**Meeting Between Staff of the Federal Deposit Insurance Corporation, Federal Reserve System, Office of the Comptroller of the Currency, and Representatives from JP Morgan Chase & Co.**

**November 28, 2023**

**Participants:**

Ryan Billingsley, Benedetto Bosco, Catherine Wood, Anjoly David, Ernest Barkett, Irina Leonova, Iris Li, Olga Lionakis, Joanne Rose, and Richard Smith (Federal Deposit Insurance Corporation)

Gillian Burgess, Andrew Willis, David Imhoff, Jasmin Keskinen, Andrew Hartlage, and Nathan Brulport (Federal Reserve Board)

Amrit Sekhon, Margot Schwadron, Carl Kaminski, and Andrew Tschirhart (Office of the Comptroller of the Currency)

Alistair Webster, Rifat Chowdhury, and Vijay Kandula (JPMC)

**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 JP Morgan Chase & Co. (JPMC) 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 JPMC representatives discussed the NPR's proposed treatment of servicing cash advance resecuritizations and its impact. They provided the attached slide deck.

# Servicing Cash Advance Resecuritizations

November 2023

# Servicing Cash Advance Securitizations

## OVERVIEW OF SERVICING CASH ADVANCES

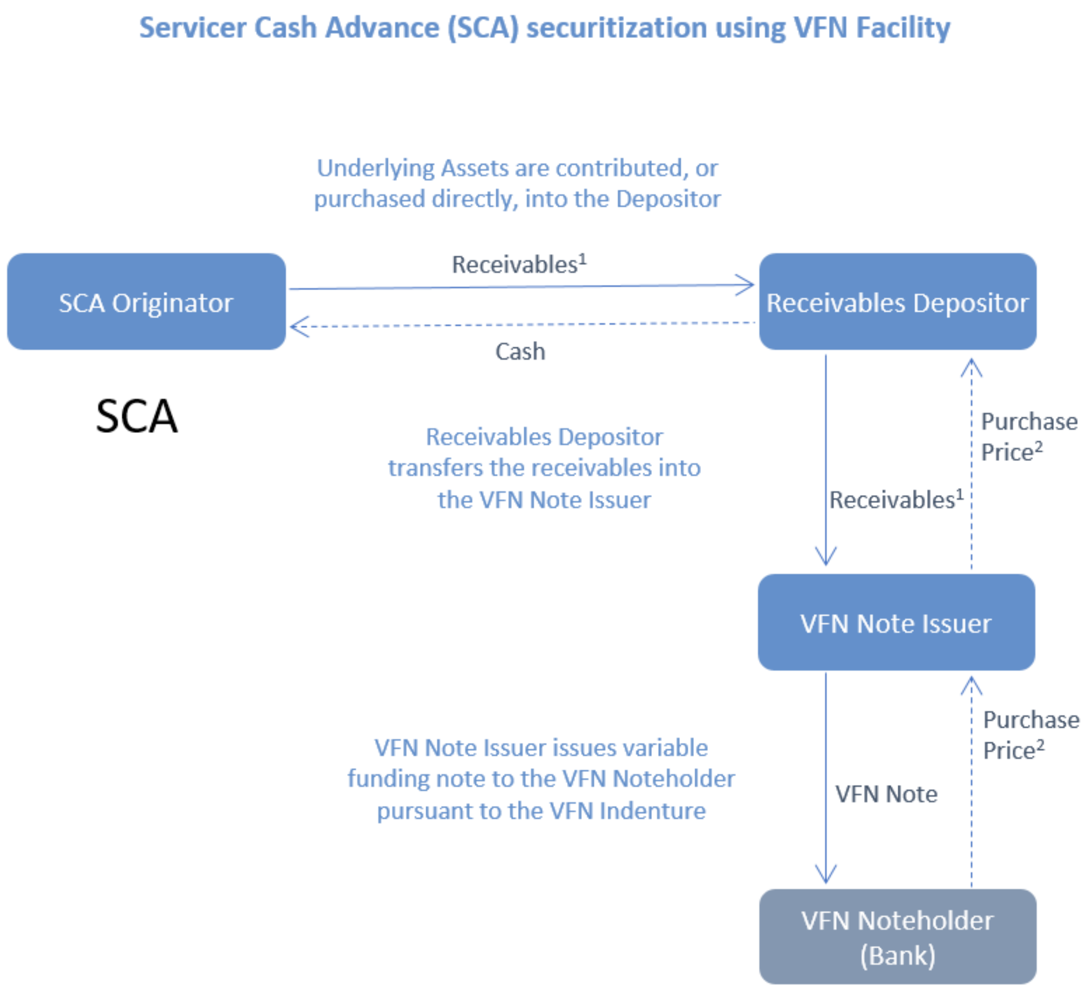
- A traditional securitization typically employs a servicing organization ("servicer") that, on a day-to-day basis, collects principal, interest, and other payments from the underlying residential mortgage exposures of a non-agency RMBS securitization and forwards such payments to the securitization SPE or to investors in the securitization. In addition, servicers often provide a credit facility to the securitization under which the servicer may advance (i.e., loan) cash to ensure an uninterrupted flow of payments to investors in the securitization, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the underlying exposures. Such servicer cash advances (i.e., loans) are securitization exposures under the current final rule and the NPR.[1]
- Servicing cash advances (SCAs) for a typical non-agency RMBS securitization can be divided into three major categories:
  - P&I Advances: For delinquent principal and interest payments
  - T&I Advances: For delinquent real estate taxes and any property insurance payments
  - Corporate Advances: For property protection and foreclosure costs including attorney fees, property maintenance fees, etc.
- SCAs are made in accordance with the Pooling and Servicing Agreement (P&SA) in each non-agency RMBS securitization.
- The P&SA provides a contractual right for the servicer to be reimbursed with the cash flows from the underlying securitized assets.
  - Once funded such advances are "receivables" owned by the servicer
  - These receivables have a super-senior priority in the cash flow waterfall from the underlying exposures in the securitization (i.e., principal cash flows are allocated to reimburse the servicer before any principal allocations to the bondholders)

