Meeting Between Staffs of the Federal Deposit Insurance Corporation, Federal Reserve System, Office of the Comptroller of the Currency, and Representatives from the Financial Services Forum ("FSF") and the Structured Finance Association ("SFA").

March 14, 2024

Participants:

Benedetto Bosco, Ryan Billingsley, Iris Li, Catherine Wood, Ernest Barkett, Kyle McCormick, Merritt Pardini, Keith Bergstresser, Adam Casella, Joanne Rose, Bob Charurat, Huiyang Zhou, David Riley and Michael Maloney (Federal Deposit Insurance Corporation).

Missaka Warusawitharana, Andrew Willis, Gillian Burgess, Robin Oh, Cecily Boggs, Leslie Chao, Daniel Schwindt, Christoper Appel and Abigail Roberts (Federal Reserve System).

Andrew Tschirhart, Margot Schwadron, Amrit Sekhon, Kevin Korzeniewski, Carl Kaminski, Benjamin Pegg, Venus Fan, Jie (Diana) Wei, Daniel Perez and Nadia Gerasimova (Office of the Comptroller of the Currency).

Sean Campbell and Emma Tong (Financial Services Forum); Michael Bright, David Dwyer, Leslie Sack, Frank Tallerico and Jeff Gudiel (Structured Finance Association); Garrett Ahitow, Damien Kudelka and Benget Redlinger (Bank of America); Jiren Xu and Rick Gambs (BNY Mellon); Jonathan Silverstone, Xiaochao Wang and Stjepan Devcic (Citigroup); Joseph Hwang, Avijit Praveer and Ben Katz (Goldman Sachs); Alister Webster, Beth Cleland, Vijay Kandula, Mansoor Sirinathsingh and Alizeh Hussain (JP Morgan); Robert McKeon and Fabrice Dumont (State Street); Tim Becker, John Allen, Mark Spaulding, Natalie Rutzell and Yosef Nussbaum (Wells Fargo); Andrew Nash, Denise Pieck, Gang Qi, Sarah Lantz, Richard Tuosto and Michael Formichelli (Morgan Stanley); Chen Xu and Taylor Richards (Debevoise & Plimpton); Marc Tourangeau and Lisa Galletta (International Swaps and Derivatives Association); Christopher Horn, Stuart Litwin, Andrew Olmem and Matthew Bisanz (Mayer Brown); Francisco Covas (Bank Policy Institute); Hu Benton, Warren Hrung and John Rothenberg (American Bankers Association); Peter Ryan, Guowei Zhang and Carter McDowell (Securities Industry and Financial Markets Association).

Summary: Staffs of the Federal Deposit Insurance Corporation, Federal Reserve System, and Office of the Comptroller of the Currency (collectively, the "agencies") met with representatives from FSF and SFA (collectively, the "industry representatives") regarding the agencies' Notice of Proposed Rulemaking on Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity (FDIC RIN 3064–AF29) (the "NPR"), which was published in the Federal Register on September 18, 2023 (88 FR 64028). The industry representatives discussed their concerns with the current and proposed securitization and credit risk mitigation frameworks in the NPR, and their recommendations for changes as outlined in the two attached slide presentations that they provided in connection with the meeting.

FINANCIAL SERVICES FORUM

Basel III Endgame Comment: Credit Risk Mitigation

March 2024

Introduction

- Credit risk mitigation is critical for prudent risk management. In that regard, we recommend certain modifications to the credit risk mitigation framework **to recognize bona fide transfers of credit risk** and ensure that banking organizations can serve their intended functions in a frictionless way.
- Various aspects of the proposal and credit risk mitigation framework may dis-incentivize and generally frustrate prudent credit risk management by banks. Our comments are designed to improve the scope and incentives for prudent credit risk management.
- Our comments are coordinated with these other trade associations - ABA, BPI, ISDA, SFA, SIFMA – reflecting the importance of these issues, the commonality of these issues across trade associations, and the ultimate workability of the Basel III Endgame (B3E) final rule.

