July 2019

EY regulatory reporting brief

The EY regulatory reporting briefs explore Federal Reserve regulatory reporting, highlighting report requirements, recent news and updates, and identifying common reporting challenges.

FR 2590 Single Counterparty Credit Limits (SCCL)

Background and key considerations

Report summary

What is the Single Counterparty Credit Limit (SCCL) and the FR 2590?

SCCL is one of the last major requirements of the Dodd-Frank Act to be finalized, following previous notices of proposed rulemaking (NPRs) in 2011 and 2016. The final rule reflects output from both industry and regulatory quantitative impact studies, and establishes limits on credit exposures to a single counterparty as a percentage of a covered company's applicable capital base.

In addition to managing against these credit exposure limits, the Federal Reserve Board (FRB) proposed the new FR 2590 quarterly report that requires detailed reporting of the covered companies' top 50 counterparty exposures, the sources of each counterparties' credit exposure, and CFO sign-off. As of this publication date, however, the FRB has not finalized the report, which impacts firms' mobilization efforts and reporting solution implementations.

The FR 2590 covers:

- Direct exposures such as loans, deposits, securities financing transactions (SFTs) or derivatives
- Exposures arising from risk-shifting, such as holding collateral issued by the counterparty, guarantees, credit derivatives referencing the counterparty, or other eligible hedges
- Any offsetting of exposures to the counterparty from risk mitigants, such as collateral or guarantees
- Consolidation approaches for subsidiaries of each of these counterparties, including economic interdependence and control relationships

Feedback from the industry

The FRB comment period on the FR 2590 closed on October 5, 2018. Two public comment letters from the Bank Policy Institute (BPI) and the Institute of International Bankers (IIB) are available on the FRB website. Key points raised in the comment letters include:

- Reduce the number of reportable counterparties from the top 50 to the top 20 counterparties and counterparties to which the covered firm has an exposure of 10 percent or more of its eligible capital base
- Consider excluded or exempt counterparties out of scope
- Allow the executive responsible for SCCL oversight and compliance to provide sign-off in addition to the chief financial officer
- Permit covered firms to maintain electronic copies of the FR 2590
- Exclude the combined US operations of foreign banking organizations (FBOs) from the list of FR 2590 filers if their home office is working toward the implementation of a large exposure standard comparable to the Basel Large Exposure Framework; the expected proposal to tailor enhanced prudential standards for FBOs may impact this requirement
- Validate additional reporting burden for consistency with bank holding company (BHC) peers
- Exclude incremental data requests that will not be used to assess SCCL compliance

Building a better working world

Spotlight on FR 2590: Single Counterparty Credit Limits

<table>
<tr><th colspan="2">Covered company type</th><th>Applicable capital base</th><th>Single counterparty limit (% of capital base)</th><th>Timeline</th><th>Compliance</th><th>Reporting (FR 2590)</th></tr>
<tr><td rowspan="2">US BHCs (covered companies)</td><td>GSIBs (major covered company)</td><td rowspan="2">Tier 1 capital of BHC</td><td>15% to major counterparties
25% to all other counterparties</td><td>January 1, 2020</td><td rowspan="2">Daily</td><td rowspan="2">Quarterly</td></tr>
<tr><td>Other BHCs with total consolidated assets of $250B or more</td><td>25% to all other counterparties</td><td>July 1, 2020</td></tr>
<tr><td rowspan="5">FBOs (covered foreign entity)</td><td>CUSO of FBOs that are GSIBs (major FBO)</td><td rowspan="2">Tier 1 capital of FBO</td><td>15% to major counterparties
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<tr><td>CUSO of other FBOs with total consolidated assets of $500B or more (major US IHC)</td><td rowspan="2">Tier 1 capital of IHC</td><td>15% to major counterparties</td><td rowspan="2">January 1, 2020</td><td rowspan="2">Daily</td><td rowspan="3">Quarterly</td></tr>
<tr><td>IHCs of the above FBOs with total consolidated assets of $250B to $500B</td><td rowspan="2">25% to all other counterparties</td></tr>
<tr><td>IHCs of the above FBOs with total consolidated assets of $50B to $250B</td><td>Total capital plus ALLL of IHC</td><td>July 1, 2020</td><td>Quarterly</td></tr>
</table>

