an impediment to the regulatory goal of encouraging central clearing.

More flexibility in derivatives exposure measurement methodology

The FRB recognizes the lack of risk-sensitivity of the current exposure method (CEM) mandated in the prior proposal. Firms would now be permitted to apply the same exposure calculation methodologies used for their US risk-based capital calculations (i.e., CEM or the internal model method [IMM]), which requires supervisory approval). Using IMM generally results in a lower exposure estimate than under the relatively blunt CEM. However, it should be noted that the FRB is expected to reform the counterparty risk-based capital rules in the future following the Basel Committee’s

publication of the standardized approach for measuring counterparty credit risk exposures (SA-CCR).³

Broader definition of ‘single counterparty’

The re-proposal largely adopts the exposure combination and aggregation rules in the BCBS LES, which mandate an analysis of “economic interdependence” for large counterparties, and includes additional criteria to determine “control relationships.” These rules would broaden the definition of a single counterparty to combine exposures where a highly correlated probability of default exists between specific counterparties. Firms that have invested in enterprise legal entity identifier (LEI) infrastructure and more agile counterparty aggregation hierarchies will be better positioned to meet the operational challenges of this requirement.

If adopted as proposed, the re-proposal would require a significant capability build for many banking institutions. Firms will likely look to integrate SCCL into their currently existing counterparty credit risk infrastructure and try to leverage related counterparty risk identification and measurement capabilities to the greatest extent possible.

Background and context

The single counterparty credit limits re-proposal implements part of the Dodd-Frank Act (DFA) building on earlier proposals released by the FRB in 2011 and 2012, and seeks to promote global consistency by generally aligning to the Basel Committee's large exposures standards (BCBS LES) released in 2014.

The re-proposal addresses regulatory objectives to:

- ▶ Reduce the risk of failure of individual BHCs by limiting their exposure to any single counterparty.
- ▶ Reduce the systemic risk in the banking system by curtailing the level of overall interconnectedness between BHCs, especially between the largest market participants (i.e., major covered companies).

The re-proposal is more closely aligned with the BCBS LES and has taken into consideration comments received on the original NPR, as well as the outcomes from both industry and supervisory quantitative impact study (QIS) exercises. There are several material differences from the original 2011 SCCL proposal that could present substantial new operational, data and technology challenges.

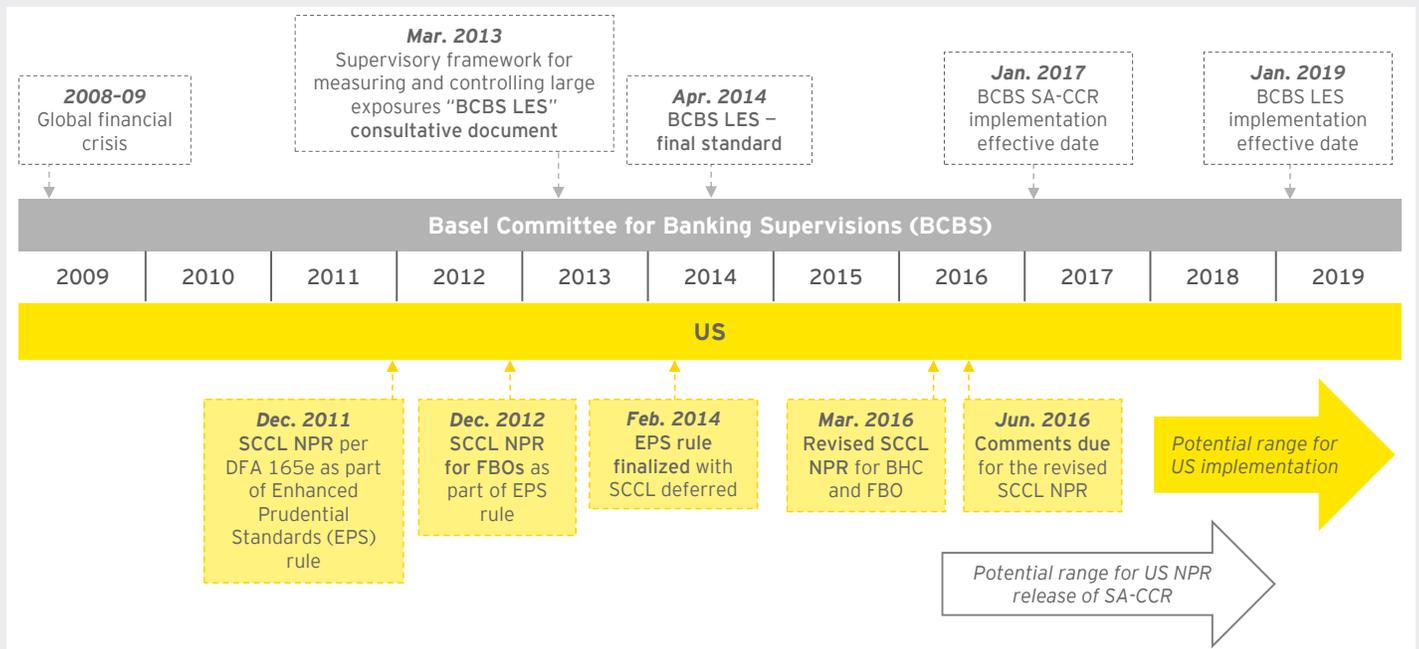
The FRB estimates that systemically important financial institutions (SIFIs) will have to reduce exposures to each other by approximately US\$100b in aggregate. This excess credit exposure is substantially less than the estimate in a 2012 industry study, as a result of changes in the proposed rule's measurement approaches, in conjunction with the progression in industry efforts to reduce bilateral exposure and further movement to central clearing.⁴ Nonetheless, bringing credit exposures within limits will require active exposure management by firms. The SCCL is expected to pose a greater compliance challenge for firms with substantial capital markets activities, particularly in derivatives and securities lending.