Key Credit Risk Mitigation Issues

1. Counterparty Credit Risk
    a. Minimum Haircuts for Securities Financing Transactions
    b. Other Counterparty Credit Risk Issues
2. Simple Approach for Collateralized Transactions
3. Eligible Guarantor Requirement
4. Credit Derivatives and Parent Entities
5. Maturity Mismatch Application
6. Recognition of Fixed Notional Credit Derivatives

Counterparty Credit Risk: SFT Haircuts

- The final rule should **remove the SFT haircut floor framework in line with other jurisdictions** and **eliminate conflict with pre-existing broker-dealer regulations.**
  - According to the FSF and ISDA/SIFMA QIS - Implementing SFT haircuts will **increase SFT RWA by $124 billion**.
  - SFT transactions play a pivotal role in financial markets. Implementing minimum SFT haircut floors could have **significant adverse effects on key financial markets.**
  - Implementation of SFT minimum haircuts may **drive SFT activity to unregulated financial institutions**, facilitating increased leverage outside the regulated banking sector.
  - SFT minimum haircuts create a **cliff effect** in capital requirements.
  - Other jurisdictions such as **Canada, the EU, Japan, and the UK have not implemented minimum SFT haircuts.** U.S. implementation would only exacerbate existing competitive disadvantages with non-U.S. banks.
  - If the Agencies adopt an SFT minimum haircut regime, we propose several critical changes to the proposed framework that are outlined in the attached appendix.

Other Counterparty Credit Risk Issues

- All FSF members are members of ISDA/SIFMA and support all of the comments made in that letter with regard to the proposal's treatment of counterparty credit risk.
- It is critical that the proposal's **methodology for quantifying exposure for derivative and securities financing transactions accurately reflect their risks and do not penalize prudent risk management.**
- Among the points made in the ISDA/SIFMA letter which bear on the treatment of counterparty credit risk we recommend:
  - **Retaining** the ability to recognize the risk-mitigating effects of non-investment grade corporate securities for term repo-style transactions by not requiring inclusion of the collateral leg in the market risk measure.
  - **Clarifying** the netting set formula applies to eligible margin loan transactions booked as a single unit account for GAAP and also permit it for single repo-style transactions with multiple securities as collateral.
  - **Reducing** market price volatility haircuts for U.S. Agency debt to better align with underlying price risk.
  - **Retaining** the ability to recognize the risk-mitigating effects of investment grade corporate security collateral regardless of whether the corporate issuer (or its parent) has a publicly traded security outstanding.

Simple Approach for Collateralized Transactions - I

- Under the proposal, the risk mitigating benefits of financial collateral may be recognized using the simple approach as long as 1) the collateral is subject to a collateral agreement for at least the life of the exposure, 2) the collateral is re-valued every six months, and 3) the collateral (other than gold) and the exposure are denominated in the same currency.
  - Requirement 1) inadvertently excludes recognition of financial collateral when rights may be stayed or avoided under applicable law.
  - As non-QFCs are typically not exempt from automatic stays, the simple approach would only realistically apply to a narrow range of QFCs where banks would generally use the collateral haircut approach that allows for exposure reduction and not just risk weight substitution. This significant limitation on the simple approach penalizes prudent credit risk management.
  - **We recommend that the Agencies remove or adjust Requirement 1) to allow for collateral recognition in the simple approach irrespective of whether it might be stayed or avoided under applicable law**

Simple Approach for Collateralized Transactions - II

- Under the proposal, the risk mitigating benefits of financial collateral may be recognized using the simple approach as long as 1) the collateral is subject to a collateral agreement for at least the life of the exposure, 2) the collateral is re-valued every six months, and 3) the collateral (other than gold) and the exposure are denominated in the same currency.
  - Requirement 3) further limits the applicability of the simple approach and is not consistent with the Basel Framework (CRE22.15). The Basel standard specifies that "currency mismatches are allowed under all approaches."
  - Non-recognition of currency mismatches will hurt U.S. competitiveness and unjustifiably penalize U.S. banking institutions.
  - Recognition of a partial currency mismatch could include recognition of the matched portion, subject to a standard haircut or recognition of the currency mismatch only for certain products, such as contingent facilities.
  - **We recommend that the currency matching requirement be removed.**

Eligible Guarantor Requirement

- The final rule should **remove any requirement that "eligible guarantees" and by extension "eligible credit derivatives" be provided by "eligible guarantors", except with regard to securitizations.**
  - The Agencies have previously acknowledged that the requirement to use only "eligible guarantors" disqualifies many guarantees of middle-market and commercial real estate loans even though they provide "valuable credit risk mitigation and should be recognized".
  - The Agencies removed an "eligible guarantor" requirement under the advanced approaches in 2014, instead only applying the requirement to certain securitization exposures. In 2014, the Agencies explained that they were retaining the "eligible guarantor" requirement in the standardized approach as the "standardized approach generally applies a single risk weight to exposures to most corporate borrowers and guarantors…"
  - While the existing standardized approach only includes a 100% risk weight for most types of corporate exposures, ERBA includes a variety of risk weights across a variety of corporate, retail, and real-estate exposures for which "valuable credit risk mitigation" should be recognized.

