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Dodd-Frank Act: Derivatives as Credit Extensions of Banks

Overview

The regulation of the over-the-counter derivatives market required by the recently enacted regulatory reform legislation has received a great deal of attention, both because of the size and importance of the derivatives market generally and the complexity and breadth of the requirements that will be imposed. However, other less-discussed provisions of the legislation impose additional restrictions by treating derivatives as extensions of credit by a bank where the bank is subject to counterparty credit risk. Those provisions will require banks, and in some cases their affiliates, to calculate and limit the total amount of credit exposure to any one counterparty based on derivatives transactions and a number of other types of transactions. Related changes will affect the treatment of derivatives with private equity and hedge funds advised or sponsored by banking organizations.

When effective, these changes will likely require significant revisions to banking organizations' risk management systems for derivatives in particular, and credit exposures generally, and might result in a decrease in derivative volumes over time. This client memorandum outlines these changes, which go into effect in stages over the next few years.

Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or the "Act", P.L. 111-203 (July 21, 2010)) will impose Federal regulation on the derivatives market and its significant players.¹ These requirements, set out in Title VII of the Act, are intended to provide a regulatory scheme for all entities active in derivatives generally. However, additional requirements – which are the focus of this client publication – will apply specifically to banks. The general idea is that credit exposures incurred by a bank when it engages in a derivative transaction should be subject to the same limits as have applied to more traditional forms of credit exposure for many years.

¹ If you would like to review more information regarding the Act and its implication for derivatives, you may refer to our other client publications at <http://www.shearman.com/dodd-frank-wall-street-reform-and-consumer-protection-act-implications-for-derivatives-07-06-2010/> and on the Act in general at <http://www.shearman.com/Landmark-Financial-Regulatory-Reform-Legislation/>.

Single-borrower lending limits

Banks in the United States historically have been subject to limits on their total loans to a single borrower. The purpose of these limits is to avoid concentration of a particular bank's assets with any one party and to encourage diversification. The national bank limit is 15 percent of the bank's capital and surplus for unsecured loans and an additional 10 percent for loans secured by appropriate collateral, subject to various exceptions. State law sets the percentage limit and definition of terms applicable to State banks chartered under the laws of the particular State, and U.S. branches and agencies (whether state or federally licensed) are subject to the national bank lending limit, calculated on the basis of global capital of the foreign bank.

National banks

The Act amends the national bank lending limit statute to include

[A]ny credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction between the national banking association and the person.... Dodd-Frank Act, § 610(a), amending 12 U.S.C. § 84(b)(1).

This provision is effective one year after the "transfer date", which is July 21, 2011 (one year after enactment of Dodd-Frank) or a later date, up to six months later, to the extent that the Secretary of the Treasury grants additional time to transfer the Office of Thrift Supervision into the Office of the Comptroller of the Currency ("OCC"), the supervisor of national banks (the "Transfer Date").² Thus, this limit would be effective some time in the second half of 2012.

"Derivative Transaction"

The provision adds a definition of "derivative transaction" to

[I]nclude[] any transaction that is a contract, agreement, swap, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets. Dodd-Frank Act, § 610(b).

This same definition is incorporated by reference in the provisions discussed below concerning other limits imposed on derivative transactions.

The definition is far less detailed than the definition of "swap" and "security-based swap" in Title VII and generally appears to be slightly broader than a Title VII swap. It includes an "option" on a "security", which under Title VII remains a "security" rather than a swap, and appears to include various linked notes, which are also probably not swaps.

"Credit exposure"

The term "credit exposure" is not defined, so apparently it will be left to the OCC to provide a definition. However, this same term is used in other provisions discussed below. Whether the relevant agencies agree on a common definition of the term

² Dodd-Frank Act, §§ 2(17), 311.

will be one of many things to look for when proposed regulations under the Act begin to be issued. A key point will be whether the term is defined as the maximum possible amount that a bank might be required to pay, or rather a risk-adjusted amount based on the probability of payment or a mark-to-market value. How to calculate the amount of credit exposure will be a key element in determining the effect of this provision.

Identifying the “single” borrower

The national bank lending limit treats all members of a corporate group that meet certain standards as a single borrower for purposes of applying the lending limit. Thus, a corporate family consisting of many different companies may be treated as one borrower for purposes of the limit. If a national bank enters into derivatives with more than one member of a corporate group, it will have to make the determination whether the particular members are a single borrower for this purpose.

