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June 28, 2013

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: Supervisory Framework for Measuring and Controlling Large Exposures

Ladies and Gentlemen:

The Clearing House Association L.L.C. (“**The Clearing House**”), the American Bankers Association (the “**ABA**”), the Global Financial Markets Association (“**GFMA**”), The Financial Services Roundtable (“**FSR**”), International Swaps and Derivatives Association, Inc. (“**ISDA**”), and The Structured Finance Industry Group (“**SFIG**”) (collectively, the “**Associations**”)¹ appreciate the opportunity to comment on the Basel Committee on Banking Supervision’s (the “**Basel Committee**” or the “**Committee**”) March 2013 Consultative Document, *Supervisory framework for measuring and controlling large exposures* (the “**Proposed Framework**” or the “**Framework**”).

¹ The Associations collectively represent financial institutions accounting for a substantial majority of global banking and financial assets as well as sponsors of structured finance products, investors, financial intermediaries, rating agencies and other market participants. Descriptions of the Associations are provided immediately following the signature page of this letter.

Each of the Associations has long supported enterprise-wide measurement and management of risk exposures and concentration. Indeed, beyond statutorily-mandated lending limits for United States (“US”) banks that were established in the 1860s,² US bank holding companies have established limits and monitored exposures in accordance with enterprise-wide risk management frameworks for many years. Likewise, in the European Union (“EU”), banking groups have long been subject to a system of exposure limits.³

Each of the Associations also supports the Basel Committee’s work to introduce a large exposures framework for internationally active banks and shares the Committee’s view that limits on exposure to any one counterparty can serve important prudential purposes and complement existing risk-based capital requirements.⁴ These limits must, however, be properly tailored and calibrated to the risks they are intended to address, so as to avoid potential damage to the financial system and the broader economy. For that reason, this letter makes recommendations that the Associations believe would improve the overall effectiveness of the final Framework without undermining the prudential benefits of an internationally-consistent large exposure regime for globally active banks. The Associations would be pleased to work with the Committee to further develop any and all of these recommendations.

² See 12 U.S.C. § 84; 12 C.F.R. Part 32.

³ See, e.g., Directive 2006/48/EC of the European Parliament and of the Council Art. 106 ¶ 3 (14 June 2006) (as amended by Directive 2009/111/EC of the European Parliament and of the Council Art. 1 ¶ 19 (16 September 2009)); Committee of European Banking Supervisors, *Guidelines on the implementation of the revised large exposures regime* (11 December 2009). Following the incorporation of credit concentration risk into Pillar 2 of Basel II, international banks are now also being required to hold capital specifically against such risks. See Basel Committee for Banking Supervision, *International Convergence of Capital Measurement and Capital Standards, A Revised Framework, Comprehensive Version* ¶¶ 770-77 (June 2006) [hereinafter “**Basel II**”].

⁴ See Letter from The Clearing House, ABA, The Financial Services Roundtable, the Financial Services Forum, and the Securities Industry and Financial Markets Association, to the Board of Governors of the Federal Reserve System (the “Federal Reserve”) (April 27, 2012), available at <http://www.theclearinghouse.org/index.html?f=073837> [hereinafter “**Joint Trades Comment Letter on the Proposed SCCL**”].

The Joint Trades Comment Letter specifically addressed the Federal Reserve’s notice of proposed rulemaking (“NPR”) implementing the single-counterparty credit limits (“**Proposed SCCL**”) under Section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“**Dodd-Frank**”) to which the Basel Committee’s Proposed Framework is substantially similar in many respects. See Pub. L. No. 111-203 (2010) (Dodd-Frank); see also Federal Reserve System, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies; Proposed Rule*, 77 Fed. Reg. 594, 612-22, 649-54 (5 January 2012) [hereinafter “**US Enhanced Prudential Standards**”].

Part I of this letter provides an executive summary of our concerns and recommendations concerning the Proposed Framework. Part II outlines our key conceptual concerns regarding the Proposed Framework and the principles around which we formulated our recommendations for addressing those concerns; Part III expands on these key concerns and recommendations relating to the measurement of exposures; Part IV examines and recommends revisions to the structure of the limit imposed by the Proposed Framework (the “**large exposure limit**” or “**LE limit**”); Part V does the same for the treatment of certain counterparties; Part VI highlights additional concerns with the Proposed Framework; and Part VII sets forth cross-references to sections of this letter addressing specific topics as to which the Basel Committee asked for comments.

I. Executive Summary

Key Conceptual Concerns and Principles

The Associations support the Basel Committee’s goal of establishing a framework for international consistency in large exposure standards to address counterparty risks and its decision to study the results of the quantitative impact study that it plans to conduct before reaching a conclusion on the final value of the large exposure limit.

However, we have fundamental concerns with certain aspects of the Proposed Framework. Most importantly:

- In a number of areas, the Framework’s proposed measurement methods are not sufficiently risk sensitive and would substantially overstate actual economic risk. For instance, the Framework’s exposure-shifting regime for credit protection providers substantially overstates actual exposures because it fails to account for the reduced risk of “double default” exposures. Similarly, the Framework significantly overstates exposures from securities financing transactions.
- Aspects of the Framework appear to be driven by policy goals other than the accurate measurement and control of counterparty risk, such as strengthening oversight and regulation of the shadow banking system and limiting the aggregate exposure of systemically important financial institutions to credit protection providers. By attempting to address disparate policy goals indirectly through a blunt supervisory tool such as the large exposure limit, aspects of the Framework have become unnecessarily complex, such as its approach to determining connected counterparties and its look-through requirements.
- Although many of the types of transactions covered by the Framework may seem complex and limited to the largest banks, such transactions ultimately form key parts of the larger financial system and therefore filter through the

financial markets, affecting the costs and availability of many types of financial products and services provided to consumers, businesses, public sector entities, and institutional investors. In view of the Framework's wide-ranging potential impact and the need for additional study of its effects, the Associations strongly urge the Committee to move cautiously in implementing the Framework to allow regulators an opportunity to evaluate the effectiveness of particular methodologies and their effects on the market.

Our specific recommendations for addressing our concerns with the Framework (which are set forth below) are informed by the following general principles: (i) incorporate, and as appropriate, enhance the risk measurement methodologies developed under the Basel Committee's risk-based capital framework, including the use of internal model methods and/or standardized approaches, to ensure that exposures appropriately reflect a realistic worst case scenario; (ii) craft a clear and consistent framework that is not so complex, granular or rigid so as to make it difficult for banks to provide economically beneficial products and services to customers; (iii) refrain from creating any new limitations on exposures that are critical to the proper functioning of banking and financial markets such as intraday exposures; and (iv) encourage risk management practices that enhance the safety and soundness of banks.

Improvements to the Proposed Framework's Measurement of Risk Exposure

- Exposure-Shifting for Credit Protection Providers: Where a bank buys credit protection for a reference exposure, the proposed requirement that the bank shift the entire exposure amount from the counterparty to the credit protection provider both (i) grossly overstates the bank's exposure to the provider by ignoring the reduced risk of double default (and in the case of a netting set with a particular credit protection provider assumes that all reference names in the netting set, as well as the credit protection provider itself, simultaneously default), and (ii) effectively ignores other national and international regulatory reforms designed to address counterparty credit risk, including limits on concentrations of such risk to particular credit protection providers. The Framework should be revised to better and more accurately reflect the actual risks of such credit mitigants, so as not to unduly restrict banks' ability to engage in important risk-management activities that enhance the fundamental safety and soundness of each institution.
- First, the Associations recommend that all derivatives, including credit default swaps, be treated in a consistent manner for purposes of determining exposures. In general, all derivatives should be subject to a uniform

counterparty credit risk exposure limit rather than singling out credit default swaps for a different, substitution approach.

- Second, to address concerns that banks may amass concentrations of “wrong-way” risk, we suggest that the Framework provide that banks would monitor: (i) potential credit protection concentrations; (ii) the default risk of the underlying reference names in the portfolio; and (iii) net position limits on particular underlying reference assets. Such monitoring and assessment would be subject to Pillar 2 oversight and review by supervisors.
- Third, the Associations believe that the Framework should contain a provision under which banks would shift the exposure of single pairs of underlying exposures and credit protection providers (“**underlier-provider pairs**”) that exceed a designated percentage of regulatory capital. The amount of exposure to be shifted would be based on the maximum jump-to-default risk of such underlier-provider pairs.
- Fourth, it is important that the Framework clarify that the exposure arising out of a credit derivative position would not be counted twice when calculating a bank’s exposure to a counterparty or group of connected counterparties for purposes of determining its compliance with the large exposure limit, *i.e.*, once as the derivative and once as a credit risk mitigant, similar to the Basel Committee’s risk-based capital framework’s approach, which avoids any such double counting.
- Treatment of Over-the-Counter Derivatives: The current exposure method (“**CEM**”) grossly overstates the exposure of derivative transactions due to the limitations regarding when netting and margin may be taken into account, and we do not know at this point whether the revised CEM (*i.e.*, the non-internal models (“**NIM**”) approach) will remedy these concerns. The Framework should be revised to allow for measures that better reflect the actual risks of derivatives transactions, so as to avoid placing new, disruptive, and wholly unnecessary restrictions on derivatives that serve no prudential purpose.
- The Associations recommend that the Framework be revised to permit banks to measure derivatives exposures through the use of a validated, risk-sensitive internal models method (“**IMM**”) consistent with the risk-based capital framework. To address the Committee’s concerns about model risk, the Associations recommend a high-confidence IMM approach to risk

measurement, as described in section III.B.3 of this letter, which we believe strikes the appropriate balance between prudential conservatism and accurate measurement of risk.

- Should the Committee choose to deviate from the risk-based capital framework's incorporation of a models-based approach, the Associations strongly urge the Committee to ensure that the Framework's measurement methodology for derivatives appropriately account for the credit exposure-mitigating effects of legally enforceable netting and margin agreements. In particular, any approach chosen should fully recognize the risk-reducing effect of the following: (i) legally enforceable netting arrangements; (ii) cash and securities margin that is held to secure current and potential future exposure; and (iii) counterparties' contractual obligations to maintain variation margin obligations and such obligations' effectiveness in limiting potential future exposure.
- If the final Framework incorporates a NIM approach, the Basel Committee should make clear that it will, when such NIM approach is actually finalized, seek further comment on the Framework to ensure the final NIM approach is appropriate for purposes of the LE limit.
- Treatment of Securities Financing Transactions: The proposed Basel II "Comprehensive Approach" dramatically overstates the risks of securities financing transactions ("SFTs") by (i) applying separate, risk-insensitive standardized haircuts to both the securities lent (or borrowed) and the underlying collateral that secures them, (ii) failing to take into account the risk-reducing effect of the correlation between the securities lent (or borrowed) and the collateral received, and (iii) ignoring the benefits of diversification within portfolios of SFTs. The intended framework should be revised to more closely reflect the actual risks of SFTs, so as to avoid the significant disruptions to the market (and the markets for the underlying securities) that would likely result if banks were forced to reduce existing SFT volumes in response to a significant overstatement of risk. A constrained securities financing market will have a negative impact on liquidity and efficiency in the broader capital markets, which could lead to wider trading spreads and more frequent settlement failures.
- Consistent with the Basel Committee's risk-based capital framework, the Associations believe that banks should continue to make use of existing supervisory approved models, such as value-at-risk models ("VaR") or IMM,

to measure their exposures to SFTs. These models much more accurately reflect risks in SFTs than the Comprehensive Approach does, and are easier to adjust to reflect changing market conditions or other risk parameters.

- The Committee's proposed "hybrid approach" for the treatment of financial collateral—which requires the haircut-adjusted amount of the initial exposure to be reduced by the haircut adjusted amount of the collateral, and to be treated as an exposure to the issuer of the collateral—significantly overstates exposures by ignoring the reduced risk of double default. Specifically, the hybrid approach fails to recognize the low probability of a default of the exposure to *both* the counterparty to the transaction *and* to the issuer(s) of the collateral assets(s). In such circumstances, the probability of loss will vary depending on the degree of correlation between the exposure and the collateral assets(s), the use of prudent internal risk management practices, and the number and nature of the underlying counterparties.
- Should the Committee choose to deviate from the risk-based capital framework by disallowing the use of well-established internal models-based methodologies, it is essential that the Committee endeavor to adopt an alternative standard that recognizes (i) the risk sensitivity of securities lent and securities received as collateral, (ii) correlations between the securities lent and the collateral supporting the transaction, and (iii) portfolio diversification benefits. In the interim before any alternative framework is adopted, banks should be permitted to continue making use of their supervisory approved internal models methodologies.
- Netting of Long and Short Exposures: The Framework's intended approach to the netting of long and short exposures in the trading book provides an unrealistic reflection of risk, and limits the recognition of valid netting benefits. As a consequence, it may prevent banks from efficiently hedging risks associated with economically beneficial financial products and services, to the detriment of both banks and their clients. This approach also imposes the additional burden of determining and tracking the various seniorities of the bank's long and short exposures, with little or no corresponding prudential benefit. The Associations recommend that the Framework be revised to include the netting of long and short positions without regard to seniority.

- Netting Across the Banking and Trading Books: The Associations believe banks should be permitted to net across the banking and trading books. Permitting such netting should provide a more accurate reflection of the economic risk in counterparty exposures. Further, the Framework's approach regarding such netting may adversely impact the availability and cost of financial products and services offered to end-users by limiting a bank's ability cost effectively to manage risks arising from such products and services.

Improvements to the Structure of the Proposed Framework's LE Limit

- Denominator of the Large Exposure Limit: The Framework's proposed denominator of Common Equity Tier 1 ("**CET1**") or Tier 1 capital is overly conservative and does not account for the full range of resources that a bank has available to absorb losses on a going-concern basis. The Framework should be revised to make use of a broader denominator that fully and appropriately reflects all capital and other resources with loss-absorbing capacity.
 - First, the Associations believe that the denominator should include total regulatory capital, as well as loan loss reserves not included in regulatory capital, because such resources are available to absorb expected and unexpected losses from large exposures and therefore accurately reflect the total resources available to an institution. US regulators have long used this denominator for their lending limits regulations, and the Federal Reserve used this denominator in its Proposed SCCL.
 - Second, if the Basel Committee nonetheless chooses to take a more narrow view that focuses strictly on "going-concern" capital, we recommend that the denominator include not only Tier 1 capital, but also (i) general loan loss provisions, and (ii) recognition of Tier 2 capital instruments that are able to absorb losses to any counterparty on a going-concern basis.
- Inter-G-SIB Exposures: Given the breadth and depth of the various regulatory reforms designed to address interconnectedness, the Associations believe that exposures between global systemically important banks ("**G-SIB**") should not be subject to a more stringent large exposure limit. G-SIBs are already subject to heightened regulatory and supervisory standards.
 - At a minimum, in view of the substantial number of prudential and macroprudential reforms currently being developed globally and the broad scope of the new methodologies contained in the Framework, we

recommend that a more restrictive inter-G-SIB limit not be incorporated into the Framework unless and until: (i) the full impact of the generally-applicable LE limit has been determined, based on actual experience and quantitative study; (ii) a comprehensive study of the potential impact and calibration of a tighter inter-G-SIB limit has been undertaken; and (iii) it has been determined that such a limit is necessary to mitigate risks to financial stability, appropriately taking into account the numerous pending changes to the international regulatory framework that will elsewhere reduce inter-G-SIB exposures. Absent such a measured and cautious approach, any more stringent inter-G-SIB limit could be highly disruptive by reducing market liquidity and loan capacity and driving certain financial services into less regulated sectors.

- Scope and Level of Application: While the Associations recognize the prudential benefits of applying the Framework to fully consolidated groups, we believe that application of the Framework at the sub-consolidated level would be extremely misguided. In particular, the Associations believe that sub-consolidated application would likely create fundamental inconsistencies with long-standing national limit frameworks that would be impossible to harmonize without amending national laws. Further, because of the nature of the market activity and risk profile of entities operating at the sub-consolidated level, the Framework would potentially constrain activity that, for the overall consolidated entity, is well within acceptable risk limits. Therefore, the Associations recommend that the Proposed Framework be revised to provide national supervisors with explicit discretion to exclude a sub-consolidated entity from the large exposure framework on a solo basis.

Improvements to the Treatment of Certain Counterparties and Exposures

- CCPs: Application of a Pillar 1 limit to “qualifying” central counterparties (“**Q-CCPs**”) may restrict the ability of institutions to make use of Q-CCPs, in direct contradiction with the clear policy consensus of the G20 that central clearing should be required wherever practicable in order to reduce systemic risk. Because there are only a limited number of CCPs capable of meeting banks’ clearing needs, banks may be unable to diversify their exposure to a Q-CCP sufficiently to satisfy LE limit requirements. Furthermore, Q-CCPs are themselves agents of systemic risk mitigation. Placing Pillar 1 limits on exposures to Q-CCPs, and thereby encouraging banks to diversify their risks away from Q-CCPs, may therefore be undesirable. Also, the application of the

Framework to Q-CCP exposures may result in the unnecessary fragmentation of clearing activities and increase in liquidity risks. The Associations recommend that exposures to Q-CCPs not be subject to a hard Pillar 1 limit, and that the Framework should instead defer to national supervisors to monitor and control Q-CCP concentration risk through the supervisory process.

- Connected Counterparties: The Framework's proposed guidance-based tests for "control" and "economic interdependence" are highly subjective and fact-intensive, and they are unlikely to result in the identification of material additional counterparties. Moreover, they are likely to lead to inconsistent application across firms and jurisdictions and will impose significant compliance obligations on banks with little, if any, prudential benefit. To avoid these adverse effects, the Associations recommend that the Framework be revised to establish a clear, transparent, and easily-determinable standard to assess connected counterparties.
 - First, the test for connected counterparties should include only counterparties that are consolidated for financial reporting purposes. This approach would create a bright-line test for institutions to follow, furthering the Framework's stated goals of both simplicity and consistency with the prevailing risk-based capital framework. Potential linkages between entities that are not members of the same accounting group should be addressed through a Pillar 2 approach.
 - Second, should the Committee choose to deviate from the risk-based capital framework and adopt a guidance-based test, we strongly recommend that such guidance-based test be subject to a meaningful and objective materiality threshold.
 - At a minimum, the Committee should permit banks to utilize existing guidance-based tests that they already deploy for other regulatory purposes (*e.g.*, the US lending limits test), so as to reduce unnecessary new compliance burdens that the Framework would otherwise impose.
- Treatment of Intra-Day and Overnight Exposures, and Exposures Related to Payment, Clearing and Settlement, and Custody ("PCS") Services: The LE limit should not apply to intra-day exposures, certain overnight interbank exposures, and exposures arising from the provision of PCS services to clients in the same way it is applied to other credit exposures. The transactions from which these

exposures arise are critical to the sound and proper functioning of financial markets, and fully subjecting these exposures to the LE limit could have significant, unintended and disruptive consequences for the financial system.

