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")

I. Introduction

The Commercial Real Estate Finance Council ("CREFC") appreciates the opportunity to respond to the request of the Board of Governors of the Federal Reserve System ("Federal Reserve"), Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation ("FDIC"; and collectively, the "Federal Regulators") for comments on proposed changes to the regulatory capital rules (the "Proposed Rule").[1] We refer to the related release herein as the "Proposing Release."

[1] 88 Fed. Reg. 64,028 (Sept. 18, 2023), https://www.federalregister.gov/public-inspection/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant.

CREFC comprises over 400 institutional members representing U.S. commercial and multifamily real estate investors, lenders, and service providers – a market with almost $6 trillion of commercial real estate ("CRE") debt outstanding. CRE debt enables the development and operation of the properties where all Americans live, work, shop, and spend their free time. Our principal functions include setting market standards, facilitating the free and open flow of market information, and educational programming for all participants in the CRE lending community.

One of our core missions is to foster the efficient and sustainable operation of CRE securitizations. To this end, we have worked closely with policymakers to educate and inform legislative and regulatory actions to help optimize market standards and regulations and ensure that CRE debt liquidity remains available to this important component of the U.S. economy.

We understand that other trade associations will be submitting comments on broader concerns with the Proposed Rule. While we share some of the concerns of these groups, this letter focuses on the CRE lending and securitization markets and discrete, constructive changes Federal Regulators should adopt to facilitate the implementation of the Proposed Rule without serious, unintended consequences for the CRE lending and securitization markets.

Securitization is a key part of the lending system, adding capital and diversification to the lender and investor base beyond what balance sheet lending can provide on its own. Securitization also allows for the efficient tailoring of investment risk and yield requirements to the specific goals and desires of investors.

Overly broad restrictions imposed on the securitization market can materially and adversely affect the liquidity of insured depositories and other regulated institutions and concentrate real estate risk on their balance sheets. The role of a healthy and liquid securitization market for the viability of the CRE financing market will be particularly important in the near term as approximately $2 trillion of CRE debt matures over the next four years.

Additionally, unnecessary constraints on the securitization markets and pressure on banks will exacerbate the debt liquidity issues currently impacting the banking sector, potentially pushing activities to the nonbank sector. This is, of course, a frequently articulated concern of our financial regulatory agencies, as demonstrated most recently by the Financial Stability Oversight Council's approval of a new analytic framework for financial stability risks and updated guidance on the Council's nonbank financial company determinations process.

II. <u>Our Recommendations</u>

We generally do not support the Proposed Rule on the grounds that Federal Regulators have failed to demonstrate why the current capital rules are inadequate to protect banks from financial stress or why the Proposed Rule is an appropriate revision to those rules. Further, the Proposing Release lacks an analysis of the quantitative impact of the Proposed Rule or an assessment of its costs versus its benefits.

Additionally, we note that Congress has not directed the Federal Regulators to adopt the Basel Committee's standards, and has, on several occasions, explicitly directed the Federal

Regulators to adopt provisions that diverge from the Basel Committee's approach.[2] Furthermore, there has been no indication from Congress since the Federal Regulators adopted the 2013 revisions to the regulatory capital rules that wholesale changes are necessary. In fact, the only expression of clear Congressional intent was the adoption in 2018 of a direction to tailor prudential standards for the specific attributes of a bank; a direction that appears to have been sidelined in the crafting of the Proposed Rule.[3] As the Supreme Court has recently counseled, 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."[4]

However, assuming that a final rule is adopted, at a minimum, we implore the Federal Regulators to revise the Proposed Rule for the items set forth below.

A. Securitization.

The Proposed Rule would increase the capital requirements for most exposures to securitizations, including commercial mortgage-backed securities ("CMBS") and CRE collateralized loan obligations ("CLOs"). This is because the Proposed Rule would increase the supervisory calibration parameter (known as the "p factor") in the approach to determining the risk weights for a securitization exposure from 0.5 to 1.0.[5] Such a doubling of the p factor would more than double the risk weight for many securitization exposures.