Credit Derivatives and Parent Entities

- The final rule should **permit recognition of credit risk mitigation benefits of an eligible credit derivative where the hedged exposure references a parent entity that controls the obligors on an underlying exposure, as long as a default on the underlying exposure triggers payment by the parent entity under the instrument.**
    - Under the proposal, the credit risk mitigation benefits of a credit derivative can only be recognized if (1) the reference exposure and the hedged exposure are to the same legal entity and (2) legally enforceable cross-default or cross-acceleration clauses are in place to assure that payments under the credit derivative are triggered when the obligor fails to pay under the terms of the hedged exposure.
    - Many corporate groups structure their operations with a holding company that often guarantees the obligations of its operating subsidiaries.
    - As long as there are legally enforceable cross-default or cross-acceleration clauses that ensure that protection purchased on the parent entity is triggered by the obligor's default, the credit risk mitigation benefits of a credit derivative on the parent entity should be recognized.

Clarification: Maturity Mismatch Application

- The credit risk mitigation framework **does not specify how maturity should be determined to apply the maturity mismatch** for netting sets of derivatives and SFT transactions meeting QMNA criteria that may include offsetting payables and receivables when recognizing the risk mitigating benefits of an eligible guarantee or eligible credit derivative for RWA purposes.
    - The credit risk mitigation framework does allow such exposure amounts to be determined according to either the standardized approach (SA-CCR) for counterparty credit risk or the collateral haircut approach.
    - We recommend that for a netting set of derivatives, repo-style transactions, or eligible margin loans that meet QMNA criteria, for the purposes of determining any maturity mismatch haircut applicable to the credit protection, **a banking organization should be able to compare the maturity of the purchased protection against the notional weighted average maturity of the netting set.**

Confirmation: Fixed Notional Credit Derivatives

- Under the proposal and under the current standardized approach, the credit risk-mitigating benefits of an eligible credit derivative via the wholesale credit risk mitigation framework **may only be recognized if credit risk is fully covered by the eligible credit derivative or is covered on a pro rata basis.**
    - We believe that a fixed notional credit default swap that hedges an interest rate swap with a variable exposure amount that could exceed or fall below the credit derivative's protection amount would meet the above requirement and could be considered a risk mitigant under the wholesale credit risk mitigation framework.
    - A bank reflecting the credit risk mitigation benefit of such a swap would take into account how much of the exposure is covered by the credit derivative.
    - **We recommend that the Agencies confirm that a banking organization may recognize the credit risk mitigation benefits of fixed notional credit derivatives that cover a derivative exposure.**

Conclusion

- Credit risk mitigation is critical for prudent risk management. In that regard, we recommend certain modifications to the credit risk mitigation framework **to recognize bona fide transfers of credit risk** and ensure that banking organizations can serve their intended functions in a frictionless way.
- Our comments are designed to improve the scope and incentives for prudent credit risk management.
- In brief we recommend to:
    - **Not adopt** minimum SFT haircuts and make adjustments to other counterparty credit risk methodologies to ensure sufficient risk sensitivity.
    - **Adjust requirements** for the simple approach for collateralized transaction.
    - **Not require** that "eligible guarantees/eligible credit derivatives" be provided by "eligible guarantors".
    - **Permit recognition** of credit derivatives referencing parent entities if cross default provisions are in place.
    - **Clarify** the application of the maturity mismatch in the credit risk mitigation framework.
    - **Confirm** that a bank may recognize the credit risk mitigation benefits of fixed notional credit derivatives.

