January 16, 2024

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention:
Ann E. Misback
Secretary
Docket No. R-1813
RIN 7100-AG64

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention:
Comments /Legal OES
James P. Sheesley
Asst. Executive Secretary
RIN 3064-AF29

Office of the Comptroller of the Currency
400 7th Street, SW
Suite 3E-218
Washington, DC 20219
Attention:
Chief Counsel's Office
Comment Processing
Docket ID OCC-2023-0008
RIN 1557-AE78

Re: Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity, 88 Fed. Reg. 64028 (Sept. 18, 2023) (the "NPR")

Ladies and Gentlemen:

The Structured Finance Association (the "SFA") appreciates the opportunity to respond to the request of the Agencies[1] for comments on the proposed amendments to the regulatory capital rule (the "Proposed Rule") set forth in the above-referenced NPR.

The SFA's mission is: *"To help its members and public policy makers grow credit availability and the real economy in a responsible manner."*

The SFA is a consensus-driven trade association with over 370 institutional members representing the entire value chain of the securitization market. By facilitating the responsible issuance and investing of loans and securities, the market provides trillions of dollars of capital to consumers and businesses in communities across the country. SFA members include issuers and

[1] We refer to the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Office of the Comptroller of the Currency (the "OCC"), and the Federal Deposit Insurance Corporation (the "FDIC"), collectively, as the "Agencies."

investors, broker-dealers, rating agencies, data analytic firms, law firms, servicers, trustees, and accounting firms. As such, unlike many other trade associations, before we take any advocacy position our governance requires us to achieve consensus by agreement rather than majority vote, ensuring the perspectives of all our diverse membership are included. This diversity is our strength, as it builds healthy tension in arriving at our consensus position. Because of this, we are methodical and thoughtful as we analyze the pros and cons of regulatory proposals before we reach a mutually acceptable position.

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Executive Summary

The Proposed Rule should not be adopted.

- The SFA opposes the Proposed Rule.

- We recommend that the Agencies modify the Proposed Rule as set forth in this letter. The Agencies should then issue a re-proposed rule that incorporates the recommendations in this letter and contains clear explanations of the changes to the securitization framework as well as the supporting data.

Why capital requirements for securitization matter.

- Consumers and businesses require access to affordable credit to flourish. Auto loans and leases, residential and commercial mortgage loans, student loans, credit cards, consumer loans, equipment loans, and solar loans enable consumers and businesses to make significant purchases and invest in themselves, thereby fostering personal well-being, business success, and economic growth.

- The cost and availability of these loans depend in large part on how they are funded. In the U.S., a large portion of consumer and business loans are funded by securitization. Banks are an integral part of the securitization market.

    - Banks make loans to bankruptcy-remote special purpose entities ("SPEs") that hold pools of consumer and business loans.

    - Banks invest in asset-backed securities ("ABS") issued by other banks and non-banks.

    - Banks act as market-makers for ABS issued by other banks and non-banks.

    - Banks sponsor securitizations of their own loans to manage their credit risks.

    - Under the Proposed Rule, loans made by banks to SPEs will become more expensive and less available; banks will require higher interest rates on ABS before investing in them; liquidity in ABS will be reduced as market-making becomes more expensive and less available; and banks will be hindered in their ability to manage the credit risks arising from their loan portfolios. As a result, credit will become more expensive and less available for consumers and businesses, thus threatening their economic well-being.

- The Proposed Rule would put U.S. banks at a significant competitive disadvantage compared to their international peers. The proposed securitization framework is much more stringent than the implementation of the Basel III Endgame standards in the EU, the UK, Canada, and elsewhere.

- The Proposed Rule's expanded risk-based approach provides U.S. banks with only one method for assigning risk weights to securitization exposures: SEC-SA.

- In contrast, the Basel III Endgame standards adopted in other major jurisdictions include not only SEC-SA, but also an internal ratings-based approach ("SEC-IRBA") and an external ratings-based approach ("SEC-ERBA").

- The Basel III Endgame standards give preferential risk weights to simple, transparent, and comparable ("STC") securitizations, a category that is not recognized under the Proposed Rule.

The Federal Reserve should undertake a quantitative analysis of securitization calibration across both Comprehensive Capital Analysis and Review ("CCAR") stress tests and risk weights under SSFA.

- The combination of CCAR stress tests and risk weights under SSFA often results in capital requirements that exceed maximum economic loss (*i.e.*, the exposure amount).

- This anomaly will only be exacerbated by the proposed SEC-SA approach due to its p-factor of 1.0.

The p-factor under SEC-SA should be reduced from 1.0 to 0.5 and the p-factor for qualifying securitization transactions should be set at 0.25.

- The proposed increase in the p-factor under SEC-SA doubles the securitization capital surcharge relative to SSFA. The NPR does not adequately explain why a change in the p-factor is necessary, nor does it provide data, quantitative analysis, or financial modeling rationale to support a p-factor of 1.0.

- According to the NPR, the proposed expanded risk-based approach (which includes SEC-SA) is intended to be more risk sensitive and better calibrated than the current standardized approach (which includes SSFA). However:

  - SEC-SA is less risk sensitive than SSFA in assigning marginal risk weights to securitization exposures. Both models use only two risk parameters: the capital requirement for the underlying exposures, adjusted for defaults (K_A), and tranche position (t). We demonstrate the reduced risk sensitivity analytically by calculating the partial elasticity of the marginal risk weighting function with respect to each of the risk parameters. Those calculations show that SEC-SA is much less sensitive to changes in the risk parameters than SSFA.

  - SEC-SA is less well-calibrated than SSFA in assigning risk weights to securitization exposures. SEC-SA has only one calibration parameter, the p-factor. That calibration parameter is effectively removed by setting it equal to 1.0:

$$\left(-\frac{1}{pK_A}\right) \rightarrow \left(-\frac{1}{1*K_A}\right) \rightarrow \left(-\frac{1}{K_A}\right)$$

- A p-factor of 1.0 causes anomalous and arbitrarily high risk weights for securitization exposures, even where the expanded risk-based approach assigns lower risk weights to underlying exposures. For example, capital requirements assigned to loans made to SPEs that hold prime auto loans are much higher under SEC-SA than under SSFA and far more than the cumulative credit loss range of 0.5% to 2.0% on such loans.

- A higher p-factor limits the ability of banks to use synthetic securitization to mitigate credit risks associated with consumer and business loans. Credit protection offered by synthetic securitizations improves credit risk management, thereby enhancing the safety and soundness of banks and promoting overall financial stability.

- The p-factor should be set at 0.25 for qualifying securitization transactions (QSTs). This would better align the Proposed Rule with the Basel III Endgame standard as currently implemented in the EU and would make the SEC-SA model more risk sensitive.

The Agencies should clarify the treatment of directly issued credit-linked notes ("CLNs").

- The capital rule should establish transparent guidelines for recognizing the risk mitigating benefits of directly issued CLNs.

- The capital rule should make clear that directly issued CLNs meet the definition of "synthetic securitization" and that: (1) an embedded credit derivative can satisfy the definition of "credit derivative"; and (2) an embedded guarantee can satisfy the definition of "guarantee."

- The capital rule should clarify that the proceeds of directly issued CLNs constitute "financial collateral" for purposes of the operational criteria for synthetic securitizations.

The accounting derecognition requirement under the operational criteria for traditional securitizations should be replaced with a legal isolation requirement.

- In a traditional securitization, a bank may exclude underlying exposures from its risk-weighted assets only if the exposures are not reported on the bank's consolidated balance sheet under GAAP.

- This approach is at odds with the Basel III Endgame standards, which require legal isolation, not accounting derecognition.

- The accounting derecognition requirement should be replaced with a legal isolation requirement to ensure that the securitization framework appropriately recognizes the transfer of credit risk.

Synthetic excess spread should not prohibit a bank from recognizing the risk-mitigating benefits of synthetic securitizations.

- In the normal course of its lending business, an originating bank will set interest rates on its loans to account for expected defaults. In a synthetic securitization, if the referenced

assets generated excess spread, there is no reason why such excess spread cannot be used to provide credit protection to investors.

- The originating bank should not be required to hold capital against excess spread. Excess spread is a form of credit enhancement provided by the underlying exposures, not by the bank.

- If the Agencies nevertheless continue to construe synthetic excess spread as credit enhancement provided by the bank and a securitization exposure against which the bank should hold capital, that is no reason to disallow recognition of any synthetic securitization that includes synthetic excess spread. Funded excess spread could be subject to a 1250% risk weight, which is like the EU approach.

Credit conversion factors ("CCFs") should apply to the unused portion of loan commitments to securitization SPEs.

- Both the proposed expanded risk-based approach and the standardized approach apply CCFs to the unused portion of loan commitments to convert them to their credit exposure equivalents.

- The securitization framework, however, effectively assigns a 100% CCF to the unused portion of loan commitments to SPE borrowers.

- This result is not only arbitrary, but it is also harmful to consumers and businesses because it increases bank financing costs for commonly securitized assets, such as auto loans, mortgage loans, and credit card receivables.

- Both the proposed expanded risk-based approach and the standardized approach should be revised such that if a commitment to lend to an SPE represents a securitization exposure that is not a resecuritization exposure:

    - the CCFs applicable to such commitment to lend under the expanded risk-based approach is applied to the unused portion of the loan commitment to such SPE and

    - SEC-SA or SSFA, as applicable, is used to risk weight the converted amount.

The calculation of various parameter values should be revised.

- The definitions of K_G and K_A produce anomalous and arbitrary results and should be revised.

    - K_G and K_A double count underlying exposures captured by parameter W. The Proposed Rule should be modified to make clear that underlying exposures included in the calculation of W (a parameter used in the definition of K_A) need not be included in the weighted average capital requirement calculation described in the definition of K_G.

  - The treatment of defaulted exposures under K_A is arbitrary and unreasonably punitive. The scaling factor of 0.5 applies to defaulted exposures under K_A should be reduced to 0.12, which is the capital requirement for defaulted exposures.

- K_G and K_A should not include defaulted underlying exposures that serve as excess collateral.

- SFA interprets the existing capital rule, as well as the Proposed Rule, as excluding modified reperforming loans from parameter W. Such exclusion is appropriate. However, to avoid interpretive confusion between the definition of parameter W and the definitions of "defaulted exposure" and "defaulted real estate exposure," and to ensure comparability in the calculation of securitization risk weights across banking organizations, the Agencies should state explicitly that parameter W does not include delinquent underlying exposures that are modified and become reperforming.

- The positive current exposures from interest rate and exchange rate derivatives should not be included in the calculation of K_G.

- The 1.5 multiplier for currency mismatches should not apply to the calculation of K_G.

The risk weight floor for resecuritizations should not apply to certain resecuritizations involving senior securitization exposures.

- The 100% risk weight floor for resecuritizations should not apply if both the resecuritization exposure and the underlying exposures are senior securitization exposures.

- For example, reimbursement for servicer advances in RMBS transactions are senior securitization exposures. A 100% risk weight floor for resecuritizations of those reimbursement rights is disproportionate to the actual risk. As a result, it will be difficult for servicers to obtain financing for their advances, thus making it more difficult for them to make such advances to investors. This would not only limit the ability of mortgage servicers to provide future forbearance in times of need (as they did during the COVID pandemic), but it would also increase servicing costs and ultimately mortgage borrowing costs.

The proposed operational risk capital requirement applicable to fee and commission income should be modified or removed.

- The Federal Reserve's own study found no statistically significant relationship between securitization income and operational losses. Indeed, the study generally found no statistically significant relationship between operational losses and most types of fee and commission income.

- The Basel Committee's proposed operational risk capital requirement does not reflect that U.S. banks are already capitalized for operational risk through CCAR.

Other provisions of the Proposed Rule should be removed or adjusted.

- For the purposes of determining the risk weights applicable to securitization exposures backed by regulatory retail exposures, the aggregate limit and granularity limit criteria should be measured at the pool level.

- Where there is no pari passu exposure, the Proposed Rule should permit the use of a derivative contract's exposure at default as an alternative method for determining tranche size.

- The look-through approach should not be subject to the 15% risk weight floor.

- Where the delinquency status of all underlying exposures is unknown, a subpool approach is reasonable.

Our suggested changes to SEC-SA should also be made to SSFA.

- Banks subject to the proposed expanded risk-based approach would be required to calculate risk weights under both that approach and the existing standardized approach and use the higher of the two.

- Requiring all large banks to calculate their securitization exposures under two unaligned approaches introduces needless complexity without any clear regulatory benefit.

- The Agencies should revise SEC-SA and its various exceptions as described in this letter and make corresponding changes to SSFA and its various exceptions.

The NPR does not satisfy the requirements of the Administrative Procedure Act.

Introduction

The SFA opposes the Proposed Rule. If adopted without significant revisions, the Proposed Rule would have a substantial negative impact on securitization and, by extension, on the availability of affordable credit to consumers and businesses in the United States. It would also harm the international competitiveness of U.S. banks and hinder their ability to manage their credit risks.

The proper determination of bank regulatory capital requirements is one of the most important and challenging aspects of economic policy. Capital requirements help to ensure the stability and solvency of our banking system, and they have a direct impact on the terms under which credit is extended and to whom credit is extended.

Why capital requirements for securitization matter. Consumers and businesses require access to affordable credit to flourish. Auto loans and leases, residential and commercial mortgage loans, student loans, credit cards, consumer loans, equipment loans, and solar loans enable consumers and businesses to make significant purchases and invest in themselves, thereby fostering personal well-being, business success, and economic growth.

Securitization, which is the process of pooling loans and repackaging their cash flows into asset-backed securities ("ABS"),[2] provides cost-effective funding for consumer and business loans. The features of securitization that lead to competitive funding for consumer and business loans include:

- Credit enhancement and bankruptcy remoteness: Credit enhancement mechanisms and bankruptcy remoteness allow ABS to be issued that have a higher credit rating than the sponsoring bank and that are of much higher credit quality than the underlying exposures.

- Risk distribution and diversification: By pooling underlying exposures, securitization distributes and diversifies credit risk. Investors can choose from a range of tranches with different risk profiles, leading to more efficient risk allocation.

- Liquidity and access to a broad investor base: Securitization transforms illiquid loans into liquid assets (ABS), which can be traded in capital markets. By converting loans into tradeable securities, ABS can be sold to institutional investors who might not otherwise directly invest in consumer or business loans. Increased liquidity and a broad investor base lead to more efficient pricing and reduced funding costs.

- Interest rate and maturity transformation: Securitization enables the transformation of underlying exposures with different interest rates and maturities into ABS that meet specific investor preferences. This results in more efficient pricing and reduced funding costs, as the ABS may be tailored to closely match the yield, risk and duration sought by investors.

Banks are an integral part of the securitization market.

[2] For ease of reference, we refer to both mortgage-backed securities and securities backed by non-mortgage assets as "asset-backed securities" or "ABS."

- Banks make loans to bankruptcy-remote special purpose entities ("SPEs") that hold pools of consumer and business loans.
- Banks invest in ABS issued by other banks and non-banks.
- Banks act as market-makers for ABS issued by other banks and non-banks.
- Banks sponsor securitizations of their own loans to manage their credit risks.

In all the above cases, banks have securitization exposures against which they are required to hold regulatory capital. The Proposed Rule would lead to a significant and unwarranted increase in the capital that banks are required to hold against these exposures. As a result, loans made by banks to SPEs will become more expensive and less available; banks will require higher interest rates before investing in ABS; liquidity in ABS will be reduced as market-making becomes more expensive and less available; and banks will be hindered in their ability to manage the credit risks arising from their loan portfolios.

The direct and predictable results of this are two-fold. First, credit will become more expensive and less available for consumers and businesses, thus threatening their economic well-being. Second, banks will be hindered in their ability to use securitization to manage their credit risks, thus compromising their safety and soundness.

Finally, the securitization framework under the Proposed Rule's implementation of the Basel III Endgame standards is much more stringent than the implementation of those standards in the EU, the UK, Canada, and elsewhere. Thus, the Proposed Rule would put U.S. banks at a significant competitive disadvantage compared to their international peers.

The NPR lacks the data, reasoning, and transparency necessary to support the proposed securitization framework and the p-factor increase. The Proposed Rule represents a significant shift in bank regulatory policy, both generally and with respect to securitization. Notwithstanding its significance, the NPR fails to provide (or otherwise reference) the data and, in many instances, the rationale, supporting the Agencies' policy choices with respect to securitization. If the NPR had included supporting data and a sufficient narrative explanation, the SFA could have provided specific comments on them and assisted the Agencies in improving the Proposed Rule.[3]

We recognize the complexity of setting capital requirements and seek to provide the most helpful comments possible by drawing on our members' data and extensive experience in the securitization market. The NPR's lack of supporting data and narrative explanation, however, makes it difficult to provide comments that are fully informed by the Agencies' underlying rationale. Moreover, as discussed in Part XII, the Federal Reserve's request for data, announced two months after the Agencies published the NPR,[4] exacerbates this problem because we will be

[3] As explained in Part XII, due to its lack of data and insufficient explanation, the NPR does not satisfy the requirements of the Administrative Procedure Act.

[4] *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Board Launches Data Collection to Gather More Information from the Banks Affected by the Large Bank Capital Proposal It Announced Earlier this Year (Oct. 20, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231020b.htm.

unable to comment on what the new data show and how the Agencies propose to use the new data to change the Proposed Rule.

Furthermore, greater transparency in the Agencies' decision-making process has benefits that extend beyond meeting the notice and comment requirements of the Administrative Procedure Act. As FDIC Director McKernan put it:

> The practice of giving reasons for our calibration decisions becomes all the more pressing in a world in which our regulatory-capital requirements matter more for at least two reasons. First, we are more likely to get capital requirements right—or at least to get them less wrong—if we are more transparent as to how we calibrated the requirements. … Second, transparency as to our calibration methodology can help foster legitimacy and consensus.[5]

With respect to securitization, the most prominent example of the NPR's lack of transparency is its proposed value of 1.0 for the supervisory calibration parameter, p (the "p-factor"), under SEC-SA. The p-factor is one of the primary determinants of capital requirements for securitizations. Yet, the NPR offers no data, and very little rationale, for its proposal to double the p-factor value relative to the existing SSFA. While this letter will explain why we believe the proposed p-factor value is wrong, the NPR's lack of data or sufficient explanation makes it impossible for us to understand and comment on the reasons why the Agencies believe their proposed value is right. The NPR's omission of data and lack of robust explanation materially compromises our ability to comment. Furthermore, since capital requirements for securitizations significantly influence the cost and availability of credit to consumers and businesses, our compromised ability to comment hinders the Agencies' ability to adopt a final rule whose impacts on the real economy are fully justified.

