

**Meeting Between Staff of the Federal Reserve Board and Representatives of the
Structured Finance Industry Group
September 9, 2016**

Participants: Anna Harrington, Ben McDonough, Pam Nardolilli, and Lucy Chang (Federal Reserve Board Staff)

Garrett Ahitow (Bank of America); Timothy Mohan (Chapman and Cutler LLP); Robin Doyle (JPMorgan Chase); Carol Hitselberger (Mayer Brown); Eric Wise (RBC Capital Markets); Sairah Burki and Jennifer Wolfe (Structured Finance Industry Group)

Summary: Staff of the Federal Reserve Board met with representatives of the Structured Finance Industry Group to discuss the proposed rule for single counterparty credit limits (“SCCL”) that the Board issued for public comment pursuant to section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act as part of the Board’s Regulation YY (Docket No. R-1534, RIN 7100–AE 48).

Among the issues raised by the representatives of the Structured Finance Industry Group regarding the proposed rule were:

- Application of the look-through approach to securitization vehicles, investment funds, and other special purpose vehicles (collectively, “SPVs”), including possible exemptions for certain types of SPVs and consideration of structural protections;
- Assignment of exposures to an unknown counterparty;
- Aggregation of exposures to an SPV and specific third parties based on the relationship of such third parties to the SPV;
- Aggregation of exposures to SPVs based on common ownership or accounting consolidation;
- Possibility of overlapping exposures, such as in the case of asset-backed commercial paper conduits; and
- Implementation period.

Materials discussed in the meeting are attached.



Single Counterparty Credit Limits – Application to Securitization Exposures

Discussion with Federal Reserve Board

September 9, 2016

Agenda

- **High-level issues with the proposed rules**
- **Discussion of specific issues**
 1. Scope of look-through approach
 2. Look-through exemption: diversified asset pools
 3. Look-through exemption: senior, investment grade exposures
 4. Application of the look-through approach to revolving structures
 5. Look-through exemption: underlying asset issuers below capital threshold
 6. Scope of unknown counterparty exposure
 7. Scope of third party counterparty exposures
 8. Affiliated Counterparties
 9. Overlapping exposures
 10. Application of counterparty limits to ABCP conduit exposures
 11. Implementation period

High-level issues with proposed rules

1. Procedural issues with look-through approach

- Vast majority of securitization exposures do not contain material underlying counterparty exposures
- Covered companies may find it unworkable in some transactions to comply with the proposed SCCL rules based on the type and frequency of the required information

2. “Third party” counterparty exposures should be limited to credit and liquidity exposures

- As written, these provisions cannot be operationalized due to the unlimited types of third parties covered and the difficult subjective judgment required

1. Scope of look-through approach

- **It is not clear which relationships that a covered company has with an SPV are intended to be covered by the look-through approach**
 - Section 252.75(a)(2) of the proposed rule would imply that the look-through approach would apply to SPVs in which a covered company “invests”

- **At most, the look-through approach should apply to:**
 - Cash investments in SPVs
 - Synthetic investments that mirror such cash investments that are held in the banking book
 - Credit and liquidity facilities, regardless of their form, extended by covered companies to SPVs

1. Scope of look-through approach (continued)

- **If the scope of the look-through approach is not narrowed, exemptions should be provided for exposures that neither present significant risks nor lend themselves to a practical application of the approach, due to their temporary nature**
 - For example, covered companies engaged in the asset-backed securities markets will have **temporary credit exposures** to SPVs through their **underwriting, market making, payment, clearing and settlement** activities
 - Covered companies also engage in **fiduciary, agency, custodial and operational activities** that may result in **temporary advances** of funds to a securitization SPV. Such advances would generally be repayable in full on a priority basis from asset cash flows on the next distribution date for such cashflows
- **There is minimal chance that such temporary exposures would lead to significant ongoing credit exposure to an underlying asset issuer**

