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April 8, 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

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

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

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)

Ladies and Gentlemen:

This letter is submitted in response to the proposed amendments to the bank regulatory capital rule (the "Proposed Rule") set forth in the notice of proposed rulemaking referenced above

(the "NPR"). The NPR was released by 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" and, together with the Federal Reserve and the OCC, the "Agencies"). I apologize for submitting this so late.

The NPR proposes to revise substantially the regulatory capital requirements applicable to large banking organizations and to banking organizations with significant trading activity. In some respects, the Proposed Rule reflects recent changes to international capital standards (the "Basel III Endgame Standards") issued by the Basel Committee on Banking Supervision (the "BCBS"). In other respects, the Proposed Rule is inconsistent with these changes.

I understand that various industry groups, such as the Structured Finance Association, have submitted detailed comment letters on the new securitization framework, as well as other securitization-related aspects of the Proposed Rule. These letters address in considerable detail the substantial negative impact that the Proposed Rule would have on securitization and on the availability of affordable credit to consumers and businesses in the United States. I share these policy concerns and urge the Agencies to heed these concerns as well. I also respectfully suggest that the Agencies give due consideration to the many constructive suggestions offered by market participants, inasmuch as their collective expertise and experience are invaluable in the context of this very technical rulemaking.

My objective as a lawyer is to offer comments that are primarily legal in nature. From that perspective, I have reviewed the NPR with a particular focus on the revised securitization framework under the new expanded risk-based approach. I hope that the Agencies find these comments useful as they consider the next phase of this rulemaking.

Introduction

It is my view that the NPR's legal infirmities are very significant and that the Agencies should either withdraw the NPR or issue a re-proposal followed by a suitable period for public comment. In any new proposal to implement the Basel III Endgame Standards, the Agencies should follow the precedent set by their implementation of Basel II and publish an advance notice of proposed rulemaking ("ANPR").[1] The ANPR should include detailed explanations of the Agencies' policy choices, as well as the supporting data.

The NPR provides very little indication of the data, if any, used by the Agencies to develop the securitization framework under the proposed expanded risk-based approach. A clear explanation of the data used is particularly important when, as here, the centerpiece of the rule, the new securitization standardized approach (the "SEC-SA"), is a mathematical model that purports to measure accurately the credit risk associated with securitization exposures. The functional form must be correctly chosen, the variables must be correctly identified, and the constant values correctly sized, in order for the model to measure correctly such risk.

Most notably, the NPR offers no data, and very little rationale, for the NPR's proposed supervisory calibration parameter (the "p-factor") value of 1.0 under SEC-SA. The proposed value

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[1] *See* 68 Fed. Reg. 45900 (Aug. 4, 2003).

is double the p-factor value of 0.5 under the existing simplified supervisory formula approach ("SSFA"). The p-factor directly controls the capital requirement for securitization exposures. It is my understanding from industry participants that doubling the p-factor would cause the securitization capital surcharge[2] to double from 50% to 100%.

Due to the NPR's lack of supporting data and rationale, the public does not know, and cannot comment on, the reasons why the Agencies believe it is necessary to double the p-factor. The NPR's lack of transparency is not confined to the p-factor; the NPR is similarly opaque as to the proposed risk weight floor values (15% for securitizations and 100% for resecuritizations and NPL securitizations), the scaling factor value of 0.5 that applies to parameter W in the definition of K_A, and nearly every other parameter value used in the SEC-SA.