Due to their simple form, neither SSFA nor SEC-SA can be relied upon to produce the "right" risk weights for securitization exposures. Both models employ a basic exponential decay function that is parameterized by only two risk measures: (1) the weighted average capital requirement of the underlying exposures, adjusted for defaults; and (2) the securitization exposure's position in the capital structure. Left out are inputs that would be essential to include in an academically rigorous risk-weighting model for securitizations, including:

- the weighted average life of the securitization exposure,
- the weighted average term to maturity of the underlying exposures,
- the probability of default, and the expected loss given default, of the underlying exposures,
- the number and granularity of the underlying exposures,

[5] *See* Jonathan McKernan, Director, FDIC, Remarks at FDIC Board of Directors, at the New York State Bar Association and Mayer Brown on the Basel Endgame and Long-Term Debt Proposals (Oct. 4, 2023), https://www.fdic.gov/news/speeches/2023/spoct0423a.html.

- correlation measures with respect to the underlying exposures, and
- structural features and complexity.

By standing in for all the relevant inputs that the SSFA and SEC-SA models omit, a single calibration parameter, the p-factor, must do the heavy work of making the models less wrong. The Agencies have not provided the modeling rationale or the empirical evidence necessary to show their proposed doubling of the p-factor makes the model less wrong, let alone right.

The SFA believes that the securitization capital surcharge is a reliable indicator of the magnitude of error in both models.[6] The p-factor under SSFA is 0.5, which corresponds to a 50% securitization capital surcharge. This surcharge is not based on any data provided in the Basel III proposing or adopting releases, or in the NPR.

The SFA believes that the current 50% surcharge is already excessively high and is unaware of any rigorous analysis by the Agencies or academics demonstrating its reasonableness. Yet, the NPR proposes an arbitrary p-factor value of 1.0 for SEC-SA, which corresponds to a 100% capital surcharge for securitization exposures. Doubling the p-factor would make the securitization framework more wrong, not less.

The doubling of the securitization capital surcharge is particularly puzzling considering that the Agencies adopted SSFA and its p-factor value of 0.5 well after having observed the peak payment default rates on commonly securitized assets during the aftermath of the global financial crisis ("GFC"). The table below presents the percent of balance that was ninety or more days delinquent for mortgage loans, auto loans and credit card receivables.[7] The GFC peak delinquency rates for commonly securitized consumer loans, as well as selected post-GFC figures to help illustrate the magnitude of the GFC stress levels.

Sector	GFC High Seriously Delinquent Rate	Post-GFC Low Seriously Delinquent Rate
Mortgage Loans	8.89% (Q1 2010)	0.37% (Q3 2022)
Auto Loans	5.27% (Q4 2010)	3.14% (Q3 2014)
Credit Card Receivables	13.74% (Q2 2010)	7.08% (Q3 2016)

[6] By "securitization capital surcharge," we mean the percentage amount by which a bank's capital requirement would increase if the bank held every tranche of a securitization, rather than holding the underlying exposures directly in its unsecuritized portfolio.

[7] *See* FED. RSRV. BANK OF NEW YORK, RSCH. AND STATS., MICROECONOMIC STUDS., QUARTERLY REPORT ON HOUSEHOLD DEBT AND CREDIT: NOVEMBER 2023 (2023), available at: https://www.newyorkfed.org/microeconomics/databank.html. Note that this delinquency rate data overstates the amount of net credit losses. A loan that is delinquent may eventually be cured or repaid, thus reducing or eliminating the eventual credit loss. In addition, even if a delinquency is never cured or repaid, the amount of the credit loss would be mitigated by any recoveries.

Moreover, the doubling of the securitization capital surcharge under SEC-SA exacerbates the existing double counting arising from the interaction between the market risk capital rule and the global market shock ("GMS") component of the Federal Reserve's stress capital buffer ("SCB") requirement. The market risk capital rule requires a bank to hold capital against tail risks in the change of value of a position, and the GMS component of the SCB requirement is designed to ensure that a bank has enough capital to withstand a sudden change in the value of its positions. Both requirements capture the risk of market risk losses from trading operations, and therefore lead to double counting. As we demonstrate with the real-world examples in the table below, even under the current framework, the capital required on securitization exposures often exceeds the maximum economic loss (*i.e.*, the bank's exposure amount). As SEC-SA would be utilized under the market risk capital rule for calculating risk weights for securitization positions non-CTP,[8] its *p*-factor of 1.0 would make this double counting problem much worse.[9]

	Rating	Attach Detach Points	SSFA Capital	SEC-SA Capital	GMS	SSFA Total Capital	SEC-SA Total Capital
Bond A CMBS CDO Vintage 2021	AA	10.0% 35.0%	14.1%	34.5%	75.4%	89.5%	109.9%
Bond B Cash Non-Agency CMBS Vintage 2020	BBB	0.0% 55%	31.6%	42.2%	70.3%	101.9%	112.5%
Bond C European RMBS Vintage Unspecified	B	12.5% 80.0%	2.8%	9.9%	85.0%	87.8%	94.9%
Bond D CLO Vintage 2014	NR	0.0% 40%	43.5%	57.4%	62.5%	106.0%	119.9%
Bond E Prime Residential Vintage 2023	AA-	4.7% 7.1%	41.0%	63.1%	14.0%	55.0%	77.1%
Bond F	BBB-	1.6% 2.8%	100.0%	100.0%	52.4%	152.4%	152.4%

[8] *See* NPR, at 64127 ("For consistency in the capital requirements for securitizations under either subpart D or subpart E of the capital rule and to recognize credit subordination, the proposed risk weights for securitization positions non-CTP [*i.e.*, securitization positions that are not correlation trading positions] are based on the risk weights calculated for securitization exposures under either subpart D or subpart E of the capital rule.").

[9] We note that even if it was appropriate for the Basel Committee to recommend raising the *p*-factor to 1.0 for certain securitizations, the unique stress-testing requirements applicable to U.S. banks renders the NPR's proposed increase unnecessary and excessive.

Prime Residential Vintage 2023							
Bond G GSE CRT Vintage 2023	A-	3.8% 5.3%	77.1%	87.4%	20.9%	98.0%	108.3%
Bond H GSE CRT Vintage 2023	BBB-	2.6% 3.8%	100.0%	100.0%	52.4%	152.4%	152.4%

The securitization market has undergone significant regulatory reforms since the adoption of Basel III. We note that the Agencies incorporated SSFA into the capital rule in 2013. Since that time, the regulatory environment in which securitization operates in the United States has changed considerably. Most notably, the requirements of Regulation RR[10] (credit risk retention) applied beginning December 24, 2015, for all asset-backed securities backed by residential mortgages, and beginning December 24, 2016, for all other classes of asset-backed securities. As the Agencies and the other regulators observed when they adopted Regulation RR, that rule was a significant, but not the only, part of a much larger legislative and regulatory effort to improve securitization and lessen its risks:

> the credit risk retention requirements of section 15G are an important part of the legislative and regulatory efforts to address weaknesses and failures in the securitization process and the securitization markets. Section 15G also complements other parts of the Dodd-Frank Act intended to improve the securitization markets. Such other parts include provisions that strengthen the regulation and supervision of nationally recognized statistical rating organizations (NRSROs) and improve the transparency of credit ratings; provide for issuers of registered asset backed securities offerings to perform a review of the securitized assets underlying the asset-backed securities and disclose the nature of the review; require issuers of asset-backed securities to disclose the history of the requests they received and repurchases they made related to their outstanding asset backed securities; prevent sponsors and certain other securitization participants from engaging in material conflicts of interest with respect to their securitizations; and require issuers of asset-backed securities to disclose, for each tranche or class of security, information regarding the assets collateralizing that security, including asset-level or loan-level data, if such data is necessary for investors to independently perform due diligence.[11]

[10] Credit Risk Retention, 12 C.F.R. § 244 (2014).

[11] *See* Credit Risk Retention, 79 Fed. Reg. 77602, 77605 (Dec. 24, 2014). Indeed, regulatory reforms continue to this day. *See, e.g.,* Prohibition Against Conflicts of Interest in Certain Securitizations, SEC Release No. 33-11254 (Nov. 27, 2023). Furthermore, banks and other mortgage lenders have subsequently adopted more prudent underwriting standards. For example, residential mortgage lenders are now required to determine a borrower's ability to repay the loan by collecting and verifying certain information rather than relying on the underlying real estate or unverified information provided in the application process. At a minimum, mortgage lenders generally must consider eight

In addition to the changes in the capital rule and the market reforms described above, starting in 2013, banks have been subject to annual stress testing under the Comprehensive Capital Analysis and Review ("CCAR") and the stress capital buffer ("SCB"). Among other things, the stress tests evaluate whether banks have sufficient capital to continue operations through times of economic and financial market stress. This quantitative evaluation was supplemented by qualitative supervisory assessments. As the Federal Reserve noted:

> In part due to the revised regulatory capital rules, the Federal Reserve's stress testing program, and enhanced supervisory program, the largest banking organizations supervised by the Federal Reserve have more than doubled their common equity capital in aggregate since 2009.[12]

The NPR does not explain why, in light of these significant regulatory reforms, the capital rule must continue to impose a securitization capital surcharge, let alone double it. The proposed securitization framework appears to be predicated on the premise that securitization risks have significantly increased, but the NPR contains no data or explanation supporting this premise. The SFA strongly believes that the risks associated with securitization have diminished significantly since the 2008 financial crisis, which was the impetus for Basel III, and even more so after the Agencies adopted Basel III in 2013.[13]

Other trade groups have submitted comments regarding broader concerns with the NPR. The SFA shares many of these groups' concerns, particularly those expressed in the joint comment letter submitted by the Bank Policy Institute and the American Bankers Association (the "BPI-ABA Letter"). We have also reviewed the comment letter by the International Association of Credit Portfolio Managers ("IACPM") and share the concerns expressed in that letter, particularly with respect to the impact of the Proposed Rule on bank credit risk transfer transactions.

The primary focus of this letter is on the proposed changes to the securitization framework. Accordingly, this letter contains a comprehensive set of comments and suggestions regarding the proposed SEC-SA approach and other aspects of the Proposed Rule that apply to securitization.

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underwriting factors: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the covered transaction; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations, alimony, and child support; (7) the monthly debt-to-income ratio or residual income; and (8) credit history. Mortgage lenders must generally use reliable third-party records to verify the information they use to evaluate the factors.

[12] *See Stress Tests*, BD. OF GOVERNORS OF THE FED. RSRV. SYS., https://www.federalreserve.gov/supervisionreg/stress-tests-capital-planning.htm (last updated June 22, 2022).

[13] In his statement in support of the Proposed Rule, FDIC Chairman Martin J. Gruenberg stated that: "With respect to market risk, during the global financial crisis banks incurred significant losses in their trading books— that is their portfolios of instruments traded over the short-term—exposing weaknesses of the existing market risk capital framework. For example, credit markets, in particular those related to structured products like Collateralized Debt Obligations (CDOs), collapsed during the financial crisis. This severely impacted liquidity in these markets. Banks were able to use internal Value at Risk models for these positions even though the models inadequately captured the risks." *See* Statement by Martin J. Gruenberg, Chairman, FDIC, On Basel III Notice of Proposed Rulemaking (July 27, 2023). We note, however, that CDOs and many of the other financial products that caused the losses referred to by Chairman Gruenberg no longer exist in the market. The various market and regulatory capital reforms (including stress testing) have dramatically altered the securitization market, and the NPR provides no evidence that would suggest these reforms have been ineffective.

Our Recommendation

We recommend that the Agencies modify the Proposed Rule as set forth in this letter. The Agencies should then issue a re-proposed rule that incorporates the recommendations in this letter and contains clear explanations of the changes to the securitization framework as well as the supporting data.

We also recommend that the Federal Reserve undertake a comprehensive quantitative review of securitization calibration across both CCAR stress tests and risk weights under SSFA. As we illustrate in this letter, the combination of the two results in capital requirements often exceeds maximum economic loss, which will only be exacerbated by the proposed SEC-SA due to its p-factor of 1.0.

I. The p-Factor Under SEC-SA Should be Reduced From 1.0 to 0.5.

Under the proposed SEC-SA model, the supervisory calibration parameter, p, (the "p-factor") is set at 1.0,[14] double the value of that parameter under the existing SSFA model. We urge the Agencies to maintain the p-factor under SEC-SA at 0.5[15] for the following reasons, each of which we explain in greater detail below:

- The NPR does not adequately explain the reason for changing the p-factor, nor does it provide any data, quantitative analysis, or financial modeling rationale to support a p-factor value of 1.0.
- A higher p-factor fails to satisfy the key policy goal of the proposed expanded risk-based approach: to assign credit risk weights that are more risk-sensitive and better calibrated than under the existing standardized approach.
- A higher p-factor produces anomalous results, amplifies the flaws inherent in SSFA, produces risk weights that are arbitrarily high, and exacerbates the double-counting of market risk.
- A higher p-factor diminishes the ability of banks to use synthetic securitizations as an effective tool to mitigate their credit risks.

The value of the p-factor is very consequential. It is effectively the amount of a securitization capital surcharge imposed by SSFA and SEC-SA. By "securitization capital surcharge," we mean the percentage amount by which a bank's capital requirement would increase if the bank held every tranche of a securitization rather than holding the underlying exposures directly in its unsecuritized portfolio.

- Where $p = 0.5$, the securitization capital surcharge is 50%.
- Where $p = 1.0$, the securitization capital surcharge is 100%.

Thus, because the p-factor is 0.5 under SSFA and 1.0 under SEC-SA, the securitization capital surcharge imposed by SEC-SA is double that of the surcharge imposed by SSFA. Note that the securitization capital surcharge percentages shown above do not include the effect of risk weight floors. If any tranche is subject to a risk weight floor, the securitization capital surcharge would be even higher.

Moreover, as we explain in Part I.B., although the Proposed Rule seeks to change both the p-factor and the risk weight floor, it fails to propose a corresponding change to the fixed value, 0.5, that scales parameter W as used in the calculation of K_A.[16] The failure to re-calibrate this scaling factor causes the securitization capital surcharge to increase much more sharply under SEC-SA than under SSFA as underlying exposures become seriously delinquent or default. This

[14] Proposed Rule, §___.133(a)(5)(i).

[15] As noted in Part II, the p-factor should be 0.25 for qualifying securitization transactions (QSTs).

[16] Under SSFA and the proposed SEC-SA, $K_A = (1 - W) * K_G + (W * 0.5)$. Parameter W is the proportion of the underlying exposures that are seriously delinquent or in default.

failure to re-calibrate the scaling factor also results in a securitization capital surcharge far in excess of the increase in the capital requirement applicable to underlying exposures when they become seriously delinquent or defaulted.

A. *The NPR does not adequately explain why a change in the p-factor is necessary, nor does it provide data, quantitative analysis, or financial modeling rationale to support a p-factor of 1.0.*

The proposed change in the p-factor is highly significant to the calculation of risk weights for securitization exposures. Yet the NPR offers no data, quantitative analysis, or financial modeling rationale to support any change in the p-factor, let alone doubling it. The only justification provided by the NPR is that:

> [t]he proposed increase to the supervisory parameter p ... from 0.5 to 1.0 would help to ensure that the framework produces appropriately conservative risk-based capital requirements when combined with the reduced risk weights applicable to certain assets under the proposal that would be reflected in lower values of K_G and the proposed reduction in the risk weight floor under SEC-SA.[17]

The NPR, however, does not explain why the proposed changes in risk weights of underlying exposures is relevant to the size of the p-factor or how those changes would cause a 0.5 p-factor to be insufficiently conservative. The NPR notes that the changes in risk weights "incorporate more granular risk factors to allow for a broader range of risk weights."[18] If such changes assign more accurate risk weights to underlying exposures, it is unclear why those changes cause the existing SSFA model to assign less accurate risk weights to securitization exposures such that an increase in the p-factor is needed.

The proposed lowering of risk weights for certain underlying exposures and its raising of risk weights for others seems to imply no more than a corresponding lowering of the risk weights assigned to related securitization exposures, in the former case, and a corresponding raising of them, in the latter case, through the normal operation of K_G under the model. The NPR offers no policy reason for raising the p-factor to neutralize the effects of lower risk weights for some types of underlying exposures. The SFA believes no sound policy reason exists to support that approach. Even if one existed, however, that policy reason would not support doubling the p-factor for *all* securitizations, regardless of whether K_G is higher or lower (as compared to the standardized approach) for any particular securitization.

Moreover, as highlighted below, a p-factor of 1.0 causes securitization risk weights under SEC-SA to be excessively high and far out of proportion to the changes in K_G under the proposed expanded risk-based approach. The NPR offers no data or analysis to justify this result.

We note that when the Agencies adopted SSFA in 2013, they indicated that they would "monitor implementation of SSFA and, based on supervisory experience, consider what

[17] *See* NPR, at 64070.
[18] *See* NPR, at 64038.

modifications, if any, may be necessary to improve the SSFA in the future."[19] The Agencies' supervisory experience concerning the implementation of SSFA would be highly relevant to the public in understanding the Agencies' policy choices with respect to SEC-SA. The NPR, however, does not contain any indication of what the Agencies' supervisory experience has been. The rationale for doubling the *p*-factor is made even more unclear by the lack of any indication in the NPR that the Agencies' supervisory experience concerning SSFA has been unsatisfactory.

The Basel Committee's approach to the *p*-factor is similarly opaque. Under the Basel III Endgame standard, the *p*-factor is set at 0.5 for STC (simple, transparent, and comparable) securitizations,[20] 1.0 for non-STC securitizations, and 1.5 for resecuritizations. The Basel Committee, however, provides no data, quantitative analysis, or financial modeling rationale to support or explain these levels.

In addition, the capital rule in the U.S. does not currently recognize the distinction between STC and non-STC securitizations. A significant portion of securitizations in the EU belong to the STC category and thus qualify for a lower *p*-factor. As of the end of 2022, about 60% of all outstanding public securitizations were STC securitizations.[21] In the third quarter of 2023, more than 50% of all securitization issuances in the EU were STC securitizations.[22]

Thus, the NPR's proposed increase of the *p*-factor from 0.5 to 1.0 is *not* the equivalent of aligning the U.S. standard with the Basel standard. Instead, the NPR's proposed increase would effectively treat all U.S. securitizations under the expanded risk-based approach in the same manner that Basel treats esoteric (non-STC) securitizations under its revised securitization framework.