The p factor is a regulator-selected variable in SEC-SA that is intended to "account for imprecision or uncertainty associated with using standardized approach risk weights for underlying exposures in calculating" securitization risk weights.[6] Or put more bluntly, the p factor is an arbitrarily selected multiplier that is intended to mitigate the risk that the general risk weights used with underlying exposures were set incorrectly. However, the general risk weights are determined by the Federal Regulators and will be revised as part of the Proposed Rule to be **more** risk sensitive, and therefore, it makes no sense to assume that there is a greater risk that they were set incorrectly. Additionally, as has been noted by others, fixing the p-factor at 1.0 ignores the expected performance of the underlying securitization pool, which increases the securitization penalty for prime assets and decreases the risk sensitivity of the formula.[7]

Further, CMBS and CRE CLOs are among the most heavily underwritten credit products passing through the review process of loan originators, underwriters, issuers, typically multiple rating agencies and layers of institutional investors. This underwriting rigor begins when loans are originated and continues in the primary market when securitizations are rated and initially placed with investors. When securitization interests trade, there are additional layers of due diligence and surveillance that constantly monitor performance at the property, borrower, and

[2] *See, e.g.,* 12 U.S.C. §§ 3907, 5371; Dodd-Frank Act, Pub. L. 111-203 § 939 (2010).
[3] *See* Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. 115-174 § 401 (2018).
[4] *West Virginia v. EPA*, No. 20-1530, slip op. at 19-20 (June 30, 2022) (internal quotations omitted).
[5] Proposed Rule at __.133(a)(5)(i).
[6] BCBS, *Consultation on Revisions to the Basel Securitisation Framework* (Dec. 2012).
[7] SIFMA, *How the Basel III Endgame Could Impair Securitization Markets and Harm US Businesses and Consumers* (Nov. 28, 2023).

bond level. This reduces the need to incorporate further conservativism factors in the capital rules because the credit risk already is well-understood and managed.

Moreover, other jurisdictions recognized the error in raising the p factor and have proposed to take a different approach. Most notably, the proposal of the Council of the European Union (the "European Council") as reflected in CRR III does not increase the p factor for determining the risk weights for a securitization exposure.[8]

Therefore, we request the Federal Regulators maintain in the final rule the current p factor of 0.5 for determining the risk weights for a securitization exposure.

B. Credit-linked notes.

We agree with FDIC Director McKernan's separate request for comment on whether the Federal Regulators should consider changes to clarify the treatment of credit-linked notes ("CLNs") under the existing standardized approach and the proposed expanded risk-based approach.[9] This clarification should be made in the text of any final rule, or at a minimum, be issued by all Federal Regulators as official agency policy or supervisory guidance.[10] Anything else would prevent community banks from taking advantage of this credit risk mitigating technique and further unlevel the playing field between Main Street banks and internationally active banks.

Cash-funded credit-linked notes in practice offer a greater degree of certainty regarding credit risk mitigation than do other arrangements. This is because a bank actually owns the cash that is used to purchase the credit-linked notes and cannot be forced to give up ownership of that cash except pursuant to the repayment terms of the credit-linked note (in which case the bank will not suffer a credit-related loss on the reference pool of assets).[11] In contrast, a security interest in cash on deposit grants a bank a right to repossession of an asset that the bank does not

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[8] Celeste Tamers, *Partial relief for synthetic securitisation in final EU rules*, Risk.net (July 5, 2023). We understand that the European Parliament also has proposed lowering the p factor from 0.5 to 0.25 for simple, transparent and comparable ("STC") securitizations. While the Federal Regulators do not propose to adopt STC for U.S. banks, this action shows how other jurisdictions are looking to decrease the securitization penalty, not increase it.

[9] Jonathan McKernan, *Statement on the Proposed Amendments to the Capital Framework* (July 27, 2023) ("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. Should the agencies consider changes to clarify the treatment of credit-linked notes under either the standardized approach or the expanded risk-based approach? If so, to what aspects of the capital framework should the agencies consider changes?")