## RESECURITIZATION OF SCA EXPOSURES

- Servicers may raise liquidity to support their servicing activities by pooling/transferring their SCA receivables (via a Receivables Depositor) into a securitization special purpose entity (SSPE) that issues a senior variable funding note (VFN) to 3rd party lenders (the VFN Note Issuer).
- The financing transaction is structured to be bankruptcy remote and the SSPE issuer's obligations to pay principal and interest on the VFN are solely secured by the cash flows from the underlying SCA receivables.
- Since the SCA receivables are themselves securitization exposures that are further tranched in a transaction that meets the definition of a Traditional Securitization, such VFN financing assets qualify as resecuritization exposures [2] for bank lenders under the current final rule and the NPR.

[1] See Appendix I
[2] See Appendix II

# SCA Securitizations – Typical Structure




[1] Receivables must satisfy eligibility criteria to be included in the collateral value.
[2] Cash is funded to VFN Note Issuer against eligible underlying collateral, and subject to the applicable Advance Rates.

# Impact of US Basel III Endgame NPR on SCA Resecuritizations

## US BASEL III ENDGAME NPR

- **Re-securitization**
  - For resecuritization exposures, the proposed SEC-SA approach would require banking organizations to apply a risk-weight floor of at least 100 percent.
  - Per the NPR preamble, the proposed 100 percent supervisory risk-weight floor for resecuritization exposures is intended to capture the greater complexity of such exposures and heightened correlation risks inherent in the underlying securitization exposures. In a typical securitization exposure that is not a resecuritization, each underlying exposure is subject to idiosyncratic default risks (for example, the employment status of each obligor) which may exhibit lower relative default correlation. In a resecuritization exposure, the underlying exposures, which are typically tranches of securitizations, usually have credit enhancement from more junior tranches that protects against many idiosyncratic risks. Systematic risks are more likely to generate defaults in the underlying exposures of resecuritizations than idiosyncratic risks, but systematic risks are also much more correlated; therefore, resecuritizations typically have higher default correlations than other types of securitizations.