Finally, we note that on February 9, 2023, in response to concerns about the *p*-factor levels set by the Basel Committee and implemented in the EU,[23] the European Commission proposed a transitional relief measure that would lower the *p*-factor from 0.5 to 0.25 for STS securitizations (the EU implementation of STC securitizations)[24], and from 1.0 to 0.5 for non-STS

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[19] *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 F.R. 62018 (Oct. 11, 2013) (the "Basel III Adopting Release"), at 62118, 62119.

[20] *See* BASEL COMMITTEE ON BANKING SUPERVISION, CALCULATION OF RWA FOR CREDIT RISK CRE40, SECURITISATION: GENERAL PROVISIONS 23–60 (2023), https://www.bis.org/basel_framework/chapter/CRE/40.htm. To qualify for STC treatment under Basel, a securitization must satisfy a number of criteria, including that the underlying assets are homogenous, reliance on refinancing or re-sale of underlying assets to pay investors is not substantial, standardized interest rates are used and no complex derivatives are used.

[21] *See* EUROPEAN SECURITIES AND MARKET AUTHORITY (ESMA), THE EU SECURITISATION MARKET – AN OVERVIEW 10 (2023), https://www.esma.europa.eu/sites/default/files/2023-09/ESMA50-524821-2908_TRV_risk_analysis_-_EU_securitisation_markets_overview.pdf.

[22] *See* ASS'N FOR FIN. MKTS. IN EUR. (AFME), Q3 2023 SECURITISATION REPORT 5, https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Securitisation%20Report%20Q3%202023_.pdf.

[23] The Basel Securitisation Framework was implemented in the EU through amendments to the Capital Requirements Regulation, Council Regulation 575/2013, 2013 O.J. (L176) (EU), introduced by Regulation (EU) 2017/2401 which entered into force at the same time as the European Securitisation Regulation, Council Regulation 2017/2402, 2017 O.J. (L 347) (EU).

[24] An "STS" securitization means a "simple, transparent and standardized" securitization, the requirements for which are set forth in Chapter 4 of Regulation (EU) 2017/2402, as amended.

securitizations.[25] The European Parliament and Council approved this proposal on June 27, 2023. The final accord stipulates that the securitization framework will undergo another review as part of the Capital Markets Union Action Plan.[26]

In revising the Proposed Rule, the Agencies should follow a similar approach. In Part II, we propose a p-factor of 0.25 for "qualifying securitization transactions." For securitizations that are not qualifying securitization transactions, the p-factor should remain 0.5. These changes would not only improve the performance of SEC-SA, but they would also help to preserve international consistency in regulatory capital standards for securitization exposures.

B. *A p-factor of 1.0 makes SEC-SA less risk-sensitive and less well-calibrated than SSFA.*

According to the NPR, the expanded risk-based approach (which includes SEC-SA) is intended to be more risk-sensitive and better calibrated than the current standardized approach (which includes SSFA).[27] The NPR asserts that "[a]pplication of the expanded risk-based approach to large banking organizations would provide granular, generally standardized requirements that result in robust risk capture and appropriate risk sensitivity."[28] This assertion is consistent with the stated goal of the Basel Committee to make the revised securitization framework more risk-sensitive and better calibrated.[29]

Increasing the p-factor, however, would have the opposite effect. As explained below, due to its higher proposed p-factor, SEC-SA is *less* risk-sensitive and *less* well-calibrated than SSFA.

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[25] *See* EUROPEAN PARLIAMENT, REPORT ON THE PROPOSAL FOR A REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL AMENDING REGULATION (EU) NO 575/2013 AS REGARDS REQUIREMENTS FOR CREDIT RISK, CREDIT VALUATION ADJUSTMENT RISK, OPERATIONAL RISK, MARKET RISK AND THE OUTPUT FLOOR A9-0030/2023, 213 (2023), https://www.europarl.europa.eu/doceo/document/A-9-2023-0030_EN.pdf.

[26] The Capital Markets Union (CMU) Action Plan aims to establish a single market for capital across EU Member States. On September 24, 2020, the European Commission (EC) announced a new CMU Action Plan, which has three key objectives: (i) to support a green, digital, inclusive and resilient economic recovery by making financing more accessible to European companies; (ii) to make the EU a safer place for individuals to save and invest long-term; and (iii) to integrate national capital markets into a genuine single market. Action 6 of the new CMU Action Plan provides that "[i]n order to scale-up the securitisation market in the EU, the EC will review the current regulatory framework for securitisation to enhance banks' credit provision to EU companies, in particular SMEs." *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: A Capital Markets Union for People and Businesses-New Action Plan*, at 10, COM (2020) 590 final (Sept. 24, 2020). As a result of this review, the p-factor may remain at 0.25 for STS securitisations and 0.5 for non-STS securitisations, or it may revert back to 0.5 and 1.0, respectively.

[27] *See* NPR, at 64030.

[28] *Id.* at 64032.

[29] *See* BANK FOR INT'L SETTLEMENTS, BASEL COMM. ON BANKING SUPERVISION, BASEL III DOCUMENT: REVISIONS TO THE SECURITISATION FRAMEWORK (2014 ed. 2016) ("The objectives and principles that have guided the Committee are that: the revised securitisation framework should be more risk sensitive; more prudent in terms of its calibration, broadly consistent with the underlying framework for credit risk, and be as simple as possible. In addition, it should give incentives to improve risk management by assigning capital charges using the best and most diverse information available to banks. Finally, it should be transparent and enable comparability across banks and jurisdictions. This framework aims to achieve the right balance between these objectives."), https://www.bis.org/bcbs/publ/d374.pdf.

1. SEC-SA is *less* risk-sensitive than SSFA in assigning marginal risk weights.

As described in Appendix A, the K_{SSFA} and K_{SEC-SA} models both employ an exponential decay function $(k(t, K_A))$ to assign marginal risk weights for points in the capital structure senior to K_A. That function is parameterized solely by two risk measures, t and K_A:

$$k_{SSFA}(t, K_A) = 1250\% * e^{\left(-\frac{1}{0.5K_A}\right)(t-K_A)}$$

$$k_{SEC-SA}(t, K_A) = 1250\% * e^{\left(-\frac{1}{1.0K_A}\right)(t-K_A)}$$

where:

- K_A is the weighted average capital requirement of the underlying exposures (K_G), adjusted for defaults (W); and
- t represents a distinct hierarchical point on the capital structure of the securitization, situated senior to the "dollar-for-dollar" threshold, K_A.

If K_A is held constant and t is allowed to vary, the percentage change in the marginal risk weight assigned under K_{SSFA} is greater than the percentage change in the marginal risk weight assigned under K_{SEC-SA}. K_{SSFA} is therefore more sensitive to changes in t (the tranche-position risk measure) than K_{SEC-SA}.

K_A	t	$\Delta k_{SSFA}(t, K_A)(\%)$	$\Delta k_{SEC-SA}(t, K_A)(\%)$	***More Risk – Sensitive Model***
0.08	0.10 → 0.11	-22%[30]	-12%	K_{SSFA}
0.08	0.16 → 0.15	$+28\%$	$+13\%$[31]	K_{SSFA}
0.08	0.20 → 0.21	-22%	-12%	K_{SSFA}
0.08	0.31 → 0.30	$+28\%$	$+13\%$	K_{SSFA}

Similarly, if t is held constant and K_A is allowed to vary, the percentage change in the marginal risk weight assigned under K_{SSFA} is greater than the percentage change in the marginal risk weights assigned under K_{SEC-SA}. Thus, K_{SSFA} is more sensitive to changes in K_A (the underlying exposures risk measure) than K_{SEC-SA}.

[30] Where $K_A = 0.08$ and $t = 0.10, k_{SSFA}(t, K_A) \approx 758.16\%$. Where $K_A = 0.08$ and $t = 0.11, k_{SSFA}(t, K_A) \approx 590.46\%$. Thus, the relative change in the marginal risk weight is $-(758.16\% - 590.46\%)/758.16\% \approx -22\%$.

[31] Where $K_A = 0.08$ and $t = 0.16, k_{SEC-SA}(t, K_A) \approx 459.85\%$. Where $K_A = 0.08$ and $t = 0.15, k_{SEC-SA}(t) \approx 521.08\%$. Thus, the relative change in the marginal risk weight is $-(459.85\% - 521.08\%)/459.85\% \approx +13\%$.

t	K_A	$\Delta k_{SSFA}(t, K_A)(\%)$	$\Delta k_{SEC-SA}(t, K_A)(\%)$	*More Risk – Sensitive Model*
0.10	0.04 → 0.05	+172%[32]	+65%	K_{SSFA}
0.10	0.06 → 0.05	−49%	−28%[33]	K_{SSFA}
0.10	0.06 → 0.07	+61%	+27%	K_{SSFA}
0.10	0.08 → 0.07	−30%	−16%	K_{SSFA}

This decrease in risk sensitivity under SEC-SA relative to SSFA is due entirely to the elevated p-factor under SEC-SA. Specifically, the partial elasticity of the risk-weighting function with respect to t is $-\frac{t}{pK_A}$,[34] and the partial elasticity of the risk-weighting function with respect to K_A is $+\frac{t}{pK_A}$.[35] Because the proposed p-factor under SEC-SA is *double* the p-factor under SSFA, the partial elasticity of $k_{SEC-SA}(t, K_A)$ with respect to both t and K_A would be *half* that of $k_{SSFA}(t, K_A)$.[36] Thus, SEC-SA would be much less sensitive to changes in the two risk parameters, t and K_A, than SSFA.[37]

This result illustrates the larger point made in the BPI-ABA Letter that the expanded dual stack proposal fails to address the ways in which it is not sufficiently risk-sensitive (which is a key objective of the Basel III Endgame standards) and is unjustifiably designed and calibrated to produce less risk-sensitive and higher capital requirements compared to the international standard. In the context of securitization, this diminished risk sensitivity would not only harm the international competitiveness of U.S. banks as described below in Part I.E., it would also raise the cost and limit the availability of consumer and business credit by making it more capital-intensive, and thus expensive, for banks to participate in securitizations as issuers, investors, lenders, and market makers.

[32] Where $t = 0.10$ and $K_A = 0.04, k_{SSFA}(t, K_A) \approx 62.23\%$. Where $t = 0.10$ and $K_A = 0.05, k_{SSFA}(t, K_A) \approx 169.17\%$. Thus, the relative change in the marginal risk weight is $-(62.23\% - 169.17\%)/62.23\% \approx +172\%$.

[33] Where $t = 0.10$ and $K_A = 0.06, k_{SEC-SA}(t, K_A) \approx 641.77\%$. Where $t = 0.10$ and $K_A = 0.05, k_{SEC-SA}(t, K_A) \approx 459.85\%$. Thus, the relative change in the marginal risk weight is $-(641.77\% - 459.85\%)/641.77\% \approx -28\%$.

[34] The partial elasticity of $k(t, K_A)$ with respect to t is given by $k'_t(t, K_A) * \frac{t}{k(t,K_A)}$, which simplifies to $-\frac{t}{pK_A}$.

[35] The partial elasticity of $k(t, K_A)$ with respect to K_A is given by $k'_{K_A}(t, K_A) * \frac{K_A}{k(t,K_A)}$, which simplifies to $+\frac{t}{pK_A}$.

[36] Indeed, as the p-factor approaches infinity, the model becomes perfectly inelastic and thus perfectly risk insensitive. That is, it would assign a 1250% risk weight to any securitization exposure regardless of the tranche position, the value of K_G, or the value of W.

[37] Risk sensitivity is properly measured by the relative, rather than the absolute, change to risk weights in response to a given change in underlying risk. For example, in response to an increase in W from 2% to 4% (a 100% increase), if the securitization risk weight under one model increases from 20% to 70% (a 250% increase) and the securitization risk weight under another model increases from 120% to 170% (a 41.67% increase), the first model is significantly more risk sensitive than the second even though the absolute change is 50 percentage points under both.

2. SEC-SA is *less* well-calibrated than SSFA in assigning risk weights.

The securitization capital surcharge is 50% under SSFA and 100% under SEC-SA. Given this enormous difference, both cannot be considered well-calibrated. However, it is clear that as between the two, SEC-SA is the less well-calibrated model.

As noted above, the SEC-SA model is parameterized by only two risk measures, t (tranche position) and K_A. The model contains only one calibration parameter, the p-factor, which must stand in for all the relevant variables that the SEC-SA model omits. The p-factor calibrates the underlying risk-weighting function's rate of exponential decay $\left(-\frac{1}{pK_A}\right)$, which controls the rate at which marginal risk weights decline as tranche position increases in seniority.[38] By setting the p-factor equal to 1.0, the NPR effectively eliminates the model's only calibration parameter:

$$\left(-\frac{1}{pK_A}\right) \rightarrow \left(-\frac{1}{1*K_A}\right) \rightarrow \left(-\frac{1}{K_A}\right)$$

Thus, marginal risk weights under SEC-SA are based solely on K_A and seniority in the securitization's capital structure. The NPR offers no data or narrative support for leaving SEC-SA uncalibrated. Clearly, some form of calibration is required to account for the other relevant inputs omitted by the model.[39] Indeed, the Agencies recognized the need to calibrate the model when they included a 0.5 p-factor under SSFA. However, even with this attempt at calibration, the paucity of the SSFA model led the Agencies to state that they:

> expect banking organizations to use the SFA rather than the SSFA in all instances where data to calculate the SFA [the supervisory formula approach] is available. ... A banking organization should be able to explain and justify (for example, based on data availability) to its primary Federal supervisor any instances in which the banking organization uses the SSFA rather than the SFA for its securitization exposures.[40]

As the Agencies acknowledged in the Basel III Adopting Release, the SSFA model is "a simplified version of the supervisory formula approach (SFA) in the advanced approaches rule, to assign risk weights to securitization exposures."[41] The SFA model utilizes highly-relevant inputs omitted by the SSFA, including the effective number of underlying exposures (N) and the exposure-weighted average loss given default ($EWALGD$).[42]

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[38] *See* Appendix A for a further discussion of the risk-weighting function.

[39] As noted in the Introduction, these include: (i) the weighted average life of the securitization exposure, (ii) the weighted average term to maturity of the underlying exposures, (iii) the probability of default, and the expected loss given default, of the underlying exposures, (iv) the number and granularity of the underlying exposures, (v) correlation measures with respect to the underlying exposures, and (vi) structural features and complexity.

[40] *See* Basel III Adopting Release, at 62141.

[41] *Id.* at 62118.

[42] *See* Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks ("Regulation Q"), Supervisory Formula Approach (SFA), 12 C.F.R. § 217.143. Under the Proposed Rule, the Advanced Approaches (which includes SFA) would be eliminated and replaced with the expanded risk-based approach (which includes SEC-SA).

Noting the "enhanced risk measurement under the SFA compared with the SSFA,"[43] the Federal Reserve's supervisory guidance requires banks to provide "robust justification for not applying the SFA."[44] If a robust justification is required for a bank to use the calibrated SSFA model, surely a robust justification is required for a proposal to use an effectively uncalibrated, and therefore much more stringent, version of the SSFA model in the new enhanced risk-based approach. The NPR offers no quantitative or qualitative justification for its proposal to use an uncalibrated model.

This result again illustrates the larger point made in the BPI-ABA Letter that the expanded risk-based approach is incorrectly calibrated. As explained below in Part I.B.3., the effective removal of the calibration parameter from SEC-SA, and the reduced risk sensitivity of that model, lead to anomalous and arbitrarily high risk weights that do not correspond to any reasonable measure range of future net credit losses.

We respectfully suggest that there is no justification for utilizing an effectively uncalibrated version of the SSFA model in the new expanded risk-based approach, an approach that is intended to be better calibrated than the standardized approach. The SFA urges the Agencies to calibrate SEC-SA by setting the p-factor back to 0.5.

3. A p-factor of 1.0 causes anomalous and arbitrarily high risk weights.

Not surprisingly, the uncalibrated and less risk-sensitive SEC-SA model leads to risk weights that are anomalous and arbitrarily high. As noted above, the p-factor is effectively the amount of a securitization capital surcharge[45] imposed by the SSFA and SEC-SA models. Before any defaults on the underlying exposures (*i.e.*, when $W = 0$):

- Where $p = 0.5$, the securitization capital surcharge is 50%.
- Where $p = 1.0$, the securitization capital surcharge is 100%.

The NPR contains no data or narrative description that explains why any securitizaton capital surcharge is necessary or why it needs to double under SEC-SA.[46] In addition, as we discuss in Part III.B., as losses on the underlying exposures begin to occur, the securization capital surchage under both the SEC-SA and SSFA models increases rapidly due to the punitive 0.5 scaling factor applied to defaulted underlying exposures in the formula $K_A = (1 - W) * K_G + (0.5 * W)$. That scaling factor effectively applies a 50% capital requirement (625% risk weight) to underlying exposures belonging to the W bucket (as compared to the NPR's proposed 150%

[43] *See* Supervisory Guidance for Implementation of the Simplified Supervisory Formula Approach for Securitization Exposures under the Advanced Approaches Risk-Based Capital Rule 2 (May 18, 2015), https://www.federalreserve.gov/bankinforeg/basel/files/bcc1501.pdf.

[44] *Id.*

[45] As noted above, the "securitization capital surcharge" is the percentage increase of a bank's capital requirement if the bank held every tranche of a securitization rather than directly holding the underlying exposures in its unsecuritized portfolio.

[46] Moreover, as noted in the Introduction, this doubling of the securitization capital surcharge exacerbates the double counting effect arising from the interaction between the market risk capital rule (which would incorporate SEC-SA in capturing the risk of market losses from trading operations) and the GMS component of the Federal Reserve's SCB requirement (which also captures such losses).

risk weight for defaulted loans). This punitive treatment of defaulted underlying exposures is excessive and aribitrary in its own right, and is greatly exacerbated by (1) the doubling of the *p*-factor under SEC-SA and (2) the failure of the NPR to decrease the 0.5 scaling factor in light of its proposed increase of the *p*-factor.