Report highlights

Using FR 2590, the Fed would be provided with a single list of each respondent's largest counterparty exposures across their consolidated organization, including details on the contributions of different exposure categories toward each counterparty's aggregate net credit exposure; heightened scrutiny may be applied to global systemically important banks (G-SIBs) exposures given the importance of interconnectedness between the largest banks. Several of the segmentation requirements and rules for measuring the exposure under various asset classes, most notably derivatives and SFTs, reflect the same requirements and risk-based capital rules already in place for existing regulatory capital calculations.

Other unique reporting form requirements include:

- Unique counterparty type classification (e.g., differentiation of political subdivisions of foreign sovereigns from the sovereign entity itself)
- Utilizing a look-through approach to identify exposures through securitizations to individual counterparties
- Classifying SFTs by the maturity and risk weight of the assets exchanged
- Segmenting exposure under qualifying master netting agreements from those who do not have such agreements
- Identifying exposure amounts using modeled approaches instead of standardized approaches for firms that are approved to use internal model methods (IMM) or simple value at risk (VaR) for risk-based capital calculations
- Identifying groups of two or more counterparties whose exposures are aggregated due to economic interdependence or control relationships

Most firms subject to the rule have mobilized capability gap assessments as well as data sourcing and validation efforts in anticipation of their first filing, but as the submission date approaches, firms will need ample time to test and finalize their implementation. This impacts firms developing in-house solutions and relying on third-party vendors for data aggregation, controls and report production. Additionally, the absence of final specifications for FR 2590 data dictionaries, edit checks and XML schema may cause firms to take tactical and/or manual approaches to complete their first submission.

Furthermore, SCCL filers already face challenges around rule interpretation (e.g., distinguishing between control relationships and economic interdependence and evaluating the impact of varying exposure measures for the same exposure type). Additional challenges and insights are highlighted within this brief.

Filing frequency

- The FR 2590 is filed quarterly as of the last calendar day of the last month in each quarter (March 31, June 30, September 30 and December 31)
- Report submission dates are 40-calendar days after the quarter-end date for March, June, and September, and 45-calendar days after quarter-end for December
- The first FR 2590 is expected to be filed as of March 31, 2020 for those covered companies required to follow the SCCL rule by January 2020, and September 30, 2020 for those covered companies with July 2020 compliance timeline

Overview of schedules

There are nine FR 2590 schedules that collect information on respondent organization exposures to counterparties in accordance with the SCCL rule.

Schedules
1) **Schedule G-1:** General Exposures
2) **Schedule G-2:** Repurchase Agreement Exposures
3) **Schedule G-3**: Securities Lending Exposures
4) **Schedule G-4:** Derivatives Exposures
5) **Schedule G-5:** Risk Shifting Exposures
6) **Schedule M-1:** Eligible Collateral
7) **Schedule M-2:** General Risk Mitigants
8) **Schedule A-1**: Economic Interdependence
9) **Schedule A-2**: Control Relationships

1. Schedule G-1: General Exposures

Schedule G-1 collects information on seven general gross credit exposure categories by counterparty.

2. Schedule G-2: Repurchase Agreement Exposures

Schedule G-2 collects gross credit exposures arising from repurchase agreements and reverse repurchase agreements rule by counterparty.

3. Schedule G-3: Securities Lending Exposures

Schedule G-3 collects gross credit exposures arising from securities lending and securities borrowing by counterparty.

4. Schedule G-4: Derivatives Exposures

Schedule G-4 requires the respondent organization to report the gross notional of its derivatives transactions — interest rate, foreign exchange rate, credit, equity, commodity, or other — by counterparty.