I therefore believe that the NPR does not comport with the requirements of the Administrative Procedure Act[3] (the "APA") and that, if the Proposed Rule is adopted, the Proposed Rule would be susceptible to legal challenge. Specifically, Section 706 of 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."[4] 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.'"[5] Courts have the power to undo agency action with respect to which the agency has failed to provide a reasoned explanation or the record belies the agency's conclusion.[6] An agency cannot simply rely on its "knowledge and experience" to justify a proposed rule.[7] It must provide "a reasoned explanation for its decision."[8]

Moreover, even if an agency relies on data and technical studies in making its policy choices, such reliance is not sufficient. The APA imposes an obligation on agencies to disclose the technical studies and data upon which they rely in their rulemaking.[9] This includes the models and

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[2] The "securitization capital surcharge" is 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.
[3] 5 U.S.C. §551 *et seq.*
[4] 5 U.S.C. §706(2)(A).
[5] *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)).
[6] *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43; *Tripoli Rocketry Ass'n v. Bureau of Alcohol, Tobacco, Firearms, & Explosives*, 437 F.3d 75, 77 (D.C. Cir. 2006) ("We must vacate ATFE's action . . . because its explanation . . . is inadequate."); *Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin.*, 626 F.3d 84, 94 (D.C. Cir. 2010) (vacating a rule where the agency's explanation for rejecting comments on the rule proposal was "conclusory").
[7] *Int'l Union*, at 94.
[8] *Id.*
[9] *See, e.g.*, *Conn. Light & Power Co. v. NRC*, 673 F.2d 525, 530–31 (D.C. Cir. 1982) ("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."); *United States v. Nova Scotia Food Prods. Corp.*, 568 F.2d 240, 251 (2d Cir. 1977) ("It is not consonant with the purpose of a rule-making proceeding to promulgate rules on the basis of inadequate data . . . ."); *Owner-Operator Indep. Drivers Ass'n v. Fed. Motor Carrier Safety Admin.*, 494 F.3d 188, 199 (D.C. Cir. 2007) (noting an agency must reveal the basis of its proposed rule to allow for meaningful commentary).

methodology used by an agency to support its policy choices.[10] The purpose of this requirement is to allow for useful criticism and to ensure that the parties develop a record for judicial review.[11] As the Court of Appeals for the D.C. Circuit explained:

> "It would appear to be a fairly obvious proposition that studies upon which an agency relies in promulgating a rule must be made available during the rulemaking in order to afford interested persons meaningful notice and an opportunity for comment. It is not consonant with the purpose of a rule-making proceeding to promulgate rules on the basis of inadequate data, or on data that, [to a] critical degree, is known only to the agency."[12]

I note that, two months after the NPR was released, the Federal Reserve announced a request for data from banks affected by the Proposed Rule.[13] 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. Although a regulatory agency may, and should, change a proposal based on public comment and further analysis, waiting until after the release of the NPR to collect and analyze relevant data makes it even less clear what data the Agencies relied upon in formulating the Proposed Rule.

Moreover, the deadline for submitting data (January 16, 2024) corresponded to the deadline for submitting comments on the NPR. As a result, the public had no opportunity to review 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. As the Supreme Court recently noted, the APA does not permit regulatory agencies to force stakeholders, litigants and courts to "chase a moving target" with respect to agency justifications for regulatory actions.[14]

Greater transparency into the Agencies' decision-making has benefits that extend beyond simply meeting the basic requirements of the APA. Well-supported and explained bank regulatory capital requirements help to foster financial stability and provide certainty to banks in their efforts to manage their credit risks. In addition, as FDIC Director McKernan explained:

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[10] *See, e.g.*, *Sierra Club v. Costle*, 657 F.2d 298, 333 (D.C. Cir. 1981) ("It is not consonant with the purpose of a rulemaking proceeding to promulgate rules on the basis of inadequate data."); *Am. Radio Relay League, Inc. v. FCC*, 524 F.3d 227, 236 (D.C. Cir. 2008) ("[A]n agency must explain the assumptions and methodology used in preparing the model.").

[11] Richard J. Pierce, Jr., Administrative Law Treatise § 7.3 (5th ed. 2010).

[12] *Am. Radio Relay League*, 524 F.3d, at 237 (citing *Portland Cement Ass'n. v. Ruckelshaus*, 486 F.2d 375, 393 (D.C. Cir. 1973).

[13] *See* Press Release, Federal Reserve Board launches data collection to gather more information from the banks affected by the large bank capital proposal it announced last fall (Oct. 20, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231020b.htm.