2. Look-through exemption: diversified asset pools

- **The Federal Reserve proposed in the alternative in its 2011 proposed rule that a securitization transaction would need to have fewer than 20 exposures for the look-through approach to apply**
 - We believe that such a threshold would better balance the concern that covered companies identify significant exposures to underlying asset issuers against the burdens that the look-through approach would impose
- **Absent this modification, securitizations of assets that do not present any reasonable possibility of significant counterparty exposures should be categorically exempted from the look-through approach**
- **Recommended exemptions:**
 - a. **Securitizations of retail receivables** - (for example, credit cards, auto loans and leases, and residential mortgages)
 - b. **Securitizations of receivables of small and medium-sized enterprises** - (e.g., dealer floor plan loans, equipment loans and leases, and trade receivables)
 - c. **Commercial mortgage loan securitizations** - given the nature of the underlying collateral for these loans (rental streams and real property) and the small likelihood of overlap with other credit exposures

3. Look-through exemption: senior, investment grade exposures

- **An exemption should be provided for senior, investment grade securitization exposures given that credit enhancement and other structural elements provide protection against the risk of loss (see page 8)**
 - Actual credit exposures to underlying asset issuers for covered companies holding these exposures are not equivalent to holding a direct exposure to these issuers

- **Issuer concentrations are a specific factor in determining the amount of credit enhancement for securitization transactions (see page 9)**
 - Credit enhancement will in many cases directly mitigate concentration risk to underlying asset issuers
 - The default of any one underlying obligation is highly unlikely to result in a loss in the value of the senior securitization exposure

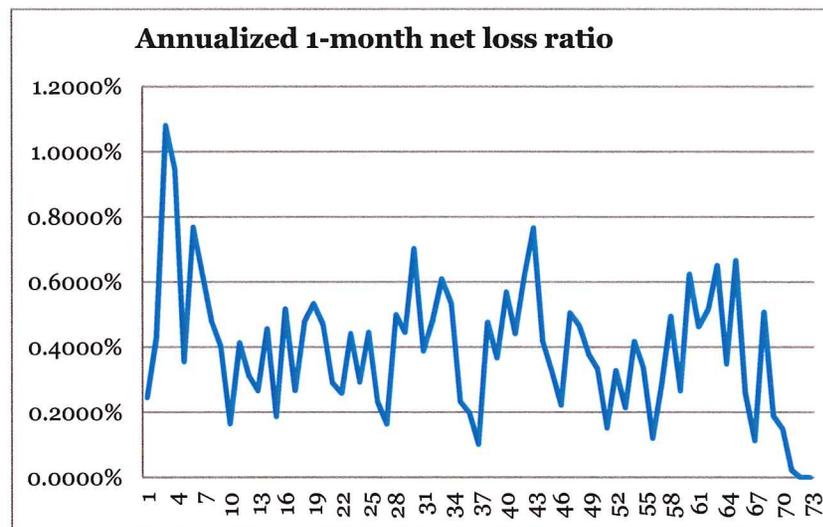
- **Proposed exemption from the look-through approach if:**
 1. The covered company's exposure is **senior** (i.e., the tranche has a detachment point of 100 percent under the risk-based capital rules); and is in the form of debt, **and**
 2. The covered company has determined that its exposure is “**investment grade**” within the meaning of the risk-based capital rules

3. Look-through exemption: senior, investment grade exposures (cont')

- **Investment grade ('IG') senior securitization exposures incorporate credit enhancement features designed to cover multiples of historical stressed losses, materially reducing exposure to obligor concentrations**
 - IG senior securitization exposures in essence offer the investor a de-leveraged exposure to the underlying portfolio of assets
 - Regulators have acknowledged the reduced risk associated IG senior securitization exposures on both an absolute and relative basis
 - On an absolute basis, senior IG securitization exposures have lowest risk weights in both the existing regulatory capital rules and in the 2016 Revisions to the Securitization Framework
 - On a relative basis, senior IG securitization exposures have lower risk weights than the risk weights associated with the underlying asset portfolios

- **Credit enhancement materially reduces the potential that the default of one or more underlying obligors will expose a bank to incremental obligor exposure**
 - This is particularly clear when the underlying portfolios are comprised of retail assets that often consist of tens of thousands of underlying obligors