5. Schedule G-5: Risk Shifting Exposures

Schedule G-5 collects information related to gross credit exposures that have been affected by the risk shifting requirements of sections 252.74 or 252.174 of the SCCL rule by counterparty.

6. Schedule M-1: Eligible Collateral

Schedule M-1 permits a respondent organization to subtract the value of any eligible collateral provided by a counterparty in connection with a particular transaction from its gross credit exposure for that transaction.

7. Schedule M-2: General Risk Mitigants

Schedule M-2 collects information related to credit risk mitigation techniques other than the receipt of collateral used by the firm to reduce its gross credit exposure in a given transaction.

8. Schedule A-1: Economic Interdependence

Schedule A-1 requires a covered company or covered foreign entity to aggregate its net credit exposures to counterparties that are economically interdependent — meaning that the underlying risk of one counterparty's financial distress or failure would cause the financial distress or failure of another counterparty.

9. Schedule A-2: Control Relationships

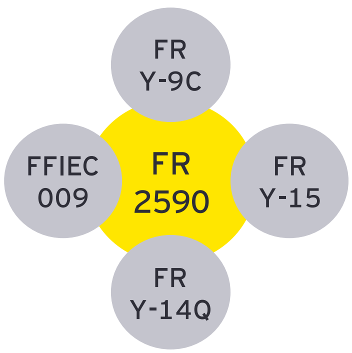
Schedule A-2 requires a covered company or covered foreign entity to aggregate exposures to counterparties due to the presence of certain control relationships.

Relationships with other reports

Regulators perform interseries analyses to identify reporting inconsistencies and verify population completeness. Thus, banking organizations will need to have mechanisms in place to address this proactively.

Notably, the FR 2590 has interseries relationships with the FR Y-9C, Call Report, FR Y-15, FR Y-14Q, and FFIEC 009.

Although not all interseries relationships are one-to-one, considerations should be given to overlaps on comparable schedule and line item requirements as an additional check on reasonableness; organizations should also identify common key data elements to support accurate reporting.



Types of interseries relationships and reporting considerations

- Counterparty credit risk exposures for SFTs reported on FR Y-15 Schedule A
- Reconciliation of net current credit exposure on FR Y-9C Schedule HC-L line 15(a) and aggregate unstressed gross current exposure on FR Y-14Q Schedule L.1.e
- Use of a financial consolidation standard to define "affiliates" and "subsidiaries" of covered companies is like the FR Y-9C consolidation requirements
- Tier 1 capital equal to common equity tier 1 capital and additional tier 1 capital as reported on the most recent FR Y-9C on a consolidated basis
- Total consolidated assets are determined by the average of the BHC's total consolidated assets in the four most recent consecutive quarters as reported on the FR Y-9C

The examples highlighted above represent types of interseries relationships found in the FR 2590, but, given the common challenges associated with report production, regulatory reporting functions should take proactive measures to establish validity and accuracy controls for the new reporting requirements.

Overview of common challenges

The FR 2590 asks for respondents to report their top 50 counterparties by name and type (e.g., sovereigns, securitization), as well as their aggregate gross credit exposure by product type (including lending, notional on traded products, and indirect exposure such as collateral or hedges). The form also requires reporting net credit exposure by counterparty group member, distinguishing between economic interdependence and control relationships.