Effect of Collateral

As noted above, the national bank limit may be higher than the generally applicable unsecured limit depending on the nature of any collateral held by the bank. In addition, subject to conditions and exceptions, to the extent that an extension of credit is fully secured by U.S. Government and agency securities, municipal securities or cash, the credit is completely exempt from the limit. The regular use of such collateral for derivative transactions may greatly reduce the cost of compliance with the lending limit. The effect will need to be considered in conjunction with any new collateral requirements imposed on derivatives under the Act.

State banks

The Act effectively requires the States to include derivative exposures in their calculation of lending limits established under State law. A State bank insured by the Federal Deposit Insurance Corporation (“FDIC”) may engage in a derivative transaction, as defined in the provision applicable to national banks discussed above, “only if the law with respect to lending limits of the State in which the insured State bank is chartered takes into consideration credit exposure to derivatives transactions.”³ Thus, unless State law in some way provides for consideration of credit exposure from derivatives, the banks chartered by that State cannot enter into derivatives. There appears to be an understanding among some State supervisors that a regulation or interpretation, and not a formal statutory amendment, would be sufficient to satisfy the provision.

This provision is effective 18 months after the Transfer Date. Accordingly, it would be effective in the first half of 2013. States have two-and-a-half years to take appropriate action, including amending their lending limits if necessary, to assure that they meet the Act’s standard.

³ Dodd-Frank Act, § 611(a), adding new Section 18(y) to the Federal Deposit Insurance Act (12 U.S.C. § 1828(y)).

Branches and agencies of foreign banks

Branches and agencies of foreign banks are subject to the single-borrower lending limits imposed on national banks. Accordingly, they would be covered by the Act's provision. This is true even for State-licensed branches and agencies, and therefore the State law provision discussed above should not affect them.

New Exposure Limit

The Dodd-Frank Act requires that the Fed issue regulations prohibiting systemically significant bank holding companies and nonbank financial companies designated as systemically significant by the Financial Stability Oversight Council from having credit exposure to any unaffiliated company that exceeds 25 percent of the company's capital and surplus; this limit may be set at a lower amount by the Fed if the Fed determines a lower amount "to be necessary to mitigate risks to the financial stability of the United States".⁴ Included in the definition of "credit exposure" for this purpose is "counterparty credit exposure to the company in connection with a derivative transaction...." Again, "credit exposure" in the derivatives context is undefined.

This provision is effective three years after the date of enactment, or July 21, 2013, and may be extended by the Fed for two additional years.

Section 23A

Section 23A of the Federal Reserve Act ("Section 23A") imposes significant limitations on transactions between a U.S. FDIC-insured bank and its affiliates. It is subject to interpretation by the Fed, which has issued its Regulation W providing detailed guidance on the meaning of its terms and how to comply with its requirements. Generally, it requires that certain transactions between a bank and an affiliate, called "covered transactions," such as extensions of credit by the bank to the affiliate and purchases of assets by the bank from an affiliate, comply with quantitative and qualitative limits. A bank can engage in covered transactions with any one affiliate only up to 10 percent of the bank's capital and surplus, and may do so with all affiliates in the aggregate only up to 20 percent of capital and surplus. In addition, certain covered transactions, such as extensions of credit, must be fully collateralized or, in some cases, over-collateralized.

Derivatives as covered transactions

In 2002 the Fed determined that a bank may enter into a derivative transaction with an affiliate without being considered a covered transaction so long as the bank has risk measurement and monitoring systems in place for such transactions, including credit limits on derivatives exposures, and the derivative transaction is on "market terms". Accordingly, derivatives between a bank and its affiliates meeting these requirements have been exempt from Section 23A limits.

The Act reverses the Fed's earlier decision. It includes within the definition of "covered transaction" any derivative transaction, using the national bank definition provided above, with an affiliate "to the extent that the transaction causes a

⁴ Dodd-Frank Act, § 165(e)(3). Systemically significant bank holding companies consist of those bank holding companies with at least \$50 billion in total consolidated assets. Nonbank financial companies may be designated as systemically significant pursuant to standards set forth in Section 113 of the Dodd-Frank Act.

[bank] to have credit exposure to the affiliate.”⁵ As with the national bank provision, there is no statutory definition of “credit exposure”. Presumably the Fed will have to amend Regulation W in order to incorporate one. The Act explicitly authorizes the Fed to issue regulations or interpretations on “the manner in which a netting agreement may be taken into account in determining the amount of a covered transaction” for purposes of calculating the amount of a bank’s covered transaction as well as the requirement for the affiliate to provide collateral.