Appendix

Appendix: SFT Haircuts - Alternative

- If SFT minimum haircuts are ultimately adopted, it is important that the final rule:

1. **Only treat in-scope transactions as uncollateralized** if a netting set comprised of both in-scope and out-of-scope transactions does not meet the portfolio-based minimum haircut floor.
    - The preamble of the proposal suggests this was the proposal's approach, but the rule language is ambiguous, so this is a request for clarification.
2. **Minimum SFT haircuts should not apply to securities borrowing transactions.**
    - Securities borrowing transactions are already covered by margining requirements under the Federal Reserve's Reg T.
    - If securities borrowing transactions are covered the rule should specify that securities borrowing transactions in which a banking organization has current or near-term reasonably anticipated uses or needs for an equivalent or greater amount of securities should not be covered.
3. **Minimum SFT haircuts should not apply to transactions in which the securities borrower is a foreign person** or is borrowing to re-lend to a foreign person, with respect to a foreign security for any purposes that are lawful under the laws of the security borrower.
    - Any minimum SFT haircut requirement would create undue competitive disadvantages for U.S. banks.

Appendix: SFT Haircuts - Alternative

4. **Specify that banks can satisfy the "written documentation" requirement through ordinary course books and records.**
   - Any other approach could be inconsistent with existing regulatory requirements and market practice.
5. **The proposal's proposed exemption for cash reinvestment should be expanded to include reinvestment in instruments without stated maturity that can be redeemed or liquidated quickly.**
   - This should include investments in money-market mutual funds, demand deposits, and repo-style transactions where cash collateral is invested in instruments of sufficient liquidity to satisfy transaction unwinds.
6. **Minimum SFT haircuts should not apply when a banking organization lends cash in exchange for GSE debt securities or MDBs and explicitly for U.S. sovereign securities.**
   - Such transactions are low risk and the underlying securities play an important role in financial markets.
7. **Minimum haircut floors should not apply to client-facing leg of cleared transactions.**
   - Final rule should clarify that such transactions are out-of-scope.

Appendix: SFT Haircuts - Alternative

8. **Minimum haircuts for MDB exposures, exposures to supranational entities, and GSEs should be reduced to 0 percent.**
    - These securities are generally low risk and play an important role in the financial system.
9. **The final rule should specify that, for the single-transaction and portfolio haircut floor calculations, the exposure amount is based on all collateral and the collateral amount is based on financial and non-financial collateral.**
    - This approach is generally consistent with the FSB and Basel frameworks for minimum haircuts.
10. **The final rule should consider collateral in transit.**
    - In many cases, collateral is settled on a T+1 basis.
11. **The final rule should clarify that the minimum haircut framework does not apply for purposes of determining exposure under the SCCL.**
    - The policy purpose of SCCL is separate and distinct from the supervisory objective of minimum SFT haircuts.

STRUCTURED FINANCE ASSOCIATION

Basel III Endgame:

Securitization Framework

March 14, 2024

THE PROPOSED SECURITIZATION FRAMEWORK SHOULD BE REVISED

Securitization is important to the real economy:

Securitization plays a pivotal role in funding consumer and business loans. Auto loans, mortgages, student loans, credit cards, and commercial loans are commonly securitized.

The Proposed Rule's treatment of securitization is harmful because it would:

- Reduce the availability and raise the cost of credit for US consumers and businesses.
- Put US banks at a competitive disadvantage with their international peers.
- Impede the ability of US banks to share credit risks with the capital markets.

Our key recommendations:

- **The p-factor should not be increased from 0.5 to 1.0.**
- **The p-factor should be set at 0.25 for qualifying securitization transactions ("QSTs").**
- **The Agencies should clarify the treatment of directly issued credit-linked notes.**
- **Traditional securitizations should require only legal isolation, not accounting derecognition.**

SECURITIZATION CAPITAL REQUIREMENTS AFFECT THE REAL ECONOMY

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

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

- Banks make loans to bankruptcy-remote special purpose entities ("SPEs") that hold pools of consumer and business loans.
- Banks invest in asset-backed securities ("ABS") issued by other banks and non-banks.

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

P-FACTOR: SECURITIZATION PENALTY

- **Both SSFA and SEC-SA impose a securitization penalty**.
  - *This penalty is in the form of a capital surcharge and is the percentage amount by which a bank's capital requirement would increase if bank held every tranche of securitization, rather than holding the underlying assets directly.*

- The p-factor controls the size of the penalty.

  - **p = 0.5 under SSFA. The penalty is 50% under SSFA.**
  - **p = 1.0 under SEC-SA. The penalty is 100% under SEC-SA.**

- The current p-factor of 0.5 was established in 2013, well after the financial crisis and the severe recession that followed.