Similar to the original NPR, the re-proposal places a quantitative limit on exposure to a single counterparty, expressed as a percentage of a firm's capital base. The re-proposal specifies the approaches firms may use in calculating counterparty exposure, in addition to the definition of connected entities that firms should apply in determining and aggregating their exposure to a single counterparty.

Timeline

The re-proposal did not provide a firm effective date but indicated a one-year implementation period for firms with consolidated assets of \$250b or greater (or \$10b+ in foreign exposures) and two years for other firms following finalization of the rule. Given the time needed to finalize the SCCL rules and this one- to two-year implementation period, the SCCL limits would likely be effective sometime in 2018-19 and potentially as early as Q4 2017. Figure 1 shows the timeline for the SCCL rulemaking and the development of the related guidelines of the Basel LES and SA-CCR:

Figure 1



The re-proposal: summary of key components

The following is a summary of the major components of the re-proposal, as well as commentary on considerations and implications.

Limit constraint framework – The constraint framework generally follows the approach from the original NPR – with larger and more systemically important banks having tighter constraints. FBOs are required to report for any IHC and also for combined US operations (CUSO) with the potential that these dual reporting levels may need to measure limits off of different capital bases, each of which could be in a different tier. Table A summarizes the new framework.

Table A

Tier	US covered company criteria	FBO covered company criteria ¹	Applicable capital base	Single counterparty limit (% of capital base)	Change from original SCCL proposal
General limit	BHCs with consolidated assets of US\$50b or greater but less than US\$250b, and less than US\$10b in foreign exposures	US intermediate holding companies (IHCs) with consolidated assets of US\$50b or greater but less than US\$250b, and less than US\$10b in foreign exposures	Total BHC or IHC regulatory capital plus allowance for loan and lease losses (ALLL) not included in Tier 2	25%	Resembles original NPR
	N/A	Combined US operations (CUSO) of FBOs with consolidated assets of US\$50b or greater but less than US\$250b, and less than US\$10b in foreign exposures	Parent entity regulatory capital plus ALLL not included in Tier 2	25%	
Tighter limit	BHCs with consolidated assets of US\$250b or greater, or US\$10b or greater in foreign exposures, but are not a "major covered company" ²	US IHCs with consolidated assets of US\$250b or greater but less than US\$500b, or US\$10b or greater in foreign exposures	Tier 1 BHC or IHC capital	25%	Denominator has been reduced to Tier 1 capital
	N/A	CUSO of FBOs with consolidated assets of US\$250b or greater but less than US\$500b, or US\$10b or greater in foreign exposures	Tier 1 capital of the parent entity	25%	
Inter-SIFI limit	Major covered companies, 2 US BHCs that are globally systemically important (G-SIB)	US IHCs with consolidated assets of US\$500b or greater	Tier 1 BHC or IHC capital	15% to major counterparties ² (i.e., G-SIFIs) 25% to all other counterparties	While the limit has been relaxed to 15%, the denominator has been reduced to Tier 1 capital
	N/A	CUSO of FBOs with consolidated assets of US\$500b or greater	Tier 1 capital of the parent entity	15% to major counterparties ² (i.e., G-SIFIs) 25% to all other counterparties	