The effect of these anomalies is a capital requirement that is far out of proportion with the peak default rates on commonly-securitized assets. We illustrate this in the table below with respect to two commonly securitized asset types: (1) auto loans and (2) credit card receivables. Specifically, the table considers:

- The highest 90+ day delinquency rate for the asset type observed during the aftermath of the GFC;
- The capital requirement that would apply if the bank held the entire pool in its unsecuritized portfolio; and
- The capital requirement that would apply if the bank held all the tranches of a securitization backed by that same pool.

	Standardized Approach		Expanded Risk-Based Approach	
GFC High 90+ Day Delinquency Rate[47]	**Unsecuritized Portfolio Capital Requirement**	**SSFA Capital Requirement**	**Unsecuritized Portfolio Capital Requirement**	**SEC-SA Capital Requirement**
Auto Loans: 5.27%	8.2%[48]	15.6%	7.1%[49]	18.2%
Credit Cards: 13.74%	8.5%[50]	20.7%	7.5%[51]	25.5%

Note that when the Agencies adopted SSFA, the effect of the GFC and subsequent deep recession on default rates for commonly-securitized assets was well known. As in the table above, the SSFA's *p*-factor of 0.5 leads to securitization capital requirements that are approximately 1.9 to 2.4 times the unsecuritized portfolio capital requirement, and that are approximately 1.5 to 3.0 times the highest 90+ day delinquency rates observed during the worst recession since the Great Depression. These already excessive securitization capital requirements are increased even further under SEC-SA even though the capital requirement for underlying exposures has been reduced.

By doubling down on the *p*-factor, the Proposed Rule would significantly increase the cost of securitizing the loans that consumers and small businesses rely on. The resulting higher costs

[47] See footnote 8 above for the data source.
[48] 0.0527*1.5+(1-0.0527)*1=102.6% risk weight, which corresponds to a 8.2% capital requirement.
[49] 0.0527*1.5+(1-0.0527)*0.85=88.4% risk weight, which corresponds to a 7.1% capital requirement.
[50] 0.1374*1.5+(1-0.1374)*1=106.9% risk weight, which corresponds to a 8.5% capital requirement.
[51] 0.1374*1.5+(1-0.1374)*0.85=93.9% risk weight, which corresponds to a 7.5% capital requirement.

and reduced availability of such loans will have real-world impacts. The NPR provides no data or explanation to justify those impacts.

Below are two concrete examples that illustrate the anomalous and arbitrarily high risk weights assigned under SEC-SA with respect to specific securitization exposures. In the first example, a bank is the lender to an SPE that holds prime auto loans. This example highlights the arbitrarily high risk weights that SEC-SA assigns to securitizations backed by prime retail assets. In the second example, a bank is an investor in the mezzanine tranche of a residential mortgage-backed securitization. This example highlights the increasingly anomalous and arbitrarily high risk weights assigned by SEC-SA as underlying exposures default.

a. *Example: SEC-SA assigns anomalous and arbitrarily high risk weights to bank loans made to SPEs holding prime credit quality retail assets such as prime auto loans.*

Banks commonly lend to SPEs that hold loans. For example, an auto loan originator will typically transfer auto loans to a warehouse SPE pending their inclusion in a take-out term securitization. Generally, a warehouse SPE will obtain bank financing to acquire those auto loans. The purchaser of an auto loan portfolio in a whole loan sale transaction will frequently use an SPE to acquire auto loans in a similar fashion.

In these situations, the bank's loan to the SPE is a securitization exposure with a detachment point, D, of 1. The attachment point, A, will primarily depend on the lending facility's applicable advance rate. When the advance rate is higher, the attachment point is lower and *vice versa*.[52]

Where D equals 1, both SSFA and SEC-SA assign risk weights that increase as the attachment point, A, decreases. This result effectively penalizes banks for lending against underlying exposures with higher credit quality, such as prime auto loans, because such exposures have a generally higher advance rate (and, therefore, a lower attachment point) than loans against underlying exposures with lower credit quality, such as subprime auto loans. Net credit losses for prime auto loans range from 0.5% (post-GFC low) to 2.0% (GFC high).

The proposed increase in the p-factor to 1.0 under SEC-SA significantly exacerbates this anomaly. The following table displays the risk weights assigned under SSFA and SEC-SA to a bank loan to an SPE holding prime auto loans. Given the high credit quality of the underlying assets, the advance rate is high; for prime auto, a typical advance rate is 87.5%. This 87.5% advance rate corresponds with an attachment point, A, of 12.5% (100%-87.5%). As shown in the table, the securitization exposure risk weight under SEC-SA is more than *twice* under SSFA, even though the risk weight for auto loans is lower under SEC-SA (85%) than under SSFA (100%).

[52] For example, if the advance rate is 80% and the outstanding principal balance of the underlying exposures is $1,000,000, the maximum loan amount would be $800,000 and the attachment point corresponding to the maximum loan amount would be 20% (100% - 80%).

	SSFA (Existing standardized approach)	SEC-SA (Proposed Expanded Risk Based Approach)
Collateral	Prime auto loans	Prime auto loans
Underlying risk weight of collateral	**100%**	**85%**
K_G	**8.0%**	**6.8%**
W (90+ day delinquencies, etc.)	0%	0%
K_A	8.0%	6.8%
Advance Rate	87.5%	87.5%
A (Attachment point)	12.5%	12.5%
D (Detachment point)	100%	100%
Risk weight of securitization exposure	**20%**	**42%**
Capital requirement for securitization exposure	**1.6%**	**3.4%**
Net credit loss range	0.5% to 2.0%	0.5% to 2.0%

The 42% risk weight imposed by SEC-SA effectively doubles the regulatory capital the bank is required to hold relative to SSFA. The NPR contains no data or analysis that would support such a result. Moreover, the level of regulatory capital required by SEC-SA is notably excessive considering the 12.5%[53] cushion of economic capital already in place to absorb future net credit losses. Given the cumulative net loss rate of 0.5 to 2.0% for prime auto loans, the economic capital cushion is approximately 6 to 25 times[54] net credit losses. A risk weight of 42% imposes an additional, and excessive, capital burden equal to approximately 1.7 to 6.7 times[55] net credit losses.

Moreover, this anomalous result occurs under SEC-SA even though the credit risk weight applicable to the underlying exposures is *lower* under SEC-SA (85%) than under SSFA (100%). The result under SEC-SA is inconsistent both logically and in relation to one of the Basel Committee's primary goals: to make the securitization framework "broadly consistent with the underlying framework for credit risk."[56]

The anomaly highlighted in this example can be easily addressed by maintaining the *p*-factor at 0.5 under SEC-SA. Doing so would result in a significantly more reasonable risk weight of 15% and would align the amount of required capital more closely with the actual economic risks and regulatory capital objectives.

b. *Example: SEC-SA assigns increasingly anomalous and arbitrarily high risk weights as underlying exposures default.*

[53] The economic capital cushion is 1 minus the advance rate which, in this case, is 12.5%.
[54] $12.5\%/2\% \approx 6.25$ *and* $12.5\%/0.5\% = 25$.
[55] $(42\% * 8\%)/2\% = 1.68$ *and* $(42\% * 8\%)/0.5\% = 6.72$.
[56] *See* footnote 29 above.

Next, we consider the example in which a bank invests in the mezzanine tranche of a securitization backed by first-lien residential mortgages with loan-to-value ratios ("LTVs") between 60% and 80%. This asset-class has the same risk weight under both the standardized approach and the proposed expanded risk-based approach (50%). Nevertheless, as shown in the table below, the risk weights assigned under SSFA and SEC-SA diverge significantly as defaults (measured by W) increase.

	SSFA (Existing standardized approach)			**SEC-SA (Proposed Expanded Risk Based Approach)**		
Collateral	First lien residential mortgage loans 60%<LTV≤80%			First Lien residential mortgage loans 60%<LTV≤80%		
Underlying risk weight of collateral	50%			50%		
K_G[57]	4.0%			4.0%		
W	**1%**	**5%**	**10%**	**1%**	**5%**	**10%**
K_A	**4.5%**	**6.3%**	**8.6%**	**4.5%**	**6.3%**	**8.3%**
A (Attachment point)	12%			12%		
D (Detachment point)	50%			50%		
Risk weight of securitization exposure	**20%** (Floor applies; otherwise, 2.5%)	**20%** (Floor applies; otherwise, 17%)	**64%**	**27%**	**84%**	**188%**
Capital requirement for securitization exposure	**1.6%**	**1.6%**	**5.1%**	**2.2%**	**6.7%**	**15.0%**

In this example, SEC-SA produces risk weights that are up to four times those under SSFA. Moreover, SSFA's 20% floor obscures just how poorly calibrated SEC-SA is due to its p-factor value of 1.0.[58] If not for the floor, where W is 1%, the risk weight under SEC-SA would be more than an order of magnitude (10.8) times the risk weight under SSFA.

C. A higher p-factor diminishes the ability of banks to use credit risk transfer ("CRT") transactions to mitigate their credit risks.

[57] Recall that $K_A = (1 - W) * K_G + (W * 0.5)$. As noted in Part III.A., the definition of K_G does not specify that defaulted underlying exposures belonging to the W "bucket" may be disregarded in calculating K_G for the (1-W) bucket, thus resulting in the unreasonable double-counting of defaults. For the sake of simplicity, the K_G value of 4.0% used in this example does not reflect this double-counting effect.

[58] In fact, as noted above, a p-factor value of 1.0 effectively leaves SEC-SA uncalibrated.

A higher p-factor limits the ability of banks to use CRT transactions, which are a form of synthetic securitization, to mitigate credit risks associated with consumer and business loans. Credit protection offered by synthetic securitizations improves credit risk management, thereby enhancing the safety and soundness of banks and promoting overall financial stability.

In most synthetic securitizations, banks retain a very thick senior tranche. A higher p-factor significantly increases the size of the junior tranche that the bank must place with investors. For example, suppose a bank is buying credit protection on a portfolio of auto loans.

- Under SSFA, where K_G is 8% and W is 0%, the bank can achieve a 20% risk weight for a retained senior securitization exposure attaching at 12.5%.

- Under SEC-SA, where K_G is 6.8% and W is 0%, the bank can achieve the same 20% risk weight for a retained senior securitization exposure attaching at 18%. Although the applicable K_G is lower than under SSFA, the higher p-factor under SEC-SA requires a higher attachment point in order to achieve the same 20% risk weight.

As a result, the size of the junior tranche that must be placed with investors is much larger under SEC-SA than under SSFA. A larger junior tranche results in a higher interest rate that the bank must pay on the tranche. For the auto loan example referenced above, the following table illustrates the increased cost of protection based on indicative pricing spreads.

	Protection (Junior Tranche)	**Risk Weight (Senior Tranche)**	**Annual Cost per Dollar of Referenced Auto Loan**[59]
SSFA (p = 0.5)	0 - 12.5%	20%	0.79%
SEC-SA (p = 1.0)	0 - 18.0%	20%	0.87%

Note that the cost of credit protection for the same underlying auto loans increases by more than 10% under SEC-SA due to its p-factor of 1.0. We respectfully suggest that the new expanded risk-based approach should not make it more costly for banks to obtain credit protection on their assets.

D. A higher p-factor will negatively impact liquidity for the mezzanine and lower tranches of CRT bonds issued by GSEs.

Freddie Mac and Fannie Mae (the "GSEs") guarantee mortgage-backed securities and hence manage the credit risk associated with trillions of dollars' worth of residential mortgages.

[59] These figures are based on indicative pricing spreads for CRT junior tranches. Such spreads are subject to market conditions and may change over time.

By doing so, the GSEs provide liquidity and stability to the U.S. mortgage market, thus helping to make home loans available and affordable for millions of Americans.

Starting in 2012, the Federal Housing Finance Agency (the "FHFA"), which is currently serving as both the regulator and conservator of the GSEs, set a strategic objective for the GSEs to share mortgage credit risk with private investors through CRT transactions.

GSE CRT is a form of synthetic securitization. With GSE CRT, investors are not funding mortgages directly (that occurs via the pass-through certificates from Freddie Mac and Fannie Mae). Instead, CRT investors are participating alongside the GSEs through the securitization of a portion of the mortgage credit risk retained by the GSEs.

Banks, acting in their capacity as market makers, are pivotal to the GSE CRT market. Under the market risk rule, banks are required to hold capital against the securitization positions in their trading books. Because SEC-SA would be utilized under the market risk capital rule for calculating risk weights for securitization positions non-CTP,[60] its p-factor of 1.0 would significantly increase the capital requirement for GSE CRT that are held by banks as market makers.

The capital requirement for the mezzanine and lower tranches of GSE CRT transactions is particularly affected by the increase in the p-factor. This is because the low detachment points of those tranches cause their risk weights to be fully determined by the SEC-SA risk weighting function, which is governed by the p-factor.

Bank market making in GSE CRT is already severely constrained by the combination of the SSFA capital requirement and the punitive CCAR GMS capital charge. In the example below, we examine the capital treatment of two bonds issued in a vintage 2023 GSE CRT transaction. When added to SSFA and SEC-SA, the CCAR GMS capital charge causes the total capital requirement associated with the more junior bond (the BBB- rated bond) to be 152.40%, which is far in excess of the bank's maximum economic loss (as measured by its exposure amount). The increase in the p-factor to 1.0 under SEC-SA pushes the total capital requirement for the more senior bond (the A- rated bond) from 98.00% to 108.30%, which results in the bank's total capital requirement for that highly-rated bond exceeding its maximum economic loss.

	GSE CRT Vintage 2023 A- Rated Bond		**GSE CRT Vintage 2023 BBB- Rated Bond**	
Attachment Point	3.80%		2.63%	
Detachment Point	5.30%		3.80%	
Capital Requirement	*SSFA (p=0.5)* 77.10%	*SEC-SA (p=1.0)* 87.40%	*SSFA (p=0.5)* 100.00%	*SEC-SA (p=1.0)* 100.00%
plus				

[60] *See* NPR, at 64127 ("For consistency in the capital requirements for securitizations under either subpart D or subpart E of the capital rule and to recognize credit subordination, the proposed risk weights for securitization positions non-CTP are based on the risk weights calculated for securitization exposures under either subpart D or subpart E of the capital rule.")

	GSE CRT Vintage 2023 A- Rated Bond		GSE CRT Vintage 2023 BBB- Rated Bond	
CCAR GMS	20.90%	20.90%	52.40%	52.40%
equals	*SSFA (p=0.5)*	*SEC-SA (p=1.0)*	*SSFA (p=0.5)*	*SEC-SA (p=1.0)*
Total Capital Requirement	98.00%	108.30%	152.40%	152.40%

The effect of raising the capital requirement for the mezzanine and lower tranches is to make it much more expensive for banks, acting in their capacity as broker-dealers, to maintain a sufficient inventory of such bonds in their trading books. The increase in the *p*-factor under SEC-SA, when coupled with the CCAR GMS capital charge, may cause banks to abandon market making in GSE CRT altogether. As a result, the market liquidity for GSE CRT bonds would be substantially reduced and spreads would widen, thus increasing the cost to GSEs of reducing their credit risks.

This result would frustrate the FHFA's objective and lead to an increase in the concentration of mortgage credit risks in the GSEs. This would, in turn, impair the ability of the GSEs to provide liquidity and stability to the mortgage markets, thus driving up the costs and reducing the availability of mortgage loans. As a result, a considerable burden would be placed on everyday Americans, further intensifying the challenges of high mortgage loan interest rates and the scarcity of affordable housing.

E. A higher *p*-factor would harm the international competitiveness of U.S. banks.

The Proposed Rule's expanded risk-based approach provides U.S. banks with only one method for assigning risk weights to securitization exposures: SEC-SA. In contrast, the Basel III Endgame standards adopted in other major jurisdictions include not only SEC-SA, but also an internal ratings-based approach ("SEC-IRBA") and an external ratings-based approach ("SEC-ERBA").[61] Furthermore, the Basel III Endgame standards give preferential risk weights to simple, transparent, and comparable ("STC") securitizations, a category that is not recognized under the Proposed Rule.

As noted in Part I, SEC-SA assigns risk weights to securitization exposures based solely on two risk measures, tranche position and K_A, and one calibration parameter, the *p*-factor. Unlike SEC-IRBA and SEC-ERBA, SEC-SA disregards, among other things, the expected future performance of the underlying exposures. Accordingly, SEC-SA is much less risk sensitive than the approaches available in other jurisdictions. Furthermore, as explained in Part I.B.1, due to its *p*-factor value of 1.0, SEC-SA is less risk-sensitive than SSFA.

As a result of these differences, SEC-SA (with its *p*-factor value of 1.0) produces significantly higher risk weights for the same securitization exposure than the other securitization risk-weighting

[61] We note that the Dodd-Frank Act prohibits the use of external credit ratings in bank regulatory capital requirements.

methods, which are available only to non-U.S. banks. The jurisdictional differences in risk weights, and the resulting impact on the competitiveness of U.S. banks, are well-illustrated by the following example published by SIFMA.[62]

> As an illustrative example, banks lend to [securitization SPEs of] prime auto loan originators at an advance rate of c. 88% (i.e., the bank lends $88 collateralized by $100 of prime auto loans; losses on the loans would therefore need to exceed $12 for the bank to suffer any impairment on its loan). This lending would generally be rated AAA by the rating agencies which is commensurate with the over-collateralization (i.e., the $12 in the prior example) being sufficient to cover 4-5x historical losses. The table below compares the risk weight for this lending under the current U.S. capital rules, the [Proposed Rule] and the approaches available to banks in other jurisdictions for the same lending.

Jurisdiction	**Approach**	**Risk Weight**
U.S.	Current Rules [SSFA (p-factor = 0.5)]	21%
U.S.	*[Proposed Rule] [SEC-SA (p-factor = 1.0)]*	*45%*
Europe[63]	Internal Ratings Based	15%
Europe	External Ratings Based	18%
Canada	Internal Ratings Based	15%
Canada	External Ratings Based	15%
Canada	STC	10%

Federal Reserve Board Governor Bowman expressed concern about precisely this kind of "potential harm to U.S. bank competitiveness in the global economy."[64] One of the primary goals of international regulatory capital rules, as Governor Bowman pointed out, is to "improve competitive equity in banking markets."[65] The vast disparity in securitization risk weights faced by large U.S. banks in comparison to their international competitors directly contradicts that goal.