Prime auto loan securitization



Relevant metrics			
Credit enhancement	avg	max	min
	16.95%	25.02%	12.48%
Obligors	avg	max	min
	22,995	47,631	8,006
Obligor balances	avg	max	min
	\$15,116	\$17,064	\$15,172

3. Look-through exemption: senior, investment grade exposures (cont')

Structural features and eligibility criteria also ensure that obligor exposures are materially mitigated

Trade receivable example:

- Trade receivable securitizations are frequently transacted in the ABCP market
- The account receivables portfolios that are securitized are comprised mainly of diversified portfolios of receivables with some exposures to larger obligors
- Through a combination of eligibility criteria (i.e. concentration limits) and credit enhancement requirements, banks are able to meaningfully reduce the impact of a default by one or more large obligors
- Eligibility criteria screens both the type of receivable and the amount of receivable that a bank will finance and therefore be exposed to in the event of default
 - Eligibility criteria are designed to exclude receivables that are not suitable for securitization (e.g. subject to a prior claim, etc.)
 - Concentration limits are designed to limit the amount of an obligor that can be financed

Obligor Name	Receivables	Concentration Limit (\$)	Purchase Limit (%)	Excess Concentrations
Obligor A	3,082,868	2,212,977	1.25%	869,891
Obligor B	2,891,981	2,212,977	1.25%	679,004
Obligor C	2,717,298	2,212,977	1.25%	504,321
Obligor D	2,597,154	2,212,977	1.25%	384,177
Obligor E	2,379,252	2,212,977	1.25%	166,275
Obligor F	2,368,132	2,212,977	1.25%	155,155
Obligor G	1,216,373	2,212,977	1.25%	-
Obligor H	1,133,392	2,212,977	1.25%	-
Obligor I	916,011	2,212,977	1.25%	-
Obligor J	862,756	2,212,977	1.25%	-

Total Excess Concentrations 2,758,821

- While concentration limits serve to limit the maximum amount of loss that could arise from a particular obligor, banks have a senior claim on all of the cash flows arising from the obligor (eligible and excess concentrations)

Borrowing Base	
Gross Receivable Balance	<u>188,483,620</u>
Ineligible Receivables	(4,519,863)
Excess Government Receivables	(4,166,753)
Excess Obligor Concentrations	(2,758,821)
Net Receivable Pool Balance (NRPB)	<u>177,038,183</u>
Loss Reserve	(13,014,524)
Dilution Reserve	(8,230,058)
Interest and Fee Reserve	(284,879)
Required Reserves	<u>(21,529,461)</u>
NRPB - Required Reserves	<u>155,508,722</u>
Outstanding Borrowings	<u>42,000,000</u>
Compliance: (NRPB - Required Reserves) - Outstanding Borrowings > 0	PASS
Purchase Price	
The lesser of (a), (b) and (c)	
(a) (e.g. Face Amount of ABCP outstandings)	<u>42,000,000</u>
(b) NRPB - Writeoffs (note: write-offs include all receivables 61 + days past due)	
NRPB	177,038,183
Write-offs	(734,812)
	<u>176,303,371</u>
(c) Funding Commitment	<u>150,000,000</u>
Senior securitization exposure	<u>42,000,000</u>

4. Application of the look-through approach to revolving structures

- **In revolving securitization transactions, securitized assets are added as frequently as daily without, in some cases, additional credit being extended or investment being made by the covered company**
 - While in many cases covered companies may receive asset issuer information on a periodic basis, this information is only a snapshot as of a reporting date, often lagging the date on which the report is delivered to the covered company
 - Because of these realities, covered companies cannot identify asset issuers on a daily basis that might exceed 0.25% of tier 1 capital
- **The legal documentation for these transactions, however, typically imposes “concentration limits” that limit the amount of credit extended against the receivables of a single affiliated group of underlying issuers to a specified percentage of the size of the overall asset pool**
 - Covered companies should be permitted to use these limits to determine whether the amount of an underlying exposure in these transactions exceeds the 0.25% of tier 1 capital threshold above which the look-through approach would apply