¹ FBOs would need to file two distinct limit reports: one for the IHC level and another for CUSO.

² "Major covered companies" are a subset of "major counterparties." Major counterparties also include any non-bank financial companies supervised by the FRB.

Considerations for foreign banking organizations – Foreign banks operating in the US that are subject to SCCL would have to produce two exposure reports: one at the intermediate holding company (IHC) level where exposure would be measured relative to the IHC’s capital base and one for its CUSO using its parent’s capital base. It is likely that FBOs would be required to also comply with equivalent BCBS LES requirements in the home country of their parent, subjecting them to multiple limit regimes. The additional requirements could introduce operational complexities for certain FBOs in maintaining related but parallel reporting capabilities.

Counterparty definition and aggregation – The re-proposal requires a counterparty’s aggregate exposure to include exposure via entities in which the counterparty has ownership interest equal or greater than 25% (similar to the BHC definition of control), but also adds the BCBS LES concepts of *economic interdependence and control relationships* to determine when entities should be aggregated into a single counterparty exposure. The new combination rules are more complex, and compliance with these new requirements may require qualitative and subjective data collection efforts – from sources that are typically not readily available – in addition to enhancing how proprietary counterparty hierarchy systems are managed.

Exemptions – The re-proposal broadened the scope of counterparty exposures that would be exempt from SCCL limits. Specifically:

- a. Foreign sovereigns attracting a 0% risk weight (RW) under risk-based capital rules would now be exempt in addition to US Government exposures. The re-proposal does not detail whether exempted sovereign exposures would need to be reported (as required in certain cases under BCBS LES). The re-proposal maintains that home country sovereign exposures for FBOs remain exempt regardless of the risk weight
- b. Exposures to QCCPs are now fully exempt in alignment with BCBS LES.
- c. US Government-sponsored entities operating under conservatorship or receivership of the US Government) and Federal Home Loan Banks are now explicitly exempt.
- d. A key point to note, however, is that US BHCs and FBOs that reduce gross exposures to exempt counterparties using non-exempt eligible risk mitigation products are required to shift these exposures to the non-exempt mitigants providers.
- e. Intraday exposures continue to be exempt.

Derivative exposure calculation methodology – The re-proposal expands the allowable methodologies to calculate credit exposure to derivatives counterparties from the previously mandated CEM. Covered companies may now use any of the methodologies authorized under the FRB’s risk-based capital rules, including the IMM if approved, which could potentially provide a reduction in exposure vs. CEM.

Though the US regulators have not proposed the BCBS revised standardized approach for counterparty credit risk, or SA-CCR, the direct reference to SA-CCR corroborates the assumption that the US implementation of SA-CCR will be in line with the proposed Basel rules and effective on or soon after the Basel effective date of 1 January 2017.⁵ The SCCL re-proposal notes that the FRB will consider the benefits of incorporating SA-CCR for risk-based capital purposes. It should be noted that SA-CCR is the only permissible methodology for measuring derivatives potential exposure under BCBS LES.

Credit risk mitigation and risk transfer methodology – The re-proposal adjusts the amount of exposure to be shifted to credit risk mitigation (CRM) providers, essentially requiring full notional risk shifting only when the obligor is a financial institution, whereas the original NPR required this for all counterparties. This methodology is directionally consistent with the BCBS LES approach. An additional clarification was made to remove the optionality of risk shifting to collateral issuers. Risk shifting to collateral issuers is now required in the re-proposal. Furthermore, the definition of eligible collateral has been slightly refined to explicitly include government-sponsored entity (GSE) asset-backed and mortgage-backed securities exposures and exclude private labels.

