CLEARY GOTTLIEB

ALERT MEMORANDUM

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OCC's Final Lending Limits Rule: Key Implications for Derivatives and Securities Financing

Last June, the Office of the Comptroller of the Currency (the "OCC") issued an interim final rule (the "Interim Rule")[1] to incorporate credit exposures arising from derivative transactions and from repurchase/reverse repurchase agreements and securities lending/borrowing transactions ("Securities Financing Transactions") into the National Bank Act's lending limits.[2] The OCC's Interim Rule evidenced considerable flexibility in approach and, unlike the approaches to credit exposure under other regulatory rulemakings, provided banks with a choice of calculation methodologies. The Interim Rule also demonstrated the OCC's continued support for internal models for calculating exposures, at a time when model skepticism has become increasingly evident in the regulatory community.

On June 20, 2013, the OCC amended and finalized the Interim Rule (the "Final Rule"),[3] extending its track record of providing flexibility in rulemakings. In the Final Rule, the OCC left the Interim Rule's overall approach to derivatives and Securities Financing Transactions largely intact, but made several important decisions, reflecting careful consideration of the comments received. Although the OCC did not adopt all of the comments provided by the industry or others, the changes in the Final Rule reflect the importance of submitting thoughtful comments on open rulemakings. This memorandum describes the most noteworthy of the OCC's decisions and their implications for the banking industry. These include:

- No exemption for, or modification to the treatment of, exposures to central counterparties ("CCPs"), despite industry concerns that application of lending limits to these entities could interfere with the global transition to cleared derivatives;
- Increased flexibility in the permitted methods of calculation of credit exposure, including an affirmation of the OCC's receptiveness to internal models and interest in reducing regulatory burdens and redundancies;

1 OCC, Lending Limits, 77 Fed. Reg. 37,265 (June 21, 2012) (interim final rule). For a description of the Interim Rule, see our Alert Memorandum, OCC Revises Lending Limits Rule to Include Derivatives and Securities Financing Transactions (June 29, 2012) (the "2012 Memo"), *available at* http://www.cgsh.com/occ_revises_lending_limits_rule_to_include_derivatives_and_securities_financing_transactions/.

2 The Interim Rule and the Final Rule (defined below) implement Section 610 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

3 OCC, Lending Limits, 78 Fed. Reg. 37,930 (June 25, 2013) (final rule).

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- For the first time, permitting banks to reduce their exposure, for lending limit purposes, from loans and other non-derivative extensions of credit through the purchase of credit protection in the form of eligible credit derivatives;

- A further extension—to October 1, 2013—of the temporary exemption excluding derivatives and Securities Financing Transactions from a bank's lending limit calculations, in order to provide banks time to obtain regulatory approval for internal models and to implement the needed operational and technological changes to comply with the Final Rule; and

- An increase in the maximum permissible threshold amount under effective margining arrangements in order to permit banks to use internal models to calculate their credit exposure from credit derivatives—a change that should allow large banks to avoid having to separate their exposure calculation for credit derivatives from their comprehensive model-based calculations.

I. Background and Scope

The National Bank Act, as implemented by the OCC's lending limits rule, requires that national banks limit their outstanding loans and credit exposure to a single counterparty to 15% of a bank's unimpaired capital and unimpaired surplus, plus up to an additional 10% (for a total credit exposure limit of 25%) of a bank's unimpaired capital and unimpaired surplus if the exposure exceeding 15% is fully secured by readily marketable collateral.[4] The Home Owners' Loan Act applies national bank lending limits to state and federally chartered savings associations, subject to certain statutory exemptions. The Final Rule will require national banks and savings associations to include credit exposures from derivative transactions and Securities Financing Transactions in their calculations of these limits.[5]

The Final Rule gives banks a choice between using internally developed models for calculating credit exposures and using simpler, non-model methods. Larger banks, in particular those that engage in complex or significant volumes of derivatives transactions or Securities Financing Transactions, are generally expected to use internal models for calculating credit exposure. Although such models must be approved by the bank's primary Federal banking regulator, they are likely to provide more flexibility and a better dynamic measure of credit exposure than the alternative methods.