This amendment is effective one year after the Transfer Date. Accordingly, it comes into effect some time in the second half of 2012.

Implications of derivatives as covered transactions

This provision could have a serious effect on the manner in which major banking organizations centrally manage their derivatives businesses. Many bank holding companies have established a central entity, either a bank or a nonbank, as a risk management center for all derivatives businesses with third parties and have set up back-to-back derivatives between that central entity and other companies in the group. The 10-percent limit in many instances could constrain a bank’s back-to-back derivatives with a nonbank that serves as the central management point depending on the Fed’s definition of “credit exposure”. Particularly in view of the requirement that certain derivatives be “pushed out” into a nonbank affiliate, the limitation may prove to be significant.⁶ Also, such an exposure would have to be collateralized under existing Section 23A requirements. Conversely, if a bank is the central management point, the 20-percent limit may well constrain its back-to-back derivatives with all affiliates.

However, as for the national bank lending limit, the use of U.S. Government and agency securities or cash as collateral generally exempts a covered transaction from the percentage limits. Many banks obtain such collateral in order to meet the “market terms” requirement noted above. If they continue to do so, then the percentage limits should not be a problem.

Attribution Rule

Section 23A has a provision, known as the Attribution Rule, that states that a transaction between a bank and a third party will be treated as a covered transaction under Section 23A to the extent that the proceeds of the transaction are “used for the benefit of, or transferred to,” an affiliate. This provision is intended to prevent evasions of Section 23A; for example, a bank could request a customer to take a loan and then transfer the proceeds to an affiliate, with appropriate compensation to the customer.

This issue has not had occasion to arise in connection with derivatives because banks’ derivative transactions with affiliates were not covered transactions at all, and accordingly there was no provision to evade. However, under the Act, the issue would arise whether the Attribution Rule would apply to a derivative by a bank with a third party where the third party also had a loan or another derivative transaction with an affiliate of the bank. Such situations may be ones that the Fed should

⁵ Dodd-Frank Act, § 608(a)(1)(A), adding new subsection (G) to Section 23A(b)(1).

⁶ Dodd-Frank Act, § 716.

address in Regulation W. The Fed is authorized to create “safe harbors” in connection with the Attribution Rule and has done so for several types of transactions.

Marking collateral to market

Another new feature relevant here is that the Act appears to require that collateral provided by an affiliate to a bank for any covered transaction, including derivatives, be marked to market. The Fed had not imposed this requirement in Regulation W due to a concern that the language of Section 23A, requiring collateral to be provided to the bank “at the time of the transaction”, did not allow such a requirement. The absence of a requirement to mark to market has greatly simplified ongoing compliance with Section 23A’s collateralization requirements. That phrase is deleted by the Act.⁷ Presumably the Fed will amend Regulation W prior to the effective date to indicate how banks will have to deal with marks to market.

Foreign banks

U.S. branches and agencies of foreign banks are not subject to Section 23A unless they are financial holding companies (“FHCs”) under the Bank Holding Company Act of 1956, as amended (“BHCA”). In that case, transactions with certain affiliates -- generally U.S. affiliates engaged in securities underwriting and dealing activities, insurance underwriting and investment activities, and merchant banking investments -- must comply with Section 23A. Accordingly, for those foreign banks that are FHCs and have U.S. affiliates engaged in those activities, derivatives between those affiliates and the bank’s U.S. branches and agencies will become subject to Section 23A.

Impact of the Section 23A Amendment on the Volcker Rule

The Act’s so-called “Volcker Rule” generally imposes a prohibition on banks and bank holding companies from engaging in proprietary trading and in sponsoring and investing in private equity and hedge funds.⁸ It has a provision that incorporates the definition of “covered transaction” as used in Section 23A in order to severely restrict the relationship between the bank holding company and certain private funds.

Under the Volcker Rule, a bank holding company is prohibited from “sponsoring” a private equity or hedge fund with specified exceptions, but not from advising such a fund sponsored by a third party. As to an advised fund or a permissible sponsored fund, the bank holding company and its affiliates are disallowed from entering into a transaction that would be a covered transaction under Section 23A with the fund, treating the fund as though it were an affiliate and the bank holding company (and all affiliates) as though they were banks.⁹ That is, the bank holding company and all of its subsidiaries are treated as though they are a “bank” subject to Section 23A, and the fund is an affiliate of the “bank”.