Securities financing transactions (SFT) methodology – The SFT exposure calculation methodology has been relaxed to allow for a 5-day holding period (as opposed to 10 days in the prior proposal), which is expected to reduce exposure values relative to the original SCCL proposal.

Exposures to funds and special purpose vehicles (SPVs) – The re-proposal clarifies the approach for funds and securitization vehicles by adopting the BCBS LES treatment, which requires the largest banks to “look through” a vehicle to the underlying assets once the total exposure to the fund exceeds 0.25% of capital. Failure to obtain the necessary data to look through a vehicle would require an allocation of such exposure to an “unknown counterparty” and subject it to the single counterparty limit. This “unknown counterparty” bucket could accumulate exposure if a firm’s data quality or data sourcing efforts yield insufficient look-through results, which could ultimately constrain business activity.

Rule design and implementation approach

Both BCBS LES and SCCL share common required capabilities for monitoring and controlling large exposures. Financial institutions (FIs) must be able to aggregate credit exposures across all products (trading book, banking book, off-balance sheet, etc.), across all internal in-scope entities and to all ultimate counterparties as prescribed.

Institutions should consider the extension of existing infrastructure build-out efforts where possible and develop capabilities that can be levered across multiple regulations. In addition to the business constraints of restricting credit exposures against a regulatory limit, compliance with **SCCL requires an integrated data and technology infrastructure across front-, middle- and back-office systems within risk, finance and lines of business**. Complex alignment of multiple limits management business processes would be also necessary to manage and monitor the SCCL limits along with other regulatory and internal limits. Largest impacts can be grouped into: counterparty identification and hierarchy management, exposure calculation and aggregation, and reporting and limits monitoring, as described in Figure 2.

