Secured Finance Network

January 10, 2024

Via Electronic Submission

Ann E. Misback, Secretary

Board of Governors of the Federal Reserve System 20th Street and Constitution Avenue, NW Washington, D.C. 20551

Docket No. R—1813; RIN 7100—AG64

James P. Sheesley, Assistant Executive Secretary
Federal Deposit Insurance Corporation

550 17th Street, NW Washington,
D.C. 20429

Attention: Comments/Legal OES (RIN 3064—AF29)

Chief Counsel's Office

Office of the Comptroller of the Currency 400 7th Street, SW, Suite 3E-218 Washington, D.C. 20219

Attention: Comment Processing, Docket ID OCC—2023—0008

Re: Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity

Ladies/Gentlemen:

We are writing to submit our comments with respect to your agencies' jointly proposed rulemaking to amend the capital requirements applicable to certain banking organizations (the "Proposed Rule").

Secured Finance Network ("SFNet") is the principal U.S. trade association for financial institutions that provide asset-based lending, factoring and trade finance services to commercial borrowers. SFNet's nearly 300 members include substantially all of the major money-center banks, regional banks, and other large and small commercial lenders that provide these services, including various banks that are covered by the Proposed Rule. Financing by SFNet members comprises a substantial portion of the United States credit market, exceeding $500 billion in outstanding committed loans in 2022.[1]

The Critical Role Played by Asset-Based Lending in the U.S. Economy

Asset-based lending plays a critical role for many U.S. businesses. Much of the financing provided by SFNet's members goes to U.S. small and medium-sized businesses that form the backbone of the U.S. economy, providing them with vital working capital to run their business, create jobs, and grow. These companies manage increasingly complex sales networks and supply chains, and asset-based lending provides the enhanced liquidity and risk mitigation tools that allow them to participate competitively in the U.S. and international marketplaces. For many of these U.S. companies, asset-based lending is the only form of financing available to them. Asset-based lending is also particularly important in times of economic stress, such as those in which we currently find ourselves. It offers a solution to companies that otherwise would not be able to obtain financing, and also provides lenders with a way to manage risk while continuing to provide essential working capital to borrowers that are temporarily distressed. Asset-based lending is also an important tool for companies that need debtor-in-possession financing in chapter 11 bankruptcy cases, allowing companies to restructure their troubled businesses and preserve jobs.

An essential characteristic of asset-based lending is that predicating advances to borrowers on the value of their eligible receivables and inventory, and in some cases specific valuable equipment or real estate, enables lenders to extend credit to middle-market companies in a way that is much less risky than other forms of commercial lending in terms of losses on a defaulted loan. The value of this loan structure has been recognized by the Office of the Comptroller of the Currency (the "OCC"). As noted in the OCC's Handbook on Asset-Based Lending, asset-based lending is a key source of credit to companies that seek "greater flexibility in executing operating plans,"[2] and also provides "important funding for companies in cyclical or seasonal industries" and to "rapidly growing companies."[3] The OCC specifically notes that, with the right controls, asset-based lending "can result in lower losses in event of default when compared to other types of lending."[4] In addition to the OCC's guidance, the regulatory agencies have recognized that the value of the collateral and lending structure in an asset-based loan mitigates risk so effectively that such loans are excluded from leveraged lending regulation.[5] In other words, asset-based lending

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[1] Additional information about SFNet may be found at www.SFNet.com.

[2] Comptroller's Handbook, Safety and Soundness, Asset-Based Lending, p.1 (Jan. 2017), available at https://www.occ.treas.gov/publications-and-resources/publications/comptrollers-handbook/files/asset-based-lending/index-asset-based-lending.html

[3] *Id* at p. 2.

[4] *Id* at p. 5.

[5] *See, e.g.*, Question 3 of *Frequently Asked Questions (FAQ) for Implementing March 2013 Interagency Guidance on Leveraged Lending*, which notes, in part, that "…it is appropriate to exclude certain loans secured by tangible collateral (for example, accounts receivable, inventory, property, plant and equipment and real estate) that do not rely on enterprise valuations for repayment… because the lender has additional sources of repayment beyond the cash flow from the operations of the borrower." *See, also,* Question 4 of that Guidance, which states, in part:

> Generally, an enterprise valuation analysis is not necessary if the ABL tranche is the only tranche that an institution holds and the ABL is subject to the full monitoring typically associated with ABLs. In these instances, the agencies expect repayment analyses based primarily on conversion of the related working capital assets to cash and an understanding of the overall cash flow of the borrower.

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fills a key need in areas of the commercial lending market that traditional financing often does not reach, particularly as it relates to small to medium-sized businesses and seasonal businesses, and is a secure investment for lenders that manage it properly.