[10] While we appreciate the Federal Reserve's recent FAQs on CLNs, it was issued by only one of the three Federal Regulators and reflects the opinions of staff. *See* Federal Reserve, *Frequently Asked Questions about Regulation Q* (Sept. 28, 2023). Further, the FAQs require banks to invoke a nonpublic exception process to obtain recognition of certain CLN structures. The Federal Regulators should act through public rulemaking to authorize these CLN structures without imposing a burdensome private application process which would only further deter participation by community banks.

[11] *See, e.g., In re Purdy*, 763 F.3d 513, 518 (6th Cir. 2014) ("a sale involves an unconditional transfer of absolute title to goods, while a security interest is only an inchoate interest contingent on default and limited to the remaining secured debt") (internal quotations omitted); *in re Lopez*, 163 B.R. 189, 191 (Bankr. D. Colo. 1994) ("a pawn transaction is not a conveyance of title, but is a secured transaction, and therefore" subject to the Bankruptcy Code); *in re Cravey & Assoc.*, 109 B.R. 472, 473 (Bankr. M.D. Fla. 1989) ("not possible for the bank to be the pledgee of its own property...ownership interest subsumed a security interest in the identical property").

yet own and may never own if it is unable to foreclose on the collateral.[12] Clearly a bird in the hand is better than one in the bush.

Further, as noted by Director McKernan, the international standards on which the Proposed Rule is based already permit banks to recognize the credit risk-mitigating benefits of cash-funded credit-linked notes. Other jurisdictions, including Canada, the United Kingdom, and the European Union, have permitted their banks to use cash-funded credit-linked notes as credit risk mitigants for several years and they are widely recognized as an efficient strategy for managing balance sheet risk.[13]

Therefore, we strongly urge the Federal Regulators to publicly confirm that 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 without the need to obtain bank-specific or transaction-specific approval.

C. Unreasonable cross-default provision.

The Proposed Rule would require banks to "look to the performance of the borrower with respect to credit obligations to any creditor" when determining if a non-retail exposure is a defaulted exposure.[14] That is, if a borrower has any credit obligation, *to any creditor*, that is (i) 90 days or more past due or in nonaccrual status, (ii) the subject of a distressed restructuring, or (iii) the subject of a negative adjustment by the creditor for credit-related reasons, then the bank would be required to treat all exposures that are credit obligations of that borrower as defaulted exposures.

Under current US capital rules, a bank must assign a risk weight of 150% to past due exposures on an exposure-by-exposure basis.[15] The Basel Committee's 2017 revisions to the international standards indicate that banks should assign a risk weight of 150% to all of a bank's exposures to a borrower if the borrower defaults on any exposure to the bank.[16]

Therefore, the Proposed Rule would inappropriately gold plate the US capital rules, compared to international standards, by imposing a universal cross-default restriction on all commercial borrowers. The Proposing Release does not indicate what has changed in the market since 2013 to make the current approach of considering defaults on an exposure-by-exposure basis unsuitable and provides no rationale for deviating from the Basel Committee's limited approach. Further, research indicates that in the CRE sector, strategic default on one loan "does not seem to be a prelude to defaults in other loans."[17] That same research found that borrowers who made a strategic default on one loan did not default on their other loans 89% of the time.

[12] Credit risk mitigants in the form of a guarantee or credit derivative may provide an even lesser degree of certainty if they are unfunded obligations of the protection provider.
[13] *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.").
[14] Proposed Rule at __.101 (definitions of "Defaulted exposure" and "Defaulted real estate exposure").
[15] 12 C.F.R. § 3.32(k), 217.32(k), 324.32(k).
[16] Basel Committee, CRE 20.104 (Jan. 1, 2023).
[17] Serdar Dinc and Erkan Yönder, *Strategic Default and Renegotiation: Evidence from Commercial Real Estate Loans* (June 22, 2022).