[14] *See* Dept. of Homeland Sec. v. Regents of Univ. of Cal, 140 S Ct. 1891 (2020), at 1909.

> [I]t is very important that the U.S. bank regulators offer well developed rationales for our decisions.
>
> While capital has many benefits, it also has costs. Any change should endeavor to strike an appropriate balance. In doing so, we should remain humbly aware of the limits on our own knowledge and cautiously cognizant of the risks of unintended consequences. We are more likely to get that balance right—or more aptly, to get it less wrong—if we explicitly state our approach to calibrating each component of the capital framework and then explain how our changes would better implement those policy objectives.
>
> Well developed rationales check the understandable inclination of stakeholders and policymakers 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 parochial interests, recency bias, or other extraneous concerns. Well developed rationales add legitimacy by dispelling any notion that the changes are arbitrary and by perhaps even fostering consensus. Where consensus fails, well developed rationales clarify where we disagree, which in turn focuses efforts to bridge disagreement.
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> Perhaps for these reasons, the law even requires us to disclose our reasons so as to give the public a meaningful opportunity to comment on what we have wrong. Reasoned explanations can be particularly important where, as here, there is a significant change in policy.[15]

Reasoned explanations are particularly important when, as here, regulatory agencies seek to make significant changes to policy without being directed to do so by Congress. Congress has not directed the Agencies to adopt the Basel Committee Endgame Standards and has on several occasions explicitly directed the Agencies to adopt provisions that diverge from the BCBS's approach.[16] In fact, the only clear expression of Congressional intent was the adoption in 2018 of a directive to tailor prudential standards to the particular characteristics of a bank.[17] Under this directive, the Federal Reserve is required to "differentiate among companies based on individual basis and by category, taking into consideration capital structure, riskiness, complexity, financial activities, size and any other risk-based factors that the Fed deems appropriate".[18] Despite this clear mandate, the Proposed Rule imposes uniform capital requirements on all banking organizations with $100 billion or more in assets. Previously, the Agencies had decided not to apply the advanced approach to Category III and IV banking organizations.[19] The Agencies are now changing their position. The sole justification they offer is the conclusory statement that "recent events have demonstrated" that such banking organizations can have an impact on financial

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[15] *See* Statement by Jonathan McKernan, Member, FDIC Board of Directors, on the Proposed Amendments to the Capital Framework (July 27, 2023) (the "McKernan Statement"), https://www.fdic.gov/news/speeches/2023/spjul2723c.html.

[16] *See, e.g.*, 12 U.S.C. §5371; Dodd-Frank Act, Pub. L. 111-203 § 939 (2010).

[17] *See* Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. 115-174 § 401 (2018).

[18] *Id.*

[19] *NPR* at 64033.

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stability.[20] Such a significant policy shift requires a "reasoned explanation," rather than a "summary discussion," as to why the change in policy was necessary.[21]

Furthermore, since the Agencies adopted the 2013 revisions to the regulatory capital rule, there has been no indication from Congress that sweeping changes to capital requirements are necessary.[22] As the Supreme Court has recently noted, it is a recurring problem when federal agencies assert "highly consequential power beyond what Congress could reasonably be understood to have granted," and courts should presume that "Congress intends to make major policy decisions itself, not leave those decisions to agencies."[23]

I. The proposed values assigned to various parameters under SEC-SA are arbitrary and would lead to arbitrary risk weights for securitization exposures.

The proposed SEC-SA model utilizes a simple exponential function featuring one exponential decay constant $\left(-\frac{1}{pK_A}\right)$, two risk variables (($K_A$) and tranche position), and three constants (a fixed floor, a fixed cap, and a fixed calibration parameter (the p-factor)), to determine fully the risk weight assigned to any given securitization exposure. The NPR does not indicate whether or how the Agencies used relevant data in constructing the model.