In addition to the OCC's own guidance, the financial industry recognizes, and has reported on, the safety and soundness of asset-based lending as compared to other types of financing. Rating agencies have noted that the recovery rate on asset-based loans is consistently better than other types of lending arrangements, particularly when the economy is in a downturn.[6] Historically, while first-lien debt facilities generally have high recoveries after default of 70-80%, asset-based facilities have performed even better due to stronger covenant and collateral protection, realizing recoveries after default at or near 100%.[7] SFNet's own data also reflects the better credit quality of asset-based loans, showing that gross charge-off rates for asset-based loans are significantly lower relative to general commercial loans, a point that is consistently reflected in data going back to 2011.[8]

It is important to distinguish asset-based lending, as practiced by SFNet's members, from the "asset-backed" derivatives which many blame for precipitating the Great Recession of 2007. When U.S. small and medium-sized enterprises were struggling during the 2007 recession, asset-based lenders played a critical role in helping those companies survive, by providing working capital financing that was not otherwise available to them. When other lenders shied away, asset-based lenders parachuted in to help save the day. And if another recession befalls us, as many predict, our members will be there to pick up the operation once again and help guide the U.S. economy through to better times.

The Impact of the Proposed Rule

The pre-Basel III regulatory framework permits two methodologies for calculating capital cushions related to credit risk – a standardized approach and an advanced approach. Under the advanced approach, regulated institutions have the flexibility to account for the significant differences in various differing types of lending (secured or unsecured, asset-based or traditional commercial) by recognizing the impact that nonfinancial collateral will have on recovery. This ability to account for nonfinancial collateral in capital reserve calculations is expressly recognized by the Federal Reserve.[9] The Proposed Rule expressly notes that "the use of collateral can reduce the credit risk of an exposure."[10] However, while the Proposed Rule recognizes the value of the limited category of "financial collateral," it fails to take into account the value of highly liquid

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See, also, Assessments, Large Bank Pricing; Final Rule, 12 CFR Part 327, which provides that banks may exclude asset-based loans from higher risk commercial and industrial loans owing by higher risk commercial and industry borrowers if they meet certain criteria.

[6] Moody's Investor Services Report, *Borrowing Base Credit Facilities do not Disappoint in a Downturn* (July 2018).

[7] For the 12.5 year period through October 2020, the recovery rate on first lien facilities was 79%, and on ABL facilities was 98% - the less than 100% recovery caused by anomalies within the oil and gas industry. By contrast, junior lien and unsecured debt averaged recoveries of 28-30%. S&P Global Ratings, *From Crisis to Crisis: A Lookback at Actual Recoveries and Recovery Ratings from the Great Recession to the Pandemic*, p.6 (Oct. 8, 2020).

[8] SFNet Market Sizing Impact Study – ABL credit performance, p. 34.

[9] Federal Reserve, Technical Overview of Final Rule, p.683, available at https://www.federalreserve.gov/generalinfo/basel2/finalrule_baselii/technicaloverview.pdf

[10] Proposed Rule, p. 106

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nonfinancial collateral, such as receivables and inventory, in determining capital requirements for purposes of the standard approach. Since the Proposed Rule also eliminates the advanced approach, it eliminates the ability for banks to recognize the impact of nonfinancial collateral, without providing any recognition under the standard approach for the important role that such collateral plays in reducing the risk of extending credit.

We understand that the impact of the above-noted change will be different for every institution. For some institutions, the change may significantly increase the overall capital required for regulatory purposes for asset-based loans, while for others it may only have an impact on how capital is allocated internally among different lending products. In either case, the Proposed Rule's failure to recognize the different attributes of differing types of lending will cause asset-based and general unsecured commercial loans to be treated the same. This result is incongruous with the Proposed Rule's stated purpose of improving capital requirement calculations to "better reflect the risks of… banking organizations' exposures"[11] and the previously noted statistics that asset-based lending is safer and has far higher recoveries after default than other types of lending.

The Proposed Rule will have unintended consequences in the market, discouraging banks from extending asset-based loans to U.S. small and medium-sized businesses. This will increase the cost and decrease the availability of asset-based loans, which will seriously harm U.S. small and medium-sized businesses that rely almost exclusively on this type of lending for vital working capital. It is possible, but not certain, that unregulated private lenders will step up to fill the need for asset-based lending when banks pull back. However, it is important to note that many non-bank lenders operating in the asset-based lending market rely on banks for a significant portion of their funding. Increasing capital costs for banks will not only impact those banks, but will also impact private lenders who rely on banks for funding by reducing the availability, and increasing the costs, of financing for these non-bank lenders, further exacerbating issues with the availability and cost of credit for the U.S. companies that rely on asset-based lending obtained from these non-bank lenders.