Therefore, there appears to be no basis for the Basel Committee's limited cross-default approach for CRE loans, let alone a universal cross-default approach.

Additionally, the universal cross-default would inject unwarranted uncertainty and gamesmanship into debt restructurings. Borrowers might threaten to selectively default on obligations to other creditors to drive up a bank's cost of capital for existing exposures. Other creditors or competitors might seek to invoke technical (non-economic) defaults against borrowers who are known to have borrowed significant amounts from specific banks, thereby forcing those banks to recognize higher capital charges. Further, banks may refrain from calling a default on an exposure when they otherwise should do so for fear of triggering the universal cross-default. Regulatory capital rules should not create such perverse and unsound incentives.[18]

We understand that the United Kingdom and European Union are likely to adopt the Basel Committee's approach of limiting the default analysis to a bank's own exposures to a borrower. The Proposed Rule's unreasonable treatment of defaults to other creditors could lead to situations where similar banks in the U.S. and U.K. are required to assign different risk weights to the same exposure (e.g., in a syndicated loan) merely because the borrower has defaulted to a third-party creditor. Therefore, if the Federal Regulators adopt a universal cross-default requirement, U.S. banks will be placed at an unjustified disadvantage relative to their peers.

Moreover, it is functionally impossible for a bank to obtain the necessary information to accurately assess whether the credit obligations of a non-retail borrower to other creditors are defaulted.[19] Unlike in the retail sector, there is no obligation or market practice for creditors to centrally report or publicize defaults by commercial customers. Consequently, there is no accurate corporate or commercial version of the consumer credit reporting agencies. Most non-retail borrowers are private companies that do not publicly disclose financial statements, let alone report defaults. At best, banks might be able to include covenants in a loan agreement requiring the borrower to notify the bank of a default, but that type of self-policing would likely be so inaccurate and fraught with conflict as to be wholly ineffective.

Further, the Proposing Release requests comment on whether the CRE-related provisions of the Proposed Rule should be revised to require a bank to consider "both the obligor and the parent company or other entity or individual that owns or controls the obligor when determining if the exposure meets the criteria for 'defaulted real estate exposure.'" We believe that this approach would be wholly unnecessary and inappropriate.

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[18] In recent years, regulators have had to respond to similar incentive in other markets. *See, e.g.,* Joe Rennison, *Global Regulators Vow to Address "Manufactured Defaults",* FT (June 24, 2019); ISDA, *Board Statement on Narrowly Tailored Credit Events* (Apr. 11, 2018); *see also* Ryan Schloessmann, *The Case for Treating Uptier Transactions as a Form of Corporate Control*, 90 U. Chi. L. Rev. 1197 (2023) (discussing gaming concerns with "uptier transactions").

[19] *See, e.g.,* Press Release, *Federal Trade Commission Finalizes Order Against Dun & Bradstreet for Deceiving Businesses and Failing to Update Errors on Business Credit Reports* (Apr. 7, 2022); Angus Loten, *Credit Reports: What Small Businesses Don't Know Can Hurt Them*, WSJ (June 21, 2013) (finding that "Of the firms that did check their reports, one quarter said they found errors, or missing financial data that put their business in a riskier category").

CRE often is held through special-purpose entities ("SPE") for the express purpose of insulating investors and lenders from issues relating to the activities or financial performance of other investors, managers, or other investments. When a bank underwrites a CRE loan, it is primarily assessing the creditworthiness of the CRE (e.g., value of the property, expected rental cashflow). The creditworthiness of a parent company or broader group is of secondary importance. Even more notably, absent a guarantee, a creditor on a CRE loan typically has no recourse to the parent company or affiliates of an SPE following an SPE's default. To require a bank to look to the status of a CRE borrower's parent company would disregard longstanding principles of corporate separateness and pierce the veil of limited liability in situations where no court would do so.

Therefore, we request that the Federal Regulators adopt the Basel Committee's limited approach of considering only a borrower's exposures to a bank when that bank is determining if an exposure should receive a defaulted risk weight.