Application of the look-through approach should be required only when the covered company first acquires its exposure and (i) on asset addition dates in connection with amortizing securitization transactions and (ii) in connection with periodic reporting dates with respect to revolving securitization transactions

5. Look-through exemption: underlying asset issuers below capital threshold

- **The look-through approach should only be required with respect to underlying asset issuers that exceed the 0.25% of tier 1 capital threshold (and not with respect to all underlying asset issuers in such transactions)**
 - The Basel Large Exposure Framework only requires a look-through where the **underlying exposures above the relevant tier 1 capital threshold are treated as separate counterparties**
 - The European Banking Authority has taken the same approach in the EBA Technical Standards

6. Scope of unknown counterparty exposure

- **We believe it was intended that in a transaction where some but not all of the issuers of underlying assets can be identified, that only exposures to unidentified issuers should be added to a covered company’s “unknown counterparty” exposure**
 - We also believe, however, that the language of Section 252.75 of the proposed rule could be read to require that *all exposures* in the relevant transaction, including the exposures to identified issuers, be included
 - We ask that the language of the final rule be modified to remove this ambiguity

6. Scope of unknown counterparty exposure (continued)

- **Assigning all unidentified exposures to a single unknown counterparty across SPVs would create compliance issues for covered companies (without evidence of correlation of credit risk)**

- **Providing that the unidentified exposures across all securitization transactions (and all other exposures to SPVs) are aggregated as a single counterparty exposure would unnecessarily restrict investment in and credit to securitization transactions that fund the real economy, with no evidence of correlated credit risk across these transactions**
 - For example, there is no possibility that the issuers of underlying assets in a securitization transaction of retail exposures are the issuers of underlying assets in a securitization of wholesale exposures

- **The following changes should be considered to address this issue:**
 - Requiring covered companies to create separate unknown counterparties for groups of unidentified asset issuers where a correlation risk exists
 - Not requiring the addition of an unidentified exposure to the single unknown counterparty where it can be established that the amount of the exposure to the unidentified counterparty does not exceed 0.25% of the covered company's tier 1 capital
 - Creating separate unknown counterparties for separate securitization asset classes or types of underlying issuers

7. Scope of third party counterparty exposures

- **A covered company should only be required to recognize third party counterparty exposures in securitization transactions where the third party provides credit or liquidity support to the transaction**
 - Exposure should not exceed the maximum amount of the loss that the covered company could suffer – the proposed rule is designed to limit *credit* exposures to unaffiliated counterparties
 - The universe of third parties that a covered company would be required to cover is unlimited and there is not necessarily any correlation between the level of potential loss that could be suffered and the amount of the required exposure (which equals the full amount of the covered company's securitization exposure under all circumstances)
- **The amount of the counterparty exposure to a third party should also be limited when appropriate and should not automatically be sized at the amount of the covered company's gross exposure to the related SPV as required by the proposed rule**
 - Where, for example, four unaffiliated third parties each provide a 25% credit guarantee of a securitization transaction, the amount of the exposure recognized to each third party should be limited to the 25% maximum credit exposure and should not equal the entire amount of the covered company's securitization exposure
- **The third party exposure requirement should be subject to the same de minimis exclusion as the look-through requirement**

7. Scope of third party counterparty exposures (continued)

- **Covered companies should not be required to recognize third party counterparty exposures where the third party is an affiliate of the SPV**
 - Many of the third parties described in the Preamble and the proposed rule would be affiliates of the SPV counterparty in a typical securitization (e.g., it is common for the asset originator and initial servicer in a securitization transaction to be affiliates of the issuing SPV)
- **Given that the SPV exposures in these transactions would already be aggregated with those other entities under the definition of “counterparty” in the proposed rule, adding an additional counterparty exposure to these entities would be double counting the risk to such an affiliated group**
- **The maximum amount that the covered company could lose as a result of the credit or other risks to that counterparty group would be the amount of the securitization exposure**