Figure 2

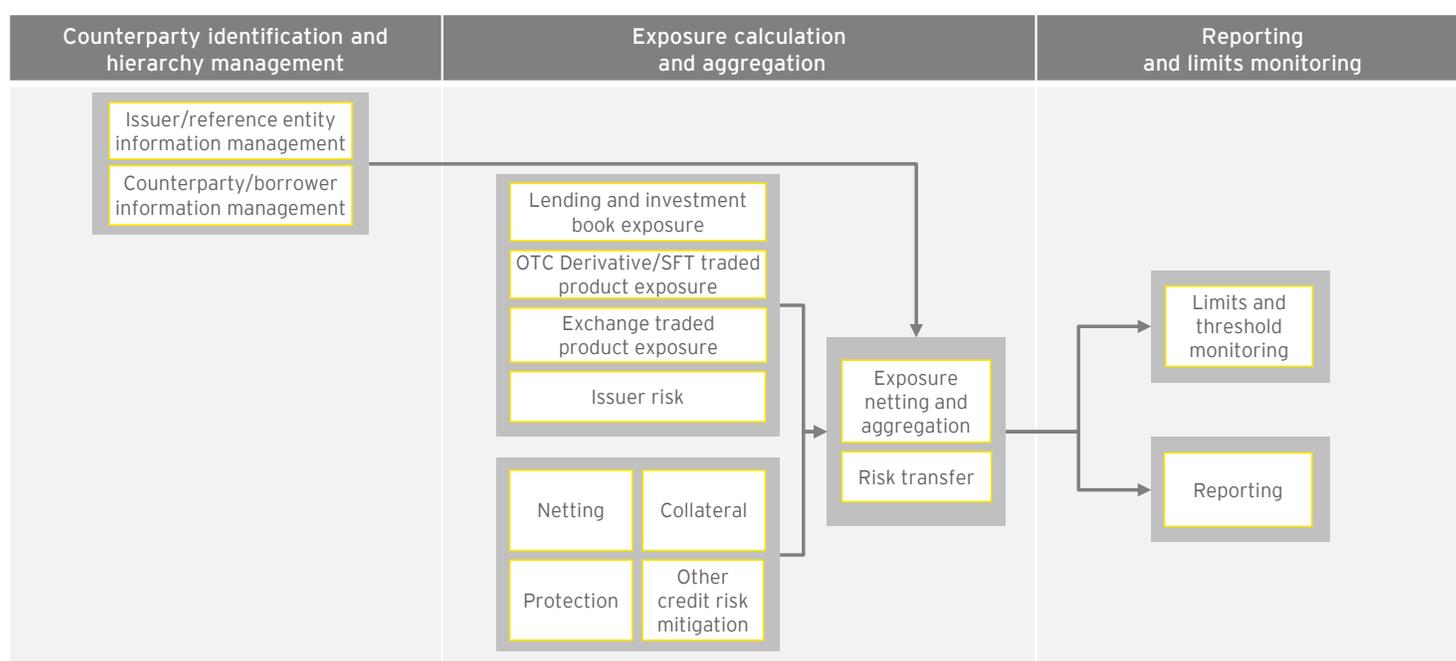


Figure 2 presents a logical division of activities required for an SCCL solution:

- i. **Counterparty identification and hierarchy management** – The re-proposal prescribes grouping counterparties together using qualitative criteria that may be new or different than how counterparties are currently grouped within a bank's systems leading to the need to maintain multiple hierarches. Additionally, the data required to determine economic interdependence and control relationships likely would require new data sourcing and management efforts.
- ii. **Exposure calculation and aggregation** – Specific rules regarding shifting risk to credit and equity derivative protection providers and issuers of collateral make this a challenging exercise across several legal entities within a firm. Universal common identifiers or extensive mapping tables would be required to enable proper calculations.
- iii. **Reporting and limits monitoring** – Calculating and monitoring exposure on a daily basis present significant data and technology challenges, highlighting the need for an integrated end-to-end infrastructure to be able to apply gross and net calculations on a timely basis. Reporting of exposures for counterparties subject to SCCL also poses challenges given the already existing regulatory mandate of producing various reports on a daily, monthly or quarterly basis.