⁷ Dodd-Frank Act, § 608(a)(2)(A), amending Section 23A(c)(1).

⁸ Dodd-Frank Act, § 619, adding Section 13 to the BHCA. If you would like to review more information on the Volcker Rule, you may refer to our other client publication at <http://www.shearman.com/financial-regulatory-reform-update--the-volcker-rule-looms-large-over-asset-management-and-fund-investment-activities-of-financial-institutions-06-08-2010/>. The memorandum does not reflect the final revisions made shortly prior to enactment.

⁹ Dodd-Frank Act, § 619(a), adding Section 13(f) to the BHCA.

This prohibition has a number of implications and difficult interpretive issues that will need to be addressed in rulemaking. However, for this purpose the important point is that, with the addition of derivatives to Section 23A coverage and this new prohibition being keyed off of such coverage, a bank holding company that sponsors or advises private equity or hedge funds will be prohibited from entering into at least some derivatives with any such fund. As a result, such funds may be forced to obtain at least some derivatives from third parties.

There is a subtle issue concerning the scope of the prohibition raised by the revised definition in Section 23A. As noted above, the definition of “covered transaction” now includes “a derivative transaction, ... to the extent that the transaction causes a [bank] to have credit exposure to the affiliate....” It does not appear to cover all derivatives, but rather only those that give rise to a credit exposure to the affiliated bank. Accordingly, any derivative in which only the affiliate could have “credit exposure” to the bank, and the bank could never have such exposure to the affiliate, should, at least in theory, fall outside of the definition. This reading would appear to be consistent with the treatment of other transactions as covered transactions; for example, a loan by a bank to an affiliate is a “covered transaction” because the bank incurs risk of loss to the affiliate, while a loan by an affiliate to a bank is not a “covered transaction.”

Playing this out under the Volcker Rule, which treats the entire banking organization as a “bank” and a sponsored or advised fund as an “affiliate”, a derivative in which the fund will always owe payments to the counterparty affiliate, and the affiliate will never owe the fund, would not be prohibited. Whether the Fed will agree with this view in regulations remains to be seen. Even if it does, the question would be whether this possibility gives a meaningful avenue for banking organizations to engage in derivatives with their sponsored or advised funds.

The Volcker Rule becomes effective no later than two years after enactment, and then there is a period of at least two years during which covered entities will have to come into compliance.

Foreign banks

Foreign banks subject to the BHCA are covered by the Volcker Rule. However, an explicit exemption allows foreign banks to engage in proprietary trading and in private fund sponsoring and investment “solely outside of the United States” pursuant to Sections 4(c)(9) and 4(c)(13) of the BHCA.¹⁰ Thus, sponsoring and investing in non-U.S. funds generally should be permissible for foreign banks when engaged in outside the United States, but the precise rules applicable to this exemption will have to await regulations. For those permissible non-U.S. funds, it is not at all clear whether derivatives between either U.S. or non-U.S. offices of the parent bank and the fund would be permissible; precedent in this area would support the idea that derivatives between non-U.S. offices and subsidiaries of the bank and non-U.S. funds should be permitted.

Regulation O

Strict requirements on transactions with shareholders, directors, officers and others considered “insiders” are implemented in the Fed’s Regulation O, which applies to all FDIC-insured banks as well as those U.S. branches and agencies of foreign banks that are FDIC-insured. These restrictions also apply to companies controlled by insiders. Among the restrictions is a

¹⁰ Section 13(d)(1)(H) of the BHCA, added by Section 619 of Dodd-Frank.

limit on credit extended to an insider similar to the single-borrower lending limit described above. The Act requires that any derivative transaction, as defined for national banks described above, be included in the measure of credit exposure for this purpose.¹¹ This provision is effective one year after the Transfer Date, and accordingly will be effective some time during the second half of 2012.

Conclusion

The several provisions discussed above will require many U.S. and foreign banks subject to their requirements to make significant adjustments to their current compliance procedures and monitoring systems as the provisions become effective. While it might appear that the time periods prior to effectiveness are long enough that planning can be delayed, in practice the amount of time available to take the necessary actions almost always turns out not to be long enough. It would be advisable for institutions to consider the effects of these provisions on their current operations and begin to plan how to make conforming adjustments. The regulatory process applicable to these provisions will also bear watching. We will be monitoring the proposed regulations and reporting on their implications.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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¹¹ Dodd-Frank Act, § 614.