The alternative methods are intended to relieve smaller banks that make more limited use of derivatives and Securities Financing Transactions from the burden of developing statistical models to estimate their credit exposure. Instead, these methods rely on fixed haircuts and conversion factors to calculate the approximate credit exposure of a transaction, sacrificing accuracy and flexibility for simplicity. Non-model methods would typically give more

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

5 For ease of reference, this memorandum uses the terms "bank" or "banks" to refer to national banks and savings associations subject to the Final Rule unless the context requires otherwise.

conservative results than internal model methods, in part because they fail to take netting and collateral fully into account.

State Banks. State-chartered banks are typically subject to lending limits under state law. Although Section 610 of the Dodd-Frank Act and the Final Rule do not by their terms apply to state chartered banks, Section 611 of the Dodd Frank Act (which took effect January 21, 2013) prohibits FDIC-insured state-chartered banks from engaging in derivative transactions unless the chartering state takes into consideration credit exposure to derivative transactions in its lending limits laws. Many states have made legislative or regulatory changes or issued guidance to address Section 611. Some chose to adopt the OCC's approach, while others decided to take alternative approaches.[6]

Branches and Agencies of Foreign Banking Organizations. The federally licensed branches and agencies of foreign banking organizations are subject to the Final Rule to the same extent as a national bank (although the capital and surplus used to determine the constraints imposed by the Final Rule would be the capital and surplus of the foreign bank that operates the branch or agency).[7]

Pursuant to the International Banking Act, state branches and agencies are also subject to the Final Rule, although states are expressly permitted to apply "more stringent restrictions."[8] As noted above, some states have implemented changes to their laws that would apply to both insured state-chartered banks and uninsured state-licensed branches of foreign banks. Foreign banks with state-licensed branches will need to evaluate both their state lending limits and the OCC's Final Rule to determine whether state law imposes "more stringent" constraints on their credit exposures from derivatives and Securities Financing Transactions.

Foreign banks that wish to use models-based approaches to calculating credit exposure will also have to determine how to obtain approval for their models. The OCC's Final Rule states that approval must come from the appropriate federal regulator, which would be the Board of Governors of the Federal Reserve System (the "Federal Reserve") for state-licensed branches and agencies. However, the Federal Reserve has not made any public indication of how a state-licensed branch should proceed to seek approval for an internal lending limit model,

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6 For example, new Part 117 of the General Regulations of the New York Banking Board calculates credit exposure on derivatives as mark-to-market ("MTM") only, and allows netting and collateral offsets, which is a departure from the Final Rule and the rules of some states that copied or incorporated all or a portion of the OCC Interim Rule. See 3 NYCRR Part 117 (Jan. 17, 2013) ("NY Part 117"). In contrast, Illinois regulators concluded that the Illinois Banking Act already meets the Dodd-Frank Act requirements, reasoning that their "parity" statute permits Illinois state banks to engage in activities authorized for national banks, and that national banks are authorized to conduct derivatives subject to including their credit exposure in lending limit calculations. See Illinois Department of Financial and Professional Regulation, Division of Banking Letter, dated January 17, 2013. As a third example, the Connecticut Department of Banking adopted all of the OCC Interim Rule's alternative methods for calculating credit exposure of derivatives. See Connecticut Department of Banking, Guidance Concerning Determination of Credit Exposure Arising from Derivative Transactions, dated September 27, 2012.

7 See 12 U.S.C. § 3102(b).

8 See 12 U.S.C. §§ 3105(h)(2) and (3).

and we understand that approaches to the Federal Reserve to date have not yet yielded significant progress toward model approval.[9]

II. Key Changes and Considerations

- *Treatment of Exposures to Clearinghouses and CCPs*. The OCC rejected industry comments requesting an exemption or differential treatment for exposures to CCPs. As noted in our 2012 Memo, the treatment of credit exposures to CCPs has been an ongoing source of concern for the industry because the Dodd-Frank Act and analogous non-U.S. rules contain mandatory clearing requirements for certain derivatives. Many banks are concerned that application of traditional exposure limits to CCP exposures could significantly constrain derivatives activities as exposures become more concentrated at a limited number of CCPs.