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[62] *See* Guowei Zhang & Chris Killian, SIFMA, *How the Basel III Endgame Could Impair Securitization Markets and Harm US Businesses and Consumers* (Nov. 28, 2023), https://www.sifma.org/resources/news/how-the-basel-iii-endgame-could-impair-securitization-markets-and-harm-us-businesses-and-consumers/.

[63] STS for Europe is not included due to the requirement that securitization parties be EU-domiciled, a requirement that U.S. prime auto loan financing would not meet.

[64] *See* Michelle W. Bowman, Federal Reserve Board of Governors, Remarks on the Economy and Prioritization of Bank Supervision and Regulation at New York Bankers Association's Financial Services Forum (Nov. 9, 2023), https://www.federalreserve.gov/newsevents/speech/bowman20231109a.htm.

[65] *Id.*

II. The *p*-Factor Should be Set at 0.25 for Qualifying Securitization Transactions ("QSTs").

As noted in Part I.A., the U.S. capital rule does not distinguish between STC and non-STC securitizations. Thus, the NPR's proposed increase of the *p*-factor from 0.5 to 1.0 is not the equivalent of aligning the U.S. standard with the Basel standard. Moreover, as noted in Part I.A., on June 27, 2023, the European Parliament and Council approved a measure that would lower the *p*-factor from 0.5 to 0.25 for STC securitizations, and from 1.0 to 0.5 for non-STC securitizations.

The Agencies should follow a similar approach here. However, the STC criteria are needlessly stringent and prescriptive. Indeed, the European Banking Authority has proposed "targeted amendments" to the STS criteria,[66] because "experience with the practical implementation of these requirements identified a need to amend and 'update' the existing guidance, to ensure further clarity and to reflect on the practical implementation of the requirements."[67] Examples cited by the European Banking Authority include:

- The requirement that a sample of the underlying exposures shall be subject to external verification by "an appropriate and independent party" (unclear). Now proposed to be clarified by a provision that "For the purposes of Article 22(2) of Regulation (EU) 2017/2402, an appropriate and independent party should be deemed to be a party that meets both of the following conditions: a. it has the experience and capability to carry out the verification; b. it is none of the following: i. a credit rating agency; ii. a third party verifying STS compliance in accordance with Article 28 of Regulation (EU) 2017/2402; iii. an entity affiliated to the originator, sponsor, investor or SSPE".

- The requirement that the debtor shall, at the time of transfer of the exposures, have made at least one payment (problematic for single exposures). Proposed further guidance will provide that "further advances and drawings in terms of one exposure or a restructuring of the same exposure to a certain borrower should not be deemed to trigger a new 'at least one payment' requirement with respect to such an exposure."

A. Streamlined criteria should apply to QSTs.

We propose that the new enhanced risk-based approach recognize "qualifying securitization transactions" ("QSTs") and assign a *p*-factor of 0.25 to QSTs and 0.5 to non-QSTs. For a traditional or synthetic securitization to qualify as a QST:

- Junior liabilities must not have payment preference over senior liabilities which are due and payable. In other words, the securitization must not be structured as a "reverse"

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[66] *See* EUR. BANKING AUTH., GUIDELINES ON THE STS CRITERIA FOR ON-BALANCE-SHEET SECURITISATION 6 (2023), https://www.eba.europa.eu/sites/default/files/document_library/Publications/Consultations/2023/Consultation%20on%20draft%20Guidelines%20on%20the%20STS%20criteria%20for%20on-balance-sheet%20securitisations/1054818/CP%20on%20draft%20Guidelines%20on%20the%20STS%20criteria%20for%20on-balance-sheet%20securitisations.pdf.

[67] *Id.* at 6–7.

cash flow waterfall such that junior liabilities are paid when due and payable senior liabilities have not been paid.

- The underlying exposures must be of the same asset class. For example, in a securitization of auto receivables, all the underlying assets must be auto loans and/or leases and related property. No other asset types (equipment loans, floorplan loans, etc.) may be included in the underlying pool.

- If the bank is not the originator of the underlying exposures, a minimum of 5 years of historical performance data for underlying exposures with substantially similar risk characteristics to those being securitized must be evaluated by the bank.

- Both the originator and servicer of the underlying exposures must have a minimum of 5 years of experience as an originator or a servicer, respectively.

- The transaction documents contain a representation and warranty to the effect that, at the time of the final cut-off date of the securitized portfolio, no underlying exposure is greater than 30 days delinquent and no underlying exposure is in default, in each case as defined by the transaction agreements for the securitization.

- The performance of the underlying exposures is described in a monthly report required by the transaction documents.

- For securitizations featuring a revolving period, the transaction documents must contain provisions for early amortization events and/or triggers to terminate the revolving period.

- For traditional securitizations, a legal opinion as to the legal isolation of the underlying exposures from the transferor must be delivered in accordance with the transaction documents. For synthetic securitizations, an enforceability opinion must be delivered in accordance with the transaction documents.

Securitizations that satisfy the QST criteria are much simpler in form and substance than other types of securitizations. Like the STC framework under Basel, the QST framework helps to reduce the risks associated with, among other things, complex or unusual structures and underlying assets that are heterogeneous or delinquent. As the Basel Committee stated, "[all] other things being equal, a securitization with lower structural risks needs a lower capital surcharge than a securitization with higher structural risks; and a securitization with less risky underlying assets requires a lower capital surcharge than a securitization with riskier underlying assets."[68]

The risks inherent in QSTs are more straightforward to evaluate and incorporate into the SEC-SA risk-weighting model. Risk weights for QSTs do not require the same degree of supervisory adjustment as do more esoteric forms of securitization. As a result, QSTs warrant a lower value for the supervisory calibration parameter, p.

[68] *See* BANK FOR INT'L SETTLEMENTS, at note 30 above.

A lower p-factor for QSTs than for non-QSTs would also help to better calibrate the SEC-SA model by enabling it to reflect differences in risk not captured by the other model parameters (K_A and tranche position). Enhanced risk sensitivity is a key objective of the new expanded risk-based approach.

We also urge the Agencies not to adopt the third-party certification and regulatory notification process currently in place for STS securitisations in Europe. The streamlined QST approach outlined above would make it much easier for banks and other market participants to reliably ascertain the QST status of any securitization. Moreover, the Agencies can rely on the bank supervisory process to ensure banks are implementing the standards for "qualifying securitizations" in a safe and sound manner.

Finally, we note that our QST proposal is not merely a technical adjustment to the SEC-SA model. The QST criteria describe the types of securitizations that finance auto loans, credit card loans, mortgage loans and other types of consumer loans. A lower p-factor for these consumer credit financing securitizations would incentivize the healthy and responsible growth of such securitizations, make such securitizations more capital efficient, and lead to lower borrowing costs and expanded credit availability for consumers.

B. QST treatment should be applicable to bank-sponsored securitizations.

In addition to securitizations meeting the above criteria, QST treatment should also be applicable to any securitization exposure held by an originating bank in connection with a traditional or synthetic securitization sponsored by that bank where the underlying exposures were originated by that bank. In such circumstances, the characteristics of the underlying exposures are inherently more transparent to the bank than to any other party. Furthermore, as the sponsor, the bank plays a central role in structuring and designing the securitization and has a heightened understanding of its characteristics and risk profile. Therefore, the Proposed Rule should be revised to include a reduced p-factor for any related securitization exposures.

III. The Definitions of K_G and K_A Produce Anomalous and Arbitrary Results and Should Be Revised.

A. K_G and K_A double count underlying exposures captured by parameter W.

Under SEC-SA:

- K_G is defined, in relevant part, as "the weighted average (with the outstanding balance used as the weight for each exposure) total capital requirement, expressed as a decimal value between zero and one, *of the underlying exposures calculated using this subpart E.*"[69]

- K_A is defined by the formula $(1 - W) * K_G + (W * 0.5)$,[70] where W is the proportion of the underlying exposures that are defaulted or seriously delinquent.[71]

When an underlying exposure defaults and is moved to the W "bucket" under the formula for K_A, neither that formula, nor the definition of K_G, specifies that the defaulted underlying exposure may be disregarded in calculating K_G for the $(1 - W)$ bucket. This effectively double-counts the defaulted exposure. Not only does the defaulted exposure receive the equivalent of a 625% risk weight when it is moved to the W bucket (as described below in Part III.B.), its underlying 150% risk weight as a "defaulted exposure" under the Proposed Rule[72] is still included when calculating the capital requirement for the underlying exposures in the $(1 - W)$ bucket (the proportion of the underlying exposures that are performing).

The double counting of defaulted underlying exposures is arbitrary and unreasonable. The Agencies should revise the definition of K_G to make clear that underlying exposures included in the calculation of W need not be included in the weighted average capital requirement calculation described in the definition of K_G.

B. The treatment of defaulted underlying exposures under K_A is arbitrary and unreasonably punitive.

The NPR explains that K_A is intended to "reflect the delinquency-adjusted, weighted-average capital requirement of the underlying exposures."[73] The NPR, however, makes this adjustment by assigning an arbitrary scaling factor of 0.5 to W, the parameter relating to defaulted and seriously delinquent exposures. Thus, K_A effectively assigns a 50% capital requirement (625% risk weight) to such exposures.

This punitive treatment of defaulted underlying exposures is aribitrary and excessive. Neither the NPR nor the Basel III Adopting Release contains any data or narrative description supporting the 0.5 value or what it is intended to represent. The effect of that scaling factor is to

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[69] *See* Proposed Rule, §___.133(b)(2) (emphasis added).
[70] *See* Proposed Rule, §___.133(b).
[71] *See* Proposed Rule, §___.133(b)(1).
[72] *See* Proposed Rule, §___.111(i). The Proposed Rule introduces a definition of "defaulted exposure" and, unlike the standardized approach, differentiates between retail and non-retail exposures. *See* Proposed Rule, §___.101(b).
[73] *See* NPR, at 64070.

assign a 625% risk weight to defaulted exposures for purposes of the SEC-SA model, a risk weight far in excess of the 150% risk weight for such exposures under the proposed general credit risk standard. Moreover, as noted Part I.B.3. above, the punitive effect of the 0.5 scaling factor is greatly exacerbated by the doubling of the p-factor under SEC-SA.

Proper calibration of the model involves setting appropriate values for all three of the constant-value parameters: the p-factor, the risk weight floor and the scaling factor for defaulted exposures (W) in K_A. As discussed in Part I, we recommend setting the p-factor back to 0.5 (and to 0.25 for QSTs). For K_A, the scaling factor value of 0.5 should be replaced with 0.12, to align it with the capital requirement for "defaulted exposures" under the Proposed Rule.[74]

C. K_G and K_A should not include defaulted underlying exposures that serve as excess collateral.

In most securitization facilities in which a bank acts as lender to an SPE, defaulted underlying exposures are not eligible to be included in the borrowing base (*i.e.*, the SPE cannot borrow or maintain existing advances against them). Despite being defaulted, out of an abundance of caution, these underlying exposures frequently remain SPE assets and serve as excess collateral for the benefit of the lending bank. This collateral retains economic value, even though it is not borrowing base eligible.

Similarly, in many term securitization transactions, excess spread and other forms of credit enhancement are used to reduce the principal balance of asset-backed securities by the amount of defaults on underlying exposures. Where these underlying exposures remain in the SPE, they continue to serve as collateral for investors, including investing banks.

If defaulted underlying exposures remain in the SPE, they can have a substantial impact on the amount of capital the lending bank or investing bank must maintain against its securitization exposure. This is because they are included in the definitions of K_G and K_A, which significantly increases the related capital requirement, particularly given the punitive treatment of defaulted underlying exposures as described above in Parts III.A. and III.B. This increase is especially pronounced under SEC-SA due its p-factor of 1.0. Thus, banks will be incentivized to remove defaulted underlying exposures from SPEs, despite their serving as excess collateral for the bank's protection.

For example, suppose that a bank has a lending facility with a securitization SPE borrower that holds underlying exposures with an aggregate outstanding principal balance of $1,000, all of which are borrowing base eligible. Assume that the advance rate under this facility is 85% and that $850 has been advanced by the bank. Finally, assume that $K_G = 8\%$ and $W = 0\%$. The related securitization risk weight calculations under SSFA and SEC-SA are as follows:

- $A = \frac{\$1{,}000 - \$850}{\$1{,}000} = 0.15$ and $D = 1.00$

[74] *See* Proposed Rule, §___.111(i), which assigns a 150% risk weight to "defaulted exposures." The related capital requirement is 12% (150% *times* 8%).

- $K_A = 8\%$
- $RW_{SSFA} = 20\%$ (Floor applies, otherwise 10.22%.)
- $RW_{SEC-SA} = 49\%$

Now assume that two percent of the underlying exposures default ($W = 2\%$) and that those exposures drop out of the borrowing base but remain in the bank's collateral pool. The borrowing base shrinks to $980, and the $850 in advances are reduced to 85% * $980 = $833. Now:

- $A = \frac{\$1{,}000 - \$833}{\$1{,}000} = 0.17$ and $D = 1.00$
- $K_A = 8.84\%$ [75]
- $RW_{SSFA} = 20\%$ (Floor applies, otherwise 11.20%.)
- $RW_{SEC-SA} = 55\%$

Both SSFA and SEC-SA impose a capital charge penalty for retaining defaulted underlying exposures as "excess collateral" for the benefit of the bank.[76] That penalty is much more apparent under SEC-SA due to its p-factor of 1.0. As a result, the Proposed Rule would incentivize banks to seek the removal of defaulted, but still economically valuable, underlying exposures from the collateral pool.

The capital rules should not encourage banks to relinquish collateral in this way. When an underlying exposure defaults, the Proposed Rule should provide that such underlying exposure does not need to be included in the calculation of K_G or K_A if:

- in the case of a securitization lending facility, the underlying exposure is removed from or otherwise not included in the borrowing base and the principal amount of advances, if any, against it are repaid; and
- in the case of a term securitization, the principal balance of the related asset-backed securities is repaid by an amount corresponding to the amount of the defaulted exposure.

If defaulted underlying exposures are removed from the calculation of K_G and K_A as described above, the outstanding principal balance of those exposures should also be excluded from the calculation of the attachment point (A) and detachment point (D). This will ensure that

[75] Recall that $K_A = (1 - W) * K_G + (W * 0.5)$. As noted in Part III.A., the definition of K_G does not specify that defaulted underlying exposures that belong to the W "bucket" may be disregarded in calculating K_G for the $(1 - W)$ bucket, thus resulting in the unreasonable double-counting of defaults. For the sake of simplicity, the K_A value in this example does not reflect this double-counting effect.

[76] In this example, the penalty under SSFA is masked by the 20% risk weight floor.

defaulted underlying exposures that serve as excess collateral are effectively removed from all calculations relating to SEC-SA.

Continuing with the hypothetical example above, under our proposal, the $20 of defaulted underlying exposures could remain in the collateral pool but are derecognized for purposes of the SSFA and SEC-SA calculations.

- $A = \frac{\$980-\$833}{\$980} = 0.15$ and $D = 1.00$
- $K_A = 8\%$
- $RW_{SSFA} = 20\%$ (Floor applies, otherwise 10.22%.)
- $RW_{SEC-SA} = 49\%$

Thus, the level of credit enhancement and the risk weights are back to where they were before any defaults occurred, but now the lending bank has the benefit of excess collateral equal to the economic value (liquidation proceeds, recoveries, etc.) of the defaulted assets that are no longer in the borrowing base. Of course, the bank could get back to the original level of credit enhancement and risk weights by removing the defaulted underlying exposures altogether, but the bank would lose whatever value those exposures have as excess collateral.

D. The Agencies should confirm that delinquent underlying exposures that are modified and become reperforming are not included in parameter *W*.

Under the Proposed Rule, an underlying exposure would be assigned to the W parameter under the K_A calculation if it is 90 days or more past due, has contractually deferred payments for 90 days or more, or is in default.[77] We do not interpret that provision (or believe that the Agencies intend that provision) as continuing to include underlying exposures that are modified and subsequently reperform. When a loan is modified to help a struggling borrower get back on track, and when the borrower has demonstrated sustained repayment performance under the modified terms of the loan, the loan no longer represents the type of non-performing asset that the definition of W describes. To continue to include such a loan in W would needlessly raise the cost of securitization financing, and thus the cost of loans, to those who have sustained a temporary setback but have gotten back on track.

We note that the definition of W is defined differently than, and does not cross-reference, the definitions of "defaulted exposure" or "defaulted real estate exposure." However, we are concerned about the possibility of interpretive confusion. Although the definitions have certain overlapping elements, underlying exposures that meet the definition of "defaulted exposure" or "defaulted real estate exposure" may not meet the definition of W, and *vice versa*.

We respectfully request that any final rule (or the Agencies' preamble to the adopting release) should make clear that the definition of W and the definitions of "defaulted exposure" and "defaulted real estate exposure" are separate and distinct definitions. Moreover, any final rule (or

[77] *See* Proposed Rule, §___.133(b)(1).

the preamble to the adopting release) should confirm our understanding (and what we believe to be the Agencies' intent); namely, that a defaulted or delinquent underlying exposure can be removed from the calculation of W if the exposure has been modified and reasonable assurance of repayment has been demonstrated by a sustained period of repayment performance (a minimum of six months in accordance with the contractual terms of the modified exposure). These clarifications will help to ensure comparability in the calculation of securitization risk weights across banking organizations.

E. The positive current exposures from interest rate and exchange rate derivatives should not be included in the calculation of K_G.

Unlike the calculation of K_G under SSFA, the NPR proposes to include in the numerator, but not the denominator of K_G the positive current exposure of interest rate and exchange rate derivative contracts *times* the risk weight of the related counterparty *times* 0.08.[78] The Agencies state that including that amount in both the numerator and denominator "could reduce the capital requirement of securitization exposures even though interest rate and exchange rate derivative contracts do not provide any credit enhancement to a securitization."[79]

Although the Agencies explain why they do not propose to include derivative contracts in the denominator of K_G, the Agencies do not explain why they propose to include derivative contracts in any portion of the K_G calculation. As a result, our ability to comment on the Agencies' reasoning is compromised.

Even if it is appropriate to include the positive current exposure of interest rate and exchange rate contracts in the calculation of K_G, that exposure amount should be included in the denominator as well as the numerator. We disagree with the premise that such exposure amount must be excluded from the denominator because interest rate and exchange rate derivatives do not provide any credit enhancement to a securitization. Payments under such derivatives are a component of excess spread, which is a significant source of (first loss) credit enhancement in securitization transactions. Indeed, without such derivatives, the credit enhancement provided by excess spread could be eliminated by unfavorable changes in interest rates or exchange rates.

