Prepared Testimony of Kenneth E. Bentsen, Jr., President and CEO

Securities Industry and Financial Markets Association (SIFMA)

before the U.S. House of Representatives

Committee on Financial Services

Subcommittee on Financial Institutions and Monetary Policy

September 25, 2024

Introduction

Chairman Barr, Ranking Member Foster, and distinguished members of the Subcommittee, thank you for the opportunity to testify today on the Basel III Endgame proposal and other rulemakings currently being considered by the banking regulators. My name is Ken Bentsen, and I am the President and CEO of the Securities Industry and Financial Markets Association ("SIFMA").[1]

I would like to start by commending the members represented on this Subcommittee for their leadership on these important issues, including via the many comment letters on the Basel III Endgame and other capital proposals that members from both parties have submitted to the regulators, as well as through hearings on these and other related topics over the past year.

While bank capital requirements are an undoubtedly complex subject, there is no question that they have material impacts across the entire economy, affecting the ability of corporations, small businesses, governmental organizations, and consumers to fund their activities and manage all types of risks. Given these impacts, it's crucial that policymakers, including Congress, conduct sufficient analysis and oversight to ensure that bank capital requirements strike the appropriate balance between ensuring financial stability and macroeconomic growth.

In this context, it is worth noting that the quantity of high-quality capital in the U.S. banking system has increased three-fold since the Global Financial Crisis, while total loss absorbing capacity has increased six-fold and liquidity levels have increased twelve-fold. Many independent studies have also found capital levels at the largest U.S. banks to either be at or close to their "optimal" levels.[2] And senior policymakers, including Treasury Secretary Yellen, Federal Reserve Chair Powell, and Federal Reserve Vice Chair for Supervision Michael Barr, amongst others, have commented in recent years that the U.S. banking system is strong, resilient, and "well-capitalized."[3] In other words, it appears that capital levels are already robust and any further proposed increases should be sufficiently scrutinized to determine both the tangible benefits, and costs to the broader U.S. economy.

It is particularly important that policymakers strike the right balance when it comes to capital requirements affecting the ability of large banking organizations to act as intermediaries in our capital markets, given that those markets fund roughly three quarters of all economic activity in the United

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] PWC conducted a study in 2023 that found that large U.S. banking organizations currently maintained capital levels that were close to or at the "optimal" level for bank capital. See PWC, "Basel III Endgame: The next generation of capital requirements, Part 1: Evaluating Optimal Capital Levels," April 2023, available at: https://explore.pwc.com/baseliiiendgame/basel-iii-end-game-report.

[3] See Financial Services Forum, "What They're Saying: Policymaker son Capital Levels an the Largest Banks." Available at: https://fsforum.com/a/media/what-they%E2%80%99re-saying--policymakers-on-capital-levels-and-the-largest-banks.pdf.

States. This contrasts with other major economies where the vast majority of commercial and economic activity is overly reliant on bank balance sheets and we believe the data has proven the U.S. model to be more efficient, resilient and growth oriented. In fact, the EU and many Asian nations aspire to develop their capital markets to mimic the U.S. model. Excessive capital requirements on banks' markets activities would negatively impact the depth, liquidity and resiliency of the capital markets and increase costs at the expense of consumers and commercial entities who benefit directly and indirectly from bank involvement in such activities.

Reforming the Basel III Endgame Proposal

SIFMA has expressed deep concern about the Basel III Endgame proposal that was issued last year by the banking regulators, not only because it would significantly increase aggregate U.S. bank capital levels well beyond their current, historically robust levels, but because it inappropriately targets banking organizations' capital markets activities for some of the largest increases. The industry quantitative impact study conducted on the original Basel III Endgame proposal estimated that capital for large banks' trading activities would increase by 129% above their current historically high levels because of the Fundamental Review of the Trading Book ("FRTB") and Credit Valuation Adjustment ("CVA") changes, impacts that were far greater than the agencies' original estimates, a consequence of the fact that they did not conduct a proper quantitative impact assessment prior to issuing the original proposal.[4]

As we and many other commentors explained, the increases arising from the original proposal would not be commensurate with the underlying risks posed by these activities and would have serious knock-on effects for the capital markets and real economy. For example, a PWC study released in June 2024 found that the original Basel III Endgame proposal would cause U.S. economic growth to decline by up to 56bps, equivalent to a reduction in growth of up to 25% over the last 10 years.[5] Moreover, these impacts are not purely hypothetical: we have already seen this negative impact occurring as some firms have indicated intentions to scale back specific business lines.[6] Finally, by "gold plating" the Basel standards, the U.S. would diverge from the implementation approaches taken in other major jurisdictions such as the EU and UK, undermining one of the goals of the Basel agreement, which was aimed at promoting greater cross-border harmonization and comparability across capital requirements.

---

[4] For additional background on the industry quantitative impact study analysis and SIFMA's response to the original Basel III Endgame re-proposal, see SIFMA, ISDA Comments on the Market Risk Components, January 16, 2024. Available at: https://www.sifma.org/wp-content/uploads/2024/01/ISDA-SIFMA-Comment-Letter-January-16-2024-Basel-III-Endgame.pdf. See also SIFMA, FIA Comments on the Operational Risk Components, January 16, 2024. Available at: https://www.sifma.org/wp-content/uploads/2024/01/SIFMA-FIA-Op-Risk-Comment-Letter-Final-1.16.2024.pdf. More information can also be found in SIFMA's Blog Series on the Basel III Endgame, available at: https://www.sifma.org/resources/news/basel-iii-endgame-blog-series/.

[5] PWC, "Basel III Endgame: Assessing the bigger picture," June 2024. Available at: https://explore.pwc.com/c/basel-iii-endgame-bigger-picture?x=v0trZH.