- The NPR does not provide data, quantitative analysis, or financial modeling rationale to support a p-factor of 1.0. Nor does it provide any analysis of the economic impact on residential mortgages, auto loans, student loans, or the broader economy.

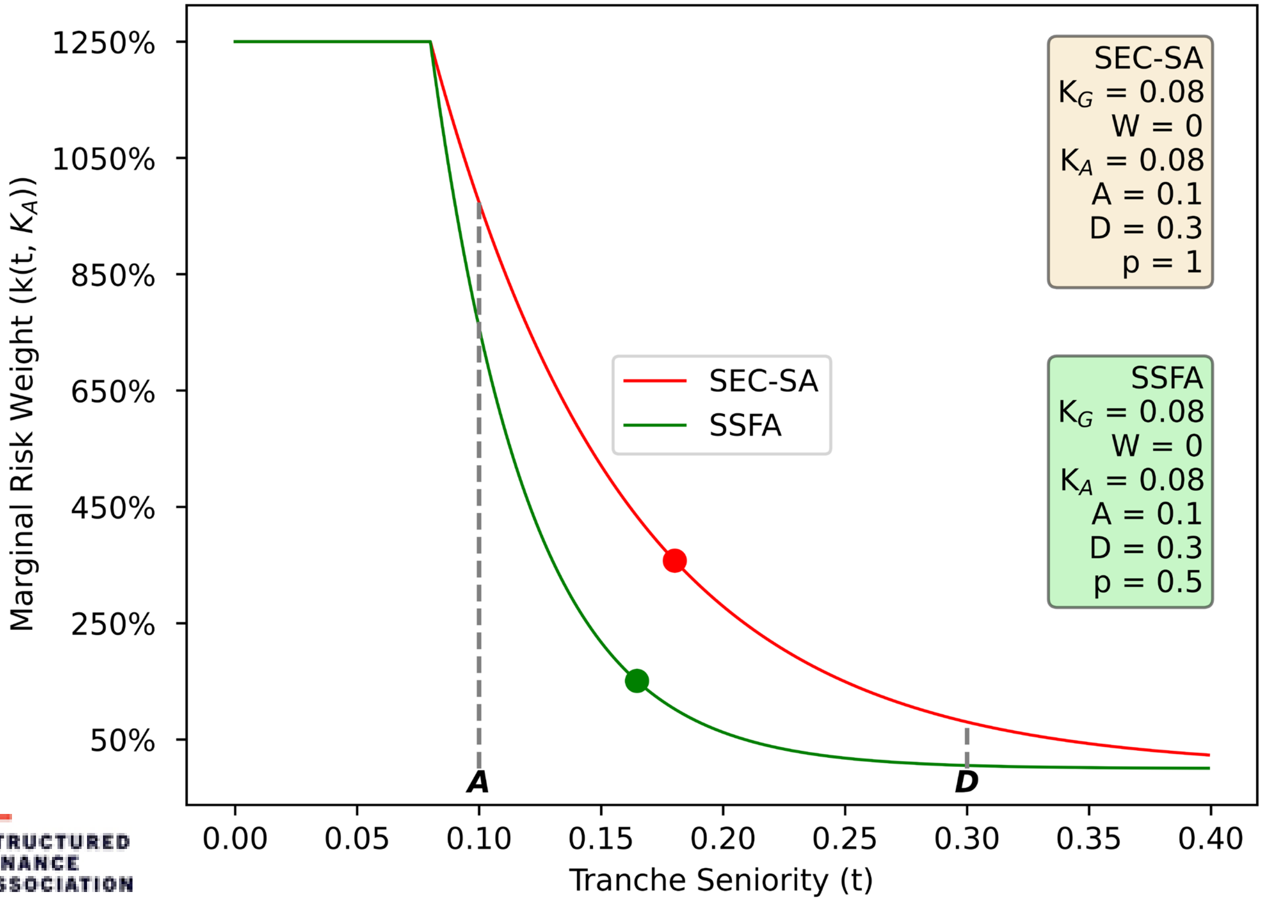
P-FACTOR: EFFECT OF INCREASING THE P-FACTOR

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

t: *tranche seniority*

K_A: *capital requirement for underlying assets (adjusted for defaults)*

$$p = \begin{cases} 1.0\ (SEC-SA) \\ 0.5\ (SSFA) \end{cases}$$



$$RW = \frac{1}{(D-A)} \int_A^D k(t, K_A)dt$$

$$RW_{SEC-SA} = 357.4\%$$
$$RW_{SSFA} = 150.6\%$$

STRUCTURED FINANCE ASSOCIATION

P-FACTOR: THE NPR's EXPLANATION

"The proposed increase to the supervisory parameter for securitizations … 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 …." NPR, at p. 64070.