There are several key and unique challenges encountered for each of the required capabilities for the FR 2590:

Counterparty identification and hierarchy management

- Enhancing customer data systems incorporate a significant amount of additional information required for appropriate aggregation due to subjective and extensive aggregation rules:
  - Unique legal entity identifier required for counterparty, issuer (including collateral) and reference entity across banking book, trading book and investment portfolio
  - SCCL aggregation rules to supplement business-as-usual (BAU) management of counterparty risks and limits
- Managing multiple hierarchies (e.g., risk vs. legal, control vs. economic interdependence)

Exposure calculation and aggregation

- Using the standardized approach is likely to result in higher exposure measure of derivative transactions and SFTs for covered companies without US Basel III IMM or simple VaR capabilities (e.g., FBOs, IHCs) or approval
- Managing multiple exposure measures with parent entities subject to a reporting FBO's home country's Basel Committee on Baking Supervision (BCBS) LES-equivalent rules with potentially different exposure measures for the same exposure type (e.g., SA-CCR for derivatives)
- Impacting credit risk mitigation strategies due to tradeoffs to "net down" direct exposure or to add mitigant exposure to counterparty
- Risk-shifting rules for credit risk mitigants when linking collateral issuer and protection providers to counterparty hierarchies may result in operational challenges

Reporting and limits monitoring

- Developing sustainable technology infrastructure and business processes to support periodic monitoring and reporting capabilities
- Enhancing MIS reporting to monitor multiple limit regimes and requirements across the counterparty credit risk landscape
- Calculating, monitoring and reporting SCCL exposures at two different levels (IHC and combined US operation), resulting in added complexities around exposure management for FBOs
- Increasing burden on reporting team due to parallel production timeline with the FR Y-9C

Insights on common challenges

Banks should start preparing for the FR 2590's first filing as of March 2020 or September 2020, as applicable. Most banks are conducting, or have conducted, impact analyses to address technology and data challenges. Some banks have also initiated the following activities:

- Conducting pro forma business impact analysis and update exposure concentration impact analyses to reflect the updated rule changes and determine whether any business strategy and limits mitigation actions are necessary
- Determining existing capabilities to be leveraged versus new capabilities to be developed
- Assessing the connection points with other internal and regulatory requirements, such as OCC Legal Lending Limits, Internal Risk Limits, BCBS LES, Basel risk-based capital, CCAR and existing reporting and monitoring frameworks
- Conducting data and technology assessment:
  - Assessing impact on overall counterparty risk management infrastructure, including foundational exposure identification, counterparty hierarchies and capabilities
  - Identifying counterparties in scope of the economic interdependence analysis
  - Performing look-through analyses to collateral issuers, credit protection providers and special purpose vehicles (SPVs)
  - Conducting a holistic application and architecture design building on the assessment of existing exposure calculation and reporting capabilities and the firm's ability to support multiple methodologies and daily monitoring

Impact of SCCL on foreign banking organizations

On October 31, 2018 and on April 8, 2019, the Federal Reserve issued NPRs to implement revised prudential standards for BHCs and FBOs, respectively. Consistent with the proposals for BHCs, the proposals for FBOs apply categories of standards based on size, risk profile and complexity of the banking organizations.

Specifically, FBOs should evaluate which category they fall into to determine if they are a covered foreign entity. Covered foreign entities must comply with the SCCL rule daily in addition to submitting a quarterly FR 2590 report to demonstrate compliance. The NPR also removes the bifurcated approach for FBO's IHCs greater than $250b in total consolidated assets, and subjects all in scope IHCs to a uniform aggregate net credit exposure limit to a single counterparty equal to 25% of tier 1 capital, SPV look-through, and economic interdependence and control relationship tests, as well as additional compliance requirements.

Conclusion

What's next for FR 2590 filers?

Banks should look to integrate SCCL and FR 2590 requirements into their current regulatory reporting environments. Filers should identify commonalities with other regulatory reports and establish common credit exposure calculation capabilities across related initiatives such as Basel III regulatory capital and internal risk management reporting. The infrastructure should be scalable and flexible enough to support the multidimensional aggregation of credit exposure and related information while responding to the changing credit measurement methodology. Exposure constraints imposed by SCCL will ultimately extend to the front office and associated policies, potentially resulting in management decision-making.

Many firms have mobilized cross-functional working groups to assess their capabilities and develop strategic remediation plans for implementation pending finalization of the report.

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