8. Affiliated Counterparties

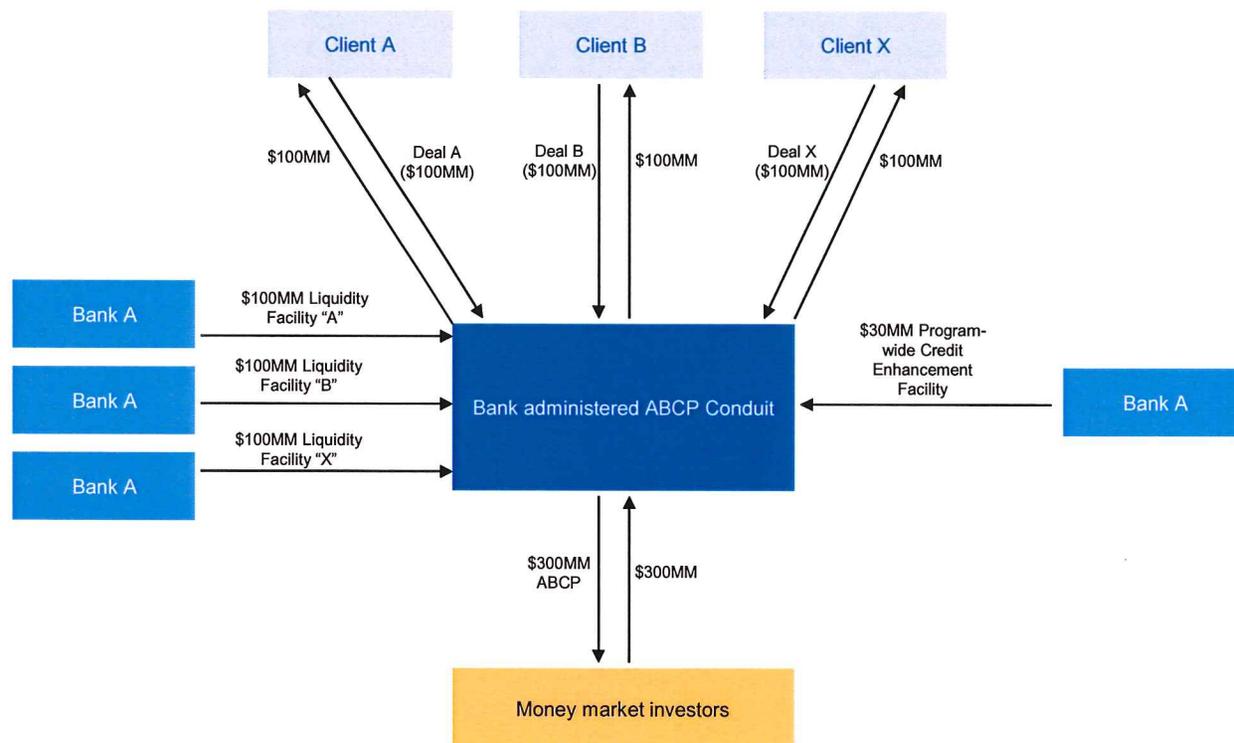
- **It is common in securitization transactions for entities that are in the business of owning equity interests and providing management services to SPVs to own the voting equity in SPVs for otherwise completely unrelated securitization transactions**
 - Many of these third party entities hold the voting equity in hundreds of otherwise unaffiliated SPVs
 - It would serve no meaningful purpose to treat such SPVs as affiliated counterparties for purposes of the final rule
- **We request that the final rule be modified to provide that SPVs should not be treated as affiliated counterparties where such affiliation is only through common ownership by or accounting consolidation with an entity:**
 - Whose primary line of business is owning equity interests in special purpose entities
 - Whose activities with respect to the SPV are limited to providing management or administrative services, and
 - Does not originate any of the underlying assets of the SPV

9. Overlapping exposures

- **Multiple, overlapping exposures to an SPV in a single securitization transaction should not be counted more than once in determining the amount of a covered company's exposure to the SPV**
 - In some securitization transactions, the same financial institutions will provide **multiple credit and liquidity facilities** to a single SPV