- The NPR does not explain why the proposed changes in risk weights of underlying exposures would cause a 0.5 p-factor to be insufficiently conservative.

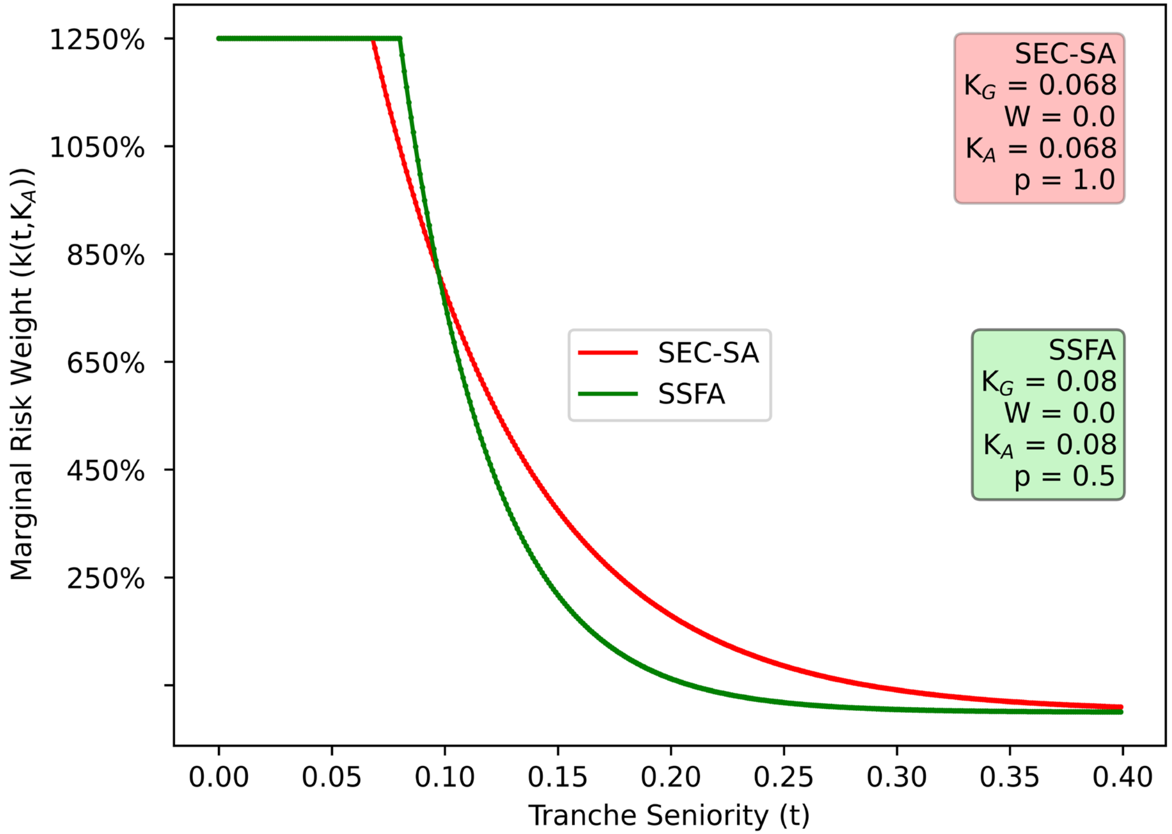
- Per the NPR, the changes in underlying risk weights "incorporate more granular risk factors to allow for a broader range of risk weights." The NPR does not explain why these improvements result in less accurate risk weights for securitization exposures such that an increase in the p-factor is needed.

- The NPR offers no policy reason for raising the p-factor to neutralize the effects of lower risk weights for some types of underlying exposures. The SFA believes no sound policy reason exists to support that approach.

- The NPR offers no empirical support for a p-factor value of 1.0.