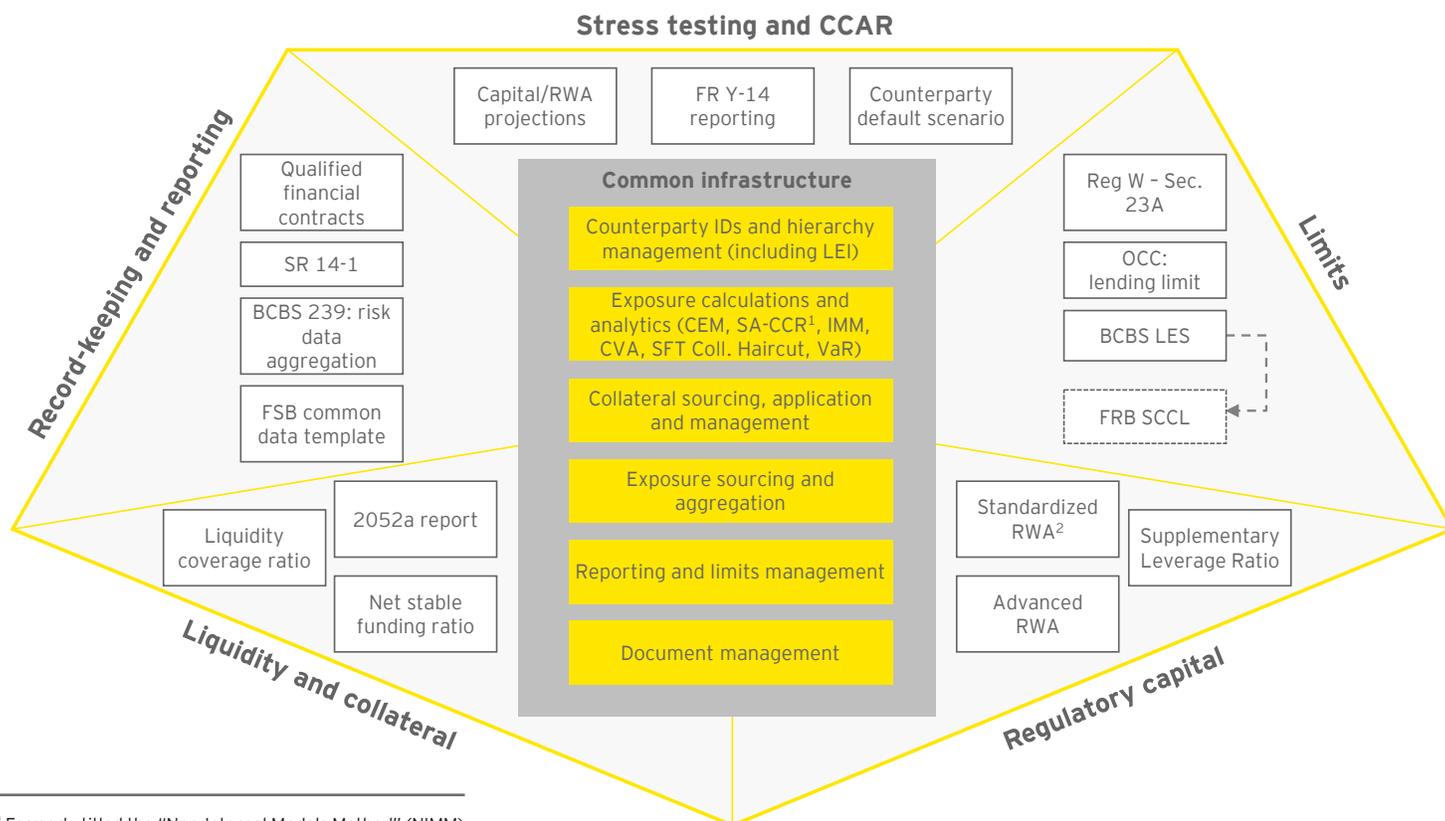
Considerations and open items

Overlap with other regulatory and business-as-usual (BAU) processes

- ▶ There are significant overlaps in data and process requirements with other regulatory exposure measures, such as Basel III risk-based capital and leverage ratio rules, CCAR Global Market Shock largest counterparty default loss and legal lending limit (LLL) rules, as well as banks' internal risk limits monitoring. The existing capabilities of these BAU processes can be significantly leveraged for SCCL implementation. See Figure 3 for an illustrative view of the overlaps within the counterparty credit risk landscape.
- ▶ These various measures of credit exposures and potentially disparate ways in which they impact capital can create additional complexities for capital management efforts. Bank capital and risk management will increasingly require enhanced MIS and analytics to efficiently manage allocation of capital and balance sheet constraints.

Figure 3

Numerous existing and emerging regulatory reform demands require an integrated counterparty risk infrastructure for financial institutions operating in the US. The regulatory set below provides an illustrative view of some of the prevailing CCR issues requiring attention.



¹ Formerly titled the "Non-Internal Models Method" (NIMM)

² Revisions to Standardized Approach currently in BCBS comment status

Final rule uncertainty

- ▶ The re-proposal contains 58 questions for which the regulators are soliciting industry feedback. The questions cover nearly all aspects of the revised rule. Approximately half of the questions address definitions included in the re-proposal and ask for industry participants to confirm whether the definitions are sufficiently clear and/or appropriate, or if additional regulatory guidance is required. Several of the questions address the calculation of gross exposures, the recognition of collateral and short-positions, as well as the recognition of eligible guarantees and credit protection. These questions are in regards to the overall exposure calculation, and any changes made by the regulators reflected in the final rule might have a significant impact on the limit calculations performed by the covered companies. Lastly, a significant proportion (17 of the 58 questions) addresses the treatment of FBOs and their related IHCs and combined US operations.
- ▶ Notably, one question (No. 52) asks whether FBOs should be allowed to use internal models to value derivatives transactions for the sole purpose of complying with the SCCL rules.

Actions to be considered

- ▶ **Coordinate comment letter and program** – Coordinate roles and responsibilities across impacted functions to establish preliminary program governance, and determine whether the bank will engage in providing comments individually or through industry efforts.
- ▶ **Conduct pro forma analyses** – Update exposure concentration impact analyses to reflect the updated proposed rule changes and determine whether mitigation actions are necessary.
- ▶ **Perform a gap analysis** – Determine the extent to which existing capabilities can be leveraged versus new capabilities that would need to be developed as part of the implementation efforts. This would include assessing the connection points with other internal and regulatory requirements, such as other limit frameworks (e.g., legal lending limits, internal risk limits), BCBS LES, Basel risk-based capital, CCAR, and existing reporting and monitoring frameworks.
- ▶ **Assess data and technology** – Assess the impact on overall counterparty risk management infrastructure and processes, including foundational exposure identification, existing counterparty hierarchies and capabilities required to 1) identify counterparties in scope of the economic interdependence analysis, and 2) look through to collateral issuers, guarantors, credit protection providers and SPVs. Firms should also conduct a holistic application and architecture design building on the assessment of existing exposure calculation and reporting capabilities, and firms' ability to support multiple methodologies and daily monitoring.