- **The most common structure presenting this issue is an ABCP conduit**
 - Sponsor banks will often provide credit facilities to the ABCP conduit that provide “second loss” credit protection to the conduit's commercial paper holders in the event that the cashflows from underlying transactions financed by the ABCP conduit prove insufficient to timely repay commercial paper
 - The same sponsor bank will also provide a liquidity facility in the full amount of each individual transaction financed by the ABCP conduit under which the ABCP conduit may sell or otherwise finance its interest in the individual underlying transaction exposure in order to obtain funds to repay commercial paper
 - In addition, in certain transactions, the sponsor bank may also provide a parallel lending commitment to the underlying transaction-level SPV in the event that the ABCP conduit cannot or elects not to provide funding through the issuance of commercial paper
 - The maximum credit exposure of a covered company providing these multiple facilities is the face amount of the ABCP conduit's commercial paper

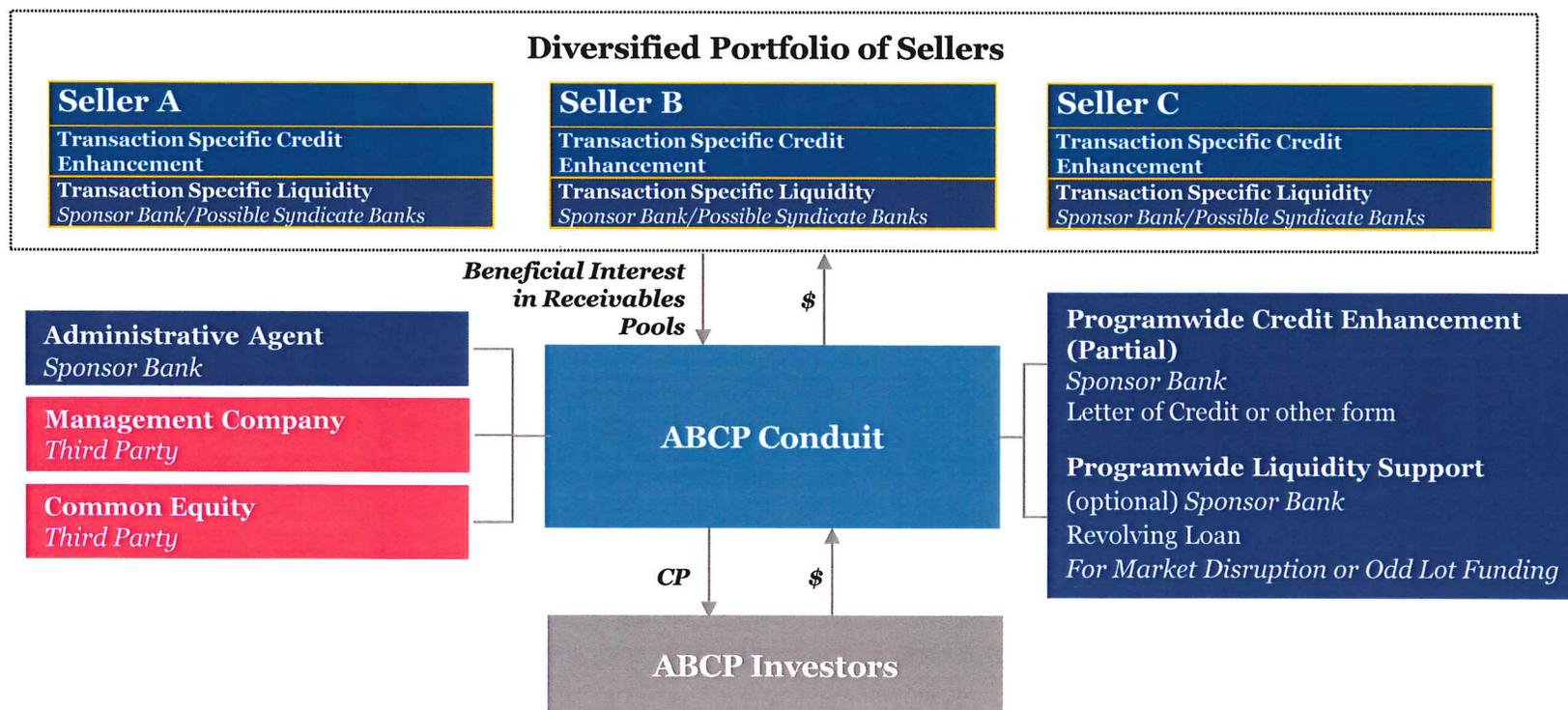
9. Overlapping exposures (continued)