- First, the Associations strongly support an exemption for intraday exposures, since such exposures serve an essential function in the provision of liquidity in support of day-to-day payment activities. Subjecting intraday exposures to the Framework could significantly reduce the ability of banks to support payment activities, or otherwise force them to charge far higher fees for such services, while providing unclear benefits.
- Second, the Associations support an exemption for certain overnight interbank exposures, such as placements with banks subject to reserve requirements and *nostro* balances held with correspondent banks, which are an important source of market liquidity and are integral to the conduct of monetary policy.
- Third, the Associations strongly believe that the Framework should provide additional flexibility for day-to-day exposures arising from the provision of PCS services to clients in view of the importance of such activities to the efficient functioning of financial markets. In particular, an exposure arising in the normal course of providing PCS services to clients should be exempt from the LE limit so long as the bank, among other steps, takes appropriate action to correct the transaction giving rise to the exposure as quickly as reasonably practicable, and in no event for longer than five business days.
- Exposures to Collective Investment Vehicles: The proposed look-through approach (“**LTA**”) for collective investment undertakings (“**CIUs**”), securitizations, and similar vehicles requires information that is not available in many instances and as proposed imposes substantial (and in many cases insurmountable) burdens not balanced by corresponding prudential benefits.
 - The Associations strongly recommend that any concerns regarding potential risk concentrations that may result from bank investments in CIUs, securitizations, or other vehicles be addressed through a Pillar 2 approach. Under such an approach, banks would monitor and document their exposures at the underwriting stage, if applicable, and thereafter on a quarterly basis. National regulators would review this monitoring process

and have the ability to require banks to look-through and aggregate certain underlying exposures that present material risk.

- Should the Committee adopt the LTA, we strongly recommend that the scope of any look-through requirement be narrowed by providing exemptions for specific classes of transactions that clearly do not give rise to material counterparty risk.
- The Committee should also recognize the risk mitigating impact of the embedded credit enhancements in senior tranches of investment grade CIUs, securitizations, and other vehicles and provide explicit exemptions from the LTA for those senior tranches meeting specific quality conditions.
- Sovereign Exposures: The Associations support the Basel Committee’s exclusion of exposures to sovereign counterparties from the large exposure limit. We also recommend that the Framework be revised to explicitly grant national regulators discretionary authority to exclude certain additional entities—such as government-sponsored entities (“**GSEs**”) or entities serving a public purpose—from the limits (but not the reporting requirements) of the Proposed Framework. The risks posed by such exposures are adequately captured by national regulatory frameworks, and subjecting these types of entities to the LE limit could potentially encumber or obstruct their critical functions.
- Natural Persons: Natural persons should not be subject to the LE limit given the extreme unlikelihood that exposure to an individual by a bank would ever reach the LE limit or pose any risk of systemic interconnectivity that the Proposed Framework was designed to address.
- Traditional Off-Balance Sheet Commitments/Calculation of CCFs: The Proposed Framework calls for the use of a 100 percent credit conversion factor (“**CCF**”) based on a “worst case” loss assumption for off balance sheet commitments, with the exception of exposures to trade finance. The Basel Committee should revise the Framework to better reflect the actual risks of certain additional off-balance sheet commitments by taking into account relevant contractual features or characteristics of a counterparty that may prohibit or otherwise prevent a full drawdown of the commitment. For example, for certain regulated counterparties (*e.g.*, mutual funds) or lending exposures, applicable regulatory leverage limits, contractual restrictions, or regulatory restrictions may legally

prohibit or otherwise preclude the counterparty from borrowing all of the committed amount that is notionally available for draw.

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II. Key Conceptual Concerns and Principles

The Basel Committee's Proposed Framework would establish, for the first time, a globally consistent approach to quantitative limits on the credit exposures of internationally active banks to any one counterparty or group of connected counterparties, as well as a related reporting framework. The proposed LE limit is intended as "a tool for containing the maximum loss a bank could face in the event of a sudden counterparty failure to a level that does not endanger the bank's solvency."⁵

The Associations support the Basel Committee's goal of establishing an internationally consistent framework for large exposures to address counterparty risks involving globally active banks. Indeed, as a matter of internal risk management, large banking organizations have long used a variety of internal exposure limits to measure and control their counterparty risks, even absent regulatory requirements. The Associations also welcome the Committee's commitment "to study the results of the quantitative impact study that it plans to carry out over the next few months before reaching a conclusion on the final value of the limit" and support the Committee's approach not to specify specific sanctions for a breach of the LE limit.⁶

However, the Associations are concerned with the manner in which the Framework proposes to measure certain exposures. In a number of areas, the proposed measurement methods are not sufficiently risk sensitive and would substantially overstate actual economic risk. For instance, the Proposed Framework's exposure-shifting regime for credit protection providers and financial collateral substantially overstates actual exposures

⁵ Proposed Framework ¶ 1. A central assumption of the Proposed Framework is that the Basel regulatory capital framework does not adequately mitigate the idiosyncratic risks in a bank's portfolio arising from large exposures to individual counterparties. See Proposed Framework, ¶ 3. In particular, the Committee states that no form of concentration risk is considered in calculating the minimum capital requirements, noting that the Basel capital framework implicitly assumes "infinitely granular portfolios." *Id.* In considering the Proposed Framework, certain of our members are undertaking an analysis of the impact of granularity and concentration risk on a bank's portfolio. The analysis will be further vetted by industry participants. Thereafter, it is contemplated that a dialogue with the Committee relating to the analysis will be sought.

⁶ Proposed Framework ¶ 40.

because it fails to account for the reduced risk of “double default” exposures.⁷ Similarly, the Proposed Framework’s approach to valuing securities lending and borrowing transactions overlooks the risk-reducing effect of the correlation between securities lent and collateral received in a lending portfolio, as well as the benefits of diversification across a pool of securities lending transactions.⁸

Other aspects of the Proposed Framework overstate exposures because they appear to be driven by policy goals other than the accurate measurement and control of counterparty risk. The Committee notes, for instance, that it also intends to: (i) address concerns that may arise where one institution sells a substantial amount of credit protection to the industry, and (ii) “strengthen the oversight and regulation of the shadow banking system.”⁹ While these are important concerns that the regulatory community should address, the large exposure Framework is not the appropriate vehicle. Rather than force these policy goals into the large exposure limit, which is a blunt tool designed to mitigate counterparty risk, regulators should develop more tailored tools to address these other concerns directly. For example, to the extent the Committee seeks to address concern that “a number of SIFIs were believed to have bought large amounts of credit protection” from a single credit protection provider,¹⁰ regulators may consider use of other available policy tools.¹¹ Likewise, to the extent the Committee seeks to “strengthen the oversight and regulation of the shadow banking system,”¹² regulators should supervise the non-banking sector directly instead of requiring an excessively burdensome LTA and evaluation of “additional risks.”¹³

By attempting to address these disparate policy goals indirectly through the large exposure limit, the Proposed Framework has become unnecessarily complex. For example, under the Framework banks must conduct a highly subjective and burdensome evaluation of “connected counterparties” that relies on information to which banks simply will not have access in many instances.¹⁴ The Proposed Framework also requires banks to look

⁷ See section II.A.1.

⁸ See section II.C.

⁹ Proposed Framework ¶ 6.

¹⁰ *Id.* ¶ 5.

¹¹ See section II.A.3.

¹² Proposed Framework ¶ 6.

¹³ The United States, for instance, has taken steps toward this end by subjecting nonbank systemically important financial institutions to bank-like regulation, including ongoing supervision and capital and liquidity requirements. See, e.g., 12 U.S.C. §§ 5361, 5365

¹⁴ See Proposed Framework ¶¶ 32, 34; see also section V.B.

through CIUs, securitizations, and other vehicles to *all* of those entities' underlying assets in the scheme if only *one* underlying asset exceeds *one* percent of the total value of the scheme's assets.¹⁵ This LTA would require banks to conduct an evaluation of assets that, in most cases, have no material effect on counterparty risk.¹⁶ Such prescriptive, subjective tests are plainly at odds with the Committee's "efforts to avoid adding unnecessary complexity to the Basel standards."¹⁷

In addition, the Framework overstates exposures because measures of exposures values under the Framework, as a general principle, do not take into account credit quality or the amount expected to be recovered in the bankruptcy process.¹⁸ The assumption that the maximum possible loss that a bank could incur if a single counterparty (or group of connected counterparties) defaulted equals the bank's exposure to that counterparty is simply unrealistic. Even in extreme scenarios, significant recoveries are expected and the present value of those recoveries is taken into account by investors.

The consequences of these and other shortcomings in the Proposed Framework's measurement methodologies for the global economy are uncertain but may be significant. Although many of the types of transactions covered by the Framework may seem complex and limited to the largest banks, such transactions ultimately are key to the workings of the larger financial system and filter through the financial markets, affecting the costs and availability of many types of financial products and services provided to consumers, businesses, public sector entities, and institutional investors.¹⁹ For example, corporate borrowers rely on banks for credit, and banks in turn manage their credit risks with the help of credit derivatives; regional and community banks rely on interest rate derivatives to manage risks on fixed rate loan products they offer to retail, small business, and corporate customers; pension funds, insurance companies, and governmental entities rely on non-clearable interest rate and equity derivatives products to manage the complex and long-dated risk profiles of their assets and liabilities; and institutional investors rely on securities financing markets for income to increase

¹⁵ Proposed Framework ¶ 109.

¹⁶ See section V.D.1.

¹⁷ Proposed Framework ¶ 7.

¹⁸ *Id.* ¶ 46.

¹⁹ See The Clearing House, *Single Counterparty Credit Limits: The Clearing House Industry Study 5* (July 2012), available at <http://www.theclearinghouse.org/index.html?f=074170> [hereinafter "**TCH SCCL Study**"].

the return for their investors.²⁰ Costs will rise for the entire system if unwarranted constraints due to the overstatement of counterparty risk lead to decreased supply of financial products.

Despite the many significant effects that LE limits may have on financial service and financial product end-users, there is no published public sector analysis of the individual or collective consequences of such limits. In light of that empirical vacuum, The Clearing House undertook and published a study in July 2012 (the “**TCH SCCL Study**”) to assess the impact of the Proposed SCCL. The TCH SCCL Study concluded that, due mainly to the overstatement of risk, large US banking organizations would be forced to substantially reduce their credit intermediation and market-making activities if the Proposed SCCL were adopted as proposed.²¹ Market participants and financial end users would be significantly affected by lower liquidity in the derivatives and securities lending markets, as well as by a higher cost of credit for consumers, small businesses, and corporate borrowers.²² The Proposed Framework is likely to have even more severe effects because it uses even more stringent exposure measurement methods, is targeted at a larger number of banks, and includes a more narrowly-defined denominator than the Proposed SCCL.²³

In response to the Basel Proposed Framework, banks could be forced to limit transactions that give rise to overstated exposures under the Proposed Framework, which could result in significant market contractions.²⁴ If, for example, banks would be required to limit hedging or risk-management activities (*e.g.*, where there are not sufficient hedging tools or counterparties available), banks would have to reduce their unhedged exposure, and corporate borrowers may find access to bank credit more limited. Also, beneficial owners of securities, such as pension funds, mutual funds, and other institutional investors would have fewer options to rebalance their positions and would lose a portion of the income they generate from securities lending activities.²⁵

²⁰ *Id.* at 13.

²¹ *Id.* at 5.

²² *Id.*

²³ The Clearing House’s preliminary analysis of the impact of the Framework based on bank responses to the Committee’s QIS on the Framework suggests that the Framework may have a significant impact on the business practices of banks and, by extension, the end-users of financial products and services offered by banks.

²⁴ The TCH SCCL Study estimated, for example, that the Proposed SCCL’s treatment of OTC derivatives would compel US bank holding companies (“**BHCs**”) to reduce the notional amount of their existing derivatives outstanding by \$30 to \$75 trillion, which amounts to 10 to 25 percent of the total notional amount of derivatives outstanding for all US BHCs. *See id.* at 11.

²⁵ *Id.* at 5, 14.

The Proposed Framework is likely to have even more unintended effects on the global economy because many aspects of the Proposed Framework are untested or indeed not even articulated at present (*e.g.*, the non-internal models method for over-the-counter (“**OTC**”) derivatives). The Associations therefore strongly urge the Committee to move cautiously to allow regulators the opportunity to evaluate the effectiveness of particular methodologies and their effects on the market.

With these concerns in mind, the Associations have considered various approaches to further the Committee’s fundamental policy objective to establish a large exposures framework to “contain the maximum loss a bank could face in the event of a sudden counterparty failure.”²⁶ Through this process, the Associations have developed a set of recommendations designed around the following general objectives:

- to incorporate, and as appropriate, enhance (rather than abandon) the risk measurement methodologies developed under the Basel Committee’s risk-based capital framework, including the use of internal model methods and/or standardized approaches, to ensure that exposures appropriately reflect a realistic worst case scenario;
- to craft clear and consistent rules that are not so complex, granular or rigid so as to make it difficult for banks to provide economically beneficial products and services to customers;
- to refrain from creating new limitations on exposures that are critical to the proper functioning of banking and financial markets such as intraday exposures; and
- to encourage risk management practices that enhance the safety and soundness of banks.

The Associations strongly believe that, both individually and collectively, following these recommendations would significantly improve the overall effectiveness of the final Framework and reinforce the policy objectives and prudential benefits of an internationally-consistent large exposures regime.²⁷

²⁶ Proposed Framework ¶ 1.

²⁷ As noted above, each of these recommendations is described in further detail in this letter, including a comprehensive explanation of the underlying issues raised by the Proposed Framework and the Associations’ rationale for suggested changes.

III. Measurement of Risk Exposures

The Associations support the adoption of a consistent large exposure limit for globally active banks. However, it is critical that the measurement methodologies reflect actual exposures—that is, that they be accurate.

- A. Exposure-Shifting to Certain Protection Providers. The Framework should be revised to more accurately reflect the risks posed by credit mitigants through a combination of monitoring and exposure-shifting requirements tailored to the probability and potential impact of a “double default” of both the protection provider *and* the reference obligor.**

The Proposed Framework requires “mandatory substitution” of credit protection providers under derivatives for primary obligors (at least where the bank applies that approach for risk-based capital requirement purposes).²⁸ As proposed, where credit derivatives or other mitigants are used to hedge and reduce an exposure, for purposes of the LE limit, the amount of the hedge would reduce the exposure to the original counterparty and would be added to the bank’s exposure to the protection provider (an “**exposure-shift**”).²⁹ The combination of using notional amounts and the shift requirement would greatly exaggerate the true economic exposure to the protection provider.³⁰ The Framework should be revised to better and more accurately reflect the actual risks of credit mitigants, so as not to unduly restrict banks’ ability to engage in important hedging activities that serve to enhance the fundamental safety and soundness of each institution.

1. **Lower Probability of Double Default**

The Framework’s aggregation of the notional value of underlying exposures and attribution of the entire amount to the credit risk provider is extraordinarily conservative. Doing so would not appropriately reflect the immediate impact of a single obligor failure that the Proposed Framework is designed to contemplate because the implicit

²⁸ Proposed Framework ¶¶ 69, 72-73.

²⁹ *Id.* ¶¶ 69, 72-73.

³⁰ In the TCH SCCL Study, mandatory exposure shifting in the credit derivatives context of the Proposed SCCL was a significant cause of excesses. The TCH SCCL Study found that 39 percent of the total aggregate exposure for all limit excesses measured was due to exposure-shifting to the counterparty protection provider. The TCH SCCL Study, at 17. Additionally, the exposure-shifting requirement of the Proposed SCCL, when combined with the use of the Current Exposure Method (“**CEM**”), increased the total amount of limit excesses to \$987 billion or roughly 38 times that of the \$26 billion baseline overage calculated using generally accepted measurement approaches. *Id.* The exposure-shifting requirement also led to an additional 25 limit excess incidents. *Id.*

assumption of a “double-default” is highly unlikely to occur except in extremely limited circumstances.

In the context of a single, margined credit default swap (“CDS”) contract purchased from a counterparty, the true economic loss that would result if the credit protection provider could not make good on its contract would be the mark-to-market value of the costs of replacing that contract, not the notional value of the underlying exposure. The purchaser could only incur a credit loss of 100 percent of the notional amount if both the protection provider *and* the reference obligor defaulted simultaneously and the reference obligation jumped from par to zero recovery. The disconnect between the approach proposed in the Framework and the actual risks taken by banks is exacerbated in firms’ trading books given that interbank CDS portfolios are generally margined and highly diversified across hundreds, or even thousands, of different reference obligors.

The risk measurement method in the Proposed Framework is unrealistically conservative as it implies both: (i) the protection provider and every reference obligor could default simultaneously (*i.e.*, a highly remote scenario especially across a large number of reference obligors), and (ii) that all obligations would decline precipitously to zero recovery (*i.e.*, not taking into account the value of any collateral that may have been received and the inherent portfolio diversification effect). In reality, for margined CDS the maximum downside would be reduced by the existing mark-to-market because it is already collateralized. For example, even in a double default scenario, the most a protection purchaser can lose on a \$100 notional CDS contract with a current mark-to-market value of \$20 is \$80 because the mark-to-market gain on the CDS contract would have been collateralized, and thus, the loss on the \$100 exposure would be reduced by the \$20 of collateral.

In the rare instances when “double defaults” have occurred, they have happened because of highly correlated “wrong-way” risk (*i.e.*, risk posed by the protection provider is highly correlated with the underlying exposure). Where high correlations of default between the reference obligor and the protection provider exist, this risk is a legitimate concern; but where no such correlation exists, it is not.