Even if the Agencies utilized relevant data in constructing the model, the NPR does not provide an adequate description of the methodologies used, or assumptions made, to validate the model.[24] For example:

- What methods were used to determine that SEC-SA produces valid risk weights?
- What is the degree of "fit" between the risk weights produced by SEC-SA compared to the Supervisory Formula Approach (under the Advanced Approaches) or other more rigorous risk weight models?
- What assumptions must be true in order for SEC-SA to produce valid risk weights?
- To what extent, if any, does the exclusion of other variables, such as the amount of excess spread, remaining maturity, expected rate of default, expected loss given

[20] *Id.*

[21] *Encino Motorcars, LLC. v. Navarro*, 136 S. Ct. 2117, 2126 (2016); *see also Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)

[22] The Agencies themselves provided no indication that sweeping changes to bank regulatory capital requirements are necessary. Federal Reserve Chairman Jerome Powell observed in a February 2019 statement to House members that capital levels are "just right" and that the Federal Reserve's policy approach will not result in meaningful changes to capital requirements. *See* https://www.americanbanker.com/news/capital-levels-are-just-right-powell-tells-house-members. Similarly, Acting Comptroller of the Currency Michael Hsu said in his May 2021 written testimony to the House of Representatives' Committee on Financial Services that "Despite a once-in-a-lifetime pandemic, the banking system remains healthy. Key measures of financial strength – capital and liquidity ratios – are strong. Bank capital levels are well above where they were before the Great Recession, and bank liquidity is also substantially higher." *See* https://www.occ.gov/news-issuances/congressional-testimony/2021/ct-occ-2021-56-written.pdf.

[23] *West Virginia v. EPA*, No. 20-1530, slip op. at 19-20 (June 30, 2022) (internal quotations omitted).

[24] *Am. Radio Relay League, Inc.*, 524 F.3d, at 236 ("[A]n agency must explain the assumptions and methodology used in preparing the model.").

default, and relative complexity of transaction structure, impair the validity of the SEC-SA model?

- What alternative models, variables or parameters were considered by the Agencies?
- Is the doubling of the p-factor under SEC-SA relative to SSFA related to an observed increase in the riskiness of securitization exposures since the adoption of the SSFA in 2013? If so, is the increase in the p-factor proportional to such increases in risks?

Not only does the NPR fail to provide empirical support for the Proposed Rule, it also fails to provide sufficient narrative support. This is particularly evident in the proposal to double the p-factor under SEC-SA relative to SSFA. 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."[25]

The NPR, however, does not explain why the proposed changes in risk weights of underlying exposures 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."[26] If such changes do a better job of assigning risk weights to underlying exposures, it is unclear why those changes cause the existing SSFA model to do a worse job of assigning risk weights to securitization exposures such that an increase in the p-factor is needed.

I note that, in 2013, the Agencies incorporated SSFA (and its p-factor value of 0.5) into the capital rule. The regulatory environment in which securitization operates in the United States has changed dramatically since then. Most notably, on December 24, 2015, the requirements of Regulation RR[27] (credit risk retention) became applicable to all asset-backed securities backed by residential mortgages, and on December 24, 2016, these requirements became applicable to all other classes of asset-backed securities. As the Agencies noted when adopting Regulation RR, that rule was a significant component, but not the only component, of a much larger legislative and regulatory effort to improve securitization and reduce 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

[25] *See* NPR, at 64070.
[26] *See* NPR, at 64038.
[27] 12 C.F.R. §244.

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.[28]

The NPR does not explain why it is necessary to double the p-factor (and thus the securitization capital surcharge) despite these significant regulatory reforms. The SEC-SA appears to reflect the assumption that securitization risks have significantly increased, but the NPR contains no data or explanation supporting this assumption. I believe that regulatory changes implemented since the adoption of Basel III in 2013 have helped to reduce the risks associated with securitization.

Similarly, the NPR does not provide any data, and very little narrative support, for other important values used in the SEC-SA model and the exceptions thereto, such as:

- The risk weight floor values of 15% for securitizations and 100% for resecuritizations and NPL securitizations.