  - The OCC's decision not to exempt or provide special treatment for exposures to CCPs evidences a continuing concern with the concentration of risk in CCPs, notwithstanding the countervailing policy among the global regulatory community to clear more derivatives through CCPs.[10] However, the OCC suggested that it would not expect a bank to exceed its lending limit with respect to a CCP if it uses an approved internal model to calculate credit exposure (because netting under the model will help reduce overall exposure) and engages in "prudent credit risk management".

  - Notably, other recent proposals to address credit exposures from derivatives—such as the Proposed SIFI Rule—would not permit the use of internal models, and may therefore pose a greater risk of interfering with clearing through CCPs. In contrast, some state lending limit regimes explicitly exclude CCP exposures.[11]

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[9] See Final Rule at 37,933 n. 16 ("The OCC will, as appropriate, consult with both the [Federal Deposit Insurance Corporation] and [Federal Reserve]. However, these agencies are responsible for implementing this rule for their regulated institutions.")

[10] See also Basel Committee on Banking Supervision (the "Basel Committee"), Supervisory Framework for Measuring and Controlling Large Exposures (March 2013) (consultative document) (the "Basel Consultation") (requesting comments on whether exposures to CCPs should be subject to limits under large exposure regimes, and if so, whether any special treatment or higher limits might be required in light of "the G20 recommendation that all standardised products will need to be cleared through CCPs in order to reduce systemic risk and make financial institutions more resilient"); Federal Reserve, Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594, 618 (Jan. 5, 2012) (proposed rule) (the "Proposed SIFI Rule") (requesting comments on the "competing policy concerns in considering whether to limit a covered company's exposure to central counterparties."). Although both proposals requested comment on the issue, neither the Basel Consultation nor the Proposed SIFI Rule—which would impose single counterparty credit limits on large bank holding companies and systemically important nonbank financial companies—included a special dispensation or exemption for CCP exposures in their baseline proposals.

[11] See, e.g., NY Part 117 at § 117.5 ("a bank need not include credit exposures to a qualifying central counterparty that has been designated by the Financial Stability Oversight Council as a financial market utility that is, or is likely to become, systemically important"); Off. Code of Ga. § 7-1-285(a)(3) (defining a "person or corporation" to whom exposure is limited as excluding any "clearing organization registered or exempt from registration with" the CFTC, SEC or other federal agencies).

- The OCC acknowledged that the role of CCPs in the financial system was important and evolving, and it stated that it will continue to monitor the application of lending limits to CCPs.

- The OCC did add provisions to the Final Rule specific to CCPs, requiring that the exposure arising from the amount of initial margin posted, and contributions to a guaranty fund made, by a bank be included as exposures subject to the lending limit.

- *Revisions to the Non-Model Methodologies*. The Final Rule introduces two significant changes to the non-model methodologies for derivatives transactions and Securities Financing Transactions published in the Interim Rule.[12] In each case, the main benefit of the newly introduced methods is to provide banks the option to reduce regulatory burden and redundancy by choosing the same method for calculating credit exposure for purposes of lending limits and the risk-based capital rules. In addition, the familiarity of the new methods to both banks and regulators should ease the transition to compliance with the Final Rule for banks that adopt these approaches.

  - *Derivatives Exposures*. For derivatives other than credit derivatives, the OCC replaced the "Remaining Maturity Method" (the "RMM") from the Interim Rule with the "Current Exposure Method" (the "CEM") from the standardized approach in the federal banking agencies' current and proposed risk-based capital rules.[13]

    - Under the CEM, a bank is required to add a measure of its current exposure under a derivative contract (equal to the greater of the derivative's MTM value or zero) to a measure of its PFE (equal to the notional value of the contract multiplied by a specified conversion factor based upon the type of derivative and its remaining maturity).