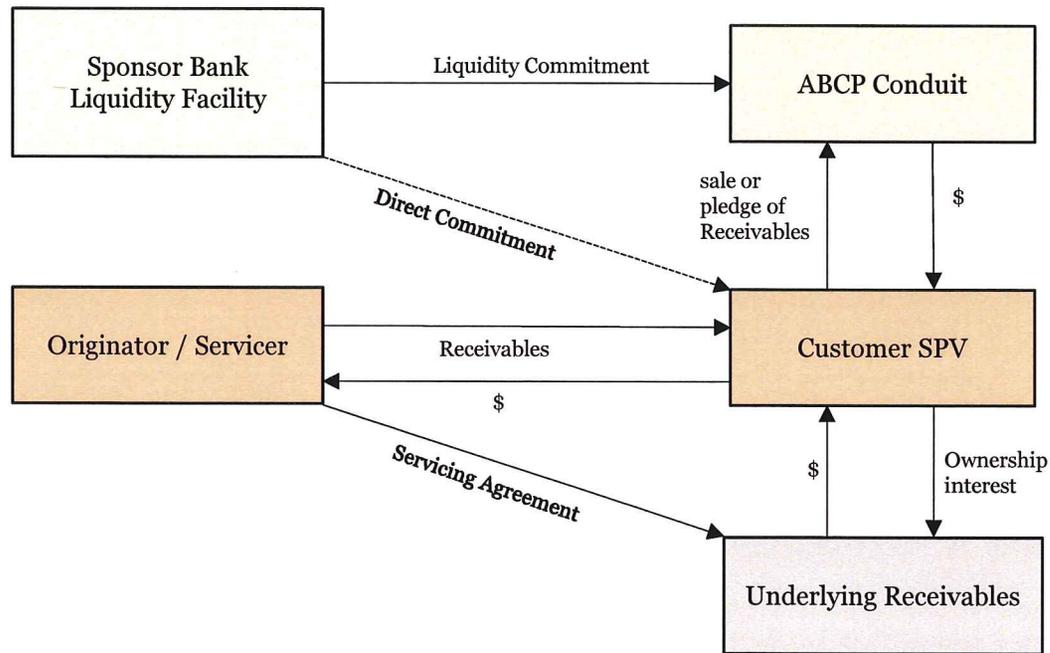
- **The overlap issue arises because the aggregate amount of committed facilities extended by Bank A in this case exceeds the maximum exposure and loss that can be incurred**
 - \$300MM of transaction specific liquidity facilities + \$30MM of a program-wide credit enhancement facility > \$300MM of ABCP
- **SFIG's recommendation that overlapping facilities should not be counted more than once is based on the fact that banks in this situation could never lose more than \$300MM**

10. Application of counterparty limits to ABCP conduit exposures

- **Our members intend to continue to treat:**
 - Liquidity facilities provided in ABCP conduit transactions as creating counterparty exposures to the underlying transaction-level SPV and not exposures to the ABCP conduit
 - Program-wide credit facilities (other than those which also serve as liquidity facilities) provided to ABCP conduits as counterparty exposures to such conduits
 - Members believe this approach is consistent with both the provisions and the intent of the proposed rule, and the risk-based capital and liquidity coverage ratio treatment of these facilities.



10. Application of counterparty limits to ABCP conduit exposures (cont')



11. Implementation period

- **The proposed one-year implementation period for larger covered companies should be extended to a minimum of two years**
 - Establishing the operational systems and procedures necessary to implement the SPV provisions of the proposed rule that are the subject of this comment letter alone will require significant time and resources
 - Systems and procedures would also need to be harmonized with the substantial systems and procedures larger covered companies will need to develop to comply with the overall provisions of the proposed rule