



BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
WASHINGTON, DC 20551

September 29, 2023

Luigi L. De Ghenghi, Esq.  
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450 Lexington Avenue  
New York, New York 10017

Dear Mr. De Ghenghi:

This is in response to your letter dated August 15, 2023, to the Board on behalf of Morgan Stanley, New York, New York, requesting relief under the Board’s Regulation Q (the “capital rule”).<sup>1</sup> Specifically, Morgan Stanley requests authorization to treat the transaction by Morgan Stanley Finance LLC, New York, New York (“MS Finance”), named “Series 2023-1 Portfolio Tranchd Credit-Linked Notes due September 7, 2030” (the “CLN transaction”), as a synthetic securitization for purposes of calculating Morgan Stanley’s risk-weighted assets under the capital rule.

In the CLN transaction, MS Finance has issued debt obligations, the principal and interest payments on which are calculated based on the performance of a pool of loans held by Morgan Stanley Bank, N.A., New York, New York. Specifically, payments on the obligations are calculated as if a credit default swap were in place.<sup>2</sup> MS Finance has received cash from purchasers in consideration for the issuance of these debt obligations.

To be a securitization exposure under the capital rule, an exposure must arise from or reference a “traditional securitization” or a “synthetic securitization,” as defined in the capital rule.<sup>3</sup> If the transaction meets certain operational criteria, a Board-regulated institution may, in the case of a traditional securitization, exclude the underlying exposures from the calculation of its risk-weighted assets or, in the case of a synthetic securitization, recognize for risk-based capital purposes the use of a credit risk

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<sup>1</sup> 12 CFR part 217.

<sup>2</sup> The transaction has been documented as if a credit default swap were in place under a 2002 Master Agreement and Schedule, as published by the International Swaps and Derivatives Association, Inc., between MS Finance and a hypothetical counterparty.

<sup>3</sup> 12 CFR 217.2 s.vv. securitization exposure, synthetic securitization, traditional securitization.

mitigant to hedge the underlying exposures.<sup>4</sup> A Board-regulated institution that meets these conditions must hold risk-based capital against any credit risk of the exposures it retains in connection with the securitization.<sup>5</sup> Morgan Stanley requests that the Board permit it to compute its risk-weighted asset amount under the capital rule as if the CLN transaction were a synthetic securitization that met the operational criteria for synthetic securitizations.

For a transaction to be a synthetic securitization under the capital rule, at least a portion of the credit risk of one or more underlying exposures must be transferred to one or more third parties through the use of one or more “credit derivatives” or “guarantees,” as defined in the capital rule.<sup>6</sup> Moreover, to meet the operational criteria for a synthetic securitization, a Board-regulated institution must use a qualifying credit risk mitigant in the form of “financial collateral,” a guarantee that meets certain requirements, or a credit derivative that meets certain requirements.<sup>7</sup> Morgan Stanley has not demonstrated that the CLN transaction satisfies each of these elements of the capital rule.

Under the CLN transaction, as represented by Morgan Stanley, a portion of the credit risk of the underlying exposures is transferred to the obligation holders by use of contractual provisions that incorporate standard industry credit derivative documentation. In addition, MS Finance receives the value of the purchased credit protection at issuance in the form of cash proceeds; the proceeds serve to mitigate credit risk of the protection providers. The amount of cash that MS Finance owes to the obligation holders depends on the credit performance of the pool of reference assets. Thus, the credit protection is pre-funded rather than backed by collateral.<sup>8</sup> Morgan Stanley contends that the CLN transaction meets all other definitional requirements and operational criteria for synthetic securitizations under the capital rule. It is expected that the risk weight produced under the securitization framework under the capital rule would be commensurate with the risk of the exposures that arise from the transaction if the CLN transaction as represented by Morgan Stanley were treated as a synthetic securitization that meets the operational criteria for a synthetic securitization.

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<sup>4</sup> 12 CFR 217.41(a) and (b); .141(a) and (b).

<sup>5</sup> Id.

<sup>6</sup> 12 CFR 217.2 s.vv. credit derivative, guarantee, synthetic securitization.

<sup>7</sup> 12 CFR 217.41(b)(1); .141(b)(1); see also 12 CFR 217.2 s.vv. eligible credit derivative, eligible guarantee, financial collateral.

<sup>8</sup> Morgan Stanley has represented that, for the CLN transaction, the principal amount of the CLN transaction, the cash proceeds of the CLN transaction, the notional amount of protection under related interaffiliate credit derivatives, and the cash collateralizing the credit derivatives would all be denominated in the same currency as the reference portfolios and thus would not present any currency mismatch.

Based on all the facts of record, the Director of the Division of Supervision and Regulation, acting pursuant to section 217.1(d)(3) of the capital rule under authority delegated by the Board,<sup>9</sup> and after consultation with the General Counsel, has determined that Morgan Stanley may calculate its risk-weighted asset amount under the capital rule as if the CLN transaction were a synthetic securitization that met all of the operational criteria for a synthetic securitization. This action also permits Morgan Stanley to treat other credit-linked-note transactions as synthetic securitizations for purposes of calculating risk-weighted assets under the capital rule, so long as any such other credit-linked-note transactions are structured and documented in a substantially identical manner to the CLN transaction and do not deviate from the definitional requirements and operational criteria for synthetic securitizations in the capital rule other than with respect to the use of a “credit derivative” and the presence of a qualifying credit risk mitigant. In addition, this action applies only to the CLN transaction and other substantially identical CLN transactions up to an aggregate outstanding reference portfolio principal amount of the lower of 100 percent of Morgan Stanley’s total capital or \$20 billion. Morgan Stanley may not apply this treatment to less than the entirety of all the exposures arising out of any given CLN transaction.

This action is based on the specific facts and representations in the request and in communications with Board staff, as well as any commitments provided by Morgan Stanley. Any change in these facts or representations should be communicated immediately to Board staff and could result in a different conclusion. This action also is limited to this transaction and like transactions as described above and does not apply to any other transaction.

Very truly yours,

*(Signed) Ann E. Misback*

Ann E. Misback  
Secretary of the Board

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<sup>9</sup> 12 CFR 265.7(k)(1)(ii)(C).