2. Other Regulatory Reforms to Address Credit Protection Provider Concentrations

The Committee has indicated that the proposed exposure-shifting provisions are designed to address concerns that banks: (i) may not be closely monitoring credit protection provider concentrations, (ii) may have excessive underlier/provider pair concentrations, (iii) may over-rely on credit protection especially where the underliers are financially-related,

(iv) may have over-lapping concentrations of “wrong-way” risk, and (v) may, in the case of excessive exposure to the failure of a credit protection provider, engage in rapid sales of underlying reference assets, thereby contributing to systemic declines in asset values.

The Associations understand the Committee’s intent in designing the Proposed Framework. In particular, we recognize that, in the years before the financial crisis, numerous banks held significant amounts of credit protection from a limited number of credit protection providers—other than banks—that ultimately did not have the necessary capacity to absorb losses.³¹ This situation led to significant concentrations of risk in these nonbank credit protection providers, such as the monoline insurance companies. While these concerns are real and significant, shifting the exposure to the credit protection provider does not address the problem: it does not limit the exposure from a single underlier or other concentration, and it does not meaningfully limit the aggregate exposure of credit protection purchasers to a single credit protection provider (*e.g.*, banks could still purchase, in aggregate, a significant amount of protection on an underlier from the same provider without any banks who purchased the hedge becoming constrained by their large exposure limit to the provider, presuming that individual banks purchased hedges that were modest in size). As discussed below, substantial steps to minimize remaining risks in this regard have already and will continue to be taken.

The LE rules as written limit the amount of aggregate protection that any particular bank may provide with respect to any particular reference obligor. Accordingly, it is large exposure limits imposed on the issuer of credit protection—rather than the proposed requirements for full substitution by a protection purchaser—that should ensure that the industry, collectively, does not have a dependence on the protection provider.³²

Moreover, bank regulators have taken substantial steps at the national and international levels to address concentration risks in credit protection providers. At the national level, regulators have focused on regulating both bank and nonbank credit protection providers, mandating measures to reduce the riskiness of derivative transactions and requiring heightened disclosures and reporting for all derivatives to increase regulators’ ability to monitor concentration risks.

³¹ See, *e.g.*, Stephen G. Cecchetti, Jacob Gyntelberg, Marc Hollanders, *Central counterparties for over-the-counter derivatives*, at 1 BIS QUARTERLY REVIEW (Sept. 2009).

³² Multiple underlier defaults could conceivably occur under circumstances where the provider sells protection on correlated underliers or an asset class, but they are very unlikely to occur simultaneously, or concurrent, with the provider’s default. Given the current practice of daily collateralization of credit protection, the industry could therefore only be effectively exposed to double default on single underlier-provider pairs.

With respect to credit protection provided by banks, national regulators have broad authority to limit the risks of such activities through bank supervision and regulation. Indeed, even during the financial crisis, the hedged exposures of regulated banks that provided credit protection products sustained far lower losses than those sustained by certain nonbank credit protection providers that were far less regulated and took far greater amounts of unhedged risk. Following the crisis, additional steps have been taken to address the risks posed by nonbank credit protection providers. The United States, for example, now has a mechanism to regulate any large, nonbank institution that is deemed a systemically important financial institution (“**SIFI**”), which could include a large nonbank credit protection provider. Such nonbank SIFIs will be subject to bank-like regulation, including ongoing supervision,³³ credit exposure limits and reporting,³⁴ and capital, liquidity, and stress testing requirements.³⁵ The Financial Stability Oversight Council (“**FSOC**”) in the US has initiated its process for designating certain nonbank institutions as SIFIs. To the extent that there are significant concentrations of risk in a large credit protection provider in the future, that provider could become a prime candidate for SIFI designation and regulation comparable to bank regulation (including limits on large exposures).

Regulators have also taken steps to reduce the riskiness of derivatives transactions. For instance, US regulators are implementing a comprehensive system to regulate OTC derivatives under Title VII of Dodd-Frank.³⁶ These reforms include mandated central clearing by a regulated clearinghouse for most OTC derivative trades³⁷ as well as enhanced collateral and initial and variation margin requirements.³⁸ The European Market Infrastructure Regulation (“**EMIR**”) similarly requires central clearing for most derivative trades³⁹ and enhanced collateral and margin requirements to reduce the risk of trades.⁴⁰

Third, national regulators also are taking steps to heighten derivatives disclosure and reporting requirements. For instance, Title VII of Dodd-Frank mandates robust, real-time

³³ 12 U.S.C. § 5361.

³⁴ 12 U.S.C. § 5365(d)(2), (e); US Enhanced Prudential Standards, 77 Fed. Reg. 613-22, 649-54.

³⁵ See 12 U.S.C. § 5365; US Enhanced Prudential Standards, 77 Fed. Reg. 594.

³⁶ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376, 1641 (2010).

³⁷ 7 U.S.C. § 2(h).

³⁸ 7 U.S.C. § 6s(e).

³⁹ Regulation (EU) No. 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories, Title II, Art. 4 (4 July 2012) [hereinafter “**EMIR**”].

⁴⁰ *Id.* Art. 11, 41, 46.

public reporting on all derivatives—whether cleared or uncleared—to increase transparency and monitoring.⁴¹ This reporting data allows regulators to fulfill “their various regulatory mandates, including systemic risk mitigation, market monitoring, and market abuse prevention,”⁴² and importantly, allows regulators to monitor concentration limits on derivatives even if the credit protection provider is a nonbank that is not subject to ongoing supervision. Likewise, in the EU, EMIR requires counterparties and central counterparties (“CCPs”) to report details of any derivative contract within one working day of the contract.⁴³

At the international level, there has similarly been a strong push toward centralized clearing,⁴⁴ more stringent collateral and margin requirements,⁴⁵ and more emphasis on transparency and disclosures to increase risk monitoring. In fact, the Proposed Framework itself requires banks to report all exposures over 5 percent of a bank’s capital base or a bank’s 20 largest exposures.⁴⁶ The international regulatory community also has made substantial progress in strengthening consolidated bank capital standards and stress-testing regimes.⁴⁷ Under the new capital regime set forth by the Basel Committee (“**Basel III**”), banks have a greater ability to absorb losses even if the credit protection provider fails.⁴⁸

⁴¹ See 7 U.S.C. §§ 2(a)(13), 6r(a).

⁴² Commodity Futures Trading Commission, *Swap Data Recordkeeping and Reporting Requirements; Final Rule*, 77 Fed. Reg. 2,136, 2,138 (13 January 2012).

⁴³ EMIR Art. 9.

⁴⁴ See, e.g., Basel Committee Banking Supervision, Press Release: Capital requirements for bank exposures to central counterparties (25 July 2012) (“Since 2009, the Basel Committee has been working to give effect to the G20 Leaders’ goal of creating incentives for banks to increase their use of central counterparties . . .”).

⁴⁵ See, e.g., *id.*; Committee on Payment and Settlement Systems & Technical Committee of the International Organization of Securities Commissions, *Principles for financial market infrastructures* (April 2012) (principle 5 on collateral and principle 6 on margin); Basel Committee on Banking Supervision & Board of the International Organization of Securities Commissions, *Second Consultative Document: Margin requirements for non-centrally cleared derivatives* (Feb. 2013).

⁴⁶ See Proposed Framework ¶ 24.

⁴⁷ See Basel Committee on Banking Supervision, *Progress report on implementation of the Basel regulatory framework* (April 2013); Basel Committee on Banking Supervision, *Peer review of supervisory authorities’ implementation of stress testing principles 2* (April 2012) (noting that “stress testing has become a key component of the supervisory assessment process as well as a tool for contingency planning and communication”).

⁴⁸ See Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* (Dec. 2010, rev. 2011) [hereinafter “**Basel III**”] (introducing a new common equity tier 1 capital requirement, leverage ratio, and additional capital buffers; increasing overall capital ratios; and strengthening the definition of capital).

Thus, at both the international and national levels, bank regulators have taken substantial steps to increase transparency, regulate credit protection providers and derivatives, and increase banks' ability to absorb losses. Both banks and certain credit protection providers must report exposure limits, making it easier for supervisors to detect and address concentration risks at an industry-wide level. Together, these new regulatory requirements mitigate the need for the excessively conservative exposure-shifting approach in the Proposed Framework.

3. Proposed Approach to Exposure-Shifting

A CDS is an OTC derivative and should be treated as any other OTC derivative under the Framework. We, do, however, recognize the desire to retain an additional exposure measure for trades with wrong-way risk characteristics, as well as situations where there is substantial concentrations of protection purchased on a single underlying exposure from a single hedge provider (because those concentrations are the ones that could present material risk to the bank in the unlikely event of double default). The Associations believe the proposed modifications to the Framework's risk-shifting provisions outlined below should address the Committee's concerns regarding credit protection providers and, at the same time, address the industry's concerns with the overstatement of exposures embedded in the Framework. In this context, we have outlined the following proposal:

- First, the Associations suggest that all derivatives, including credit default swaps, be treated in a consistent manner for the purposes of determining exposures. In particular, we recommend that, in general, all derivatives be captured only in the counterparty credit risk exposure calculation, rather than singling out credit default swaps for the different, substitution approach.
- Second, to address concerns that banks may have concentrations of "wrong-way" risk as well as situations where there are substantial concentrations of protection purchased on a single underlying exposure from a single hedge provider, we suggest that the Framework calls for banks to document (with such documentation being subject to supervisory review): (i) potential credit protection concentrations, (ii) the default risk of the underlying reference names in the portfolio, and (iii) net position limits on particular underlying reference assets. Such monitoring and assessment would be subject to Pillar 2 oversight and review.
- Third, the Associations recommend that the Framework provide that banks "exposure shift" exposures from the reference asset counterparty to a third

party protection provider based on the maximum jump-to-default risk⁴⁹ of the CDS protection purchased only for underlier-provider pairs that exceed a designated percentage of regulatory capital.

Particularly taking into account regulatory reforms described above that would limit the amount of net protection that a single provider could sell on a single reference obligor, we believe that the recommended approach more appropriately and accurately addresses the concentration risks that the Basel Committee is seeking to mitigate. The approach would call for banks to document and closely monitor their credit protection practices and profile subject to review by the appropriate bank supervisor. Moreover, it would rely upon an appropriately conservative “exposure-shifting” for those concentrations that pose the most salient prudential and systemic risks—that is, concentrations of single underlier-provider pairs.⁵⁰

4. Request for Clarity Relating to Double Counting of Credit Derivatives

Under one possible interpretation of the Proposed Framework, a bank that purchases credit protection in the form of a derivative may be expected to count the exposure twice—once as a derivative and once as a credit risk mitigant—and therefore effectively double count the capital against the credit protection provider. Credit derivatives are one form of OTC derivatives, and therefore, banks must generally take into account a credit derivative exposure as an OTC derivative exposure under paragraphs 54 through 58 of the Proposed Framework. A credit derivative also can be used as credit protection, and to the extent such a derivative qualifies as a risk mitigant, a bank also must take into account the derivative as a credit protection exposure under paragraphs 69 through 73 of the Proposed Framework. As a result, we seek clarification that the exposure for a credit derivative position would not be counted twice, to ensure that it could never exceed over 100 percent of the notional value of the derivative—a result that would be contractually impossible.⁵¹

⁴⁹ The amount of exposure applicable to exposure-shifting should be based on the maximum loss in the event of an instantaneous default by the reference name assuming zero recovery. For unmargined CDS, this means notional, but for margined CDS the maximum downside would be reduced by the existing mark-to-market because it is already collateralized. For example, the most a protection purchaser can lose on a \$100 CDS contract with a current mark-to-market of \$30 is \$70.

⁵⁰ See note 32 above.

⁵¹ See Proposed Framework ¶ 54 (stating that derivatives create two types of exposures: “an ‘on-balance sheet’ present value reflecting the fair value of the contract, and a *notional economic exposure representing the underlying economic interest of the contract*”) (emphasis added).

Significantly, the Basel risk-based capital framework (which is intended to serve as a basic template for this aspect of the Proposed Framework)⁵² recognizes and eliminates the possibility of double counting in this context.⁵³ In particular, a special counterparty credit risk recognition is not prescribed for a credit derivative when a bank is the credit protection buyer and the derivative instrument constitutes an eligible credit risk mitigant. We strongly believe that any exposure-shift approach adopted by the Basel Committee for purposes of the LE limit should likewise ensure that there is no such double counting of the exposure—that is, the Framework should treat credit derivatives as an eligible credit risk mitigant (where they qualify as such) and not expect an additional counterparty risk exposure calculation through application of the “substitution approach.”

B. Valuation of OTC Derivatives. The Associations strongly urge the Basel Committee to allow banks to employ for LE limit purposes the same models used to calculate risk-based capital under the IMM to capture peak loss exposures, and to the extent any successor approach to CEM (i.e., NIM approach) is adopted, that it appropriately take into account legally enforceable netting and margin.

The Proposed Framework rejects the use of internal models for the measurement of derivatives counterparty risk. Banks that regularly engage in a significant volume of derivative transactions generally have developed IMM for purposes of measuring counterparty credit risk for compliance with regulatory capital requirements and for internal risk management. These IMM are implemented under rigorous model development standards, audited internally, reviewed by the appropriate bank supervisor and are subject to regular validation and rigorous back testing. As the outputs of IMM are used for internal risk management at the banks, substantial time and focus is placed on ensuring their efficacy, which aligns the bank’s interest in the model’s accuracy with regulatory objectives. In fact, when the testing and reliability of the models are taken into account, they are more accurate than the CEM approach in measuring risk. Notwithstanding these protections, the Basel Committee appears to be reluctant to include the use of IMM to measure derivative exposure in the framework, only allowing IMM until a revised CEM (i.e., NIM) is available, in part because of a belief that IMM is not designed to capture the type of peak loss exposures that the Framework is intended to capture.⁵⁴

⁵² See *id.* ¶¶ 67, 69.

⁵³ See Basel II ¶ 114.

⁵⁴ Proposed Framework ¶ 57.

Instead, the Proposed Framework suggests that it would employ the yet-to-be-finalized successor to the CEM approach (*i.e.*, NIM) to calculate counterparty credit risk exposure on OTC derivatives transactions. The Proposed Framework does not provide any specific guidance on the characteristics of the successor approach. Until that successor is approved, the Proposed Framework would permit banks to use “the same approach . . . that they adopt for risk-based capital requirements purposes (including the IMM).”⁵⁵

Following any interim period provided for in the Proposed Framework, the alternative approach will be a critical element of the large exposures regime. The fact that the alternative approach has not been available for review to date raises practical difficulties in commenting on the Proposed Framework and evaluating the quantitative impact of the Proposed Framework (*e.g.*, through a study similar to the TCH SCCL Study) in this area.

Absent a specific, definitive approach upon which to comment, the Associations note the following observations relating to the existing CEM and IMM approaches as well as the criteria that any measurement methodology should meet.

1. CEM

The calculation methodology for derivative transactions contained in CEM results in a gross overstatement of the exposure in relation to the risk posed by such transactions because of two principal defects, both inherent in the CEM’s approach to calculating future exposures: (i) the arbitrarily limited recognition of netting, and (ii) the failure to recognize margin posted at future dates referred to as “variation margin.”

Although the Proposed Framework would temporarily allow banks to use the same approach they adopt for risk-based capital requirements purposes (including IMM), ultimately the Basel Committee proposes to use a non-model-based method (NIM) to measure the exposures of OTC derivatives—in particular a NIM approach that is to be approved after the Basel Committee’s forthcoming review. In its current form, the limitations of CEM are readily apparent. As stated in the Joint Trades Comment Letter to the Proposed SCCL, CEM’s flaws lie in its risk-insensitivity, which results in an overstatement of the true economic exposure of derivative transactions with potentially severe consequences for the liquidity of the derivative markets.⁵⁶ In particular, counterparty credit exposure under CEM is calculated as net current exposure plus potential future exposure, with the overstatement driven mostly by the calculation of potential future exposure and the inadequate recognition of the risk mitigating

⁵⁵ *Id.* ¶ 58.

⁵⁶ Joint Trades Comment Letter on the Proposed SCCL, at C-7 to C-8.

benefits of netting agreements. Under CEM, the potential future exposure calculation significantly limits the degree to which netting and margin may be taken into account, even where the transactions are subject to a qualifying master netting or margin agreement. (The overstatement is particularly significant for large netting sets with cross-product positions, and offsetting derivatives.) In addition, the calculation does not account for the reduction in potential future exposure due to counterparties' contractual obligations to maintain variation margin obligations and such obligations' effectiveness in limiting potential future exposure. A methodology that does not account for these shortcomings will generate a measurement of exposure for bilateral derivative transactions between large market-makers, that is vastly overstated and may have no correspondence to the potential state of the market, even in a severely stressed state.

The CEM approach produces exposures that are, in many cases, not merely significantly higher than those calculated under IMM (which seek to measure actual risk), but are substantial multiples of the IMM calculations. Some of the Associations' members have calculated that the "exposure" created by CEM is approximately 8-12 times that determined under regulatory-reviewed IMM.⁵⁷ Such a radical departure simply cannot be justified as a function of measuring risk. Moreover, in the case of credit and equity derivatives, the distortion is compounded by the "exposure-shifting" requirement discussed in section III.A above.

Although the NIM approach may address some of the Associations' concerns with CEM, we simply will not know until we have had an opportunity to review its terms, and, such a variation of CEM is almost certain to continue to be less accurate than IMM (for the reasons described below in section III.B.2) and therefore less appropriate than IMM itself. Additionally, any changes or additions to the methodology that the Basel Committee adopts in the NIM approach will have a significant impact on the treatment of OTC derivatives under the Proposed Framework. The Associations therefore believe that it is premature to comment on the Proposed Framework as it relates to OTC derivatives, until such time as there is a final proposal on the Revised CEM.

Moreover, while we appreciate the Basel Committee's requests for quantitative impact studies ("QIS") on the effects of the Proposed Framework, we respectfully submit that without a proposed NIM approach, an accurate QIS is impossible to undertake and any results would not reflect the actual or likely effect of the LE limit on member institutions. If, in the

⁵⁷ See TCH SCCL Study.

future, a credible alternative model arises, the Associations believe that would be the appropriate time to revise the Proposed Framework to call for the use of such alternative.

2. IMM

In view of the flaws with the CEM approach and the inherent limits of non-model based approaches discussed above, the Associations urge the Basel Committee to allow financial institutions to use validated, risk-sensitive models when assessing their exposures under the Proposed Framework.⁵⁸ The Associations acknowledge that the financial crisis exposed deficiencies in models used to measure and evaluate risk. Likewise, we recognize that the understatement of risk was significant in the case of some internal models used by banks for capital purposes. Nonetheless, the areas where significant deficiencies existed were limited.