- The scaling value of 0.5 as used in the definition of K_A,[29] which effectively assigns a 625% risk weight to seriously delinquent and defaulted underlying exposures, as compared to the 150% risk weight applicable to such exposures if held directly by the bank.

- The 50% minimum nonrefundable purchase price discount set forth in the exception for senior securitization exposures to NPL securitizations.[30]

- The 15% risk weight floor applicable to the look-through exception.[31]

I recognize that some of the parameter values in the Proposed Rule are taken from the Basel III Endgame Standards adopted by the BCBS. I note, however, that, with respect to the p-factor under the Basel III Endgame Standards, the value is set at 0.5 for STC (simple, transparent, and comparable) securitizations, 1.0 for non-STC securitizations, and 1.5 for resecuritizations. However, the U.S. capital rules do not distinguish between STC and non-STC securitizations. As a result, 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 III endgame standards. The expanded standardized

[28] *See* Credit Risk Retention, 79 Fed. Reg. 77602 (Dec. 24, 2014), at 77605. Indeed, regulatory reforms continue to this day. *See, e.g.*, Prohibition Against Conflicts of Interest in Certain Securitizations, 88 Fed. Reg. 9678 (Feb. 14, 2023).

[29] Under the Proposed Rule, $K_A = (1 - W) * K_G + (W * 0.5)$, where K_G is the weighted average capital requirement of the underlying exposures and W is the proportion of underlying exposures that are defaulted, seriously delinquent, etc. *See* Proposed Rule, §___.133(b). The scaling factor of 0.5 applied to the W parameter effectively assigns a 50% capital requirement (625% risk weight) to underlying exposures covered by the W parameter.

[30] *See* Proposed Rule, §___.132(l)(2).

[31] *See* Proposed Rule, §___.132(k)(1)(ii). I note that the BCBS does not include any floor in its version of the look-through exception.

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approach under the NPR would effectively treat all U.S. securitizations the same way that Basel treats esoteric (non-STC) securitizations.[32]

Moreover, with respect to SEC-SA parameter values generally, the BCBS itself provides little or no data, quantitative analysis, or financial modeling rationale to support or explain these levels. Accordingly, simple reliance on the BCBS is not a substitute for the analysis and explanation that the APA requires. As FDIC Director McKernan noted:

> The Basel Committee serves an important role in developing the underlying theories for calibrating the capital framework, pooling data, coordinating research, developing international consensus, and fostering a level regulatory playing field for internationally active banks. The Basel Committee should have a continuing role to these ends.
>
> What has changed is the extent to which we are asked to put our faith in the Basel Committee. As the complexity of the capital framework mounts, we are asked to defer more and more to the technical work of, and the backroom deals made at, the Basel Committee. In the case of the Basel III standards, the Basel Committee has made some key decisions with little or no explanation. That then leaves the U.S. bank regulators unable to defend or perhaps even understand important aspects of the Basel III standards that we are now proposing to implement.[33]

I agree with Director McKernan's assessment. Even where the Proposed Rule follows the Basel III Endgame Standards, simple adherence to those standards is not sufficient to satisfy the requirements of the APA. In the case of the Proposed Rule, neither the NPR nor the source BCBS documents provide the data and narrative explanation required in order to permit the public to offer fully informed comments. Moreover, as I note above, the proposed securitization framework fails to follow the Basel III Endgame Standards in important respects, thus making it all the more difficult for the public to understand and comment upon the Proposed Rule.

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

FDIC Director McKernan asks, in a separate request for comment on the proposed rule, "Should the agencies consider changes to clarify the treatment of credit-linked notes under either the standardized approach or the expanded risk-based approach?"[34] I believe that the Agencies should confirm that cash-funded credit-linked notes that are issued by a bank to mitigate credit

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[32] I note that, on June 27, 2023, the European Parliament and Council approved a proposal to lower on a transitional basis the *p*-factor from 0.5 to 0.25 for STS securitizations (the EU implementation of STC securitizations), and from 1.0 to 0.5 for non-STS securitizations. The final accord states that the securitization framework will be reviewed as part of the Capital Markets Union Action Plan. The Capital Markets Union (CMU) Action Plan seeks to create a single market for capital across all EU Member States. On 24 September 2020, the European Commission (EC) announced a new CMU Action Plan. 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."