Moreover, we note that requiring banks to calculate the positive current exposure of an interest rate or exchange rate derivative contract presents a significant operational burden. The information necessary to calculate the positive current exposure is not readily available from the other sources of information used to calculate risk weights generally, such as monthly servicing reports, trustee reports, or data from providers such as Intex and Bloomberg.

F. For purposes of the calculation of K_G, the 1.5 multiplier for currency mismatches should not apply.

The Proposed Rule would impose a new requirement on banks to apply a multiplier of 1.5 to the risk weight (subject to a maximum risk weight of 150%) assigned to real estate exposures[80]

[78] *See* Proposed Rule, §___.133(b)(2)(i).
[79] *See* NPR, at 64070.
[80] *See* Proposed Rule, §___.111(f)(9).

and retail exposures[81] that contain currency mismatches between the bank's lending currency and the borrower's source of repayment. This requirement is intended to "reflect the borrower's increased risk of default to the borrower's exposure to foreign exchange risk … [and] would apply to exposure types where the borrower generally does not manage or hedge its foreign exchange risk."[82]

We agree with the BPI-ABA Letter's comments on the multiplier for currency mismatches.[83] With respect to its specific application to securitization, the definition of K_G should be revised to make clear that the multiplier for currency mismatches should not apply. Securitized pools contain a diversified and granular set of underlying exposures. This diversification mitigates the idiosyncratic risk associated with any single exposure, including those with currency mismatches. The arbitrary nature of a fixed 1.5 multiplier as applied to a single exposure is compounded in the context of securitization, where diversification already mitigates idiosyncratic risk.

In addition, applying this individual exposure-specific multiplier in the context of securitization would add considerable complexity to the calculation of K_G under SEC-SA. To calculate K_G, a bank would have to consider, on a loan by loan basis, whether the underlying obligor has a source of repayment in the currency of the loan equal to at least 90% of the annual payment from either income generated through ordinary business activities or from a contract with a financial institution that provides funds denominated in the currency of the loan. This complexity is compounded where the bank holding the exposure is not the bank that originated the exposure.

Finally, as we have already noted, SSFA and SEC-SA both impose a significant capital surcharge on securitization exposures. Whatever incremental risk is posed to a securitization exposure arising from idiosyncratic currency mismatch risks at the underlying exposure level is more than covered by that surcharge.

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[81] *See* Proposed Rule, §___.111(g)(3).

[82] *See* NPR, at 64053.

[83] We also note that the description of the multiplier with respect to real estate exposures under §___.111(f)(9) is somewhat different than the description with respect to retail exposures under §___.111(g)(3). Moreover, it is unclear how the "90 percent of the annual payment amount from … income generated through ordinary business activities" prong would apply to natural persons who are not engaged in any business activities.

IV. The Risk Weight Floor for Resecuritizations Should Not Apply to Senior/Senior Resecuritizations.

The Proposed Rule specifies a 100% risk weight floor for resecuritization exposures.[84] That floor should not apply if:

- The resecuritization exposure is a senior securitization exposure;[85] and
- The underlying exposures are also senior securitization exposures.

The NPR states that the 100% risk weight floor for resecuritizations "is intended to capture the greater complexity of such exposures and heightened correlation risks inherent in the underlying securitization exposures."[86] The NPR explains that:

> In a typical securitization exposure that is not a resecuritization, each underlying exposure is subject to idiosyncratic default risks (for example, the employment status of each obligor) which may exhibit lower relative default correlation. In a resecuritization exposure, the underlying exposures, which are typically tranches of securitizations, usually have credit enhancement from more junior tranches that protects against many idiosyncratic risks. Systematic risks are more likely to generate defaults in the underlying exposures of resecuritizations than idiosyncratic risks, but systematic risks are also much more correlated; therefore, resecuritizations typically have higher default correlations than other types of securitizations.[87]

According to the NPR, resecuritization exposures warrant a higher capital requirement "particularly if the underlying exposures reflect similar high-risk tranches of other securitizations."[88] Neither the underlying exposures nor the resecuritization exposures are "high-risk tranches" in the case of senior/senior resecuritization exposures referred to above. As noted by the Agencies, "[s]ince senior securitization exposures absorb losses only after more junior securitization exposures, these exposures have an added layer of security."[89] This additional layer

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[84] *See* Proposed Rule, §___.133(a)(4).

[85] The Proposed Rule defines "senior securitization exposure" as "a securitization exposure that has a first-priority claim on the cash flows from the underlying exposures. When determining whether a securitization exposure has a first-priority claim on the cash flows from the underlying exposures, a [BANKING ORGANIZATION] is not required to consider amounts due under interest rate derivative, currency derivative, and servicer cash advance facility contracts; fees due; and other similar payments. Both the most senior commercial paper issued by an ABCP program and a liquidity facility that supports the ABCP program may be senior securitization exposures if the liquidity facility provider's right to reimbursement of the drawn amounts is senior to all claims on the cash flows from the underlying exposures except amounts due under interest rate derivative, currency derivative, and servicer cash advance facility contracts; fees due; and other similar payments." *See* Proposed Rule, §____.101.

[86] *See* NPR, at 64070.

[87] See NPR, at 64070-64071 (fn. 139). The NPR does not provide data or support for its factual assertion that systematic risks are more likely than idiosyncratic risks to cause defaults in the underlying exposures of resecuritizations. The NPR provides neither an empirical basis nor a narrative explanation justifying a risk weight floor of 100% as appropriate for resecuritizations. Without the pertinent definitions and empirical support, it is difficult for us to comprehensively comment on the Agencies' reasoning.

[88] *See* NPR, at 64069.

[89] *See* NPR, at 64063.

of security at both the underlying securitization level and the resecuritization level mitigates the risks normally associated with resecuritizations. Senior/senior securitization structures are likely very different from the types of resecuritizations that the Agencies analyzed in sizing the proposed 100% floor.

A notable example demonstrating why the 100% risk weight floor should not apply to senior/senior resecuritization structures is the securitization of servicer cash advances ("Servicer Advances") made in non-agency residential mortgage-backed securities (RMBS) transactions. Servicer Advances, which are essentially loans made by servicers to RMBS trusts in order to ensure timely payments to investors, generally fall into three categories: (1) principal and interest (P&I) advances for past-due mortgage loan payments, (2) tax and insurance (T&I) advances for past-due real estate taxes and insurance payments, and (3) corporate advances for property protection and foreclosure-related expenses.

Servicer Advances are typically repaid at a senior position in the payment waterfall of the RMBS transaction.[90] Such advances are securitization exposures under both the current capital rule and the Proposed Rule.

To finance their Servicer Advances, servicers often pool their Servicer Advance receivables in an SPE which then issues senior variable funding notes ("Senior VFNs") to third-party lenders. This transaction is structured to be bankruptcy remote, with the SPE's obligations secured solely by cash flows from the Servicer Advances. Given that the Servicer Advance receivables are securitization exposures and are re-tranched in a separate traditional securitization (the VFN transaction), the resulting Senior VFNs are resecuritization exposures for the Senior VFN-holding bank under both the current capital rule and the Proposed Rule.

The Proposed Rule would impose a 100% floor on the risk weight that a bank lender would be required to assign to the Senior VFN. Given the seniority of the bank lender's claims in the Senior VFN transaction and the seniority of the underlying Servicer Advance receivables in the related RMBS transaction, this 100% floor requirement is disproportionate to the actual risk.

Banks currently provide servicers with financing at roughly a 200 basis point spread over the applicable benchmark interest rate under the SSFA and its 20% risk weight floor. If the 100% risk weight floor under SEC-SA is retained, we estimate that banks could require a 500 basis point spread, making Servicer Advances significantly more expensive.

This adverse impact on the cost and availability of Servicer Advances would have serious real-world impacts. During the COVID-19 pandemic, the demand for P&I Servicer Advances surged as banking regulators encouraged forbearance for affected borrowers. While banks stepped in to provide Senior VFN funding for Servicer Advances to help with the strain, the Proposed Rule's 100% resecuritization risk weight floor would reduce the amount and increase the cost of Servicer Advances. This would not only limit the ability of servicers to provide future forbearance relief in times of need, but it would also increase mortgage servicing costs and, as a result, mortgage borrowers' costs.

[90] While we do not have comprehensive data on past securitizations of Servicer Advances, if any such securitizations have defaulted, the occurrence of such defaults is extremely rare.

V. The Accounting Derecognition Requirement Under the Operational Criteria for Traditional Securitizations Should be Replaced with a Legal Isolation Requirement.

Under the current standardized approach and the proposed expanded risk-based approach, a bank that transfers exposures to a securitization SPE or other third party in connection with a traditional securitization may exclude the exposures from the calculation of its risk-weighted assets only if the exposures are not reported on the bank's consolidated balance sheet under applicable accounting principles.[91]

In contrast, the Basel framework requires that the underlying exposures be legally isolated from the bank and its creditors, even in the event of bankruptcy or receivership. The Basel framework does not require that the exposures be derecognized from the bank's consolidated balance sheet under GAAP.[92] The Agencies have provided no explanation or rationale for this significant discrepancy from the Basel framework.

A traditional securitization must, by definition, involve the transfer of credit risk associated with the underlying exposures to third parties.[93] Such a transfer achieves legal isolation of the underlying exposures only if the credit risk, and the other risks and rewards of ownership, have been fundamentally and substantively transferred away from the bank in accordance with well-established legal principles.

Whether an underlying exposure is on-balance sheet or off-balance sheet under GAAP does not – and should not – determine whether the bank has effectively transferred the credit risk associated with that exposure. The operational criteria for recognizing the transfer of risk should focus on the economic reality of the transfer, which is the focus of established legal isolation analysis, and not on its classification under accounting principles, which are subject to change.

The accounting derecognition requirement should be replaced with a legal isolation requirement to ensure that the securitization framework appropriately recognizes the transfer of credit risk. A securitization that (1) meets the definition of "traditional securitization"; (2) legally isolates the underlying exposures from the bank; and (3) adheres to the other operational criteria for traditional securitizations constitutes a transfer of risk that should be recognized by the capital rule. This revision would also help to ensure that the Proposed Rule is better aligned with international standards and does not impede the ability of U.S. banks to manage their credit risks through traditional securitizations.

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[91] *See* Regulation Q, Operational Requirements for Securitization Exposures, 12 C.F.R. § 217.41(a)(1) (existing standardized approach); Proposed Rule §___.130(a)(1) (proposed expanded risk-based approach).

[92] *See* CRE 40.24.

[93] *See* clause (1) of the definition of "traditional securitization", Regulation Q, Definitions, 12 C.F.R. § 217.2 ("All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties other than through the use of credit derivatives or guarantees").

VI. Synthetic Excess Spread Should Not Prohibit a Bank from Recognizing the Risk-Mitigating Benefits of Synthetic Securitizations.

The NPR proposes to expand the operational criteria for synthetic securitizations by prohibiting banks from recognizing the risk-mitigating benefits of a synthetic securitization that includes "synthetic excess spread."[94] The NPR defines "synthetic excess spread" as "any contractual provisions in a synthetic securitization that are designed to absorb losses prior to any of the tranches of the securitization structure."[95] The NPR reasons that:

- "Synthetic excess spread is a form of credit enhancement provided by the originating banking organization to the investors in the synthetic securitization."[96]
- "[T]herefore, the originating banking organization should maintain capital against the credit exposure represented by the synthetic excess spread."[97]
- "However, a risk-based capital requirement for synthetic excess spread may not be determinable with sufficient precision to promote comparability across banking organizations because the amount of synthetic excess spread made available to investors in the synthetic securitization would depend upon the maturity of the underlying assets, which itself depends on whether any of the underlying exposures have defaulted or prepaid. In particular, the total amount of synthetic excess spread made available at inception to investors over the life of the transaction may not be known *ex ante*, as the outstanding balance of the securitization in future years is unknown."[98]
- "Therefore, if a synthetic securitization structure includes synthetic excess spread, the banking organization would be required under the proposal to maintain capital against all the underlying exposures as if they had not been synthetically securitized."[99]

The SFA respectfully disagrees with this reasoning. First, in the normal course of its lending business, an originating bank will set interest rates on its loans to account for expected losses. Loan products with higher expected losses typically have higher interest rates. The interest payments received on performing loans help cover the originating bank's losses on nonperforming loans.

In a synthetic securitization, if the referenced assets generate excess spread, we can see no reason this excess spread cannot be used to provide credit protection for the parties that bear the

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[94] *See* Proposed Rule, §___.130(b)(5).
[95] *See* Proposed Rule, §___.101(b).
[96] *See* NPR, at 64068.
[97] *Id.*
[98] *Id.*
[99] *Id.*

risk of loss, *i.e.*, the securitization investors. The referenced assets, not the originating bank, provide credit protection to investors through excess spread.[100]

In addition, we disagree with the NPR's assertion that the originating bank should maintain capital against the synthetic excess spread. Prior to conducting a synthetic securitization, the originating bank faces the risk that its portfolio of assets will not generate enough interest income to cover credit losses in its loan portfolio. When a bank securitizes the portfolio in a synthetic securitization, however, this risk is transferred to investors. Synthetic excess spread does not fall within the definition of "securitization exposure" because it does not represent a credit exposure to the synthetic securitization.

If, despite the foregoing, the Agencies continue to construe synthetic excess spread as credit enhancement provided by the originating bank and a securitization exposure against which the bank should hold capital, the Agencies should not disallow recognition of any synthetic securitization that includes synthetic excess spread. Rather, funded synthetic excess spread should be subject to a risk weight of 1250%, which is like the approach taken in the EU.[101]

[100] The EU has recognized that synthetic excess spread "is a helpful mechanism for both investors and originators, in order to reduce the cost of the credit protection and the exposure at risk respectively." *See* Commission Regulation 2021/557, 2021 O.J. (L116) 5, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0557&from=EN.

[101] In the EU, synthetic excess spread is considered a securitization position and is subject to capital requirements. *See* EUR. BANKING AUTH., FINAL REPORT ON DRAFT REGULATORY TECHNICAL STANDARDS SPECIFYING THE DETERMINATION BY ORIGINATOR INSTITUTIONS OF THE EXPOSURE VALUE OF SYNTHETIC EXCESS SPREAD PURSUANT TO ARTICLE 248(4) OF REGULATION (EU) NO 575/2013 (2023), https://www.eba.europa.eu/sites/default/files/document_library/Publications/Draft%20Technical%20Standards/2023/EBA-RTS-2023 02%20RTS%20on%20calculation%20of%20exposure%20value%20of%20SES/1054910/Draft%20RTS%20on%20the%20calculation%20of%20the%20exposure%20value%20of%20SES.pdf.

VII. Credit Conversion Factors ("CCFs") Should Apply to the Unused Portion of Loan Commitments to Securitization SPEs.

Under both the proposed expanded risk-based approach and the standardized approach, CCFs are applied to the unused portion of loan commitments to convert them to their credit exposure equivalents.[102] The various CCFs are shown in the table below.

Commitment Type	CCF (Standardized Approach)	CCF (Proposed Expanded Risk-Based Approach)
Unconditionally cancelable	0%[103]	10%[104]
Not unconditionally cancelable; original maturity ≤ 1 year	20%[105]	40%[106]
Not unconditionally cancelable; original maturity > 1 year	50%[107]	

The securitization framework, however, effectively assigns a 100% CCF to the unused portion of loan commitments to securitization SPE borrowers. In stark contrast to other forms of lending, the securitization framework does not distinguish between the credit risk associated with (a) loans made to an SPE and (b) loans that may be made in the future if the SPE wishes to increase borrowing and the conditions precedent to additional borrowing are satisfied.[108] This result is particularly anomalous in that loans to SPEs are typically senior securitization exposures and have the benefit of credit enhancement provided by the subordinated securitization exposures and/or overcollateralization.

In the table below, we provide an example illustrating the capital rule's arbitrary treatment of unused loan commitments to securitization SPEs. We compare an unsecured lending commitment to a sub-investment grade corporate borrower and a lending commitment to a bankruptcy remote SPE holding a pool of prime credit quality auto loans.

Borrower Type:	Sub-investment grade corporate borrower.	Bankruptcy remote special-purpose entity.

[102] *See* Proposed Rule, §___.112(b) (proposed expanded risk-based approach); 12 C.F.R. § 217.33(b).
[103] *See* 12 C.F.R. § 217.33(b)(1).
[104] *See* Proposed Rule, §___.112(b)(1).
[105] *See* 12 C.F.R. § 217.33(b)(2).
[106] *See* Proposed Rule, §___.112(b)(3).
[107] *See* Regulation Q, Off-balance Sheet Exposures, 12 C.F.R. § 217.33(b).
[108] For the avoidance of doubt, our references to "loans" in this section refer to loans for credit purposes, not for liquidity purposes.

Collateral:	None.	Prime credit quality auto loans with a cumulative net loss range of 0.5% to 2.0%.
Credit Enhancement:	None.	12.5%[109]
Bankruptcy Risk:	Potentially significant.	Minimal to none.
Lending Commitment Type:	Not unconditionally cancelable; original maturity ≤ one year	
CCF: **(standardized approach)**	20%	100%
CCF: **(proposed expanded risk-based approach)**	40%	100%

This result is not only arbitrary, but it is also harmful to consumers and businesses. A significant portion of auto loans, mortgage loans, credit card receivables, and many other types of consumer and business loans are transferred to SPEs and financed by banks. Applying a 100% CCF to the unused portion of loan commitments to securitization SPEs increases the cost of bank financing and reduces the amount of credit available to SPEs and, ultimately, to consumers and businesses.

Both the proposed expanded risk-based approach and the standardized approach should be revised such that if a loan to an SPE represents a securitization exposure that is not a resecuritization exposure:

- The CCFs applicable to unconditionally cancelable and not unconditionally cancelable commitments under the expanded risk based approach are applied to the unused portion of the loan commitment to such SPE; and

- SEC-SA or SSFA, as applicable, is used to risk weight the converted amount.

We note that Canada's banking regulators have adopted a similar approach. Under the Capital Adequacy Requirements (CAR), a 40% CCF applies to the undrawn portion of securitization commitments to SPEs.[110]

[109] An advance rate of 87.5% is representative for bank loans to an SPE holding prime auto loans.