Over the last several years, an enormous amount of effort and attention has been devoted to correcting the deficiencies in internal models. These efforts involve banks and their internal risk experts, outside consultants, and the regulators themselves. Specifically, risk methodologies used in models typically have two primary components: (i) mathematical modeling of contractual future cash flow, and (ii) methods for simulating future states of the market, including assumptions of volatility and correlations. The output of such models can be specified over a range of confidence levels. Supervisors can and do evaluate the validity of the first component and, as a policy matter, can and do set prudent parameters for the other components (*e.g.*, specifying a minimum confidence level and requiring the use of stress assumptions). As described in section III.B.3, regulators could even specify the use of a multiplier on the output of the model. The use of risk-sensitive models allows banks to align regulatory limits on exposure, risk, or capital adequacy with economic reality in individual cases. It also avoids the distortive effects of risk-insensitive, one-dimensional methods, such as CEM.⁵⁹

The Associations believe that the notion that IMM does not capture peak loss exposures is misguided. While it is true that specific metrics of IMM that feed into the risk-based capital requirements (such as effective expected positive exposure (“**EEPE**”) and exposure at default) are not peak exposure metrics or high confidence interval metrics, this is

⁵⁸ See Joint Trades Comment Letter on the Proposed SCCL, at C-7 to C-10.

⁵⁹ Three key features of IMM provide banks with a more realistic picture of risk than can reasonably be expected to be obtained from a non-model based method: (i) full recognition of valid netting relationships, (ii) use of both cash and securities collateral as risk mitigants for current and potential future exposures through the simulation process, and (iii) margin features, particularly variation margin requirements and their impact on potential future exposure.

by design and an appropriate method for a portfolio level calculation. IMM are designed to capture both capital metrics and peak loss exposure. Financial institutions typically use these same models to manage their counterparty credit risk internally using peak exposure metrics at confidence intervals that are typically in the range of 95 percent.

Although we recognize that models are not infallible, excluding IMM from the large exposure framework is unwarranted given enhanced, thorough supervisory reviews of these models as well as internal reviews, independent model validation, improved governance, and back testing. Further, using models is consistent with the Committee's objective to "avoid adding unnecessary complexity" by following the Basel risk-based capital framework.⁶⁰

3. Proposed Approach: IMM at Higher Confidence Level

If the Basel Committee is concerned that the expected exposure output of internal models employed in calculating risk based capital does not effectively capture higher future exposure values which could be observed, we recommend that the Framework specify the use of higher confidence levels by internal models.

Expected exposure, as an average of the simulated potential future exposure values, is not intended to estimate worst-case or peak future exposure values. As discussed above, to address this, most institutions employ internal model outputs at higher confidence levels, typically the 95th percentile, to measure counterparty exposure against limits. Given the widespread adoption of a metric of peak future exposure in current risk management practices, it represents a sound choice for measuring derivative exposures for this purpose.

Alternatively, a simple scalar could be applied to expected exposure to increase the confidence level of the model output. Risk based capital rules essentially do this today by requiring the multiplication of EEPE by an alpha factor to calculate exposure at default, although the alpha requirement was introduced for different reasons. The application of such a scalar would represent another option for the Framework to capture peak future exposure values which enter into but do not result from expected exposure calculations.

4. Alternative Approach: Modified Standardized Approach (NIM)

If the Committee nevertheless decides not to adopt a models-based approach, the Associations strongly believe that any methodology for calculating derivative exposures should be risk sensitive and fully account for the credit exposure mitigating effects of legally

⁶⁰ Proposed Framework ¶ 7.

enforceable netting and margin agreements on both current and future potential exposure by recognizing the effects of both any initial margin, as well as, dynamic margining (*i.e.*, the fact that the posted variation margin will increase over time as the underlying exposure increases). Recognition of netting and margin agreements would be limited to circumstances where the agreements meet legal enforceability and other standards provided for in the existing Basel risk-based capital rule framework. An approach that does not address these fundamental limitations of CEM will result in an outsized measure of exposure that will limit the ability of financial institutions that are active in these markets to continue these activities.

Further, to the extent the Committee adopts the NIM approach, it should take into account that the approach (which is principally being developed for risk-based capital purposes) may not be a suitable measure for LE limits since the calibrations of the underlying parameters are expected to be based on hypothetical stress scenarios rather than reflecting large losses under existing market conditions. We encourage the Committee to align the measurement approach to existing risk measurement and risk management practices in financial institutions for counterparty credit risk exposures. Active risk management and hedging of exposures in OTC derivatives portfolios are driven by a measure of exposures at relatively high confidence levels that are derived based on current market conditions rather than hypothetical stress scenarios.

Finally, we request the Basel Committee to incorporate the proposed alternative approach as part of a QIS for large exposures with both an EEPE approach and an IMM approach based on a sufficiently high confidence level.

- C. Treatment of SFT Exposures. The Basel Committee’s intended treatment of exposures to SFTs is flawed and banks should be allowed to continue making use of risk-sensitive supervisory approved internal models. To the extent that the Committee opts to deviate from this approach, it should develop an alternative that recognizes (i) the risk sensitivity (volatility) of securities lent and securities received as collateral, (ii) correlations between the securities lent and collateral legs of the transaction, and (iii) portfolio diversification benefits. Pending the release of an appropriate alternative, banks should be permitted to continue making use of their existing supervisory approved risk-based methodologies.**

The Proposed Framework calls for banks to measure exposures arising out of securities financing transactions (“SFTs”), which include repos, reverse repos and other securities lending and borrowing transactions, using the standardized Basel II Comprehensive

Approach.⁶¹ This involves a series of risk-insensitive supervisory haircuts applied to both the value of the securities placed on loan (or borrowed) and the value of collateral received. In addition, the Basel Committee proposes to require banks when making use of financial collateral to mitigate their credit exposures to SFTs, to apply the so-called “hybrid” approach which involves the mandatory transfer of the haircut-adjusted risk exposure to the issuer of the collateral. The Associations believe that the Committee’s proposed approach is inadequate for the proper measurement of bank exposures to SFTs.

SFTs play a critical role in the efficient functioning of global financial markets. They facilitate timely settlement, market making and hedging activities. SFTs also increase market liquidity and enhances the overall price-discovery process. Moreover, SFTs provide benefits to institutional investors by enabling the receipt of low risk returns on portfolio assets. Banks that are active in SFTs have long-used supervisory approved internal models, such as simple VaR methodologies, in the measurement of their exposure to SFTs. This practice reflects, among other things, the significant limitations in other available risk-based capital methods.

1. The Framework’s Haircut Matrix Does Not Accurately Assess Exposures

Under the Framework as proposed, banks would need to abandon these well-established methodologies in favor of a haircut-based matrix that will result in a considerable overstatement of credit risk. Significantly, the Basel Committee’s intended approach overstates risk in SFTs by applying supervisory haircuts to the securities and collateral legs of the transaction *independently* from each other. Concerns with the proposed approach include the following:

- The static haircuts used in the Proposed Framework are excessively conservative and do not reflect observable market data. This includes a failure to reflect asset volatility and the short duration of most SFTs. The Comprehensive Approach also provides for very limited recognition of portfolio netting.
- The proposed approach fails to recognize the correlation between the securities lent and the collateral received (*i.e.*, the important relationship between future movements in the value of the loan and the underlying collateral).⁶²

⁶¹ Proposed Framework ¶ 60; *see also id.* ¶ 71-73.

⁶² For well-diversified lending and collateral portfolios, the “exposure-at-default” (“EAD”) calculated under the supervisory haircut method can be as much as 20 times higher than under a simple VaR methodology. The primary driver of such overstatement is the assumption that all lent positions have a correlation of 1.00, all collateral positions have a correlation of 1.00, and all loans vs. collateral have a correlation of -1.00.

- The portfolio diversification benefits from a pool of securities lending transactions are also not recognized (*i.e.*, the use of a broad pool of securities with differentiated risk profiles, as well as having trades with both long and short positions, limit the potential for unanticipated concentration risk as the total risk from all of the SFTs would be less than the sum of the risks from each individual transaction).⁶³
- The additional exposure to the issuers of assets under the “hybrid” approach does not recognize the low probability of joint (or “double”) default of both the issuer of the collateral received and the bank’s counterparty, particularly in the context of “right way” risk.
- The double application of haircuts for securities lending transactions collateralized by securities discourages non-cash transactions. Non-cash transactions serve important policy interests because they reduce the probability of a liquidity squeeze, because loan and reinvestment transactions are linked, thereby enabling a lender to provide funding to counterparties without simultaneously reducing lending balances.

The Associations believe that the Committee’s Framework should be revised to appropriately address these limitations, and in so doing, more closely reflect the actual risks of SFTs, so as to avoid significant disruptions to the market (and the markets for the underlying securities) that could result if banks were required to reduce existing SFT volumes in response to the significant and unnecessary overstatement of risks.⁶⁴ A constrained securities financing market would have a negative impact on liquidity and efficiency in the capital markets generally, which could lead to wider trading spreads and increased levels of settlement failures.

2. Proposed Approach: Supervisory Approved Internal Models

In order to minimize these broad adverse consequences, we strongly support the continued use of supervisory approved internal models for the measurement of exposures to SFTs. These methodologies have proven advantages over the proposed Comprehensive Approach in areas where the proposed approach is deficient (*i.e.*, including, risk sensitivity,

⁶³ *See id.*

⁶⁴ A Risk Management Association analysis of the impact of the Proposed SCCL on securities lending (which, like the Proposed Framework, adopts a similar standardized haircut approach) estimated a decline of 30 percent to 50 percent from levels already well below 2008 peak. Committee on Securities Lending of the Risk Management Association, Comment Letter on Issues Concerning Application of Proposed Single Counterparty Credit Limits to Agency Securities Lending and Related Transactions, at 7 (April 30, 2012). The impact of the Basel Committee’s Proposed Framework can be expected to be even greater given the larger population of affected banks.

recognizing correlations between securities lent and the collateral received, and portfolio diversification). Moreover, the internal models approach—in contrast to the proposed “hybrid approach”—can properly account for the “double default” nature of the risk in collateralized transactions (*i.e.*, the unlikelihood of a joint default of the issuer of collateral received and the bank’s counterparty).⁶⁵

The use of a supervisory approved models approach would also have the advantage of consistency with the existing Basel risk-based capital regime and industry practice for the measurement and control of credit exposures. Accordingly, such an approach would help promote the Basel Committee’s objective of relying, to the fullest extent practicable, on methodologies applied in the existing capital framework.

Still, the Associations recognize the Basel Committee’s stated concerns about model risk and comparability across institutions, and note that it is possible to develop alternative approaches that avoid the many limitations of the Comprehensive Approach.⁶⁶ Regardless of the approach chosen, the Associations emphasize the need for a methodology that recognizes (i) the risk sensitivity (volatility) of securities lent and securities received as collateral, (ii) correlations between the securities lent and collateral legs of the transaction, and (iii) portfolio diversification benefits.

In the interim, should the Committee deviate from the supervisory models-based approach, banks should be permitted to continue making use of supervisory approved internal methodologies for the measurement of their exposures to SFTs. This is consistent with the treatment of derivatives exposures, where the Committee proposes to allow banks to continue making use of their existing risk-based processes, until such time as an appropriate successor to CEM has been defined.

⁶⁵ The proposed “hybrid approach” fails to reflect the substantial unlikelihood of a double default impacting both the initial exposure and the underlying collateral. Indeed, the Basel Committee’s approach makes no distinction between direct and indirect exposures, and therefore makes the highly unlikely assumption that a bank will face the simultaneous default of both the initial exposure and the underlying collateral.

⁶⁶ Alternatives may include the Supervisory Inputs Approach, in which banks would make use within their internal models of a series of uniform inputs provided by regulatory authorities that reflect observable market data calibrated at a high-level of confidence. Supervisory inputs could also be used to improve the risk-sensitivity of the intended haircuts-based matrix.

D. Netting of Different Issues of Same Counterparty. The Large Exposures Framework should allow the netting of long and short positions without regard to seniority.

The Proposed Framework would only permit netting of long and short exposures to the same counterparty in the trading book where the short exposure arises out of the same issuance or where, if they arise in different issues, the short exposure is junior to the long exposure or they are the same seniority. We do not believe the requirement that the short exposure be junior to, or the same seniority as, the long exposure is appropriate for several reasons.

First, short senior positions increase in value as a counterparty moves closer to default, so even if the “peak exposure” occurs (*i.e.*, 100 percent default on the long junior position, and no default on the short senior position) the short senior position still will increase in value and provide an economic offset to the default on the long junior position. Further, positions in the trading book are actively managed. As a consequence, as a counterparty’s credit quality deteriorates, the bank could sell its long positions (decreasing in value) as well as its short positions (increasing in value) to offset one another, even if the seniorities did not match.

Second, peak exposure is a very low probability event and it is unduly punitive to measure exposures based on this assumption. In a true crisis event, all categories of equity and debt positions—equity, subordinated debt and senior debt, among others—would decline in value. Recognition of short positions across maturity categories is a realistic reflection of risk. The Proposed Framework, in contrast, is overly focused on a narrow and improbable risk category and thus the prohibition on netting more senior short exposures does not reasonably reflect economic reality.

Third, in view of the Proposed Framework’s narrow recognition of hedging, if the Framework is finalized as proposed, not only would the hedging benefits of senior short positions in different issues fail to be recognized under the Proposed Framework, but the short position itself may be assigned a separate exposure value, effectively penalizing banks for hedging in this manner. Given that the risks banks hedge include those associated with the wide range of economically beneficial financial products and services banks offer to their clients, the availability and cost of those products and services may be impacted if the Framework impedes the ability of banks to hedge in an efficient manner, to the detriment of both banks and end-users.

Finally, for many banks it would be very difficult to implement the complex and costly systems required to track and measure positions by their seniority in the capital

structure. In light of these costs and the apparent absence of a need for, and the drawbacks of, a limitation on netting based on the seniority for the reasons discussed above, we do not believe banks should be expected to track, or otherwise consider, the seniority of trading positions in order to net them against each other.

Should the Committee determine to maintain the prohibition on netting senior short positions against junior long positions and implement the bucketing approach outlined in paragraph 93 of the Proposed Framework, the Committee should confirm that the netting of all exposures of the same name in a given seniority bucket is permitted.

E. Netting Across the Banking and Trading Books. Banks should be permitted to net across the banking and trading books.

The Proposed Framework would not permit netting across the banking and trading books. In support of this prohibition, the Committee notes that banks typically risk-manage positions in the banking and trading books separately.

The Associations urge the Committee to permit banks to net across both books. Contrary to the suggestion of the Committee, banks do manage name specific risks regardless of whether these risks are in the banking book or the trading book. Further, prohibiting banks from netting across the trading and banking book could discourage consolidated risk management. As discussed in section III.D, the risks banks manage through hedging include those associated with the financial products and services banks offer to their clients. Limiting a bank's ability to manage those risks effectively across the banking and trading books may adversely impact the availability and cost of those products and services for end-users. The Framework proposes to measure a bank's exposure to a counterparty on a consolidated basis, including exposures in both the banking and trading book. Positions in the trading book and the banking book both reflect economic risk to the consolidated organization. Allowing banks to net across the banking and trading books is therefore consistent with the consolidated view of counterparty exposure taken by the Framework. Permitting such netting would also provide a more realistic economic view of the consolidated organization's exposure to a counterparty.

IV. Structure of the Large Exposure Limit

A. LE Limit Denominator. The LE limit should include a bank's total regulatory capital as defined in Basel III and excess loan loss reserves.

The Basel Committee proposes that the capital base on which the large exposure limit is calculated consist of either CET1 or Tier 1 Capital, as defined in Basel III. We believe that using either CET1 or Tier 1 Capital does not reflect the full amount of resources that an

institution has available to absorb losses. Instead, the Proposed Framework should recognize total regulatory capital and excess loan loss reserves in the denominator because both types of resources are available to absorb losses, as other regulators have recognized for years. At a minimum, the Framework should adopt as the capital base Tier 1 capital together with general loan loss provisions and partial recognition of certain Tier 2 instruments.⁶⁷

1. Proposed Approach: Recognition of Total Regulatory Capital and Excess Loan Loss Reserves

A limit based only on either Tier 1 or CET1 does not account for all the resources that a bank has to absorb losses. The capital base denominator instead should include total regulatory capital and excess loan loss reserves, which are available to absorb losses on a going concern basis. This broader capital base is especially warranted based on the new, more restrictive definitions of Tier 1 and Tier 2 capital in Basel III. The new Basel III definitions significantly narrowed the characteristics of instruments that qualify as Tier 1 and Tier 2 capital to “raise both the quality and quantity of the capital base”⁶⁸ and “to ensure loss absorbency at the point of non-viability.”⁶⁹

Using total regulatory capital as the denominator for the exposure limit would be consistent with the approach to large exposure limits taken by many jurisdictions, including the US and EU, both of which recognize Tier 2 capital in their large exposure regimes. In the US, bank regulators have long used “capital stock and surplus” as the denominator for lending limits,⁷⁰ affiliate transaction limits,⁷¹ and other exposure limits, including the large exposure limits in the Proposed SCCL.⁷² “Capital stock and surplus” includes total regulatory capital

⁶⁷ We also request that the Committee clarify in the final version of the Framework that, to the extent a bank is required to consolidate an entity’s exposures with its regulatory consolidation group’s exposures, the bank is permitted to consolidate the regulatory capital of such entity with its group’s regulatory capital measure. For example, if a bank were required to consolidate the exposures of a joint venture for large exposure purposes, the bank should be permitted to recognize the regulatory capital of the joint venture when determining exposure limits. This approach would align exposure and capital measurements and would avoid irrational outcomes in which a bank is constrained by a joint venture’s exposure levels without appropriate recognition of the joint venture’s available loss-absorbing capital. We believe this approach is fully consistent with the Proposed Framework, but request that the Committee include express guidance regarding this matter in the final version of the Framework.

⁶⁸ Basel III ¶ 7.

⁶⁹ Basel Committee on Banking Supervision, *Minimum requirements to ensure loss absorbency at the points of non-viability* (13 January 2011).

⁷⁰ See 12 C.F.R. § 32.2(b).