[33] *See* the McKernan Statement, *infra*, at fn. 12.

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

risk in its banking book ("Directly Issued CLNs") should be treated as cash-collateralized transactions, thus recognizing their risk-mitigating benefits.

The Federal Reserve stated in a recent FAQ[35] that it is unclear whether Directly Issued CLNs meet the definition of "synthetic securitization" or the operational criteria applicable to synthetic securitizations.[36] 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."[37] Unfortunately, the NPR does not address the Federal Reserve's concerns about the lack of clarity regarding Directly Issued CLNs.

The Agencies should revise both the proposed expanded risk-based approach and the existing standardized approach to provide certainty and transparency by expressly recognizing the risk-mitigating benefits of Directly Issued CLNs on terms and conditions that any bank can rely on without seeking specific approval from the Agencies.

A. The capital rule should make clear that Directly Issued CLNs meet 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)."[38]

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 party (the protection purchaser) to transfer the credit risk of one or more exposures (reference exposure(s)) to another party (the protection provider) for a certain period of time."[39]

Some Directly Issued CLNs transfer credit risk to investors via an embedded credit derivative (typically, a credit default swap "CDS").[40] In its FAQ, the Federal Reserve states that

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[35] *See* Frequently Asked Questions about Regulation Q (September 28, 2023), available at: https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-q-frequently-asked-questions.htm.
[36] *Id.*, p. 2.
[37] *Id.*, p. 3.
[38] *See* 12 CFR §217.2 (emphasis added).
[39] *See* 12 CFR §217.2 (emphasis added).
[40] Directly Issued CLNs that use a credit derivative typically incorporate an embedded credit default swap in which the bank acts as the buyer 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

such credit derivatives may not meet the definition of "credit derivative" because they "frequently reference, but are not executed under, standard industry credit derivative documentation."[41]

Rather than a rigid, form-based approach, the capital rule should take a substantive view focused on how the embedded derivative transfers credit risk. Directly Issued CLNs use an embedded CDS to provide credit protection to the bank. 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. Other recognized credit risk mitigants, including eligible derivatives and eligible guarantees, entail counterparty risk, security interest risk, and a time lag between the occurrence of a credit event and the bank's receipt of credit protection payments. Directly Issued CLNs, on the other hand, eliminate counterparty risk and security interest risk and provide immediate, pre-paid, credit protection.[42]

A credit derivative need not be executed on any prescribed form in order for it to incorporate or reflect the relevant principles of standard industry credit derivative documentation. A large portion of standard ISDA documentation primarily addresses counterparty risks, which are not present with Directly Issued CLNs. Because there is no counterparty risk with Directly Issued CLNs, strict adherence to counterparty-focused ISDA forms is unnecessary.

The capital rule should focus on whether the embedded derivative transfers credit risk in substance, not whether it mimics ISDA forms. This approach aligns with the "economic substance over legal form" doctrine and avoids needless disqualification of effective risk mitigants.

B. <u>The capital rule should clarify that the proceeds of Directly Issued CLNs constitute "financial collateral" for purposes of the operational criteria for synthetic securitizations.</u>

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.[43] 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 any

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embedded credit default swap. 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.

[41] *See* FAQ, p. 2.

[42] 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.