Key change summary table

Table B summarizes additional key changes across the SCCL NPR from the original proposed rule and notes some potential implications.

Table B

Category	Item	Commentary
Scoping and definitions	Considerations for FBOs	An FBO would likely be required to monitor and report on another layer of concentration limits if its home country regulator has BCBS LES requirements. ¹
	Eligible collateral definition	The list of eligible collateral now explicitly includes GSE exposures. The eligible collateral definition differs slightly from the risk-based capital rules, which could cause implementation challenges.
Counterparty identification and hierarchy management	Combinations	New rules prescribing how counterparties must be aggregated around economic interdependence and control relationships could have significant data sourcing, IT and due diligence implications.
	Attribution rule	The FRB softens language on when the attribution rule must be applied. The FRB now states the intent to prevent “undue burden.” The attribution rule must only be monitored in “the ordinary course of business.”
	Funds and securitizations	A new “look-through approach” and “unknown counterparty” bucket may cause business and operational challenges.
Exposure calculation and aggregation	Derivative exposure calculation methodology	The new potential to use IMM as another option instead of only CEM presents certain banks with a more risk-sensitive approach to calculating exposure.
	Credit risk mitigation methodology – eligible credit/equity derivatives	The adoption of BCBS LES-styled methodology in which full credit/derivative notional is shifted to the protection provider only for financial reference assets should reduce overall inter-SIFI exposures.
	Credit risk mitigation methodology – risk shifting	Removing optionality and requiring risk shifting to collateral issuers and protection providers could create an exposure if collateral was being used to offset an exempt exposure.
	SFT exposure calculation methodology	The re-proposal permits a 5-day liquidation period, down from 10 days in the original NPR; this is expected to reduce exposures.
Reporting and limits monitoring	Exemptions	The re-proposal features an expanded set of counterparties exempted from the limit, including QCCPs and sovereign entities that have a 0% RW under risk-based capital rules, which could alleviate some business concerns.
	Timing	Larger banks still must monitor exposures on a daily basis and produce a monthly report to the FRB; however, the operational burden has been softened on smaller banks <US\$250b, which now have quarterly calculation and reporting requirements.

Glossary

ALLL	Allowance for loan and lease losses	IHC	Intermediate holding company
BCBS	Basel Committee on Banking Supervision	IMM	Internal models method
BHC	Bank holding company	LEI	Legal entity identifier
CCAR	Comprehensive Capital Analysis and Review	LES	Large exposure standards
CCP	Central counterparty	LLL	Legal lending limit
CCR	Counterparty credit risk	NPR	Notice of proposed rulemaking
CEM	Current exposure method	OTC	Over the counter
CRM	Credit risk mitigation	QCCP	Qualifying central counterparty
CUSO	Combined US operations	QIS	Quantitative impact study
DFA	Dodd Frank act	RW	Risk weight
FBO	Foreign banking organizations	RWA	Risk weighted assets
FRB	Federal Reserve Board of Governors	SA-CCR	Standardized approach for counterparty credit risk
GSE	Government-sponsored entity	SCCL	Single counterparty credit limits
G-SIB	Global systemically important bank	SFT	Securities financing transactions
G-SIFI	Global systemically important financial institution	VaR	Value at risk