## IMPACT OF BASEL IIIE NPR

- As a senior securitization exposure that attracts a 20% risk-weight, banks can provide servicers financing at ~200bps spread.  Under the proposal and assuming the 100% risk-weight floor is retained, the market could require a ~500bps spread, significantly increasing the financing cost for the servicers and with a potential knock-on impact for liquidity.
- The 5-fold increase in minimum RWA given the proposed 100% risk weight floor on the VFNs as re-securitizations is inconsistent with the limited risk of loss that lenders are exposed to given their senior claim under the VFN on the underlying super-senior claims under the SCAs.
- During COVID, when the Agencies encouraged banks to provide forbearance relief to borrowers impacted by COVID, P&I SCAsa materially increased.  Absent bank supplied liquidity via SCA resecuritizations, servicers will have to seek alternate sources of funding and reprice their risk, which could increase the cost of mortgage servicing and ultimately the cost paid by mortgage borrowers.

## RECOMMENDATION

- The 100% risk weight floor for resecuritizations should not apply if the resecuritization exposure is a senior securitization exposure and the underlying exposures are also senior securitization exposures.

# APPENDIX I

## SCAS meets the definition of a securitization exposure under 12 CCFR 217.2

- **§ _12 CFR 217.2 Definitions**
  - **Servicer cash advance facility (SCA)** means a facility under which the servicer of the underlying exposures of a securitization may advance cash to ensure an uninterrupted flow of payments to investors in the securitization, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the underlying exposures.

- **Preamble (Page 62118)**
  - A traditional securitization typically employs a servicing banking organization that, on a day-to-day basis, collects principal, interest, and other payments from the underlying exposures of the securitization and forwards such payments to the securitization SPE or to investors in the securitization. Servicing banking organizations often provide a facility to the securitization under which the servicing banking organization may advance cash to ensure an uninterrupted flow of payments to investors in the securitization, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the underlying exposures. **These servicer cash advance facilities are securitization exposures**

# APPENDIX II

## VFNS meets the definition of a resecuritization exposure under 12 CCFR 217.2

- **§ _12 CFR 217.2 Definitions**
  - ***Resecuritization*** means a securitization which has more than one underlying exposure and in which one or more of the underlying exposures is a **securitization exposure**.
  - ***Securitization exposure*** means:
    1) An on-balance sheet or off-balance sheet credit exposure (including credit enhancing representations and warranties) that arises from a traditional securitization or synthetic securitization (including a resecuritization), or
    2) An exposure that directly or indirectly references a securitization exposure described in paragraph (1) of this definition.
  - ***Traditional securitization*** means a transaction in which:
    1) All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties other than through the use of credit derivatives or guarantees;
    2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;
    3) Performance of the securitization exposures depends upon the performance of the underlying exposures;
    4) All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities);
    5) The underlying exposures are not owned by an operating company

- **Analysis**
  - VFN financing meets the definition of a resecuritization exposure since it is a securitization transaction with underlying exposures (SCAs) that are securitization exposures.
  - Further, the transaction meets the definition of a traditional securitization since:
    i. The credit risk of the underlying SCAs is transferred to one or more third parties through the legal sale of the SCAs to a securitization special purpose entity (SSPE) that issues a VFN to bank lender/investor;
    ii. The VFN is over-collateralized and structured to be repaid principal according to a senior/subordinated cash flow waterfall;
    iii. Repayment of principal on the VFN depends upon the cash flow generated from the underlying SCAs;
    iv. All the underlying exposures are receivables (i.e., financial exposures); and
    v. The underlying exposures are legally sold to a SSPE.