⁷¹ See *id.* § 223.3(d).

⁷² See US Enhanced Prudential Standards, 77 Fed. Reg. 615, 649.

(CET1, Tier 1, and Tier 2) as well as the balance of the allowance for loan and lease losses (“**ALL**”) not included in Tier 2 capital. In the EU, large exposure limits are calculated using “eligible capital” as the denominator, which includes Tier 1 capital as well as Tier 2 capital that is equal to or less than one-third of Tier 1 capital.⁷³

The Associations believe that the US approach to the denominator more accurately captures all of a bank’s loss-absorbing resources. This approach has been tested over decades as a workable prudential regulatory measure to limit risk and exposures to a single entity. We therefore request that the final Framework include total regulatory capital and reserves as the denominator for the large exposure limit.

2. Alternative Approach: Tier 1 Capital with General Provisions and Certain Tier 2 Instruments

Should the Committee decide not to use total regulatory capital and excess loan loss reserves as the denominator of the LE limit, we strongly recommend that the denominator at least include all Tier 1 capital (not just CET1), together with general loan loss provisions and certain Tier 2 instruments.

Tier 1 Capital

The large exposure limit capital base should, at a minimum, include Tier 1 capital. The elements of Tier 1 capital—including but not limited to CET1—are intended to absorb unexpected losses on a going concern basis. Indeed, Basel III further strengthened the definition of Tier 1 capital to ensure its loss absorbing character for going concerns. Tier 1 capital no longer includes hybrid instruments that proved not to be adequately loss absorbing during the financial crisis; instead, the “predominant form of Tier 1 capital must be common shares and retained earnings.”⁷⁴ In addition, most of Tier 1 capital must be “instruments that are subordinated, have fully discretionary noncumulative dividends or coupons and have neither a maturity date nor an incentive to redeem.”⁷⁵ These Tier 1 capital instruments are clearly the type that would absorb unexpected losses on a going concern basis, such as perpetual noncumulative preferred stock.

⁷³ Directive 2006/48/EC of the European Parliament and of the Council Art. 106 ¶ 3 (14 June 2006) (as amended by Directive 2009/111/EC of the European Parliament and of the Council Art. 1 ¶ 19 (16 September 2009)); European Parliament, Texts Adopted: P7_TA-PROV(2013)0115, Prudential requirements for credit institutions and investment firms, Pt. 1, Art. 4 ¶ 23 & Pt. 4, Art. 381 (16 April 2013) [hereinafter “**CRR**”].

⁷⁴ Basel III ¶ 9.

⁷⁵ *Id.* ¶ 9.

The inclusion of Tier 1 capital in the large exposure limit capital base also would be consistent with the Basel III leverage ratio, which relies on Tier 1 capital and not just CET1.⁷⁶ Like the large exposure limit, the Basel III leverage ratio is a “backstop” measure used to mitigate risk by facilitating a bank’s ability to absorb unexpected losses from all types of exposures.⁷⁷ Thus, as in the Basel III leverage ratio, the large exposure limit should include at least all of Tier 1 capital, not just CET1.

General Loan Loss Provisions

In addition to Tier 1 capital, the LE limit also should include general loan loss provisions in its denominator. Like Tier 1 capital, general provisions absorb losses of going concerns. Moreover, even though not appropriate for full inclusion in risk-based capital, general provisions are an appropriate resource for loss absorption in the context of a large exposures limit because such provisions are generally available to absorb losses that may arise from exposures to any individual counterparty. The large exposures regime is “a backstop to risk-based capital requirements” designed “so that the maximum possible loss a bank could incur if a single counterparty or a group of connected counterparties were to suddenly fail would not endanger the bank’s survival as a going concern.”⁷⁸ That is, the large exposures regime is designed to mitigate *both* expected and unexpected losses from a counterparty. In contrast, the risk-based capital framework “focus[es] on unexpected losses.”⁷⁹ Because of these different purposes, the US has long included general provisions in the capital base for lending limits,⁸⁰ affiliate transaction limits,⁸¹ and other exposure limits, including the large exposure limits in the Proposed SCCL.⁸²

The currently proposed CET1 or Tier 1 capital base in the Framework especially penalizes banks in countries where the home regulator places a strong emphasis on loan loss reserves. For example, US and Spanish regulators have long required banks to maintain conservatively high levels of ALLL as a matter of safety and soundness.⁸³ If the large exposure limit failed to recognize the plainly loss-absorbing character of these large cushions of

⁷⁶ See *id.* ¶ 154.

⁷⁷ See *id.* ¶ 7.

⁷⁸ Proposed Framework ¶ 3.

⁷⁹ Basel III ¶ 31.

⁸⁰ See 12 C.F.R. § 32.2(b).

⁸¹ See *id.* § 223.3(d).

⁸² See US Enhanced Prudential Standards, 77 Fed. Reg. 615, 649.

⁸³ See, e.g., Interagency Policy Statement on the Allowance for Loan and Lease Losses (Dec. 13, 2006).

provisions, it would effectively and inappropriately penalize banks headquartered in these countries.

Certain Tier 2 Instruments

National supervisors should retain discretion to include certain additional Tier 2 capital instruments in the denominator of the LE limit that are able to absorb losses on a going concern basis. For example, Tier 2 instruments that are mandatorily convertible into CET1 should be included in the capital base because they are available to absorb losses of going concerns much like CET1. At a minimum, the Committee should follow the EU approach of recognizing all “eligible capital” in the denominator, which includes Tier 2 capital that is equal to or less than one-third of Tier 1 capital.⁸⁴

B. Inter-G-SIB Exposures. Exposures between G-SIBs should not be subject to a more stringent 10 to 15 percent large exposure limit at this time.

The Proposed Framework would seek a more stringent LE limit of “between 10% and 15%” for exposures of one G-SIB to another G-SIB.⁸⁵ Although the Associations understand and appreciate the Committee’s concern regarding “interbank contagion” if a large, systemically important bank were to fail,⁸⁶ we believe that a number of other policy tools and new regulatory reforms are already available to address the same risk. In the midst of significant international regulatory reform, as well as simultaneous legislative, regulatory, and supervisory changes, it is difficult to anticipate what the effect of any one change will be. As a result, where possible, substantial changes in market practice should be approached cautiously and on a sound evidentiary basis, especially where those changes may pose a real danger of negative consequences for market liquidity and financial stability. Accordingly, we believe the more prudent approach is to monitor the impact of the required 25 percent large exposure limit in the context of the many other regulatory changes that are occurring before imposing a more stringent inter-G-SIB LE limit.

The 10 to 15 percent LE limit for inter-G-SIB exposures is not necessary at this time due to the new Basel III capital conservation buffer, the countercyclical capital buffer, the G-SIB surcharge, and other measures designed to address systemic risk and interconnectedness. The capital conservation buffer is intended to “promote the conservation of capital and the build-up of adequate buffers above the minimum that can be drawn down in

⁸⁴ CRR Art. 4(23) & Art. 381.

⁸⁵ Proposed Framework ¶ 132.

⁸⁶ Proposed Framework ¶ 131.

periods of stress.”⁸⁷ These periods of stress could include, for example, situations where a bank’s major counterparty fails or is otherwise unable to meet its obligations. The countercyclical capital buffer further strengthens banks’ ability to weather economic stress, and “initiatives on provisioning focus on strengthening the banking system against expected losses.”⁸⁸

In short, the greater the level of loss absorbency that banks are required to hold, the less need there is for an exceptionally stringent large exposure limit. In this context, Basel III imposes a capital surcharge on G-SIBs to further enhance these institutions’ capital base and to minimize systemic risk and interconnectedness.⁸⁹ The G-SIB surcharge is particularly aimed at reducing both the probability of default and loss given default for these institutions.⁹⁰ Additionally, “[s]everal of the capital requirements introduced by the Committee to mitigate the risks arising from firm-level exposures among global financial institutions will also help to address systemic risk and interconnectedness.”⁹¹ These measures include: “capital incentives for banks to use central counterparties for over-the-counter derivatives”; “higher capital requirements for trading and derivative activities, as well as complex securitisations and off-balance sheet exposures (*e.g.*, structured investment vehicles)”; “higher capital requirements for inter-financial sector exposures”; and “the introduction of liquidity requirements that penalise excessive reliance on short term, interbank funding to support longer dated assets.”⁹² Supervisors also receive large exposure reports and have other tools necessary to monitor and address concentration risks. Finally, international and national regulators have taken substantial steps to facilitate recovery and resolution planning to mitigate the effects of any G-SIB default.⁹³

Given these many regulatory reforms designed to enhance the loss absorbency of G-SIBs and reduce systemic risk and interconnectedness, the Committee should not take the very substantial additional step at this time—to address the very same risks—of requiring the

⁸⁷ Basel III ¶ 26.

⁸⁸ *Id.* ¶ 31.

⁸⁹ *See id.* ¶ 32.

⁹⁰ *See* Basel Committee on Banking Supervision, *Global systemically important banks: assessment methodology and the additional loss absorbency requirement*, Rules text ¶ 14 (November 2011).

⁹¹ Basel III ¶ 33.

⁹² *Id.* ¶ 33.

⁹³ *See, e.g.*, Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (October 2011); Basel Committee on Banking Supervision, *Resolution policies and frameworks – progress so far* (July 2011); FINMA, *Addressing “Too Big to Fail”: The Swiss SIFI Policy* (23 June 2011).

10 to 15 percent inter-G-SIB limit. Instead, the Committee should wait and assess the impact of these still untested reforms on the global financial system before layering yet another stringent regulatory limit on G-SIBs. Moreover, the cumulative effect of the inter-G-SIB LE limit and these other regulatory reforms could have even more severe negative, unintended consequences than any one reform alone. We urge the Committee to move cautiously and incrementally on this front to minimize the negative, unintended consequences of imposing at the same time so many new regulatory reforms designed to address the very same risks.

In particular, we request that a heightened inter-G-SIB limit not be incorporated into the Framework unless and until: (i) the full impact of the generally-applicable 25 percent LE limit has been determined based on actual experience and quantitative study; (ii) comprehensive studies of the potential impact of a tighter inter-G-SIB limit have been undertaken; and (iii) it has been determined that such a limit is necessary to mitigate risks to financial stability after appropriately taking into account the numerous pending changes to the international regulatory framework intended to reduce systemic risk and interconnectedness. Otherwise, the proposed lower limit for inter-G-SIB transactions, combined with the proposed risk-insensitive measurement methodologies and the lower capital base, may significantly reduce market liquidity and capacity to meet credit needs.

Should the Committee adopt the higher inter-G-SIB limit, G-SIBs could be forced to unwind many of their positions, reducing market liquidity and loan capacity. Many of these activities, such as derivatives trading, require significant investments in technology, personnel, and other resources that make it unlikely that smaller banks could readily enter the market to fill demand. Nonbank competitors might be able to step in to fill some of this demand to the extent they have the capability to do so—but that could lead to considerably more risk in the less regulated part of the financial system.

In addition, although many of the types of transactions in which G-SIBs engage seem complex, they constitute key parts of the global financial system and filter through the financial markets to affect the costs and availability of many types of financial products and services provided to consumers, businesses, public sector entities, and institutional investors.⁹⁴ For example, corporate borrowers rely on banks for credit, which in turn hedge these risks with credit derivatives; regional and community banks rely on interest rate derivatives to hedge risks on fixed rate loan products they offer to retail, small business, and corporate customers; pension funds, insurance companies, and governmental entities rely on non-clearable interest rate and equity derivatives products to manage the complex and long-dated risk profiles of

⁹⁴ See TCH SCCL Study, at 5.

their assets and liabilities; and institutional investors rely on securities financing markets for income to increase the return for their customers.⁹⁵ The more stringent inter-G-SIB limit could be highly disruptive to precisely these products and services, which smaller firms are less able to provide, thereby reducing market liquidity and loan capacity.

Should the Committee choose to adopt the inter-G-SIB LE limit as proposed, we request that, at a minimum, the final Framework provide for a transition period for exposures—both to and from—newly-designated G-SIBs. From an operational perspective, institutions cannot always successfully predict when a counterparty (or the bank itself) may be designated as a G-SIB, which could lead to market disruptions should there not be an appropriate transition period. Without this transition period, a mandatory large exposure limit of 10 to 15 percent would likely result in a significant number of breaches based on current exposure levels.

The TCH SCCL Study conducted on the impact of an analogous G-SIB-type requirement in the Proposed SCCL (a 10 percent cap on exposures between two “major counterparties”—that is, entities with \$500 billion or more in assets) provides some quantitative underpinning for the belief that the inter-G-SIB limit would likely lead to a significant number of breaches of the LE limit based on current exposure levels.⁹⁶

This tighter limit for exposures between the largest financial institutions was found to be a substantial driver of the breaches identified by the TCH SCCL Study. The Study found that if only the 25 percent limit were applied to all counterparties, the number of excess exposure incidents across the participating banks would decline from 100 to 63.⁹⁷ The aggregate estimated exposure in excess of the 25 percent limit, as measured under the Proposed SCCL, would amount to \$665 billion, or roughly 51 percent of the excesses identified under the full application of both the discretionally prescribed 10 percent and the statutorily required 25 percent limits.⁹⁸ Notably, because the denominator under the Proposed Framework would be CET1 or Tier 1 Capital (in contrast to the denominator of total regulatory capital and loan loss reserves under the Proposed SCCL), the effect of the inter-G-SIB limit in the

⁹⁵ See *id.* at 13.

⁹⁶ See US Enhanced Prudential Standards, 77 Fed. Reg. 651-52.

⁹⁷ TCH SCCL Study, at 9.

⁹⁸ *Id.*

Proposed Framework would likely be significantly more binding than the analogous Proposed SCCL for the largest US institutions (*i.e.*, institutions with more than \$500 billion in assets).⁹⁹

The full impact would ultimately depend upon the Framework's treatment of derivatives, which is unclear. The TCH SCCL Study observed that there would be in the aggregate 100 exposures to 29 unique counterparties in excess of the applicable credit limit under the Proposed SCCL, which uses the existing CEM methodology.¹⁰⁰ However, under the Proposed Framework, the number of breaches of the limit would likely exceed those identified in the TCH SCCL Study, as the Proposed SCCL includes a bigger denominator through its use of total regulatory capital plus ALLL, while the denominator in the Proposed Framework is limited to only either CET1 or Tier 1 Capital.¹⁰¹

C. Scope and Level of Application Generally. The Basel Committee should afford national supervisors discretion to apply the LE limits only at the consolidated parent company level.

The Proposed Framework would apply the LE limit to "full consolidated and sub-consolidated levels" at which the risk-based capital requirements are required to be applied.¹⁰² The Proposed Framework applies at the "solo level," however, only "when the risk-based capital requirements are required to be applied at a solo level."¹⁰³ Accordingly, the Framework would apply to any subsidiary to which the Basel risk-based capital framework applies.

The Associations agree that it is appropriate to apply the large exposure framework to fully consolidated groups. Full consolidation reflects the entirety of a banking organization's exposures as well as all available loss-absorbing capital. While regulated subsidiaries within a banking group may engage in specialized lines of business in response to operational considerations, regulatory requirements, funding costs or client needs, the fully consolidated balance sheet aggregates all of a banking organization's risks and available resources. Large banking organizations typically manage credit and market risk on a centralized basis, taking into account the consolidated group's diverse range of counterparty exposures, each category of which may be isolated in particular subsidiaries.

⁹⁹ This possible outcome could be compounded by certain other aspects of the Framework not adopted as part of the Proposed SCCL (*e.g.*, approach to aggregation of exposures to connected counterparties).

¹⁰⁰ TCH SCCL Study, at 8.

¹⁰¹ Similarly, both the CET1 and Tier 1 capital base denominators are substantially smaller than the capital base used in US bank-level lending limits which is generally total regulatory capital.

¹⁰² Proposed Framework ¶ 14.

¹⁰³ *Id.* ¶ 17.

Application of the Framework at the sub-consolidated level, however, could potentially lead to: (i) fundamental inconsistencies with long-standing statutory frameworks that would be impossible to eliminate without amending national laws, and (ii) inconsistencies with the market activity and risk profile of an entity operating at the sub-consolidated level.

Where operational subsidiaries are subject to Basel capital standards, regulators may impose distinct exposure requirements on such subsidiaries in light of the unique activities and risks of these entities. For example, while the Proposed SCCL would impose a single counterparty credit limit on large US bank holding companies (*i.e.*, the consolidated level entity),¹⁰⁴ the OCC has long administered a distinct lending limits regime for national banks in the US (*i.e.*, a sub-consolidated level entity), which the OCC recently revised to incorporate exposures from OTC derivatives and SFTs.¹⁰⁵ The OCC's lending limits rules, which differ in material respects from the Proposed Framework, reflect both: (i) statutory requirements (in this case, the National Bank Act) that are different from those contemplated by the Proposed Framework,¹⁰⁶ and (ii) policy judgments by the regulatory agency with oversight authority and expertise in the risks and market functions of national banks' activities relative to those of consolidated bank holding companies. In other cases, national law or regulation may impose a capital regime on a nonbank subsidiary that is appropriate for the subsidiary's market activity and risk profile.

Accordingly, in our view, the Proposed Framework should be revised to provide national supervisors with explicit discretion to exclude a sub-consolidated entity from the large exposure framework. This policy should help promote safety and soundness by allowing national regulators the flexibility to develop and implement more finely-tuned exposure frameworks appropriate for the risks and activities of regulated subsidiaries within their jurisdictions, and, in many cases, would avoid conflicts or duplication of, national laws that already apply a large exposures framework to the sub-consolidated entity.

¹⁰⁴ US Enhanced Prudential Standards, 77 Fed. Reg. 594.

¹⁰⁵ Lending Limits, 77 Fed. Reg. 37,265 (June 21, 2012).

¹⁰⁶ National banks have been subject to US federal lending limits since 1863. 12 U.S.C. § 84 (“**Section 84**”) describes lending restrictions and limitations placed on national banks. According to Section 84, “the total loans and extensions of credit by a national banking association to a person outstanding at one time and not fully secured . . . by collateral having a market value at least equal to the amount of the loan or extension of credit shall not exceed 15% of the unimpaired capital and unimpaired surplus of the association.”

V. Treatment of Counterparties and Exposures

A. CCPs. While the Associations support robust reporting requirements for exposures to qualifying central counterparties, these exposures should not be subject to the Pillar 1 “hard limit.”