In addition to discouraging asset-based lending overall, the Proposed Rule poses a disincentive for covered banks to serve as the administrative agent on syndicated asset-based facilities. Many asset-based facilities include a full cash dominion structure whereby amounts collected in a borrower's deposit account are swept on a daily basis to pay down the loan (thereby efficiently minimizing interest costs for the borrowers). When the borrower's operating expenses are paid from its operating account, draws on the loan are made in an amount sufficient to cover the payments. This structure is one of the keys to the safety of asset-based lending, as it allows lenders to closely monitor the borrower's cash flows and match the collateral to the outstanding loan obligation. However, because advances are made on a daily or other frequent basis, syndicated asset-based facilities often rely on a swingline loan structure to ease the administrative burden of all lenders settling on a daily basis. The Proposed Rule would increase the amount of capital that swingline lenders (most often the administrative agent bank) would be required to hold, even as it relates to exposure to the most highly secure, investment grade counterparties. This impact is exacerbated even more for counterparties that are not investment grade, which is especially applicable for any facilities that also involve private credit lenders, a structure that is more and more common in the market.

[11] Proposed Rule, p. 10

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How the Proposed Rule Can be Improved

As noted above, the impact of the Proposed Rule may be different depending on the extent to which a regulated institution is currently using an advanced approach to calculating capital requirements. Regardless of the impact of the change, however, given the extraordinary impact of nonfinancial collateral in actually reducing the risk of commercial loans, we recommend that the Proposed Rule should, to fulfill its stated purposes, be revised to expand the treatment of nonfinancial collateral in a way that allows it to reduce capital requirements for covered banks in a manner that accurately reflects the role that such collateral plays in reducing credit risk for those banks.

Regulatory agencies, particularly the OCC, already have a deep understanding of the value and the risks of asset-based lending. As noted above, the OCC has issued detailed guidance intended to assist lenders in making safe and sound asset-based loans. This guidance includes factors that should be considered in assigning a credit risk rating to an asset-based facility.[12] The guidance covers collateral quality issues, such as concentration limits, cross-aging, dilution, and various other categories of ineligibility of nonfinancial collateral. Such collateral quality criteria are routinely included in the eligibility criteria set forth in the applicable loan agreements, and are closely monitored by banks' asset-based lending teams. The criteria noted by the OCC and commonly used in the industry should continue to be used to assess collateral value for asset-based loans to provide a more nuanced reflection of an institution's actual credit risk applicable to these loans under the standard approach. SFNet submits that, at a bare minimum, your agencies should conduct an in-depth analysis of data from this segment of the market to develop a nuanced understanding of the true risk of asset-based lending as compared to other forms of commercial lending, the extent to which the Proposed Rule will disincentivize covered banks and other lenders from making asset-based loans, and the impact that this might have on U.S. small and medium-size businesses.

SFNet respectfully submits that the purpose of banking regulation should not be to require large banks to eliminate risks at all costs. Rather, a certain level of risk is inherent and necessary for the proper functioning of the banking industry and the economy if U.S. commercial enterprises are to receive the financing they need to operate and grow. Instead, we believe that the purpose of regulation should be to strike the proper balance between mitigating the systemic risks posed when individual institutions are undercapitalized, while still allowing banks to function as drivers of economic growth and to serve segments of the economy that otherwise would be underserved. Asset-based lending is both secure and fills a gap in the market that is key to U.S. economic stability and growth. However, under the regulatory framework envisioned by the Proposed Rule, high quality asset-based loans would be treated, from a risk perspective, as the same as unsecured commercial loans, a result that is both inaccurate and incompatible with the Proposed Rule's stated purpose of better measuring credit risk.

[12] Comptroller's Handbook, p. 32-34

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Conclusion

U.S. law (as embodied in the Uniform Commercial Code) is recognized throughout the world as a model for facilitating the secured commercial lending transactions that are so vital for the U.S. economy in a safe, efficient and predictable way. By discouraging large U.S. banks from engaging in asset-based lending, the Proposed Rule creates a dissonance with the other legal and policy decisions that underlie the goal of encouraging secured credit.[13] The unintended consequence of this approach will be to significantly curtail and increase the cost of capital available to U.S. small and medium-sized businesses, with an attendant increase in business failures.

At a minimum, SFNet urges your respective agencies to reevaluate the Proposed Rule to take into account the powerful role played by nonfinancial collateral in reducing the risk profile of the vast amount of asset-based loans that fuel and sustain the U.S. middle market. In that regard, we encourage you to take the necessary time to examine the large body of data that supports the powerful role that nonfinancial collateral plays, day in and day out, in supporting the vital economic funding that enables U.S. companies to thrive and grow in times of economic prosperity, and to survive in times of economic stress. Although we believe much of this data is already in your possession as a result of your activities in overseeing banks, SFNet would be pleased to help provide any additional information you may require to properly conduct this evaluation.

Sincerely,

[redacted]

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[13] Giuliano G. Castellano & Marek Dubovec, *Global Regulatory Standards and Secured Transactions Law Reforms: At the Crossroads Between Access to Credit and Financial Stability* (41 Fordham Int'l L.J., 531 (2018).

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