[110] See OSFI CAR 6.5.1.1 (paragraph 47) ("For the undrawn portion of securitization commitments extended to a client to fund the securitization of client vehicle acquisition of assets in the securitization subject to asset eligibility criteria, use a credit conversion factor (CCF) of 40%.)

VIII. An Operational Risk Capital Requirement on Securitization Income is Not Supported by the Federal Reserve's Own Research and Would Needlessly Increase Securitization Costs.

The NPR introduces a capital requirement for operational risk.[111] A comprehensive set of comments on this proposed requirement is beyond the scope of this letter. We have reviewed and agree with the comments and recommendations contained in the BPI-ABA Letter with respect to the operational risk proposal.

With respect to the operational risk capital requirement on fee and commission income, we note that the data does not indicate any relationship between securitization income and a bank's operational risks. The Federal Reserve Bank of Dallas conducted a study to determine the statistical relationship between the total assets of bank holding companies and their operational losses per dollar of assets.[112] The study's regression analysis utilized several control variables to account for factors other than total assets that might influence operational losses, such as income from fiduciary activities, income from investment banking, advisory, brokerage and underwriting, and securitization income. *The study found no statistically significant relationship between securitization income and operational losses.*[113] Indeed, the study generally found no statistically significant relationship between operational losses and most types of fee and commission income.

The NPR provides no data or analysis that negates the Federal Reserve's previous research or that otherwise provides any empirical support for an operational risk capital charge on securitization income or any other fee and commission income. The Proposed Rule should be revised to remove the capital charge on securitization income.

While the Federal Reserve's research shows that fee and commission income is generally not significantly related to operational risks, a bank's operational *costs* are directly proportional to the amount of regulatory capital it is required to maintain against its fee and commission income. In the context of securitization, this new capital requirement would apply to underwriting fees, third-party servicing fees and servicing fees under off-balance sheet securitizations for which a bank is the servicer.

In response to these increased costs, banks are likely to increase the fees charged for securitization-related services. This would increase the cost of securitization and, by extension, the cost of credit to consumers and businesses. In addition, the proposal could incentivize banks to restructure their fee- and commission-generating activities, potentially resulting in a reallocation of bank resources away from securitization-related activities that are otherwise beneficial for banks, their counterparties and clients, and investors in asset-backed securities.

Finally, we reiterate our recommendation that the Agencies undertake a comprehensive quantitative review of calibration across CCAR and Basel III Endgame. The operational risk

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[111] *See* Proposed Rule, §.___150.

[112] *See* Filippo Curti,, W. Scott Frame, and Atanas Mihov, *Are the Largest Banking Organizations Operationally More Risky?* (Fed. Rsrv. Bank of Dall., Working Paper No. 2016), https://www.dallasfed.org/research/papers/2020/wp2016 (the "FRB Dallas Study"). A peer-reviewed journal later published this study. *See* Filippo Curti,, W. Scott Frame, and Atanas Mihov, *Are the Largest Banking Organizations Operationally More Risky?*, 54 J. OF MONEY, CREDIT AND BANKING 1223 (2022).

[113] *See* the FRB Dallas Study, at 12–13, 39 tbl.4.

capital requirement proposed by the Basel Committee does not reflect that U.S. banks are already capitalized for operational risk through CCAR.

IX. The Agencies Should Clarify the Treatment of Directly Issued Credit-Linked Notes.

In a separate request for comment, FDIC Director McKernan asks, "Should the agencies consider changes to clarify the treatment of credit-linked notes under either the standardized approach or the expanded risk-based approach?"[114] The SFA considers this rulemaking an opportune moment for the Agencies to affirm that cash-funded, or "pre-funded," credit-linked notes issued by a bank to mitigate credit risk in its banking book ("Directly Issued CLNs") should be treated as cash-collateralized transactions, thereby recognizing their risk-mitigating benefits.[115]

As explained below, Directly Issued CLNs entail no counterparty or security interest risk and provide immediate pre-paid credit protection to the issuing bank. The capital rule should facilitate their use.

A. The capital rule should establish transparent guidelines for recognizing the risk mitigating benefits of Directly Issued CLNs.

In its recent FAQ,[116] the Federal Reserve stated that, compared to synthetic securitizations that utilize SPEs, it is "less clear" that [Directly Issued CLNs] meet the definition of "synthetic securitization" or the operational criteria applicable to synthetic securitizations.[117] The FAQ invites banks to "request a reservation of authority under the capital rule for directly issued credit-linked notes in order to assign a different risk-weighted-asset amount to the reference exposures."[118]

The SFA appreciates the Federal Reserve's willingness to consider bank requests to recognize the risk-mitigating benefits of Directly Issued CLNs. The SFA also appreciates the FAQ's discussion of those characteristics of Directly Issued CLNs that, in the view of the Federal Reserve, make their treatment under the existing capital rule less clear than synthetic securitizations involving SPEs. Unfortunately, the NPR does not address the FAQ or the Federal Reserve's concerns about the lack of clarity regarding Directly Issued CLNs.

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[114] *See* Jonathan McKernan, FDIC, Statement on the Proposed Amendments to the Capital Framework (July 5, 2023) (the "McKernan Dissent").

[115] We note that until late 2021, the Federal Reserve's Bank Holding Company Supervision Manual (the "BHC Supervision Manual") Section 4060.3.5.3.18.1 stated that: "For purposes of risk-based capital, the SBOs [sponsoring banking organizations] may treat the cash proceeds from the sale of CLNs that provide protection against underlying reference assets as cash collateralizing these assets." The BHC Supervision Manual, which was republished in 2011, had been amended several times since the adoption of the existing capital rule without changes to Section 4060.3.5.3.18.1. That section was removed from the BHC Supervision Manual in November 2021 on the grounds that it was "outdated." However, we note that the Federal Reserve has continued to approve requests by banks to treat cash proceeds from the sale of CLNs as cash collateralizing the underlying reference assets. See, e.g., letter from the Federal Reserve regarding synthetic securitization sponsored by Morgan Stanley Finance LLC, dated Sept. 29, 2023 (available at: https://www.federalreserve.gov/supervisionreg/legalinterpretations/bhc_changeincontrol20230929.pdf).

[116] *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., *Frequently Asked Questions about Regulation Q* (September 28, 2023), https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-q-frequently-asked-questions.htm ("FAQ").

[117] *Id.* at 2.

[118] *Id.* at 3.

The SFA respectfully suggests that the "reservation of authority" approach outlined in the FAQ should serve only as an interim measure until the capital rule is clarified. Accordingly, the SFA urges the Agencies to revise the proposed expanded risk-based approach, as well as the existing standardized approach, to provide certainty and transparency by expressly recognizing the risk-mitigating benefits of Directly Issued CLNs with terms and conditions upon which any bank can rely without having to seek specific approval from the Agencies.

B. The capital rule should make clear that the embedded credit derivatives and guarantees used in Directly Issued CLNs satisfy the definition of "synthetic securitization."

In the FAQ, the Federal Reserve states that, compared to synthetic securitizations utilizing SPEs, "it is less clear that a [Directly Issued CLN] meets the definitional requirements … to be considered a synthetic securitization." The definition of "synthetic securitization" requires, among other things, that:

> All or a portion of the credit risk of one or more underlying exposures is retained or transferred to one or more third parties through the use of one or more *credit derivatives or guarantees* (other than a guarantee that transfers only the credit risk of an individual retail exposure).[119]

1. The Agencies should confirm that an embedded credit derivative can satisfy the definition of "credit derivative."

As explained below, some Directly Issued CLNs use an embedded credit derivative (typically, a credit default swap ("CDS")) to provide credit protection to banks. In its FAQ, the Federal Reserve questions whether these embedded credit derivatives satisfy the capital rule's definition of "credit derivative."[120] The SFA believes they do satisfy the definition. We respectfully request that the Agencies confirm this in the rule text by stating that an embedded credit derivative satisfies the definition of "credit derivative" if it references standard industry credit derivative documentation or incorporates their relevant terms.

Directly Issued CLNs that use a credit derivative typically incorporate an embedded CDS in which the bank acts as the buyer of credit protection and an embedded seller acts as the seller of credit protection. If credit losses on the referenced exposures exceed a certain threshold, the bank retains cash equal to the credit-related losses. The return on the Directly Issued CLNs is linked to the embedded CDS. Consequently, when the bank retains cash in proportion to its credit-related losses, the principal balance of the Directly Issued CLNs is reduced by an equivalent amount.

As noted above, the definition of "synthetic securitization" requires a risk transfer by way of either a credit derivative or a guarantee. The capital rule defines "credit derivative" as:

> a financial contract *executed under standard industry credit derivative documentation* that allows one part (the protection purchaser) to transfer the credit

[119] *See* Regulation Q, Definitions, 12 C.F.R. § 217.2 (emphasis added).
[120] FAQ, at Q2.

risk of one or more exposures (reference exposure(s)) to another party (the protection provider) for a certain period of time.[121]

In its FAQ, the Federal Reserve states that the credit derivatives used in Directly Issued CLNs may not meet the definition of "credit derivative" because they "frequently reference, but are not executed under, standard industry credit derivative documentation."[122] This interpretation, however, overlooks the substantive essence of those credit derivatives in favor of a rigid, form-based approach. The embedded credit derivatives used in Directly Issued CLNs provide credit protection superior to that provided by traditional CDS. Unlike traditional CDS, the credit protection provided by the CDS embedded in Directly Issued CLNs is effectively pre-funded when the bank receives the proceeds of issuance from investors. Directly Issued CLNs entail no counterparty risk or security interest risk, and provide immediate, pre-paid, credit protection.[123]

We note also that a significant portion of standard industry documentation for credit derivatives addresses counterparty risk, a risk that is not present in Directly Issued CLNs. The centerpiece form document, the ISDA Master Agreement, focuses primarily on (1) specifying events of default (most notably, failure to pay), early termination events and close-out provisions, (2) requiring assurances that the counterparty will comply with law, maintain required authorizations, and furnish specified information, (3) requiring representations and warranties as to the counterparty's existence and ability to execute the trade, and (4) prescribing netting and set-off procedures. The ISDA Credit Support Annex addresses counterparty credit risk by setting forth the terms and conditions for posting collateral.

There is no regulatory justification for disqualifying embedded credit derivatives simply because they are not executed on ISDA forms whose primary focus is counterparty risk. Rather, the regulatory purpose motivating the definition of "credit derivative" is satisfied if the embedded credit derivative in a Directly Issued CLN references standard industry credit derivative documentation or incorporates their relevant terms.

2. The Agencies should confirm that an embedded guarantee can satisfy the definition of "guarantee."

In addition to a credit derivative, the definition of "synthetic securitization" permits the transfer of risk to one or more third parties through a "guarantee." Some Directly Issued CLNs use an embedded financial guarantee to transfer credit risk to investors. As explained below, the SFA believes that an embedded financial guarantee meets the definition of "guarantee" under the capital rule. We note that the Federal Reserve's FAQ does not raise any specific concerns regarding embedded financial guarantees. In the interest of clarity, however, the Agencies should confirm in

[121] *See* Regulation Q, Definitions, 12 C.F.R. § 217.2 (emphasis added).
[122] *See* FAQ, at 2.
[123] Moreover, the phrase "executed under" is a legal term of art that refers to the substance, not the form, of a contract. For instance, a security agreement is commonly described as "executed under the Uniform Commercial Code." This does not imply that the contract must adhere to a particular form or template; rather, it indicates that the contract adheres to the UCC principles that govern security agreements. A credit derivative need not be executed on any particular form in order for it to incorporate or reflect the relevant principles of standard industry credit derivative documentation.

the rule text that an embedded financial guarantee meets the definition of "guarantee" under the capital rule.

Directly Issued CLNs that utilize a guarantee typically incorporate an embedded financial guarantee under which the bank is the beneficiary of credit protection, and a guarantor is the provider of credit protection. If credit losses on the referenced exposures exceed a certain threshold, the bank retains cash equal to the credit-related losses. The return on the Directly Issued CLNs is linked to the embedded financial guarantee. Consequently, when the bank retains cash in proportion to its credit-related losses, the principal balance of the Directly Issued CLNs is reduced by an equivalent amount.

As noted above, the definition of "synthetic securitization" requires a risk transfer by way of either a credit derivative or a guarantee.[124] Under the capital rule, the term "guarantee" is defined as:

> a financial guarantee, letter of credit, insurance, or other similar financial instrument (other than a credit derivative) that allows one party (beneficiary) to transfer the credit risk of one or more specific exposures (reference exposure) to another party (protection provider).[125]

The embedded financial guarantee described above fits squarely within this definition. As with the embedded credit derivative, there is no counterparty risk associated with the embedded guarantee. Thus, the guarantor is far superior even to a guarantor who qualifies as an "eligible guarantor" and can directly provide an "eligible guarantee" to the bank to cover its credit losses.[126]

C. The capital rule should clarify that the proceeds of Directly Issued CLNs constitute "financial collateral" for purposes of the operational criteria for synthetic securitizations.

The operational criteria for synthetic securitizations under both the standardized and the proposed expanded risk-based approaches require the use of a recognized credit risk mitigant. For most Directly Issued CLNs, financial collateral is the credit risk mitigant.[127] As defined in the capital rule:

"Financial collateral means collateral:

(1) In the form of … Cash on deposit with the [bank] (including cash held for the [bank] by a third-party custodian or trustee); … and

(2) In which the [bank] has a perfected, first-priority security interest … (with the exception of cash on deposit; and notwithstanding the prior security interest of

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[124] *See* definition of "synthetic securitization" under 12 C.F.R. § 217.2.
[125] *See id.*
[126] *See* definitions of "eligible guarantor" and "eligible guarantee" under *id.*
[127] *See* Regulation Q, Operational Requirements for Securitization Exposures, 12 C.F.R. § 217.41(b)(1)(i), Proposed Rule, §___.130(b)(1)(i), which recognize "financial collateral" as a credit risk mitigant under the operational criteria for synthetic securitizations.

any custodial agent or any priority security interest granted to a CCP in connection with collateral posted to that CCP)."[128]

The SFA believes that cash proceeds received by the bank that issues a Directly Issued CLN constitute "financial collateral" under the existing definition and are therefore a credit risk mitigant under the operational criteria for synthetic securitizations under both the standardized and the proposed expanded risk-based approaches.[129] In the interest of clarity and transparency, however, the final rule should confirm this in the definition of "financial collateral" and/or the operational criterion for synthetic securitizations.

That approach would ensure consistency between U.S. and international standards. As FDIC Director McKernan noted in his dissent, the international standards upon which the Proposed Rule is based already allow banks to recognize the credit risk-mitigating benefits of Directly Issued CLNs.[130] Other jurisdictions, such as Canada, the United Kingdom, and the European Union, have permitted their banks to use cash-funded Directly Issued CLNs as credit mitigants for a number of years, and they are widely recognized as an effective method for managing balance sheet risk.[131]

1. A bank should not be required to have a security interest in the proceeds of a Directly Issued CLN.

In its FAQ, the Federal Reserve explains that "[t]he cash purchase consideration for [Directly Issued CLNs] is property owned by the note issuer, not property in which the note issuer has a collateral interest."[132] But that is a good thing – cash owned by the bank is a superior credit risk mitigant than cash in which the bank has a mere security interest. There is no reason to increase the bank's risk by compelling it to downgrade its ownership interest in the cash proceeds to a mere security interest in cash belonging to a third party.

When a bank owns the proceeds of the Directly Issued CLNs, it is not required to relinquish that ownership interest except in accordance with the repayment terms of the Directly Issued CLNs. When a bank has only a security interest in the cash proceeds, it must (1) continue to make

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[128] *See* Regulation Q, Definitions, 12 C.F.R. § 217.2.

[129] The Agencies should also make clear in their criteria that a collateral agreement is not required. Neither the definition of "financial collateral" nor the securitization framework requires a collateral agreement. Although the term "financial collateral" is defined in Regulation Q, Definitions, 12 C.F.R. § 217.2, it is used elsewhere in the capital rules.

[130] *See* McKernan Dissent ("Under the Basel III standards, cash-funded credit-linked notes issued by a bank against exposures in the banking book that fulfill the criteria for credit derivatives may be treated as cash-collateralized transactions."). Director McKernan's characterization of the Basel III standards matches the Basel Committee's own characterization, word for word. *See* BASEL COMMITTEE ON BANKING SUPERVISION, CALCULATION OF RWA FOR CREDIT RISK CRE 22 STANDARDISED APPROACH: CREDIT RISK MITIGATION 22.34 n.3 (2023) ("Cash-funded credit-linked notes issued by the bank against exposures in the banking book that fulfil the criteria for credit derivatives are treated as cash-collateralised transactions.").

[131] *See* Daniel L. Sussman & David Wright, THE BANKER, *Banks' Growing Use of SRT as a Balance Sheet Strategy* (Jan. 23, 2023), https://www.thebanker.com/Banks-growing-use-of-SRT-as-a-balance-sheet-strategy-1674470438 ("Significant risk transfer (SRT) is a transaction structure prevalent balance-sheet strategy that has been explicitly provided for under the European and UK regulatory framework.").

[132] *See* FAQ, at 2.

payments in accordance with the repayment terms of the Directly Issued CLNs and (2) enforce its security interest to obtain the cash. To enforce its security interest:

- The bank must have the right to do so under the related security agreement. This right could be challenged by creditors of the institution that is holding the cash or by third parties, including investors in the Directly Issued CLNs.

- The institution holding the cash must be willing and able to transfer the cash to the bank for the bank to successfully enforce its security interest. A financial institution may be unwilling or unable to transfer cash to a secured party for a variety of reasons, including insolvency or uncertainty regarding the legal or factual basis for the bank's exercise of its rights as a secured creditor.

Lastly, we note that clause (2) of the definition of "financial collateral" requires the bank to have a security interest "with the exception of cash on deposit." As we explain below, cash proceeds received by a bank that issues a Directly Issued CLN should be considered "cash on deposit" for purposes of the definition of financial collateral.

The SFA urges the Agencies to clarify in the final rule that the definition of financial collateral does not require a bank to have a security interest in cash proceeds of Directly Issued CLNs, regardless of where that cash is deposited.

2. Cash proceeds of Directly Issued CLNs should be considered "cash on deposit."

When a bank issues Directly Issued CLNs, the investors pay for those notes in full and without conditions on the date of issuance. The proceeds of Directly Issued CLNs belong to the issuing bank. A bank that receives cash proceeds from the issuance of Directly Issued CLNs can (1) deposit the cash in an account at its own bank, (2) deposit the cash in an account at another bank, or (3) hold the cash as an asset on its balance sheet. In all circumstances, the cash is deposited at or held by a bank.