The Proposed Framework considers two options for the treatment of exposures to Q-CCPs.¹⁰⁷ The first would be to apply the LE limit to banks’ exposures to Q-CCPs, although potentially at a “higher” limit than 25 percent. The second option the Basel Committee contemplates is not applying the Pillar 1 LE hard limit to a bank’s Q-CCP exposures and instead deferring to national supervisors’ role in monitoring CCP concentration risks. Under either option, the Framework would require that banks report all large exposures to Q-CCPs to their supervisors. All bank exposures to a non-qualifying CCP would be treated as bilateral transactions and therefore subject to the large exposure limits. We appreciate the Basel Committee’s thoughtful discussion relating to exposures to Q-CCPs¹⁰⁸ and would urge that Q-CCPs not be subject to the LE limit.

As noted in the Framework, requiring the central clearing of derivatives has been a major component of international regulatory reform and the application of the LE limit to Q-CCPs may impede progress towards the goal of using them to mitigate systemic risk.¹⁰⁹ Doing so may also result in the fragmentation of the clearing marketplace and increase liquidity risks.

In addition, exposures to Q-CCPs differ from exposures to most other counterparties in at least two important respects, each of which justifies adopting the second option. First, there are only a limited number of CCPs (and by extension Q-CCPs) capable of meeting most banks’ clearing needs, and many banks are required by law to clear or otherwise settle certain trades through a CCP. As a consequence, if a bank’s exposure to a Q-CCP reaches the exposure limit of 25 percent, it may not be, as a practical matter, possible for the bank to find other Q-CCPs (or even CCPs) to diversify its exposures sufficiently. Second, as recognized

¹⁰⁷ Q-CCPs are subject to stringent standards, including a requirement that the Q-CCP “is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the [Committee on Payment and Settlement Systems – International Organization of Securities Commissions] Principles for Financial Market Infrastructures.” Basel Committee on Banking Supervision, *Capital Requirements for bank exposures to central counterparties*, 1 (July 2012).

¹⁰⁸ See Proposed Framework, ¶¶ 123-130.

¹⁰⁹ See Leaders’ Statement for the 2009 G20 Summit on Financial Markets and the World Economy (seeking the implementation of central clearing by end of 2012), available at http://www.treasury.gov/resource-center/international/g7g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

by both national regulators and the international regulatory community, Q-CCPs are themselves agents of systemic risk mitigation. Because of the important role Q-CCPs are assigned in reducing risk, placing limits on exposures to Q-CCPs, and thereby forcing banks to diversify their risks away from Q-CCPs, may be impracticable.

Moreover, the fact the Basel Committee's approach to capital that banks must hold against their Q-CCP exposures is still under development illustrates the rapid and evolving developments in this area. Accordingly, any future limitation of exposures to Q-CCPs should only be addressed in tandem with the further development of the regulatory reforms addressing CCPs more broadly.¹¹⁰

Finally, because of the limited number of CCPs available to satisfy banks' clearing needs, if Q-CCPs are subject to the Pillar 1 LE limit, it is possible that banks will need to reduce the volume of their derivative activity below what market needs demand or safety and soundness considerations would prescribe. A significant reduction in derivatives activity could have serious destabilizing consequences for market liquidity and reduce the availability of economically beneficial products and services, such as credit and derivative products for risk management. Banks could also be limited in the amount of new clearable transactions they could accept from clients, to the detriment of both end-users and, in light of the role CCP's play in reducing risk, the financial markets in general.

Accordingly, we endorse the second approach contemplated by the Basel Committee (*i.e.*, not applying the Pillar 1 LE hard limit to a bank's Q-CCP exposures and instead deferring to national supervisors in monitoring CCP concentration risk), which should assist in the implementation of goals set by the G20 and provide institutions with proper incentives and means to provide their clients with access to centralized clearing.¹¹¹

¹¹⁰ In view of the importance of the treatment of Q-CCPs to multiple aspects of the financial regulatory framework, the Associations strongly support the international consistency for Q-CCP designation and review to ensure that Q-CCP designations are consistent across jurisdictions.

¹¹¹ See also Joint Trades Comment Letter on the Proposed SCCL, at C-18 to C-19.

B. Definition of Connected Counterparties. The test for connected counterparties should be financial consolidation under the appropriate accounting standard with other types of connections broadly addressed through a Pillar 2 monitoring requirement.

The Proposed Framework would require banks to aggregate exposures to “connected” counterparties as an exposure to a single counterparty where either a “control relationship” test or “economic interdependence” test is satisfied.

The Framework combines a rules-based approach with a guidance-based approach for identifying connected counterparties.¹¹² Under the rules-based control test, a bank’s counterparty would be deemed “connected” if the bank owned more than 50 percent of the voting rights of the counterparty.¹¹³ In addition, the guidance-based approach would identify control relationships based on other criteria, including the existence of voting agreements; significant influence on the appointment or dismissal of an entity’s administrative, management or supervisory body; significant influence on senior management; or other qualitative factors recognized in international accounting standards as establishing control relationships.¹¹⁴ The guidance-based approach would also identify connected counterparties through an “economic interdependence” test based on criteria such as where a “significant part of the counterparty’s production/output is for a single customer which cannot easily be replaced” or “[w]hen the expected source of repayment for each loan is the same and neither counterparty has another source of income from which the loan may be fully repaid.”¹¹⁵

In view of the guidance-based analysis, a bank would have to conduct significant due diligence with respect to even the most speculative potential counterparty connections or identify counterparty relationships on the basis of facts not known or knowable to the bank (*i.e.*, unless control is automatically established by virtue of the “rule-based” test of ownership of more than 50 percent of the voting rights of another entity). Application of each of the connected counterparty tests is, in substantial part, judgment based and dynamic by nature (as economic relationships may change throughout the course of a day). In our view, it would be extremely difficult, and in many cases impossible, for banks to make reliable and consistent judgments. For the reasons set forth below, the Associations request the Basel Committee to abandon this approach and instead call for aggregation only of exposures to companies that are

¹¹² Proposed Framework ¶ 30.

¹¹³ *Id.* ¶ 31.

¹¹⁴ *Id.* ¶ 32.

¹¹⁵ *Id.* ¶ 34.

consolidated for financial reporting purposes (*e.g.*, international financial reporting standards (“IFRS”) or US generally accepted accounting principles (“GAAP”), as applicable).

1. The Inappropriateness of the Guidance-Based Approach in the Proposed Framework

The Associations agree that banks should assess interdependence among counterparties as a matter of safety and soundness. Internationally active banks currently capture and assess interdependencies among entities as part of their ordinary risk management procedures. Such interdependencies may be incorporated into internal ratings methodologies and internal exposure limits imposed on individual borrowers.

In the United States, for example, national banks have long been required to comply with an economic interdependence standard. Likewise, the Federal Reserve has long imposed a controlling interest standard of control on bank holding companies, whereby a bank holding company or its subsidiary would be deemed to control a company if it directly or indirectly exercised a controlling influence over the company’s policies or management (the “**Controlling Influence Standard**”).

However, we believe that such subjective, guidance-based tests are not appropriate in the large exposures context. While we understand and appreciate the Basel Committee’s objective to minimize systemic risk posed by closely connected counterparties, we believe that the control test in the Proposed Framework poses significant challenges. Trying to measure “control” through various qualitative measures would be a challenge to implement, as the Federal Reserve has recognized. Indeed, the Federal Reserve has a well-established body of precedent concerning the Controlling Influence Standard but pointedly proposed not to apply that precedent in the Proposed SCCL “because a simpler, more objective definition of control is more consistent with the objectives of single-counterparty credit limits.”¹¹⁶ Thus, the Proposed SCCL would only connect counterparties based on an objective definition of “control” triggered by: (i) ownership or control of 25 percent or more of voting securities; (ii) ownership of 25 percent or more of total equity; or (iii) consolidation for financial reporting purposes.¹¹⁷

It is not hard to understand why the Federal Reserve adopted this simpler approach. The Federal Reserve’s Controlling Influence Standard—like the Proposed Framework’s economic interdependence standard—is highly fact intensive. A “controlling influence” may result from a variety of factors, including, for example, equity ownership,

¹¹⁶ US Enhanced Prudential Standards, 77 Fed. Reg. 614.

¹¹⁷ *Id.* at 649.

representation on the board of directors of another company, and the nature and significance of business relationships among companies. A small change in any one of these factors could move a relationship from non-control to control under the Federal Reserve's precedent, which involves numerous interpretations over the course of more than 50 years. Moreover, in many, if not most cases, the Federal Reserve's determination of control or non-control under the Controlling Influence Standard relies on confidential, proprietary business information that would be known only to the parties directly involved and quite often only available when one entity makes a significant equity investment in another or has significant business relationships with that entity. Such information is not always available or immediately transparent to a third party lender or its supervisors.

When indirect subsidiaries and joint ventures (“JV”) are considered, implementation of the fact-intensive approach of the Proposed Framework to determine a control relationship becomes even more problematic. In many instances, banks have carefully negotiated voting and management arrangements to ensure that one investor effectively controls the JV structure, even where other investors may have a significant stake in the structure. In these situations, application of the control relationship test could lead to double-counting of a single entity's exposures. An example illustrates this point. Consider a JV where Bank A controls 60 percent of the voting interests of the JV, and Bank B controls 40 percent of the voting interests of the JV. Bank A and Bank B have allocated risk and control between themselves, including by granting majority voting ownership and managerial and operational control of the JV to Bank A. These arrangements may reduce rather than increase systemic risk by, for example, combining the capital commitments of both banks rather than each operating distinct and separate subsidiaries. Under either a financial consolidation standard or an objective, greater-than-50 percent voting interests standard, Bank A would clearly “control” the JV for purposes of the large exposure framework, which is the appropriate outcome for risk management purposes.

It is unclear, however, whether Bank B in this example might also “control” the JV under the Proposed Framework's guidance-based control criteria. If Bank B is deemed to “control” the JV, then counterparties facing the JV should consolidate the JV's exposures with those of Bank B. In this situation, the counterparty would be required to consolidate the JV's exposures twice—once with Bank A as the 60 percent voting interests owner, and again with Bank B, as a shareholder with “significant influence.”

We believe such double-counting of the JV's exposures is neither logical nor appropriate. Moreover, because Bank B lacks operational control over the JV, Bank B will not be able to prevent the JV from taking positions that could be attributed to Bank B and could potentially result in counterparties to Bank B violating their exposure limits to Bank B based on

the JV's activities. Finally, Bank A and Bank B would each have to treat the JV as part of the other bank's consolidated group, in which case Bank A's exposures to the JV would be consolidated with Bank A's exposures to Bank B and vice versa.

The guidance-based economic interdependence test in the Proposed Framework is also unworkable in practice. The criteria in paragraph 34 of the Proposed Framework call for a bank to be deeply familiar with a counterparty's clients, business relationships, business models, and finances; in many instances, banks will not have access to information to make this "economic interdependence" determination. Even assuming banks could obtain this information before investing, it would be very difficult for banks to continue to obtain information and monitor each counterparty's dynamic business on an ongoing basis. Finally, even assuming banks could obtain sufficient information initially and on an ongoing basis, assessing "economic interdependence" between counterparties on the basis of this information would be a highly subjective exercise that could vary widely among institutions.

In summary, the guidance-based control and economic interdependence tests in the Proposed Framework are not appropriate for the large exposures framework because they would be difficult—if not impossible—to apply in practice and could inflate exposure measurements well beyond banking organizations' actual economic exposures. Although we recognize that the "exceptional cases" language¹¹⁸ provides supervisors with some discretion for modifying the application of the control rules in specific circumstances, market participants would be exposed to considerable uncertainty across a wide range of transaction structures unless and until national regulators provided guidance on a case-by-case basis. The Associations urge the Committee to reformulate its approach to control and economic interdependence so that it will be possible for regulators and regulated entities to apply the final rules.

2. Proposed Approach to Connected Counterparties: Aggregation Based on Applicable Financial Consolidation Standards

In view of the considerations set out above and the goals of the Basel Committee, we urge the Committee to adopt an objective connected counterparty rule. In particular, we recommend that for purposes of the formal LE limit, the test for connected counterparties should include only companies that are consolidated for financial reporting purposes (*e.g.*, under IFRS or US GAAP, as applicable). This creates a "bright line" test that accomplishes the Proposed Framework's stated goal of simplicity because it is generally consistent with the approach taken under the risk-based capital framework. It also ensures

¹¹⁸ Proposed Framework ¶ 33.

that the definition appropriately reflects credit risk and is readily administrable for measuring and limiting exposures, thus avoiding the market confusion that might arise from the uncertain application of subjective standards to entities such as JVs.

We believe that this standard is a reasonable proxy for situations where a company will have responsibility for another company in which it invests. In addition, a bank's own internal credit risk management policies may require aggregation in other situations in order to address safety and soundness concerns. Revising the definition in accordance with a company's financial accounting consolidation requirements would lessen the burden associated with identifying subsidiaries and economically interdependent entities and allow for more-efficient review and back-testing while still capturing the credit exposures that are likely to concentrate risk. The application of a financial consolidation standard for determining control should avoid harmful, illogical outcomes such as the JV example presented above and would appropriately reflect and arrest the build-up of risk in the financial system.

An aggregation rule based on financial reporting consolidation could be supplemented by a Pillar 2 approach that assesses interconnectedness—whether determined by control relationships or economic interdependence—through bank risk management policies and practices. To the extent a bank's internal process concludes the default correlation of two counterparties are very high, the bank could then be required to connect them for purposes of applying the LE limit. This Pillar 2 approach would be generally consistent with existing industry practices that consider risk posed by connected counterparties as part of a broader risk management framework.

We believe that the proposed approach described above adequately addresses circumstances where separate, but linked, counterparties represent a single significant risk. It should also be effective in capturing risk posed by interconnectedness.

3. Alternative Approach: Materiality Threshold and Objective Standards

If the Basel Committee does not implement the consolidation approach supplemented by a Pillar 2 approach as described above, the proposed control relationship and economic interdependence tests should be revised to include a materiality threshold so that the aggregation principles only apply to a meaningful subset of existing exposures. Moreover, the control relationship and economic interdependence tests should be sufficiently objective to ensure consistency and comparability across institutions and jurisdictions.

In addition, to the extent the guidance-based tests are retained, the Basel Committee should issue guidelines that are more objective and easier for banks to apply consistently to determine if two counterparties are connected. Rather than adopt new,

untested control and economic interdependence standards, the Committee should leverage existing tests where banks have systems and infrastructure in place to make the necessary determinations. For example, guidance-based tests modeled on the lending limits of the Office of the Comptroller of the Currency (“**OCC**”) would address many of the same issues – such as where the expected source of repayment for each loan is the same for each borrower and neither borrower has another source of income from which the loan may be repaid¹¹⁹ – but would not require many banks to incur substantial additional compliance costs. Likewise, the UK Prudential Regulation Authority (“**PRA**”) (a successor to the UK Financial Services Authority) issued standards to evaluate a group of connected counterparties.¹²⁰

Finally, if the Basel Committee is concerned about evasion of the Proposed Framework, we would support an anti-evasion prong analogous to lending limit requirements in the US. For example, the final version of the Framework could provide national regulators with authority to require aggregation of counterparties whenever warranted by the facts and circumstances.

C. Large Exposure Exemptions. Intraday exposures, certain overnight interbank exposures and exposures arising from the provision of PCS services should be exempted from the LE limit.

The Proposed Framework would apply the LE limit to interbank exposures in the same way that it is applied other third-party exposures.¹²¹ The Committee, nonetheless, recognized the “potential constraints that banks may face given the different payment and

¹¹⁹ Compare 12 C.F.R. § 32.5(c)(1) with Proposed Framework ¶ 34.

The OCC, the lead regulator for national banks, has long applied regulatory restrictions on economic interdependence. See 12 U.S.C. § 84; 12 C.F.R. Part 32. The OCC’s current rules specify that in order for counterparties to be connected for purposes of its “loan to one borrower” rules, there must either be a “direct benefit” to a third party or a “common enterprise” that exists with the third party. See 12 C.F.R. § 32.5(a). The OCC’s rules find a “direct benefit” giving rise to interdependent credit risk when the loan proceeds will be taken and given to the third party, other than as part of a valid arms-length transaction. 12 C.F.R. § 32.5(b). And, a “common enterprise” will only be found to exist where either the “expected source of repayment” is the same for each borrower (and there is not another source of borrower income from which the loan may be fully repaid), or the borrowers are entities that are related by common control (pursuant to a standard similar to the Controlling Influence Standard), and there is “substantial financial interdependence” between the entities where “substantial financial interdependence” means over 50 percent of one entity’s gross receipts or gross expenditures are derived from transactions with the other entity. 12 C.F.R. § 32.5(c).

¹²⁰ See Financial Services Authority, *Prudential Sourcebook for Banks, Building Societies, and Investment Firms (Large Exposures) (Amendment) Instrument 2012*, FSA 2012/59, BIPRU 10.3.6 (12 October 2012).

¹²¹ Proposed Framework ¶ 99.

settlement systems they operate in or in relation to monetary policy implementation,” and therefore, seeks input on a possible exemption for certain limited categories of exposures.¹²²

For the reasons discussed below, the Associations strongly support exemptions for intraday exposures, certain overnight interbank exposures and exposures arising from the provision of PCS services to clients. At a minimum, national supervisors should be allowed flexibility to provide for exemptions for such exposures within their jurisdictions.

1. Proposed Exemption for Intraday Exposures

As an initial matter, the Associations support an exemption from the Framework for intraday exposures to all counterparties. This includes both interbank exposures and exposures between a bank and a nonbank counterparty. This approach is consistent with the Basel risk-based capital regime as well as the OCC’s lending limit rules and Proposed SCCL.¹²³ As the Federal Reserve recognized in the similar context of the Proposed SCCL, an exemption for all intraday exposures “would help minimize the impact of [the proposal] on the payment and settlement of financial transactions.”¹²⁴

Intraday exposures between financial institutions are crucial to providing the liquidity needed for the completion of payments activities. Intraday exposures frequently occur when extending credit to banks in the course of making payments for them or their customers or in the expectation of settlement in end-of-day net settlement systems. Intraday exposures may also result because global banks provide services to customers in various time zones and the timing of payments across the globe is uneven. Subjecting intraday exposures to the Framework could significantly reduce the ability of banks to facilitate the completion of such payments.

