February 28, 2017

Via Electronic Mail

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Constance Horsley

Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Mail Stop 9W-11
Washington, DC 20219
Attention: Margot Schwadron

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Bobby Bean

Re: Treatment of Fronting Commitment Exposures for Purposes of Risk-Based Capital and Leverage Calculations

Ladies and Gentlemen:

The Clearing House Association L.L.C.[1] is writing to confirm the appropriate treatment of fronting commitment exposures under the Federal banking agencies'[2] regulatory capital rules for purposes of calculating (i) risk-weighted assets under both advanced and standardized

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1 The Clearing House is a banking association and payments company that is owned by the largest commercial banks and dates back to 1853. The Clearing House Association L.L.C. is a nonpartisan organization that engages in research, analysis, advocacy and litigation focused on financial regulation that supports a safe, sound and competitive banking system. Its affiliate, The Clearing House Payments Company L.L.C., owns and operates core payments system infrastructure in the United States and is currently working to modernize that infrastructure by building a new, ubiquitous, real-time payment system. The Payments Company is the only private-sector ACH and wire operator in the United States, clearing and settling nearly $2 trillion in U.S. dollar payments each day, representing half of all commercial ACH and wire volume.

2 "*Federal banking agencies*" is used throughout to refer to the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

approaches and (ii) total leverage exposure as the denominator in the supplementary leverage ratio.

Fronting exposures represent a bank's[3] commitment to fund obligations, including swingline loans and letters of credit, on behalf of other participating lenders ("*fronting commitments*"). A bank with a fronting commitment (a "*fronting bank*", acting in such capacity) is legally responsible for advancing funds, on behalf of the participants in a syndicated revolving credit facility, up to a pre-defined fronting amount (the "*fronting amount*"). The other lenders participating in the syndicated facility are then responsible for reimbursing the fronting bank for their *pro rata* share of the fronted amount according to their contractual participations.

We believe that a fronting bank should include only the exposure amount corresponding to its *pro rata* share of the fronting commitment as an off-balance-sheet exposure for both risk-based capital purposes and for its total leverage exposure in calculating its supplementary leverage ratio. This treatment is wholly consistent with the Federal banking agencies' capital rules[4] as well as the reporting instructions for the consolidated regulatory financial statements for both bank holding companies and their depository institution subsidiaries.[5]

First, because a fronting bank in a syndicated revolving credit or letter of credit facility is obligated to fund loans (such as swingline loans) and issue letters of credit on behalf of the other lender participants in the syndicate as long as the terms and conditions included in the credit agreement are met, the fronting bank's obligation constitutes a "commitment" as defined in the Federal banking agencies' capital rules.[6] In determining risk-weighted assets for off-balance-sheet exposures—using credit conversion factors to determine the exposure amounts for certain off-balance-sheet commitments that are then risk weighted—the capital rules make clear that "where a [Bank] provides a commitment structured as a syndication or participation, the [Bank] is only required to calculate the exposure amount for its *pro rata* share of the commitment."[7] Typically, under the terms defining the fronting amount for a letter of credit, each participant lender in the syndicate is deemed to have purchased a participation in any issued letter of credit

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[3] The term "*bank*" is used throughout to mean any firm—whether a bank holding company or bank or non-bank subsidiary—subject to a Federal banking agency's capital rules.

[4] *See infra* note 7.

[5] *See* Federal Financial Institutions Examination Council, *Instructions for Preparation of Consolidated Reports of Condition and Income* (FFIEC 031 and 041), *available at* https://www.ffiec.gov/forms031.htm (the "*FFIEC instructions*"); and Board of Governors of the Federal Reserve System, *Instructions for Preparation of Consolidated Financial Statements for Holding Companies*, Reporting Form FR Y-9C, *available at* https://www.federalreserve.gov/reportforms/forms/FR_Y-9C20161231_i.pdf.

[6] *See* 12 C.F.R. § 217.2 (Federal Reserve); § 324.2 (FDIC); § 3.2 (OCC).

[7] *See, e.g.*, the standardized approach to risk-weighted assets, 12 C.F.R. § 217.33(a)(3) (Federal Reserve); § 324.33(a)(3) (FDIC); § 3.33(a)(3) (OCC).

in an amount equal to such participant lender's *pro rata* share. Similarly, under the terms defining the fronting amount for loans issued by a fronting bank, each participant lender in the syndicate is deemed to have purchased a participation in all outstanding fronted loans (such as swingline loans) in an amount equal to such participant lender's *pro rata* share. Fronting banks for loans and letter of credit issuances therefore benefit from the *pro rata* participations of the other participant lenders in the syndicate, each of which is required to recognize their own off-balance-sheet exposure from the unconditional commitment. The fronting bank should thus be required to include only the exposure amount corresponding to its *pro rata* share of the fronting commitment in determining its off-balance-sheet exposure amount for purposes of calculating its risk-weighted assets and, for a fronting bank subject to the advanced approaches, its total leverage exposure.[8]

Allocating capital to these fronting exposures otherwise would be inappropriate as it would result in a duplicative capitalization of the same exposure for which each bank in the syndicate is already holding capital.[9] In addition, the regulatory reporting instructions for banks

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[8] 12 C.F.R. § 217.10(c)(4)(ii)(H).

[9] For example, assume a $100 million revolving credit facility that has been syndicated to four banks equally, with each bank having a $25 million commitment. If this facility does not have a fronting amount, each bank would recognize $25 million of exposure to the obligor for aggregate recognized exposures of $100 million. In these circumstances, there is no duplicative capitalization of the same exposure.