P-FACTOR: INCREASE IN P-FACTOR DOES NOT NEUTRALIZE LOWER RISK WEIGHTS FOR UNDERLYING EXPOSURES—AUTO LOAN EXAMPLE

Example: The proposal reduces the risk weight for auto loans from 100% to 85%. Thus, K_G is reduced from 8% (under SSFA) to 6.8% (under SEC-SA).
Increasing the p-factor does not neutralize the reduction in auto loan risk weights; rather it introduces anomalies that harm both consumers and U.S. banks.



Proposal would harm consumers and the international competitiveness of US banks:

For US banks, the risk weight will *double* for warehouse lending facilities to SPEs that hold prime auto loans. This will lead to higher financing costs for auto loans and higher borrowing costs for consumers.

Because of higher p-factor, no QST, and lack of external or internal ratings-based approaches, US banks will have a risk weight for such facilities that is *2x to 4x greater* than non-US banks.

P-FACTOR RECOMMENDATION: 0.5 / 0.25 FOR QSTs

- **The p-factor should be kept at 0.5 and reduced to 0.25 for "qualifying securitization transactions ("QSTs")**.
    - Problem: BCBS and EU standards have a lower p-factor for securitizations that meet certain criteria ("STC" or "STS"). The US proposal would treat all US securitizations the same way that BCBS treats non-qualifying securitizations.
    - Solution: The SFA proposal would align with the US with the current approach in the EU, which is 0.5 for securitizations and 0.25 for qualifying securitizations.
        - *Our proposed QST criteria (see next slide) are a streamlined version of the STC criteria. They focus clearly on those attributes that reduce risk and warrant a lesser securitization capital surcharge.*

QST CRITERIA

- Junior liabilities must not have payment preference over senior liabilities which are due and payable. In other words, the securitization must not be structured as a “reverse” cash flow waterfall such that junior liabilities are paid when due and payable senior liabilities have not been paid.
- The underlying exposures must be of the same asset class. For example, in a securitization of auto receivables, all the underlying assets must be auto loans and/or leases and related property. No other asset types (equipment loans, floorplan loans, etc.) may be included in the underlying pool.
- If the bank is not the originator of the underlying exposures, a minimum of 5 years of historical performance data for underlying exposures with substantially similar risk characteristics to those being securitized must be evaluated by the bank.
- Both the originator and servicer of the underlying exposures must have a minimum of 5 years of experience as an originator or a servicer, respectively.
- The transaction documents contain a representation and warranty to the effect that, at the time of the final cut-off date of the securitized portfolio, no underlying exposure is greater than 30 days delinquent and no underlying exposure is in default, in each case as defined by the transaction agreements for the securitization.
- The performance of the underlying exposures is described in a monthly report required by the transaction documents.
- For securitizations featuring a revolving period, the transaction documents must contain provisions for early amortization events and/or triggers to terminate the revolving period.
- For traditional securitizations, a legal opinion as to the legal isolation of the underlying exposures from the transferor must be delivered in accordance with the transaction documents. For synthetic securitizations, an enforceability opinion must be delivered in accordance with the transaction documents.

THE AGENCIES SHOULD CLARIFY THE TREATMENT OF DIRECTLY ISSUED CREDIT-LINKED NOTES

- Problem: Cash-funded credit-linked notes issued by a bank to mitigate credit risk in its banking book (“directly issued CLNs”) require a reservation of authority to be treated as cash-collateralized transactions.

- Solution:

  - The proposed expanded risk-based approach, as well as the existing standardized approach, should be revised to provide certainty and transparency by expressly recognizing the risk-mitigating benefits of directly issued CLNs with terms and conditions upon which any bank can rely without having to seek specific approval from the Agencies.

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

TRADITIONAL SECURITIZATIONS SHOULD REQUIRE ONLY LEGAL ISOLATION, NOT ACCOUNTING DERECOGNITION

- <u>Problem</u>: The US rule is misaligned with international standards.
    - BCBS requires that the underlying exposures be legally isolated from the bank and its creditors.
    - **BCBS does not require that the exposures be derecognized from the bank's consolidated balance sheet under applicable accounting principles.**
- *The rule should focus on the legal isolation analysis, like BCBS, and not on its classification under accounting principles.*
- <u>Solution</u>: A securitization constitutes a transfer of risk that should be recognized by the capital rule if it:
    - meets the definition of "traditional securitization";
    - legally isolates the underlying exposures from the bank; and
    - adheres to the other operational criteria for traditional securitizations.