In addition, the benefits of imposing additional regulation on intraday exposures are unclear. Banks have substantial experience evaluating and controlling exposures to their customers, and intraday overdrafts are almost always cured by the receipt of incoming payments before the close of business. Moreover, the payment, clearing and settlement systems used to process many intraday transactions are typically required to provide their

¹²² *Id.* ¶ 101.

¹²³ US Enhanced Prudential Standards, 77 Fed. Reg. 654.

¹²⁴ *Id.* at 622.

participants with the tools necessary for them to understand, manage, and control the risks that arise from participation in these systems.¹²⁵

2. Proposed Exemption for Certain Overnight Interbank Exposures

In addition, the Associations believe that the Framework should provide an exemption from the LE limit for certain overnight interbank exposures, such as placements with banks subject to reserve requirements and nostro balances held with correspondent banks. Overnight interbank exposures are a critical source of market liquidity, and applying the large exposure limit to such exposures could have a significant, detrimental effect on monetary policy. For example, central banks manage interest rates by controlling the level of bank reserves available for overnight borrowings in local money markets, such as the federal funds market in the United States. Overly restrictive exposure limits could constrain the ability of banks to lend excess reserves in these markets, thus impairing the link between the level of reserves and interest rates in overnight markets, thereby limiting central banks' control over a critical aspect of monetary policy.

3. Proposed Exemption for Certain Exposures Arising from the Provision of PCS Services

Although PCS services provided by banks to their clients typically result only in intra-day exposures, in some instances, a transaction may be unexpectedly delayed due to timing, matching, systems or other operational impediments, therefore resulting in an exposure that extends beyond the end of the business day. It is generally acknowledged that the provision of such services plays a critical role in ensuring the efficient operation of financial markets.¹²⁶ Subjecting these activities to the LE limit may discourage the provision of PCS services, and thereby increase the costs or decrease the availability of such services, to the detriment of end-users and the broader financial system.

¹²⁵ See Committee on Payment & Settlement Systems, Bank for International Settlements, *Core Principles for Systemically Important Payment Systems*, at 23-28 (2001).

¹²⁶ See, e.g., Preamble to CRD IV, ¶ 36 (noting that an exemption arising from the provision of PCS services was included in the counterparty credit exposure framework "to facilitate the smooth functioning of financial markets and of the related infrastructure").

Specifically, we request that the Basel Committee include a time-limited exemption within the Framework for exposures arising from the provision of PCS services under the following circumstances:¹²⁷

- The exposure arises in the normal course of providing PCS services to clients, including those that arise in foreign exchange, securities, derivatives, commodities, and similar investment activities;
- The bank has appropriate policies and procedures governing the credit and liquidity risks of the counterparty and that it monitors such exposures on a daily basis;
- In the event the aggregate exposure to the counterparty exceeds the large exposure limit (as a result of exposures relating to PCS services that were not settled or otherwise completed on an intra-day basis), the bank takes appropriate action to reduce the exposures arising from the provision of PCS services as quickly as reasonably practicable, and in no event longer than five business days of the initial breach; and
- The bank reports the large exposure breach to its appropriate national regulator no later than the first business day after the excess occurs, and advises it as to the actions the bank has taken or will take to promptly eliminate the exposure within the prescribed period.

D. Exposures to Collective Investment Vehicles. Rather than requiring banks to apply the LTA, the indirect exposures of banks to positions held by CIUs, securitizations, and other investment vehicles should be addressed through a Pillar 2 approach that relies on a bank's own monitoring of indirect exposures; alternatively, the LTA should be narrowed to include only those investment vehicles that could reasonably present material risks of credit concentrations.

The Proposed Framework would have a bank engage in a highly burdensome “look-through” approach to determine its indirect exposures to the underlying assets in CIUs, securitizations, and similar investment vehicles. Under the Framework, a bank must either verify that these vehicles satisfy a “granularity test” (*i.e.*, the vehicle holds no asset representing more than 1 percent of scheme assets), or look-through to all of the underlying

¹²⁷ Regulators have recognized the need for a flexible approach with respect to the treatment of such exposures in the context of counterparty credit exposure limits. *See, e.g.*, CRD IV, Article 379(6)(c) (excluding, “in the case of the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking or financial instruments clearing, settlement and custody services to clients,” exposures from “delayed receipts in funding and other exposures arising from client activity which do not last longer than the following business day”).

assets in the vehicle. Where the bank must look through but cannot determine the issuer of an underlying asset, each such “unknown exposure” would result in aggregation with all other unknown exposures as if they represented exposures to a single unknown counterparty.

The Associations support the Committee’s goal of identifying material underlying exposures that may have a material impact on a bank’s single counterparty concentration risk. However, we believe that there are significantly less burdensome ways to do so that do not sacrifice the prudential or risk mitigation benefits of the LTA. The Associations strongly urge the Committee to forego the LTA, adopting instead a Pillar 2 approach that achieves the same goals of measuring and limiting indirect exposures without the associated compliance burden.

1. The LTA Would Impose a New, Overly Complex Requirement on Banks

Applying the LTA as set out in the Proposed Framework would introduce a new requirement for a large number of internationally-active banks because (i) banks outside the EU are not subject to an LTA approach with respect to LE limits, (ii) banks inside the EU are subject to a different LTA for exposure limits that are less stringent than the LTA in the Proposed Framework,¹²⁸ and (iii) the Basel Committee’s capital rules apply a concept that is similar to the LTA that allows for more exceptions than what is contemplated by the Framework.

First, banks outside the EU are not currently subject to an LTA comparable in scope to that of the Proposed Framework. For example, in the US, the Proposed SCCL does not introduce a separate exposure calculation method for CIUs, securitizations, or similar vehicles. Instead, it would require such exposures to be calculated like any other debt or equity exposure based on the greater of the purchase price or market value.¹²⁹ To address the concern that such an approach might improperly mask certain bank exposures, the Federal Reserve has reserved authority to look through some special purpose vehicles (“**SPVs**”) either to the issuer of the underlying assets or to the sponsor.¹³⁰ Alternatively, the Federal Reserve may require the bank to look through to the underlying assets of an SPV—but only if the SPV fails certain

¹²⁸ We are aware that the European Banking Authority (“**EBA**”) is currently consulting on Draft Regulatory Technical Standards on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets under Article 379 of the proposed EU Capital Requirements Regulation (“**EBA Consultation**”). In its consultation paper, the EBA proposes going further than the Proposed Framework, including not applying a granularity threshold at all. However, the EBA notes that it will also monitor closely the development of the Proposed Framework. The Association for Financial Markets in Europe (“**AFME**”), a sister association to GFMA, plans to respond by 16th August 2013 to the EBA Consultation, and reserves its position in this regard accordingly.

¹²⁹ See US Enhanced Prudential Standards, 77 Fed. Reg. 652.

¹³⁰ *Id.* at 615.

discrete, objective concentration tests, such as by having fewer than 20 underlying exposures.¹³¹

In the EU, banks are subject to an LTA for exposure limits that is less stringent than the approach in the Proposed Framework.¹³² In particular, EU banks are subject to a 5 percent granularity threshold as opposed to the 1 percent granularity threshold envisioned by the Committee.¹³³ EU banks also have the option of choosing the full look-through approach, the partial look-through approach with unknown exposures, or the structure-based approach.¹³⁴ Even with this more flexible approach, the LTA has proved difficult to implement in the EU. The LTA in the Proposed Framework is likely to present even more serious implementation problems given the Framework's lower granularity threshold and mandatory look-through requirement.

The Basel Committee's capital rules also apply a look-through approach in various contexts that provide more flexibility than the intended LTA in the Proposed Framework. For example, the Basel II Internal Ratings Based ("**IRB**") Approach permits "[h]oldings in funds containing both equity investments and non-equity types of investments" to be treated, "in a consistent manner, as a single investment based on the majority of the fund's holdings *or*, where possible, as separate and distinct investments in the fund's component holdings based on a look-through approach."¹³⁵ The Basel III deduction for investments in the capital of banking, financial, and insurance entities requires banks to look through holdings of index securities to determine their underlying holdings of capital.¹³⁶ However, Basel III gives national authorities discretion to permit banks to use a conservative estimate if "banks find it operationally burdensome to look through and monitor their exact exposure to the capital of other financial institutions."¹³⁷ Likewise, under CRD IV, institutions

¹³¹ *Id.*

¹³² See CRR Art. 379 ¶ 7.

¹³³ Committee of European Banking Supervisors, *Guidelines on the implementation of the revised large exposures regime* ¶ 74 (11 December 2009). Note, however, that the European Banking Authority is currently consulting on this topic in its consultation paper on *Draft Regulatory Technical Standards on the determination of the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets* (EBA/CP/2013/07).

¹³⁴ See *id.*

¹³⁵ Basel II ¶ 360.

¹³⁶ Basel III ¶¶ 80, 84.

¹³⁷ *Id.* ¶ 80 n. 27 & ¶ 84 n. 31.

may use a conservative estimate rather than the LTA where it would be “operationally burdensome” to do so.¹³⁸

In contrast to the Proposed SCCL, the EU large exposure regime, and the Basel Committee’s capital rules, the LTA in the Proposed Framework does not permit any exception to the LTA. Moreover, the Proposed Framework has an extraordinarily low granularity threshold—if only *one* underlying asset exceeds 1 percent of the total value of the transaction, then a bank is required to look through to *all* underlying assets.¹³⁹

As such, the proposed LTA will be extremely difficult to implement and likely will not be balanced by corresponding prudential benefits. Applying the LTA would require extensive systems and human intervention, and in some cases, will not be possible. In particular, banks do not have real time access to underlying portfolios in many instances because the fund is subject to frequent change and does not disclose changes to underlying assets with the same frequency.¹⁴⁰ It would be impossible, for example, for banks to report many exposures using the LTA on a daily basis.¹⁴¹ In these instances, banks are unable to apply the LTA because of the characteristics of the underlying fund—not because the bank does not have sufficient infrastructure. In other instances, issuers may be prohibited by privacy laws from disclosing information regarding underlying obligors, particularly in the context of

¹³⁸ CRR Art. 71(1), (2).

¹³⁹ Proposed Framework ¶ 109.

¹⁴⁰ Many type of funds/CIUs are not required to make real-time public disclosures of positions under applicable law. In the US for instance, the US Securities and Exchange Commission (the “SEC”) does not require reporting funds and CIUs to make continuous real-time disclosures of their portfolio positions. Issuers of asset-backed securities subject to the SEC’s Regulation AB must file periodic Form 10-K and Form 10-D reports including information regarding “significant obligors” on pool assets, but the term “significant obligors” is defined to exclude obligors or properties (or groups of related obligors or properties) that do not represent at least 10 percent of the relevant asset pool. Regulation AB, Items 1101(k), 1112. In adopting Regulation AB, the SEC noted that the 10 percent standard follows “longstanding” SEC staff and market practices in analogous accounting contexts. SEC Release No. 33-8518 (Dec. 22, 2004), text accompanying nn. 315 and 316.

Further, the Investment Company Act of 1940 requires registered investment companies to provide to investors semiannual reports, including a list showing the “amounts and values of securities owned” on the balance sheet date. Investment Company Act § 30(e)(2); Investment Company Act Rules 30e-1(a), 30e-2(a). Again, however, this listing is not given on a real-time basis, but only in the semiannual reports.

¹⁴¹ See US Enhanced Prudential Standards, 77 Fed. Reg. 654 (proposed 12 C.F.R. § 252.96(a)) (requiring daily reporting, but not the LTA). With respect to exposures to securitizations, even when information regarding underlying obligors is disclosed at the point of the initial issuance, the ongoing disclosure of the underlying positions may vary in frequency and quality. The frequency and quality of disclosure could have a significant impact on the accuracy of large exposure calculations, particularly in the context of securitizations that are not static.

transactions securitizing retail exposures or in which the obligors are natural persons (*e.g.*, typical mortgage, automobile, credit card or student loan ABS). Given the difficulties in applying the LTA, many underlying assets could be deemed “unknowns” and therefore require aggregation as exposures to the single “unknown client.”¹⁴² The implicit assumption that a single client underlies all of the various diverse exposures across asset classes and markets is punitive and unrealistic, and imposing a large exposure limit on the “unknown client” is not narrowly tailored to the Committee’s objective of mitigating the maximum losses a bank could face in the event of a sudden counterparty failure.¹⁴³ Although this approach is meant to incentivize banks to improve their exposure identification process, it also penalizes banks that invest in vehicles where the bank does not have real time access to underlying portfolios—regardless of the quality of the bank’s internal exposure identification infrastructure—and therefore provides a disincentive for banks to invest in such vehicles.

More importantly, these operational burdens and complexities are not balanced by corresponding prudential benefits. Regulators could assess material underlying exposures that impact a bank’s large exposure calculations in a variety of less burdensome ways, as discussed below. The LTA does not result in additional prudential or risk mitigation benefits when compared with these less burdensome alternatives.

2. Proposed Pillar 2 Approach to LTA

Given the impracticality and significant compliance burden of the intended LTA proposal, we urge the Basel Committee to adopt a Pillar 2 approach to address the risks posed by underlying exposures to positions held by CIUs, securitizations, and other investment vehicles. We believe the proposed Pillar 2 approach appropriately addresses the Basel Committee’s concerns that, “absen[t] a look-through, it would be impossible to identify the true concentration risk to a single counterparty, and banks could easily avoid large exposure limits by investing in multiple transactions with identical underlying assets.”¹⁴⁴

Under this proposed alternative, banks should be called upon to review underlying exposures to determine, document, and offer quantitative support for whether an

¹⁴² See Proposed Framework ¶¶ 111-12.

¹⁴³ If the Committee retains the “unknown client” construct, it should at a minimum permit banks to place unknown exposures in different categories (rather than attribute them to a single “unknown client”) when it can be determined with reasonable certainty that they cannot be the same because, for example, the underlying exposures are in distinct regions or commercial sectors.

¹⁴⁴ Proposed Framework ¶ 105.

underlying asset impacts its large exposure calculations.¹⁴⁵ This review would occur both at the underwriting stage as applicable, and on a quarterly basis to monitor changes in exposure size. This inventory would supplement banks' own internal risk management processes and also would provide written, quantitative documentation for national regulators to review. Further, national regulators may use their supervisory authority to look through any vehicles where they believe the underlying assets present large exposure risks. For example, the Framework could allow national regulators to look through where the vehicle fails discrete, objective concentration tests and presents a risk that the underlying assets improperly mask a bank's concentration exposures.

Where underlying assets impact large exposure calculations—either as determined by the bank itself or through the supervision process—then the bank should be expected to aggregate the underlying exposure with other exposures to the same counterparty. For example, mortgage-backed securities and other retail asset backed securities should not call for look through because the underlying borrowers are natural persons or other small-dollar borrowers that do not impact a bank's large exposure calculations, and this determination would be documented and supported in the Pillar 2 review.

The Associations strongly urge the Committee to adopt the Pillar 2 alternative. This approach would more effectively focus on identifying material underlying exposures that actually impact large exposure calculations for a given bank, thereby accomplishing the Committee's goal of capturing indirect investments in large exposures,¹⁴⁶ while also reducing compliance burden and complexity.

Alternative Approach: Modified LTA

If the Pillar 2 approach is not adopted, the Committee should endeavor to exempt certain classes of CIUs, securitizations, and other investment vehicles that do not present material underlying concentration risks. This alternative approach includes an appropriately structured feasibility test.

First, the Committee should exempt the following categories of CIUs, securitizations, and other investment vehicles that are unlikely to impact a bank's large exposure limits:

¹⁴⁵ In making such an assessment with respect to securitizations, a bank should be permitted to take into account the presence of credit enhancement and other structural elements that may mitigate the impact of any such underlying exposure.

¹⁴⁶ Proposed Framework ¶ 104.

- Retail asset backed securities, such as securitizations of underlying assets of credit cards, auto loans, and residential mortgages because the underlying borrowers are natural persons and other small-dollar borrowers such as small and medium-sized enterprises.
- Pools of finance receivables because the underlying borrowers are small businesses (*e.g.*, dealer floor plans and equipment lease and loans).
- Commercial mortgage-backed securities because the underlying assets are rentals, leases, or the physical properties themselves (and there should be little overlap across a bank's lending portfolio).
- Registered mutual funds because they already meet transparency, asset quality and asset diversification requirements. They are also subject to ongoing regulatory oversight. Moreover, banks invest in these funds for the fund manager's expertise, not to gain access to the underlying assets.
- Other types of funds that are subject to stringent regulatory requirements intended to minimize risk, leverage, and conflicts of interest.

These categories of vehicles should be exempt because they simply do not hold the types of underlying assets that present large exposure issues.

Second, for those CIUs, securitizations, or other investment vehicles that are not exempt from the LTA (as detailed in the preceding bullets), the Committee should adopt a feasibility test to determine whether the LTA would apply. This test would require a bank to apply the LTA if it has ready access to the information required to look through to the underlying investment. If it is otherwise "operationally burdensome to look-through and monitor their exact exposure" to the underlying assets, banks should be permitted to use a conservative estimate of their exposures, with supervisory approval from their national regulatory authority—the same approach that is used in the Basel III capital framework.¹⁴⁷ National regulators could structure this process, for example, by requiring banks to provide a list of their investments that fit into this category, an explanation of or support for the bank's determination that the information required for a look-through is not reasonably available, and the categorization of the underlying exposures and asset type (*e.g.*, by industry and market).

We believe that this approach is far more tailored and effective than the proposed requirement to aggregate all unknown underlying assets as exposures to a single "unknown client."¹⁴⁸ Indeed, as the Committee itself acknowledges, the single "unknown

¹⁴⁷ Basel III ¶ 80 n. 27 & ¶ 84 n. 31.

¹⁴⁸ Proposed Framework ¶ 111.

client” assumption “would be unrealistic in many cases.”¹⁴⁹ The Associations’ proposed approach avoids these overly conservative results, is consistent with Basel III look-through provisions, and effectively mitigates the risk that CIUs, securitizations, or other investment vehicles may mask the true concentration risk to a single counterparty.