In comparison, assume that there is a fronting bank that has an obligation to advance the full $100 million amount of the facility even though the fronting bank's total commitment under the revolving credit facility is only $25 million. (If the $100 million facility were advanced, the other banks in the syndicate would be responsible for reimbursing the fronting bank for $75 million, representing their combined *pro rata* shares of the fronted amount.) If the fronting bank were required to recognize exposure amounts for the fronting commitment (in this example, $75 million, representing 75% of the facility), the aggregate recognized exposures for this facility would increase to $175 million (representing $100 million for the syndicate members' respective $25 million exposures to the obligor, plus $75 million for the fronting bank's exposures relating to the fronting commitments).

Similarly, assume that the credit facility instead contains a $30 million fronting sublimit. A typical example is a facility that includes a "*swingline*" component that the borrower may draw down on shorter notice than the other portions of the facility. The fronting bank has an obligation to advance the full $30 million amount of this sublimit even though the fronting bank's total commitment under the revolving credit facility is only $25 million. (If the $30 million fronting amount were advanced, the other banks in the syndicate would be responsible for reimbursing the fronting bank for $22.5 million, representing their combined *pro rata* shares of the fronted amount.) If the fronting bank were required to recognize exposure amounts for the fronting commitment (in this example, $22.5 million, representing 75% of the $30 million fronting amount), the aggregate recognized exposures for this facility would increase to $122.5 million (representing $100 million for the syndicate members' respective $25 million exposures to the obligor, plus $22.5 million for the fronting bank's exposures relating to the fronting commitments).

In the examples with fronting commitments, there clearly would be duplicative capitalization of the same exposures, and the aggregate recognized exposures increase beyond the notional amount of the applicable credit facility, even though that notional amount represents the maximum potential aggregate loss among the syndicate.

and bank holding companies support the approach outlined above.[10] For example, with respect to unused commitments, there is a contrast between the instructions for Schedule RC-L of Call Reports—which states at the top of the schedule that that "[s]ome of the amounts reported in Schedule RC-L are regarded as volume indicators and not necessarily as measures of risk"—and the instructions for Schedule RC-R of Call Reports and Schedule HC-R of FR Y-9C Reports. The FFIEC instructions for Schedule RC-L state that "[u]nused commitments are to be reported gross, *i.e.*, [a bank must report] the unused amount of commitments acquired from and conveyed or participated to others," indicating that the full amount of the fronting commitment would be captured under this schedule. By contrast, the FFIEC Instructions to Schedule RC-R (as well as the Federal Reserve Board's instructions to FR Y-9C Schedule HC-R)—which are to be "read in conjunction with the regulatory capital rules"—explain that "where a [bank or bank holding company] provides a commitment structured as a syndication or participation, the [bank or bank holding company] is only required to calculate the exposure amount for its *pro rata* share of the commitment."[11]

This distinction reinforces our view that a fronting bank should include only the exposure amount corresponding to its *pro rata* share of the fronting commitment as an off-balance-sheet exposure. In addition, the instructions to the FR Y-14Q Schedule D, Regulatory Capital Transition, state (i) generally that "[w]here applicable, BHCs and IHCs should also reference the methodology descriptions outlined within the FR Y-9C," and (ii) specifically with respect to each of the off-balance-sheet line items for unused commitments that firms should "[r]eport the risk-weighted asset amount consistent with the definition for FR Y-9C, HC-R, Part II, Line Item 18."[12] These instructions make clear that these fronting exposures should be determined in the

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[10] We recognize that other public regulatory guidance could be read to indicate a different outcome, and, for various supervisory purposes, the Federal banking agencies collect more granular information on fronting exposures. *See, e.g.*, Federal Reserve Board, Division of Banking Supervision and Regulation, *Bank Holding Company Supervision Manual*, Section 4060.3.5.3.8.3, *Participations of Off-Balance Sheet Transactions*, page 34 (noting that where the fronting bank is liable for the full amount of the commitment if a participant fails to pay, the entire commitment should be converted to an on-balance-sheet credit-equivalent amount, with the *pro rata* share and remaining portions of the commitment risk weighted based on the applicable risk-weights for exposures to the borrower and the participating lenders). We note, however, that the guidance on fronting exposures in the Bank Holding Company Supervision Manual was published in December 2004—at which time banks were subject to the Basel I-based capital standards—and has not been updated since the adoption of the Basel III-based revised U.S. capital rules by the Federal banking agencies.

See also Federal Reserve Board, *Instructions for the Capital Assessments and Stress Testing Information Collection* (Reporting Form FR Y-14Q), page 184, (stating that for fronting exposures, "BHCs and IHCs should … report their pro-rata portion of the stated commitment amount as one facility to the borrower and the fronting obligations as separate credit facilities to each of the lending group participants.").

[11] FFIEC instructions at 105 (Item 18); Y-9C instructions HC-R-101 (Item 18).

[12] Federal Reserve Board, *Instructions for the Capital Assessments and Stress Testing Information Collection* (Reporting Form FR Y-14Q), pages 64, 84.

same manner for purposes of both reporting risk-weighted asset amounts on the FR Y-9C, discussed above, as well as for the Capital Assessments and Stress Testing reports on the FR Y-14Q.

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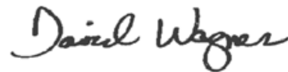
The Clearing House would appreciate your confirming, as outlined above, that a fronting bank should include only the exposure amount corresponding to its *pro rata* share of the fronting commitment as an off-balance-sheet exposure for purposes of determining its risk-weighted assets and total leverage exposure. If you have any questions, please contact the undersigned by phone at (212) 613-9883 or by email at *david.wagner@theclearinghouse.org*.

Respectfully submitted,



David Wagner
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cc: Scott Alvarez
Michael Gibson
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