    - Although the CEM has been criticized in other contexts for overstating the risk of derivatives transactions, it is generally viewed as an improvement to the method it replaces, and industry commenters urged the inclusion of this option due to their familiarity with its use. Also, CEM recognizes the risk mitigating effects of netting and collateral to a greater extent than the RMM, and the multipliers for calculation of PFE are better tailored to credit risk under the CEM than under the RMM.

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[12] For a description of the non-model methods published in the Interim Rule, see our 2012 Memo. With regard to the non-model "Conversion Factor Matrix Method," the OCC declined to add a process to that method for taking into account netting, stating that the ability to choose the model method or the CEM (defined below) addresses any concerns about the ability to use netting in calculating counterparty exposure.

[13] See 12 C.F.R. Part 3, Appendix C, Sections 32(c)(5)-(7); 12 C.F.R. Part 167, Appendix C, Sections 32(c)(5)-(7); 12 C.F.R. Part 390, subpart Z, Appendix A, Sections 32(c)(5)-(7); Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements; Joint Notice of Proposed Rulemaking, 77 Fed. Reg. 52,888 (August 30, 2012) (the "Standardized Approach NPR").

- *Securities Financing Transactions*. The OCC also added a second non-model method for calculating credit exposure from Securities Financing Transactions. The new method—the "Basel Collateral Haircut Method" (the "BCHM")—adopts the standard supervisory haircuts used in the current advanced approaches capital rules and under the standardized approach in the proposed risk-based capital rules, and is viewed as a more accurate measurement of credit exposure than the "Basic Method" (formerly known, in the Interim Rule, as the "Non-Model Method").[14]
  - Under the BCHM, a bank is required to measure exposure from a Securities Financing Transaction as the sum of the following: (i) the market value of the exposure minus the market value of the collateral; (ii) for each type of security exchanged or collateral posted, the market value of the net position in the collateral/exchanged securities (subtracting any similar collateral/securities given to the counterparty) multiplied by the supervisory market volatility haircut set forth in a look-up table in the capital rules; and (iii) the market value of the net position (subtracting any similar collateral given to the counterparty) in collateral denominated in a different currency from the currency of the exposure multiplied by an appropriate currency mismatch haircut factor (generally 8%).

- *Credit Protection for Non-Derivative Credit Exposures*. In a significant departure from past practice under the OCC's lending limit rule, the OCC has decided to permit banks to purchase credit protection in the form of credit derivatives to offset other, non-derivative credit exposures, subject to certain criteria.[15] A bank will be permitted to exclude from its lending limit that portion of one or more loans or extensions of credit with respect to which the bank has purchased protection, subject to the following criteria:
  - The protection must be a single-name credit derivative that meets the requirements for an eligible credit derivative under the Final Rule;
  - The credit derivative must be purchased from an eligible protection provider;
  - The reference obligor must be the same legal entity as the borrower in the loan or extension of credit;

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[14] See 12 C.F.R. Part 3, Appendix C, Section 32(b)(2)(i) and (ii); 12 C.F.R. Part 167, Appendix C, Section 32(b)(2)(i) and (ii); 12 C.F.R. Part 390, subpart Z, Appendix A, Section 32(b)(2)(i) and (ii); Standardized Approach NPR at 52,911 and 52,943.

[15] In the Interim Rule, the OCC would have permitted protection in the form of "eligible credit derivatives" only to offset a bank's credit exposure to a reference entity from protection sold under another credit derivative on that reference entity, but asked whether eligible credit derivatives should be permitted to reduce other forms of exposure under the lending limits rule, such as exposure from loans.

- The maturity of the protection purchased must equal or exceed the maturity of the loan or extension of credit; and
- The total amount of such exclusion may not exceed 10% of the bank's capital and surplus.[16]

- *Effective Margining Arrangements for Credit Derivatives*. Before a bank can use an internal model to calculate credit exposure to a counterparty in connection with credit derivatives, it must have established an "effective margining arrangement" with that counterparty, which is defined in the Final Rule as "a master legal agreement governing derivative transactions between a [bank] and a counterparty that requires the counterparty to post, on a daily basis, variation margin to fully collateralize that amount of the bank's net credit exposure to the counterparty that exceeds $25 million created by the derivative transactions covered by the agreement."[17] Under the Interim Rule, the variation margin threshold for an effective margining arrangement was set much lower, at only $1 million.