D. Narrow definition of "regulatory commercial real estate" category.

The Proposed Rule would define **regulatory commercial real estate** as a real estate exposure in which the bank holds a first-priority security interest in the CRE (and would assign it preferential risk weights ranging from less than 60% to 110%).[20] Correspondingly, the definition of **real estate exposure** would be limited to CRE that is secured by collateral in the form of real estate.[21] Getting this scope right is critical given that banking organizations make more than 50% of CRE loans by dollar value.[22] If this scope is set too narrowly, then low-risk CRE loans will be subject to a highly punitive 150% risk weight merely because of their structure.

While a requirement for a security interest in real estate might make sense in the residential real estate setting, it does not make sense for the wide range of CRE finance structures. As noted above, it is common for CRE to be held by an SPE for purposes of bankruptcy remoteness and legal separateness. Therefore, mezzanine lenders for CRE commonly do not receive a security interest in the CRE, but rather, are secured by equity interests of the borrower. This is because having recourse to the SPE that owns and borrows against the CRE is economically equivalent to a security interest in the equity of the CRE.

Therefore, we request that the Federal Regulators revise the definitions of (i) real estate exposure to include direct recourse obligations of a borrower that has no material assets beyond commercial property holdings and (ii) regulatory commercial real estate exposure to include exposures that are primarily secured by a first or subsequent lien on commercial property or are recourse obligations of a borrower that has no material assets beyond commercial property holdings. If the Federal Regulators feel a need to differentiate the credit risk of first and subsequent liens, this could be managed through an add-on risk weight for real estate exposures that are not a first-priority interest (e.g., increase the risk weight by 15%).

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[20] Proposed Rule at __.101 (definition of "Regulatory commercial real estate exposure").
[21] Proposed Rule at __.101 (definition of "Real estate exposure").
[22] Vivek Denkanikotte, *CRE Bank Performance: Answering Questions Surrounding Lending & Debt*, Trepp (May 18, 2023).

E. Undrawn commitments.

The Proposed Rule would change the capital treatment for unconditionally cancelable commitments and commitments that do not have an express contractual maximum amount that can be drawn.[23] For unconditionally cancelable commitments, the credit conversion factor ("CCF") would increase from 0% to 10%. For commitments that do not have an express contractual maximum amount that can be drawn, banks would be required to impute an amount based on 10 times the historical line usage.

The approaches in the Proposed Rule would have a negative impact on CRE lending that is not justified by the scant speculation regarding potential risk put forward in the Proposing Release. Draws on commercial facilities are far from automatic and require substantial engagement and assessment through a bank's due diligence process. Our members report that in the current marketplace, some loans are rejected from being placed in lending warehouse facilities, which is clear evidence of the substantive and dynamic nature of banks' line management.

Our members also reported that warehouse lending facilities are essential to the securitization process because they allow lenders to accumulate an amount of loans that can be efficiently transformed into asset-backed securities. Without warehouse lending facilities, there would be fewer financing opportunities available to lenders and borrowers, and securitizations would become more expensive to execute. The regulatory capital rules should not imperil such a significant part of the economy without substantial evidence showing a need for change and benefits that outweigh the expected costs.

Additionally, CRE warehouse lines are typically secured. Applying the proposed CCF to secured CRE warehouse facilities would be punitive and cause more banks to cease offering this product. Given that relatively few banks currently offer this essential product, the result will be decreased CRE lending and likely greater involvement by nonbanks (a perennial concern of regulators).[24] Our members continue to believe that the senior portion of CRE financing should live within regulated financial institutions, and object to a change that will drive this lending out of banks and may result in further deterioration of underwriting standards.[25]

Further, subjecting unconditionally cancelable commitments to a 10x multiplier exacerbates the inefficiency caused by holding capital against undrawn facilities and ignores

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[23] Proposed Rule at __.112(a)(5), (b)(1).