Cash owned by, or deposited at, the issuing bank itself is the most effective credit risk mitigant. Not only has the bank received cash proceeds prior to incurring any credit losses on the referenced exposures, but it is also not exposed to the counterparty risk associated with depositing the cash proceeds at another bank.

SFA urges the Agencies to make clear in the final rule that the cash proceeds of Directly Issued CLNs constitute cash on deposit, regardless of whether the issuing bank holds or deposits those cash proceeds with its own bank or with another bank.

X. Other Provisions of the Proposed Rule Should Be Removed or Adjusted.

A. For the purposes of determining risk weights applicable to securitization exposures backed by regulatory retail exposures, the aggregate limit and granularity limit criteria should be measured at the pool level.

Under the Proposed Rule, to qualify as a regulatory retail exposure:

- The sum of the exposure amount and the amounts of all other retail exposures to the obligor and its affiliates may not exceed $1 million (the "aggregate limit")[133]; and

- For any single retail exposure, only the portion up to 0.2% of the bank's total retail exposures that are eligible products would be considered a regulatory retail exposure (the "granularity limit"). The portion of any single retail exposure that exceeds the granularity limit would not qualify as a regulatory retail exposure.[134]

In the context of the securitization of retail exposures, the Proposed Rule should make clear the aggregate and granularity limits should apply and be measured solely with respect to the underlying exposures in the securitized pool. Credit exposures to obligors that are not included in the securitized pool are not relevant to the risk associated with the related securitization exposures, and the regulatory capital purpose of those limits is served by applying them to the specific pool of underlying exposures from which securitization risk weights are derived.

Therefore, for the purpose of determining the capital requirement of the underlying exposures in calculating securitization exposure risk weights under SEC-SA, if the aggregate and granularity limits are satisfied at the securitization pool level as described above, then the underlying retail exposures should be deemed to be regulatory retail exposures for purposes of the securitization framework.

B. Where there is no pari passu exposure, the Proposed Rule should permit the use of a derivative contract's exposure at default as an alternative method for determining tranche size.

The Proposed Rule requires banks that act as a counterparty under interest rate and foreign exchange derivative contracts that constitute securitization exposures to use SEC-SA to calculate the risk weight for such exposures. Such exposures would be assigned the same risk weight as a securitization exposure *pari passu* to the derivative contract, as calculated under SEC-SA. If there is no such *pari passu* exposure, the risk weight of the next subordinated securitization tranche is used.[135]

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[133] *See* Proposed Rule, §___.101(b) (definition of "regulatory retail exposure").

[134] *Id.*

[135] *See* Proposed Rule, at §.___132(a)(2). According to the NPR, "A banking organization may otherwise not be able to calculate a risk weight for these derivative contracts using the SEC–SA because the attachment and detachment points under the proposed formula could equal one another, rendering the formula inoperable. The proposed treatment is intended to appropriately reflect how the credit risk associated with these derivative contracts would be commensurate with or less than the credit risk associated with a pari passu tranche or the next subordinated tranche of a securitization exposure." *See* NPR, at 64071.

As an alternative method for calculating a derivative's risk weight where there is no *pari passu* exposure, the Proposed Rule should be revised to (1) allow the derivative contract's tranche size ("the derivative tranche size") to be calculated as a fraction, the numerator of which is the exposure at default ("EAD")[136] of such derivative contract and the denominator of which is the outstanding balance of all underlying assets in the securitization, and (2) specify that the derivative contract's attachment and detachment points may be calculated as follows:

- If there is no securitization exposure senior to the derivative contract, (a) the detachment point of the derivative contract would be one and (b) the attachment point of the derivative contract would be one minus the derivative tranche size; and

- If there is a securitization exposure senior to the derivative contract, (a) the detachment point of the derivate contract would be the attachment point of the tranche immediately senior to the derivative contract (the "senior tranche attachment point") and (b) the attachment point of the derivate contract would be the senior tranche attachment point minus the derivative tranche size.

The risk weight for the derivate contract would then be calculated under SEC-SA using those attachment and detachment points.

This alternative approach would make the treatment of derivative contracts more risk sensitive because it aligns the risk weight more closely with the actual credit risk posed by the contract given its position in the capital structure of the securitization. The precise calculation of the derivative contract's risk weight using its EAD and its position in the capital structure would ensure that the capital requirement is commensurate with the risk profile of the derivative exposure.

C. The look-through approach should not be subject to the 15% risk weight floor.

The Proposed Rule would set a floor of 15% on the risk weight assigned using the look-through exception to SEC-SA.[137] As explained by the NPR:

> Notwithstanding the proposed risk weight cap, the proposal would require banking organizations to floor the total risk-based capital requirement under the look-through approach at 15 percent, consistent with the proposed 15 percent floor under the SEC–SA. The proposed 15 percent floor, even if it results in a risk weight amount greater than the risk weight cap, is intended to appropriately reflect the minimum amount of risk-based capital that a banking organization should maintain for such exposures given that the process of securitization can introduce additional risks that are not present in the underlying exposures such as modelling risks and correlation risks.[138]

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[136] *See* Regulation Q, Counterparty Credit Risk of Repo-Style Transactions, Eligible Margin Loans, and OTC Derivative Contracts, 12 C.F.R. § 217.132(c).
[137] *See* §___.132(k)(1)(ii).
[138] *See* NPR, at 64072.

The imposition of the SEC-SA's 15% floor on the look-through exception contradicts the Agencies' stated reason for the look-through approach:

> The proposed risk-weight cap is intended to recognize that the credit risk associated with each dollar of a senior securitization exposure generally will not be greater than the credit risk associated with each dollar of the underlying assets, because the nonsenior tranches of a securitization provide credit enhancement to the senior tranche.[139]

We note that the approach of the Proposed Rule also contradicts the BCBS standard, which states that "Where the risk weight cap [referring to the look-through] results in a lower risk weight than the floor risk weight of 15%, the risk weight resulting from the cap should be used." The NPR provides no support for deviating from international standards with respect to the look-through approach.

The look-through approach should not be subject to the 15% risk weight floor.

D. Where the delinquency status of all underlying exposures is unknown, a subpool approach is reasonable.

In NPR Question 66, the Agencies ask:

> Recognizing that banking organizations may not always know the delinquency status of all underlying exposures, what would be the benefits and drawbacks of allowing a banking organization to use the SEC–SA if the banking organization knows the delinquency status for most, but not all, of the underlying exposures? For example, if the banking organization knew the delinquency status of 95 percent of the exposures, it could (1) split the underlying exposures into two subpools, (2) calculate a weighted average of the K_A of the subpool comprising the underlying exposures for which the delinquency status is known, (3) assign a value of 1 for K_A of the other subpool comprising exposures for which the delinquency status is unknown, and (4) assign a K_A for the entire pool equal to the weighted average of the K_A for each subpool. What other approaches should the agencies consider and why?[140]

We generally agree that a subpool approach is reasonable. However, for the subpool of exposures for which the delinquency status is unknown, the value of K_A should be 0.12, rather than the value of one, as specified in clause (3) above. The value of 0.12 is the equivalent of assuming that all the exposures in that subpool are defaulted exposures. Defaulted exposures have a risk weight of 150%, which corresponds to a capital requirement of 12%.

A cap on the size of the "delinquency status unknown" subpool is not required with an approach that treats exposures in that subpool as defaulted exposures. Treating such exposures as

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[139] *Id.*

[140] *See* NPR, at 64070.

if they are defaulted is a sufficiently conservative solution to the bank's lack of knowledge about the delinquency status of underlying exposures.

XI. Our Suggested Changes to SEC-SA Should Also be Made to SSFA.

Banks subject to the proposed expanded risk-based approach would be required to calculate risk weights under that approach and the new expanded risk-based approach and use the higher of the two. While a full discussion of the "dual stack" approach is beyond the scope of this letter, we note that requiring all large banks to calculate their securitization exposures under two unaligned approaches introduces needless complexity without providing any clear regulatory benefit. For example:

- There is no rationale for calculating the attachment and detachment points for securitizations differently under the two approaches, or for using "unpaid principal" under SSFA and "outstanding balance" under SEC-SA for weighting purposes. Differing calculations for the same foundational parameters is operationally burdensome for banks and would lead to arbitrary differences in the values of those parameters.

- There is nothing about the stated rationale for the look-through exception that is applicable under the expanded risk-based approach but not the standardized approach. We agree with this proposed look-through exception and appreciate the Agencies' recognition that "[s]ince senior securitization exposures absorb losses only after more junior securitization exposures, these exposures have an added layer of security …".[141]

We respectfully suggest that the Agencies should revise SEC-SA and its various exceptions as described in this letter and make corresponding changes to SSFA and its various exceptions. Such an approach alleviates unnecessary complexity and reduces the arbitrary differences in risk weights calculated under SSFA and SEC-SA. At the same time, the K_G parameter under SSFA and SEC-SA would continue to reflect the different risk weights assigned to underlying exposures under the expanded risk-based approach and standardized approach.

Even if the Agencies decline to make all of the corresponding changes to SSFA as described above, we urge them to reduce the discrepancies between the two approaches as much as possible. At a minimum, the look-through approach should be added to the standardized approach, and the definitions of parameters A (attachment point), D (detachment point), K_G, and W should be revised as suggested in this letter and made consistent across SSFA and SEC-SA.

[141] *See* NPR, at 64063.

XII. The NPR Does Not Satisfy the Requirements of the Administrative Procedure Act.

Section 706 of the Administrative Procedure Act, 5 U.S.C. § 551 *et seq.* (the "APA") provides that "reviewing court[s] shall hold unlawful and set aside agency action, findings, and conclusions found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). Under APA Section 706, courts must "assure [them]selves the agency has 'examine[d] the relevant data and articulate[d] a satisfactory explanation for its action including a rational connection between the facts found and the choices made." *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (citing *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)).

Due to its lack of data and sufficient explanation, the NPR does not satisfy the requirements of the APA. The legal infirmities of the NPR are particularly evident in the proposed securitization framework. Any financial model as consequential as SEC-SA requires significant empirical support, calibration, and explanation to demonstrate its validity. This is particularly true of the SEC-SA model, which utilizes only one calibration parameter, the *p*-factor, but then effectively eliminates it by setting its value equal to 1.0. The NPR does not provide a "rational connection between the facts found and the choices made."[142]

Indeed, the NPR does not disclose the facts found by the Agencies, let alone the connection between the facts found and the choices made. The Agencies provide no data or empirical support for any of the key parameters of the SEC-SA model.[143]

We note that two months after the NPR was released, the Federal Reserve announced a request for data from banks affected by the Proposed Rule.[144] The instructions for this initiative indicate that the Federal Reserve is particularly concerned with understanding the impact of the proposals on the calculation of risk-weighted assets. The data collection includes spreadsheets that banking organizations may use to submit information. The spreadsheets contain dozens of tables that effectively ask banks to restate their entire financial positions and recent income statements as if the proposals have been finalized.

The APA requires regulatory agencies to collect and analyze information prior to releasing a proposal. While a regulatory agency may (and should) change a proposal based on public

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[142] *Business Roundtable*, 647 F.3d at 1148.

[143] Under the APA, a regulatory agency has a duty "to identify and make available technical studies and data that it has employed in reaching the decisions to propose particular rules … An agency commits serious procedural error when it fails to reveal portions of the technical basis for a proposed rule in time to allow for meaningful commentary." *Owner-Operator Indep. Drivers Ass'n v. FMCSA*, 494 F.3d 188, 199 (D.C. Cir. 2007) (citing *Solite Corp. v. EPA*, 952 F.2d 473, 484 (D.C. Cir. 1991)).

[144] *See* Press Release,, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Board Launches Data Collection to Gather More Information from the Banks Affected by the Large Bank Capital Proposal It Announced Earlier this Year (Oct. 20, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231020b.htm.

comment and further analysis, the changes should be a "logical outgrowth"[145] of the proposed requirements.

Moreover, the deadline for submitting data (January 16, 2024) is the same deadline for submitting comments on the NPR. The lack of transparency deprives the public of the opportunity to understand what the collected data show and to comment on the ways in which the Agencies propose to use the collected data to revise the Proposed Rule.

Greater transparency in the Agencies' decision-making process would benefit the Agencies as well. As FDIC Director McKernan put it:

> The practice of giving reasons for our calibration decisions becomes all the more pressing in a world in which our regulatory-capital requirements matter more for at least two reasons.
>
> First, we are more likely to get capital requirements right—or at least to get them less wrong—if we are more transparent as to how we calibrated the requirements. Well-developed rationales check the understandable inclination to work backward from some gut sense as to the right level of capital, a gut sense that might be motivated less by evidence and more by recency bias or other extraneous concerns. Well-developed rationales also give researchers and stakeholders an opportunity to show what we got wrong.
>
> Second, transparency as to our calibration methodology can help foster legitimacy and consensus. Given the importance of capital requirements to banks and society at large, there is likely to be more scrutiny and even controversy engendered by changes in these requirements. Well-developed rationales add legitimacy by dispelling any notion that the changes are arbitrary. Where consensus fails, well-developed rationales clarify where we disagree, which in turn can focus research efforts to eventually bridge those disagreements.[146]

We respectfully reiterate our recommendation that the Agencies modify the Proposed Rule as set forth in this letter. The Agencies should then issue a re-proposed rule that incorporates the recommendations in this letter and contains clear explanations of the Agencies' policy choices, as well as the supporting data.

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[145] *Am. Coke & Coal Chemicals Inst. v. EPA*, 452 F.3d 930, 938 (D.C. Cir. 2006) (citing *Northeast Md. Waste Disposal Auth. v. EPA*, 358 F.3d 936, 951–52 (D.C. Cir. 2004)).

[146] *See* Remarks by Jonathan McKernan, Director, FDIC Board of Directors, at the New York State Bar Association and Mayer Brown on the Basel Endgame and Long-Term Debt Proposals (Oct. 4, 2023), available at: https://www.fdic.gov/news/speeches/2023/spoct0423a.html.

Conclusion

The SFA appreciates your consideration of the views set forth in this letter. If you have any questions, please contact me at (202) 999-0536 (email: michael.bright@structuredfinance.org), or our counsel, Mayer Brown LLP, attention: Stuart M. Litwin at (312) 701-7373 (slitwin@mayerbrown.com), Christopher B. Horn at (212) 506-2706 (cbhorn@mayerbrown.com), or Matthew G. Bisanz at (202) 263-3434 (mbisanz@mayerbrown.com).

Regards,

Michael Bright
CEO
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Appendix A

The Marginal Risk Weighting Function under the K_{SEC-SA} and K_{SSFA} Models

We refer to the exponential decay function below as the marginal risk-weighting function under the K_{SEC-SA} and K_{SSFA} models:

$$\boldsymbol{k(t, K_A) = 1250\% * e^{\left(-\frac{1}{pK_A}\right)(t-K_A)}}$$

where:

- K_A is the weighted average capital requirement of the underlying exposures (K_G), adjusted for adverse performance (W); and
- t represents a distinct hierarchical point on the capital structure of the securitization, situated senior to the "dollar-for-dollar" threshold, K_A.

The term $-\frac{1}{pK_A}$ represents the decay rate of the marginal risk-weighting function, $k(t, K_A)$.

The marginal risk-weighting function, $k(t, K_A)$, can be recovered from the formula for K_{SEC-SA} and K_{SSFA} provided by the Agencies, which is $\frac{e^{au}-e^{al}}{a(u-l)}$. This formula calculates the area under an exponential function over the interval $[l, u]$:

$$K_{[SEC-SA][SSFA]} = \frac{e^{au} - e^{al}}{a(u-l)} = \int_l^u \frac{1}{(u-l)} e^{at} dt$$

As noted in the table below, the value of a is negative. Therefore, the function $\frac{1}{(u-l)} e^{at}$ follows the general form for exponential decay, which is given by $g(t) = Ae^{-kt}$, where A is the value of the function at $t = 0$ and where k is the decay rate of the function.

The table below provides a summary description of the parameters used in the $K_{[SEC-SA][SSFA]}$ model.

Parameter	***Description***	***Value***
a	Decay rate of the exponential decay function	$-\frac{1}{pK_A}$
p	Supervisory calibration parameter	$p_{SEC-SA} = \begin{cases} 1.0, for\ securitization\ exposures \\ 1.5, for\ resecuritization\ exposures \end{cases}$ $p_{SSFA} = \begin{cases} 0.5, for\ securitization\ exposures \\ 1.5, for\ resecuritization\ exposures \end{cases}$
K_G	Weighted average total capital requirement of the underlying exposures.	*Decimal value between* 0 *and* 1

Parameter	*Description*	*Value*
W	Proportion of underlying assets that are defaulted, etc.	*Decimal value between* 0 *and* 1
K_A	Performance-adjusted weighted average total capital requirement of the underlying exposures.	$(1-W)K_G + 0.5W$
u	Distance of the detachment point of the tranche (D) from K_A	$D - K_A$
l	Distance of the attachment point of the tranche (A) from K_A	$max(\mathrm{A} - K_A, 0)$
e	Base of the natural logarithms	2.71828 ...

The integral expression of $K_{[SEC-SA][SSFA]}$ shown above can be adjusted to put it in a more convenient form:

$$K_{[SEC-SA][SSFA]} = \int_l^u \frac{1}{(u-l)} e^{at}\,dt = \frac{1}{(D-A)} \int_A^D \boldsymbol{e}^{\left(-\frac{1}{pK_A}\right)(t-K_A)}\,dt$$

where:

- K_A is the weighted average capital requirement of the underlying exposures (K_G), adjusted for adverse performance (W); and
- t represents a distinct hierarchical point on the capital structure of the securitization, situated senior to the "dollar-for-dollar" threshold, K_A.

Thus, the total risk weight for a securitization exposure under $K_{[SEC-SA][SSFA]}$ is given by:

$$1250\% * K_{[SEC-SA][SSFA]} = \frac{\int_A^D (\boldsymbol{k(t, K_A)})dt}{(D-A)}$$

where $k(t, K_A)$ is the marginal risk weighting function:

$$\boldsymbol{k(t, K_A) = 1250\% * e^{\left(-\frac{1}{pK_A}\right)(t-K_A)}}$$