  - The increased $25 million threshold should address the concerns of some large banks with significant books of credit derivatives that many of their existing margining arrangements would not have qualified under the $1 million threshold, and therefore would not have been eligible for exposure calculation using models. Extracting those credit derivatives that were not subject to an effective margining arrangement under the Interim Rule from banks' internal models, and subjecting those derivatives to a net notional exposure calculation, would have been a burdensome and potentially monumental task for banks that deal in credit derivatives.
  - The OCC rejected comments suggesting that models should be able to take into account "whatever threshold is applicable for a particular margining arrangement", stating that "[t]he OCC . . . finds that variation margin is an important credit risk mitigation tool for prudent participation in over-the-counter derivatives markets. Beyond a prudently established variation margin threshold, the OCC does not believe it is appropriate to permit an institution to use the Model Method for credit derivatives transactions."

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[16] The text of the Final Rule is somewhat ambiguous regarding whether the 10% limit applies on a per obligor basis or applies to the total amount of all loans and extensions of credit that may benefit from the offset. Given the emphasis of the OCC's lending limit rules on per obligor limits, we believe that the better reading is that the 10% limit applies on a per obligor basis. We note, however, that purchase of credit protection, even under an "eligible credit derivative," yields credit exposure to the protection seller under the Final Rule that must be attributed to the bank's lending limit to the protection seller. The 10% limit does not apply to protection purchased to reduce a bank's credit exposure arising from other credit derivatives.

[17] The alternative non-model approach to calculating counterparty credit exposure arising from credit derivatives requires a bank to add the net notional value of all protection purchased from the counterparty across all reference entities.

- To mitigate potential risks posed by the increased variation margin threshold, the Final Rule requires any such threshold under an effective margining arrangement to be added to a bank's measurement of its counterparty credit exposure. In addition, the OCC emphasized that the lending limit threshold does not obviate or modify a bank's obligation to maintain margining arrangements consistent with safe and sound banking practices, suggesting that OCC examiners may scrutinize margining agreements featuring high variation margin thresholds.[18]

- *Treatment of Paid-in-Full Options*. In response to requests for clarification, the OCC confirmed in the preamble to the Final Rule that sold and fully paid for options would not give rise to credit exposure for purposes of the lending limits rule, since there would be no further performance obligation on behalf of the bank's counterparty. The preamble states that this fact is "evident" from the nature of the transaction, and no amendments to the Final Rule are necessary.

  - The OCC's acknowledgement that it is "evident" that paid-up options do not give rise to credit exposure under the Final Rule may be significant for other transaction types. For example, prepaid swaps or forwards might qualify as not giving rise to any credit exposure, although the prepayment would need to cover the full amount that could potentially be paid by the counterparty under the swap or forward.

  - Furthermore, this determination may be helpful in other regulatory contexts. For example, Section 608 of the Dodd-Frank Act amended Section 23A of the Federal Reserve Act to include derivatives transactions in the definition of "covered transaction" "to the extent that the transaction causes a member bank . . . to have credit exposure to the affiliate".[19] Under the Volcker Rule (Section 619 of the Dodd-Frank Act), banking entities are prohibited from entering into Section 23A covered transactions with "covered funds" (e.g., hedge funds, private equity funds, and many other structured vehicles that rely on specific exemptions from the Investment Company Act) that they sponsor, advise, manage or organize and offer—a restriction commonly known as "Super 23A" because it applies a flat prohibition on covered transactions and because it has been interpreted by U.S. regulators to not incorporate any of the exceptions or exemptions found in Section 23A or the Federal Reserve's Regulation W. The OCC's interpretation supports the proposition that, to the extent a derivative transaction with a covered fund is fully prepaid, it should not be part of the definition of covered transaction and, therefore, should not be subject to Super 23A.