3. Proposed Approach for Senior Tranches of Securitizations

The LTA also does not accurately capture the risks of certain CIUs, securitizations, and similar vehicles. In particular, the pro rata LTA does not accurately capture the risk differences among senior, mezzanine, and junior tranches of such vehicles. In addition, the Committee recently clarified in its responses to frequently asked questions regarding the large exposure QIS that all exposures to a securitization are treated in an equal manner and that there is no recognition of credit enhancement.¹⁵⁰

The failure to recognize risk differences among the tranches of securitizations or, more broadly, any form of credit enhancement is a matter of significant concern for the Associations. As outlined below, should the Committee adopt the LTA, we strongly believe that it should revisit the treatment of such vehicles and take into account the loss absorbing capacity and credit enhancement provided by junior tranches and any form of credit enhancement.

Within a securitization, there are important differences between the various tranches, and the Proposed Framework should take into account the structural features in securitizations and other credit enhancements that, upon underlying single obligor default, reduce both loss probabilities and loss severity. Most senior securitization tranches are protected by various forms of credit enhancement, and therefore, actual exposures to underlying obligors are not equivalent to a bank’s pro-rata interest in the underlying issuer. Further, obligor concentrations are an explicit factor in determining the amount of required credit enhancement for a particular securitization transaction, and as a consequence, credit enhancements may also directly mitigate the concentration risk of such exposures.¹⁵¹ In view of these protections, the default of any single underlying obligation is highly unlikely to result in any material loss in the value of the senior securitization position.

¹⁴⁹ *Id.* ¶ 112.

¹⁵⁰ Basel Committee, *Frequently asked questions on Large Exposures QIS* (June 2013).

¹⁵¹ Securitization transactions typically have concentration limit covenants designed to ensure that the default of a single underlying obligor will not cause a realized loss to an investor.

In addition, the risk-based capital frameworks of both the Committee and national regulators broadly recognize the loss absorbing capacity of, and credit enhancement provided by, more junior tranches of securitizations, and thus deem a relatively senior tranche to be less risky than a more junior tranche. For example, the Basel II securitization framework provides that a securitization exposure is a tranching exposure to the underlying assets that differs from ordinary senior or subordinated debt instruments because junior securitization tranches can “absorb losses without interrupting contractual payments to more senior tranches.”¹⁵² Similarly, in the US, the recently proposed simplified supervisory formula approach for risk weighting securitization exposures was designed to apply “relatively higher capital requirements to the more risky junior tranches of a securitization that are the first to absorb losses, and relatively lower requirements to the most senior exposures.”¹⁵³

Accordingly, we propose an exception from the LTA (to the extent applied) in the following circumstances: (i) the bank’s exposure is senior (*i.e.*, the tranche has a detachment point of 100 percent) and is in the form of debt, (ii) the securitization exposure is rated as investment grade or the bank has determined that its exposure is “investment grade” (*i.e.*, the issuer has adequate capacity to meet financial commitments, the risk of default is low, and the full and timely repayment of principal and interest is expected).¹⁵⁴

4. Proposed Approach for “Additional Risks” Associated with CIUs

The proposed identification of “additional risks” associated with CIUs, securitizations and other vehicles is highly subjective and we believe that the Basel Committee should not be evaluating operational risk as part of an LE limit.¹⁵⁵ This is yet another example of the LE limit—a blunt tool designed to measure and limit counterparty risk—being used to address additional policy objectives.

The “additional risks” analysis is unnecessary in the LE regime because it is already addressed in the Pillar 2 supervisory process. Banks have other policies and procedures in place to measure fraud risk and other types of operational risk. For example, the Committee has recognized that “[c]ommon industry practice for sound operational risk governance often

¹⁵² Basel II ¶ 539.

¹⁵³ Office of the Comptroller of the Currency, Federal Reserve System and Federal Deposit Insurance Corporation, *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements*, 77 Fed. Reg. 52888, 52919 (30 August 2012).

¹⁵⁴ See, e.g., Alternatives to the Use of External Credit Ratings in the Regulations of the OCC, 77 Fed. Reg. 35,253 (June 13, 2012).

¹⁵⁵ See Proposed Framework ¶¶ 116-20.

relies on three lines of defence—(i) business line management, (ii) an independent corporate operational risk management function, and (iii) an independent review.”¹⁵⁶ Moreover, any deficiencies in a bank’s operational processes are addressed through the supervisory process. As the Committee has noted, “[s]upervisors use the tools most suited to the particular circumstances of the bank and its operating environment” to address “[d]eficiencies identified during the supervisory review.”¹⁵⁷

Given these additional mechanisms in place to address fraud and other operational risk, the Associations strongly urge the Committee to remove the “additional risks” requirement in any final version of the Framework.

E. Sovereign Exposures. Sovereign exposures, including certain government sponsored entities or entities serving a public purpose as determined by national supervisors, should be exempted from the Proposed Framework.

The scope of the Proposed Framework does not encompass “entities considered as sovereigns, their central banks and public sector entities treated as sovereigns” according to the risk-based capital framework (the “**Sovereign Exclusion**”).¹⁵⁸ We welcome the Basel Committee’s proposal to conduct a separate review of the appropriate treatment of sovereign concentration risk.

The Associations believe that national governments should also be explicitly provided appropriate flexibility to include certain additional entities—namely, government sponsored entities or entities serving a public purpose—within the scope of the Sovereign Exclusion. In our view, it would be appropriate for this discretion to be exercised in the case of certain entities (*e.g.*, Federal Home Loan Bank exposures in the United States) that play a critical role in the promotion of financial or housing market stability for a national economy.¹⁵⁹ Subjecting these types of entities to the LE limit could potentially encumber or obstruct their critical economic function.

¹⁵⁶ Basel Committee on Banking Supervision, *Principles for the Sound Management of Operational Risk 3* (June 2011).

¹⁵⁷ *Id.* at 2.

¹⁵⁸ See Proposed Framework ¶ 97.

¹⁵⁹ Historically, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (collectively called the government-sponsored enterprises or “**GSEs**”) have played a very large role in mortgage provision in the United States.

The Associations would support the reporting of sovereign exposures to national supervisors in order to appropriately monitor any risk posed by these exposures. However, we believe that bank exposures to high-quality sovereigns, defined on the basis of objective and consistent criteria, should be explicitly exempted from any future extensions of the Proposed Framework.¹⁶⁰

F. Natural Persons. Natural persons should not be covered as counterparties under the Proposed Framework.

Paragraph 28 of the Proposed Framework would, in certain cases, include within the definition of connected counterparties “two or more natural persons or legal persons,” suggesting that exposures to individuals are covered by the LE limit.¹⁶¹

The Associations believe that natural persons should not be subject to the LE limit. As a practical consideration, including exposures to natural persons in the LE limit cannot be justified on the basis of safety and soundness or financial stability given the extreme unlikelihood that exposure to an individual by a bank would ever reach the LE limit or pose any risk of systemic interconnectivity the Proposed Framework was designed to address. On this basis, it would also be unwarranted under any reasonable cost/benefit analysis to require banks to develop and maintain the mechanisms for tracking exposure to an individual and the individual’s immediate family for purposes of this limit. Exposures to individuals are already amply covered by existing national lending limits and by internal risk management systems.

¹⁶⁰ Joint Trades Comment Letter on the Proposed SCCL, at C-19 to C-21 (providing support for the proposition that the following types of securities should be exempt from the single counterparty credit limits: (i) sovereign debt securities that are assigned a specific risk-weighting factor of 1.6 or less (equivalent to a risk-weighting of 20 percent or less under the US banking agencies’ Basel I-based capital rules) under the market-risk rules as they are amended; (ii) securities issued or guaranteed by the government of a country that is a full member of the Organization for Economic Cooperation and Development or that has concluded special lending arrangements with the International Monetary Fund (which is the current standard under the US banking agencies’ Basel I-based capital rules for 20 percent risk-weighted sovereign securities); and (iii) central banks in countries that are identified through these criteria should also be exempt.)

¹⁶¹ Proposed Framework ¶ 28.

VI. Additional Concerns

A. Traditional Off Balance Sheet Commitments/Calculation of CCFs. The Committee should adjust its intended approach to off-balance sheet commitments to better reflect the risk profile of individual exposures, by taking into account contractual, legal or regulatory characteristics that may prohibit or otherwise prevent a full drawdown of the commitment.

Outside a limited exemption granted to address potential concerns related to trade finance activities, the Proposed Framework requires use of a 100 percent CCF based on a “worst case” loss assumption for traditional off balance sheet commitments. The Associations believe that the proposed approach to traditional off balance sheet items should be revised to better reflect both the actual risks of certain commitments and their benefits to financial markets, by taking into account certain features that may prevent or otherwise restrict a full drawdown of the commitment. For example, for certain counterparties, such as US mutual funds, there are regulatory constraints that limit the extent of a fund’s borrowing relative to the value of assets held. Similarly, certain performance bonds and letters of credit contain contractual restrictions that may legally prohibit or otherwise prevent the borrowing of the full notional value of the facility.¹⁶²

Since the exposure value for essentially all off-balance sheet commitment under the Committee’s approach is based upon notional exposure, the Framework may significantly overstate the maximum risk of loss in lending commitments where prohibitions or other restrictions on future drawdowns exist. This overstatement of the maximum risk of loss would make it more difficult for banks to provide certain products to customers, thereby possibly resulting in a material contraction of credit availability. The Associations therefore recommend that the final Framework should be amended to incorporate a more granular CCF for certain financial activities beyond trade finance where the risk of a ‘worse case’ loss assumption does not apply.

In addition, as currently drafted, it is unclear if the unused portion of unconditionally cancellable commitments is included in the calculation of the exposure. For similar reasons, we strongly urge the Committee to clearly establish a zero percent CCF for such products, as by definition banks can cancel them at any time. Such an approach would be consistent with the treatment of these products under the risk-based capital framework.

¹⁶² For certain regulated counterparties (e.g., mutual funds), applicable regulatory leverage limits or other regulatory restrictions may legally prohibit the counterparty from borrowing all or some of the committed amount that is notionally available for draw.

B. Eligible Collateral. The definition of “eligible collateral” is too limited and should be expanded consistent with the Basel capital framework.

The Proposed Framework treats “eligible collateral” in the same manner as in the Basel II Standardized Approach,¹⁶³ but it does not include physical collateral.¹⁶⁴ The Committee reasons that “eligible collateral can mitigate the risk posed by the sudden failure of a counterparty only if it is immediately available and liquid, a condition that physical collateral is unlikely to fulfil[!].”¹⁶⁵

Although the Associations appreciate the Committee’s concern, we believe that the definition may not reflect the risk mitigation value of other forms of collateral that have well-established markets that have demonstrated similar levels of liquidity as the markets for financial collateral. Accordingly, the Basel Committee should provide national supervisors with flexibility to recognize the risk mitigation value of forms of collateral that do not qualify as eligible financial collateral for purposes of the Basel capital standardized approach. The Basel Committee has noted, for example, that a “national supervisor may . . . recognize mortgage[s] on multifamily residential real estate as eligible collateral for corporate exposures” if “multifamily housing makes up an important part of the housing market and where public policy is supportive of the sector.”¹⁶⁶ Likewise, the Committee recognized that “in exceptional circumstances for well-developed and long-established markets, mortgages on office and/or multi-purpose commercial premises and/or multi-tenanted commercial premises may have the potential to receive alternative recognition as collateral in the corporate portfolio.”¹⁶⁷ In these local jurisdictions, the market for certain types of mortgages may be as well-established and as liquid as the market for financial collateral. Any large exposures framework therefore should allow national supervisors discretion to include other types of collateral that may include, for example, certain types of mortgages.

C. Effective Date. The Committee should proceed cautiously and not commence implementing the Framework before 2019 and, if prudent to do so in light of subsequent analysis of the impact of the final Framework, begin a phase-in of the final Framework’s requirements at that time.

¹⁶³ *Id.* ¶ 67.

¹⁶⁴ *Id.* ¶ 74.

¹⁶⁵ *Id.*

¹⁶⁶ Basel II ¶ 507 n. 92 (IRB approach).

¹⁶⁷ *Id.* ¶ 289 n. 73 (IRB approach).

As discussed in Part III, the transactions covered by the Framework are fundamental to key parts of our financial system. The Framework will affect not just large internationally active banks, but also the cost and availability of many types of financial products and services provided to end-users, such as consumers, businesses, public sector entities, and institutional investors. In light of the wide-ranging potential impact that the Framework could have, it is vital that its methodologies and calibration be fully analyzed and its likely consequences for banks, end-users and financial markets be well understood before it becomes effective. We strongly believe it will not be possible to perform such an analysis until, at the earliest, the NIM approach has been finalized and the Framework is in essentially final form. In order to avoid potential market disruptions, banks will also need sufficient time to adapt to the final Framework, recalibrate their risk management systems and unwind any relationships in an orderly matter. Accordingly, we urge the Committee to proceed cautiously and not to call for implementation of the Framework before 2019 and, if prudent to do so in light of subsequent analysis of the impact of the final Framework, begin a phase-in of the final Framework's requirements at that time.¹⁶⁸

We would also urge the Committee to call for implementation of the Framework in a manner that is consistent with, and complementary to, other regulatory reform initiatives. Particular attention should be paid to the ongoing migration of derivatives markets to CCPs as a result of mandatory clearing determinations and the anticipated imposition of regulatory margin requirements for uncleared derivatives. The Large Exposure Framework should be flexible enough to accommodate structural changes to the derivatives markets as central clearing and margining increase; imposing a rigid regime today may prevent the development of more effective risk-mitigation practices. In addition, the Financial Stability Board has endorsed the adoption of Legal Entity Identifiers (“LEIs”) by all market participants to improve transparency and reduce operational risk. Market utilities are currently working to develop and implement a global LEI solution, and the Proposed Framework should build on that effort for purposes of identifying counterparties, rather than impose parallel, burdensome requirements for identifying and classifying counterparties.

¹⁶⁸ See also section III.B above (requesting that a heightened inter-G-SIB limit not be incorporated into the Framework unless and until: (i) the full impact of the generally-applicable 25 percent LE limit has been determined based on actual experience and quantitative study; (ii) comprehensive studies of the potential impact of a tighter inter-G-SIB limit have been undertaken; and (iii) it has been determined that such a limit is necessary to mitigate risks to financial stability after appropriately taking into account the numerous pending changes to the international regulatory framework intended to reduce systemic risk and interconnectedness).

VII. Responses to Requests for Comment in the Proposed Framework

We have set forth below cross-references to discussions of certain specific requests for comments by the Basel Committee in the Proposed Framework.

Question 2. *The Committee welcomes views on the criteria proposed for the identification of connected counterparties when they pose a single risk.*

Please see our comments in section V.B.

Question 3. *The Committee welcomes views and quantitative information on whether the limit should be based on CET1 or Tier 1.*

Please see our comments in section IV.A.

Question 4. *The Committee welcomes views on the extent and nature of the use of internal models (when they have received supervisory approval for being used for Pillar 1 capital requirements purposes) to measure large exposures.*

Please see our comments in sections III.B and III.C.

Question 5. *The Committee welcomes views on the proposal to calculate exposure value of banks' investments in OTC derivatives.*

Please see our comments in section III.B.

Question 6. *The Committee welcomes views on the proposal for how the exposure values of banks' investments in securities financing transactions should be calculated, in particular on the need to deviate from the risk-based capital requirement rules given the objectives of a large exposures framework.*

Please see our comments in section III.C.

Question 7. *The Committee welcomes views on the proposal to generally apply a 100% CCF for "traditional" off-balance sheet commitments.*

Please see our comments in section VI.A.

Question 8. *The Committee welcomes views on the proposed hybrid approach for banks that apply the "comprehensive approach" to financial collaterals.*

Please see our comments in sections III.A and III.C.

Question 10. *The Committee welcomes views on the proposals for offsetting long and short positions, in particular when these positions are in different issues.*

Please see our comments in section III.D.

Question 11. *The Committee welcomes comments on the proposal regarding interbank exposures and in particular in which cases specific exemptions would be warranted.*

Please see our comments in section V.C.

Question 12. *The Committee welcomes comments on the calibration of the granularity threshold and whether the mandatory application of the look-through approach to the transaction where an underlying exposure may exceed the granularity threshold will raise specific issues.*

Please see our comments in section V.D.

Question 13. *The Committee welcomes comments on the proposals for the treatment of the identified additional risks in the large exposures framework.*

Please see our comments in section V.D.4.

Question 14. *The Committee welcomes views on the options for the treatment of banks' exposures to CCPs.*

Please see our comments in section V.A.

* * * *

We thank you for considering the comments provided in this letter. If you have any questions or need further information, please contact (i) at The Clearing House, Gregg L. Rozansky (e-mail – gregg.rozansky@theclearinghouse.org, telephone number – (212) 612-9220; (ii) at the ABA, Beth Knickerbocker, Vice President and Senior Counsel, Office of Regulatory Policy (e-mail – bknicker@aba.com, telephone number – (202) 663-5042); (iii) at the FSR, K. Richard Foster, Senior Counsel for Regulatory and Legal Affairs (e-mail – richard.foster@fsround.org, telephone number – (202) 589-2424); (iv) at GFMA, Michael Lever, Head of Prudential Regulation at the Association for Financial Markets in Europe (e-mail – michael.lever@afme.eu, telephone number – +44 (20) 7743-9506) or Carter McDowell, Managing Director and Associate General Counsel at the Securities Industry and Financial Markets Association (e-mail – cmcdowell@sifma.org, telephone number – (202) 962-7327); (v) at SFIG, Richard A. Johns (e-mail – Richard.Johns@SFIndustry.org, telephone number – (571) 296-6017); and (vi) at ISDA, Olivier Miart, Assistant Director, Risk & Capital (e-mail – omiart@isda.org, telephone number – +44 (0)20 3088 3515).

Respectfully submitted,



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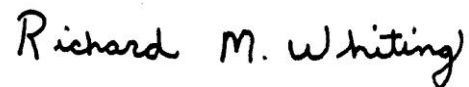
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The Clearing House Association

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American Bankers Association

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The Financial Services Roundtable

The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for \$92.7 trillion in managed assets, \$1.2 trillion in revenue, and 2.3 million jobs. For more information, visit The Financial Services Roundtable's website at www.fsround.org.

Structured Finance Industry Group

Structured Finance Industry Group, Inc. (“SFIG”) is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary changes, be an advocate for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. Members of SFIG represent all sectors of the securitization market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. Members of SFIG contributed material to Section D of this letter. Further information can be found at www.sfindustry.org.

International Swaps and Derivatives Association

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