[24] *See e.g.,* Martin Gruenberg, *Remarks on the Financial Stability Risks of Nonbank Financial Institutions* (Sept. 20, 2023) ("If a nonbank financial institution conducting these activities is sufficiently large or otherwise serves critical functions, systemic risk issues could be implicated."); McKinsey, *Global Banking Annual Review 2023* (Oct. 10, 2023) ("between 2015 and 2022, more than 70 percent of the net increase of financial funds ended up off banking balance sheets, held by insurance and pension funds, sovereign wealth funds and public pension funds, private capital, and other alternative investments, as well as retail and institutional investors").

[25] *See, e.g.,* Mark Calabria, *The Rise of Nonbank Mortgage Lending*, Cato Institute (2023) ("Ironically, the widely touted National Mortgage Settlement in 2012 had the long-term effect of pushing banks away from mortgage servicing, leaving borrowers to be more likely served by nonbank servicers, who are subject to less oversight."); Michael Fratantoni, *Why Have Banks Stepped Back From Mortgage Servicing*, International Banker (Sept. 2, 2020) ("There have been three primary drivers: the capital treatment of mortgage servicing assets, increase in servicing costs and, for Federal Housing Administration (FHA) servicing, exposure to the False Claims Act.").

certain unique aspects of CRE lending. CRE borrowers may carry relatively high balances on warehouse lines for a short-term, defined maturity because of the large dollar value of such properties. The fact that a CRE warehouse borrower has a high line utilization does not correlate with financial stress because it is expected that such borrowers will use the warehouse lines to accumulate CRE exposures. Requiring banks to apply the proposed multiplier to secured CRE will cause banks to impose express limits on CRE warehouse facilities, which will slow real estate lending and require unnecessary renegotiation and re-underwritings.

Therefore, we request that the Federal Regulators eliminate the proposed 10% CCF and 10x multiplier for commitments that do not have an express contractual maximum amount.

F. Grandfather existing exposures at no-higher risk weight.

The Proposed Rule would require banks to phase-in the new risk weights and related provisions over three years.[26] These changes would apply to exposures a bank incurs prior to the effective date of a final rule and may result in an existing exposure being subject to a higher risk weight.

CRE loans and CMBS may have lengthy terms that extend beyond the proposed phase-in. Banks underwrite these exposures based on their analysis of the expected cost of capital over the entire life of the exposure. If the Proposed Rule is implemented in a way that requires banks to increase the risk weight assigned to existing CRE exposures, a bank will need to hold more capital relative to the exposure and a loan or investment that was once profitable for a bank may become unprofitable and remain that way for many years.

We note that in 2018, Congress explicitly supported the grandfathering of risk weights for existing exposures when imposing increases to capital requirements because it excluded pre-2015 loans from being classified as high volatility CRE.[27] This is an appropriate approach to capital regulation that avoids penalizing banks for fulfilling a vital role by transforming short-term deposits into long-term loans.

Therefore, we request that the Federal Regulators revise the Proposed Rule to grandfather exposures that are on a bank's balance sheet prior to the effective date of a final rule at the lower of the current risk weight assigned the exposure and the risk weight that would be assigned under the final rule. This would allow banks to preserve the delicate economic basis that supports long-term credit intermediation.

* * *

We support a safe, sound, and resilient approach to banking regulation, including capital rules that ensure banks are able to withstand periods of financial stress. However, capital rules should be thoughtfully tailored to mitigate the actual risks to which a bank is exposed, and to not inhibit the robust US economy or merely shift risks to the shadow banking system. As discussed in the introduction to this letter, the CRE market is a large and essential part of the U.S. economy and financial system, and the Federal Regulators must ensure that the Proposed Rule would not

[26] Proposed Rule at 3.300(b), 217.300(b), 324.300(b).
[27] 12 U.S.C. § 1831bb(b)(3).

impair the functioning of that market. Therefore, we strongly urge you to consider the requests we have made in this letter.

We would be pleased to address any questions you or your staff may have regarding the Proposed Rule.

Sincerely,

Lisa A. Pendergast

Lisa Pendergast
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CRE Finance Council