- *Technical Corrections*. The Final Rule also makes several technical corrections to the Interim Rule, including the following:

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[18] The OCC further noted that "[m]any large institutions currently require, or likely soon will require, that all credit exposures from derivative transactions be fully collateralized."

[19] Section 23A imposes certain quantitative limits and collateralization requirements on covered transactions between banks and their affiliates. See 12 U.S.C. § 371c; 12 C.F.R. Part 223.

- *Use of Internal Models Previously Approved under the Risk-Based Capital Rules*. The Interim and Final Rules each permit banks to use internal models for calculating credit risk exposure from derivatives and from Securities Financing Transactions. However, as we noted in our 2012 Memo, the cross-references to the risk-based capital rules in the Interim Rule were not always consistent with the asset class being measured—the Final Rule revised those cross-references to models that "more appropriately" reflect credit exposures from derivatives and from Securities Financing Transactions.[20]

- *Treatment of Non-Conforming Credit Exposures Calculated under a Non-Model Method*. The introduction of dynamic methods for measuring credit exposure from derivatives and Securities Financing Transactions created new possibilities for banks to breach their lending limits inadvertently, since exposure measurements that include a MTM component can go up as well as down after inception of the transaction.[21] Under the Interim Rule, credit exposures calculated using internal models that caused a bank to exceed its lending limit would have been treated as "non-conforming" rather than a violation of the Interim Rule, but, as we noted in our 2012 Memo, the Interim Rule did not make the same accommodation regarding the RMM, which was also based on a MTM measurement that could vary dynamically.

  - The Final Rule remedies this oversight by (i) eliminating the RMM and (ii) providing the same treatment for non-conforming credit exposures calculated under the CEM and BCHM as was provided for the model method under the Interim Rule.[22]

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[20] For derivatives, the Final Rule refers to Section 32(d) of the advanced approaches appendices (e.g., 12 C.F.R. Part 3, Appendix C), which contains the capital rules governing models for over-the-counter derivatives, whereas the Interim Rule had cross-referenced Section 53 of the advanced approaches appendices, which sets forth the requirements for internal models used to calculate equity exposures for purposes of risk-based capital rules. For Securities Financing Transactions, the reason for the change in the Final Rule is less clear. Although the OCC stated that they found that models approved under Section 32(b) of the advanced approaches appendices are "more appropriate" models than those approved under Section 32(d) (which was the Interim Rule cross-reference), (1) Section 32(b) does not describe a full internal model methodology with respect to repo-style transactions, (2) nevertheless, Section 32(b) references the internal model methodology of 32(d) as a permissible method of "exposure at default" calculation and (3) Section 32(d) would still have been appropriate for Securities Financing Transactions.

[21] Under the current lending limits rule, a loan that was within the lending limits when made, but then later exceeds those limits (because, for example, the bank's capital has declined or the collateral securing the loan has dropped in value) is treated as non-conforming. Rather than being deemed in violation of the lending limits rule, the bank is given the opportunity to bring a non-conforming loan back into conformance in a manner consistent with safety and soundness. Since the Final Rule introduces dynamic formulas for the calculation of credit exposure under derivative transactions and Securities Financing Transactions, an exposure could now exceed the lending limits for reasons other than those set forth in the current lending limits rule, such as through changes in the valuation of the transaction itself.

[22] The Conversion Factor Matrix Method for derivatives and the Basic Method for Securities Financing Transactions calculate fixed credit exposures that do not vary over time, and therefore cannot grow to become non-conforming or in violation of the lending limits after inception of the transaction.