[43] *See* 12 CFR §217.41(b)(1)(i) and Proposed Rule, at §___.130(b)(1)(i), which recognize "financial collateral" as a credit risk mitigant under the operational criteria for synthetic securitizations.

custodial agent or any priority security interest granted to a CCP in connection with collateral posted to that CCP)."[44]

I believe that cash proceeds received by a 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 the standardized approach, and under the proposed expanded risk-based approach.[45] 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 that U.S. standards are consistent with 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.[46] 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 such CLNs are widely recognized as an effective method for managing balance sheet risk.[47]

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."[48] However, 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, the bank must (1) continue to make 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:

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[44] *See* 12 CFR §217.2.

[45] 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 12 CFR §217.2, it is used elsewhere in the capital rules.

[46] *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* CRE 22 Standardised approach: credit risk mitigation" (Jan. 1, 2023), at 22.34 fn. 3 ("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.")

[47] *See* Daniel Sussman and David Wright, "Banks' Growing Use of SRT as a Balance Sheet Strategy", *The Banker* (Jan. 23, 2023) ("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.").

[48] *See* FAQ, p. 2.

- 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 enforce successfully 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.

Finally, I 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 I 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.

I urge 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 itself, (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, 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 also it is not exposed to the counterparty risk associated with depositing the cash proceeds at another bank.

I urge 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 itself or with another bank.

III. The GAAP derecognition requirement should be replaced with a legal isolation requirement in the operational criteria for traditional securitizations.

Under the current standardized approach and the proposed expanded risk-based approach, a bank that transfers exposures it has originated or purchased to a securitization SPE or other third party in connection with a traditional securitization may exclude the exposures from the calculation

of the bank's risk-weighted assets only if, among other requirements, the exposures are not reported on the bank's consolidated balance sheet under GAAP.[49]

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.[50] 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. This requirement, along with a requirement that a bank achieve legal isolation, would constitute a sufficient eligibility framework for the recognition of a risk-transfer transaction. The basis of legal isolation is that the credit risk and other risks of ownership associated with the underlying exposures have been transferred by the bank.

The accounting de-recognition requirement should be replaced with a legal isolation requirement to ensure that the securitization framework appropriately recognizes the transfer of credit risk. This approach would also help to ensure that the Proposed Rule is better aligned with international standards and does not harm the international competitiveness of U.S. banks or impede their ability to manage their credit risks through traditional securitizations.

IV. The operational criteria for synthetic securitizations should not prohibit synthetic excess spread.

The Proposed Rule would prohibit originating banks from recognizing the risk-mitigating benefits of a synthetic securitization that includes "synthetic excess spread".[51] 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."[52] The Agencies reason that (1) excess spread is credit enhancement provided by the originating bank,[53] (2) therefore the originating bank should hold capital against it,[54] (3) however, the amount of excess spread, and any related capital requirement, would be too difficult to calculate and re-calculate over the life of the securitization,[55] and (4) therefore if a synthetic securitization includes synthetic excess spread, the bank should be required to maintain capital against all the underlying exposures as if they had not been synthetically securitized.[56]

I respectfully disagree with this reasoning. In the normal course of its lending business, an originating bank will set interest rates on its loans to account for expected defaults. Loan products

[49] *See* 12 C.F.R. §217.41(a)(1) (existing standardized approach); Proposed Rule §___.130(a)(1) (proposed expanded risk-based approach).
[50] *See* CRE 40.24.
[51] *See* Proposed Rule, §___.130(b)(5).
[52] *See* Proposed Rule, §___.101(b).
[53] *See* NPR, at 64068.
[54] *Id.*
[55] *Id.*
[56] *Id.*

with higher expected defaults typically have higher interest rates. The interest payments received on performing loans help offset the originating bank's losses on nonperforming loans.

If the referenced assets generate excess spread, I can see no reason why this excess spread cannot be used to provide credit protection for the parties who bear the risk of loss--*i.e.*, the securitization investors. The referenced assets, not the originating bank, are the source of the excess spread. The availability of excess spread to cover credit losses does not negate the risk-mitigation benefits of a synthetic securitization. As a result, I believe that prohibiting synthetic excess spread is unreasonable and arbitrary.

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I appreciate your consideration of the views set forth in this letter.

Respectfully submitted,

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