Footnotes

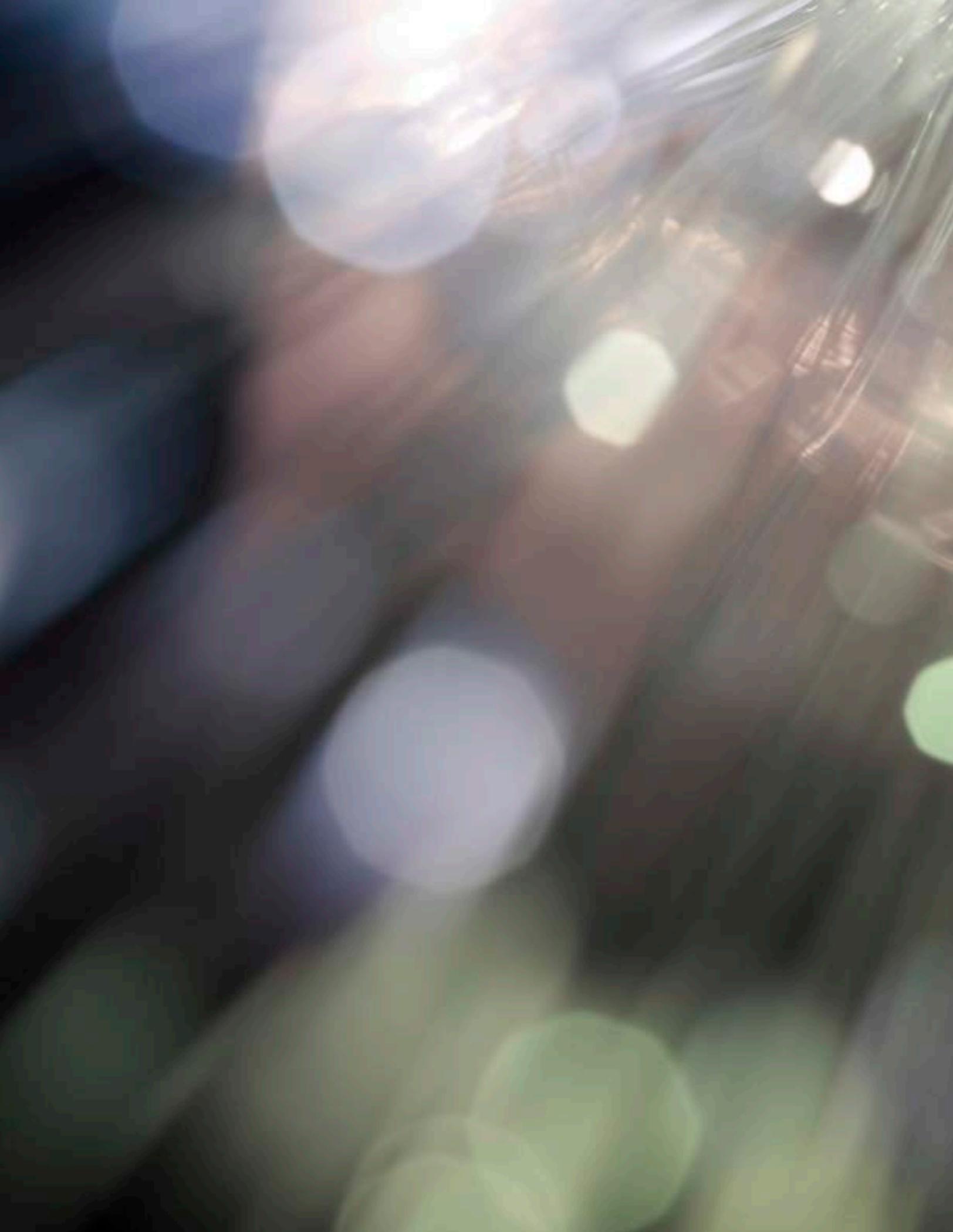
¹ Board of Governors of the Federal Reserve website, <http://www.federalreserve.gov/newsevents/press/bcreg/20160304b.htm>, 4 March 2016

² Supervisory framework for measuring and controlling large exposures, Basel Committee on Banking Supervision standards, April 2014 (accessed via <http://www.bis.org/publ/bcbs283.pdf>, Accessed March 2016)

³ The standardised approach for measuring counterparty credit risk exposures, Basel Committee on Banking Supervision, March 2014 (accessed via <http://www.bis.org/publ/bcbs279.pdf>, Accessed March 2016)

⁴ "TCH Study Finds that Measurement Methodologies Proposed for Estimating SSCL Exposures Overstate Actual Risk," *The Clearing House Association website*, <https://www.theclearinghouse.org/publications/2012/sccl-study>, 19 July 2012

⁵ The standardised approach for measuring counterparty credit risk exposures, Basel Committee on Banking Supervision, March 2014 (accessed via <http://www.bis.org/publ/bcbs279.pdf>, Accessed March 2016)



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