- *Consistency with Other Credit Exposure Regimes*. The OCC has chosen a different approach to calculating credit exposure from derivatives transactions and Securities Financing Transactions than has been proposed by other regulators, in particular with respect to its willingness to accept internal model-based approaches. Neither the Basel Consultation nor the Proposed SIFI Rule included a model-based approach to calculating credit exposures, although both asked for comments on whether such an approach would be appropriate.
  - Indeed, in contrast to the skepticism expressed by the Basel Committee and other regulators regarding the value of models, the OCC included in the preamble to the Final Rule a strong statement about the value of internal models in producing accurate measurements of credit exposure, provided "appropriate supervisory safeguards" are in place.[23]
  - The OCC also appears to be more willing to provide banks with choices and flexibility in order to reduce regulatory burden and simplify their compliance options with multiple overlapping regulatory regimes.
    - By including the CEM and the BCHM in the Final Rule, the OCC has given banks the option to adopt the same credit exposure calculation approach for derivatives and Securities Financing Transactions for purposes of both national bank lending limits and for risk-based capital. In contrast, neither the Proposed SIFI Rule nor the Basel Consultation would provide optionality for banking institutions in how they calculate credit exposure for exposure limits, thereby potentially multiplying the number of calculations that must be applied to the same set of assets and exposures.
    - In addition, the Final Rule gives banks the opportunity to request prior regulatory approval to use a different method for some subset of their derivatives transactions or Securities Financing Transactions, thereby creating additional flexibility to tailor calculation methods to a bank's particular activities and exposures. (The Interim Rule required banks to use the same

[23] Compare Final Rule at 37,933 ("The use of an internal model, with the safeguards described below, improves the accuracy of the calculation of the institution's credit exposures to derivative and securities financing transactions. Not including such a modeling option . . . would result in a rule that would not accurately reflect counterparty exposure for certain banks.") with Basel Consultation at 11 ("Although the [internal model method] is designed to deliver more risk-sensitive capital requirements than the CEM or the standardised approach, it is not designed to capture the type of peak loss exposures that the large exposures framework needs to capture. Non-internal model methods are better suited to meeting this objective while also avoiding model risk and ensuring consistency between banks internationally.").

We note that the CEM is undergoing review by the Basel Committee, and it remains to be seen whether changes will result that will permit greater recognition of netting and actual risk. See Basel Consultation at 11. We further note that the OCC referenced the Basel Consultation and indicated that "[i]f such an agreement is reached, the OCC would consider whether further amendments to [the Final Rule] are necessary and appropriate." Final Rule at 37,932 n. 11.

method for all derivatives transactions and the same method for all Securities Financing Transactions.)

- o As the first federal regulator to finalize its rules for including derivatives exposure in credit exposure limits, it remains to be seen whether the OCC's approach will remain an outlier, or is a potential sign of how other regulators will respond to similar industry concerns.

- *Timing Considerations*. The Interim Rule became effective last July, but provided a temporary exemption from lending limits for derivative transactions and Securities Financing Transactions. The temporary exemption was extended once until July 1, 2013,[24] and in the Final Rule the OCC further extended the temporary exemption until October 1, 2013, both because of the late publication of the Final Rule and, importantly, because many large banks have not yet been able to obtain final approval for their internal models.

  - o The OCC expressed the belief that the further extension to October 1 should give sufficient time for banks to obtain approval for their internal models, and rejected requests for provisional approval to use internal models for which final approval remains pending.

- *Application of the OCC's Combination Rules*. As we noted in our 2012 Memo, the Interim Rule did not discuss the application of the lending limit combination rules to derivatives or Securities Financing Transactions.[25] The "direct benefit test" in particular is likely to raise complicated issues in the context of derivative transactions and Securities Financing Transactions, and commenters asked the OCC to limit its application to situations of evasion. The OCC declined to make changes to the wording of the test, but the preamble to the Final Rule indicates that the OCC "will continue to apply the test sensibly to these transactions in light of their facts and circumstances" and will monitor the application of the test as the OCC gains experience with its application to derivatives and Securities Financing Transactions.

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[24] See 77 Fed. Reg. 76,841 (Dec. 31, 2012).

[25] Under the combination rules, an extension of credit may be attributed to another person or persons, in addition to the direct counterparty, if (i) the proceeds of the extension of credit are used for the direct benefit of the other person (other than in a bona fide arm's length transaction where the proceeds are used to acquire property, goods or services), or (ii) if a common enterprise is deemed to exist among the direct counterparty and other persons.

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