[6] Investment News, "Citigroup to Exit Distressed Debt Business," December 31, 2023. Available at: https://www.investmentnews.com/industry-news/citigroup-to-exit-distressed-debt-business/247395. See also: The Financial Times, "Barclays Explores Plan to Drop Thousands of Investment Banking Clients," November 28, 2003. Available at: https://www.ft.com/content/ff5b56d8-51a3-48f6-b7e5-5854abcf219a.

The recent comments of Federal Reserve Vice Chair for Supervision Michael Barr earlier this month[7], announcing the agencies' intent to issue a re-proposal of both the Basel III Endgame rule and the related Global Systemically Important Bank ("GSIB") surcharge rule, was therefore a welcome first step. We are concerned that the re-proposal would still raise capital levels by an additional 9% for the largest U.S. banks above levels that are already comparatively high by international standards, and in contrast to other major jurisdictions where implementation is expected to be closer to capital neutral in the aggregate.

Nonetheless, we commend the agencies for acknowledging the need to make "broad and material revisions" to the Basel III Endgame rule based on their analysis of the data collected after the original proposal was issued and the comments they received, and we look forward to providing our comments and analysis on both the re-proposals and QIS once they are released. In evaluating the rule re-proposals, we will be looking to see whether and to what extent they address our key recommendations. These include:

1. **Addressing the Overlaps with the Stress Tests/Other Capital Requirements:** Any re-proposal of the Basel Endgame should account for overlaps with other prudential requirements, particularly overlaps with the stress testing framework, as well as the other pending capital proposals – i.e., the GSIB surcharge and long-term debt rules. It is crucial that regulators take a holistic view on these pending rulemakings and finalize them in conjunction with one another.

2. **Accounting for the Interactions between the Global Market Shock ("GMS") & the FRTB:** Regulators should address the overcapitalization of market risk between these two frameworks by, for example, applying the FRTB to banks' trading portfolios on a post-GMS shock basis. They should also only apply the Stress Capital Buffer ("SCB") annual stress to the U.S. standardized approach to avoid over capitalizing the CVA and operational risk measures, which are already captured under the Basel Endgame's proposed expanded risk-based approach.

3. **Diversification:** Although not mentioned in Vice Chair Barr's remarks, an important reform would be giving greater credit for diversification under both the modeled and standardized FRTB approaches to better align with actual risk exposures and reward good risk management practices. It is crucial that greater diversification recognition be included in the final rule.

4. **Internal Models:** We appreciate Vice Chair Barr's statement that the re-proposal will include "changes to facilitate banks' ability to use internal models for market risk," given that internal models better reflect firms' risk profiles. However, the specifics will matter. In the FRTB portion of the proposal, adjustments will need to be made to the capital requirements for modellable risk factors ("IMCC") and non-modellable risk factors ("NMRF") in addition to the P&L loss attribution ("PLAT") test in order to facilitate greater use of internal models approaches.

[7] Michael S. Barr, "The Next Steps on Capital," Remarks at the Brookings Institution, September 10, 2024. Available at: https://www.federalreserve.gov/newsevents/speech/barr20240910a.htm.

5. **Derivatives:** Under the original proposal, the additional capital requirements for derivatives could require banks passing on additional costs of greater than $10 billion per annum, while the cost to hedge interest rate risks would likely increase by nearly 10 bps, significant increases that would lead to higher costs for businesses and consumers.[8] While Vice Chair Barr did indicate that the capital treatment for the client-facing leg of client-cleared derivatives transactions will be reduced, we continue to believe that these transactions should be excluded altogether from scope of the CVA.

   Moreover, we believe that over-the-counter derivatives transactions with commercial end-users need to receive more favorable treatment in the final U.S. rule to bring that treatment into line with the approach adopted by the EU, UK, and other major jurisdictions and consistent with longstanding policies designed to facilitate prudent risk management practices derivatives. We also recommend that CVA risk weights should also be adjusted to reflect the different levels of regulation that a bank's financial counterparties are subject to.

6. **Securitizations:** In his remarks, Vice Chair Barr did not comment on possible revisions to the proposed treatment of securitizations, a key concern for SIFMA and its members. Securitized products provide significant economic benefits by lowering borrowing costs on a wide variety of consumer and business loans such as mortgages, equipment, inventory, auto and student loans, and credit cards. They also help banks to prudently manage their exposures. However, the Basel III Endgame proposal, by doubling the regulator set "p-factor," would create perverse risk incentives that would discourage large banks from engaging in securitization activities; for example, it would increase the capital requirements for certain senior securitization exposures much more than relatively junior (and thus riskier) exposures. Capital treatment for securitization exposures in other major jurisdictions is materially less punitive than the U.S. proposal. We have made several recommendations for addressing this undue punitive treatment.[9] One straight forward fix is to keep the p-factor at its current level rather than doubling it.

7. **Securities Financing Transactions ("SFT") Haircut Framework:** We welcome indications that the proposed SFT haircut framework will not be adopted in the U.S., given the significant adverse effects on the critical securities borrowing and lending markets that it would have. Removing this framework would also align the U.S. with the approach taken by other major jurisdictions.

8. **Investment grade counterparties and collateral:** We have also advocated for the removal of the so-called public listing requirement, which would penalize credit worthy counterparties that do not have publicly listed securities such as pension funds and municipal issuers. Vice Chair Barr's remarks suggest that this treatment will be revised in line with the approach taken by the EU and UK, but we

---

[8] See PWC Report, June 2024.

[9] For an overview of this issue and our recommendations, see the blog attached in the Appendix: Guowei Zhang and Chris Killian, "How the Basel III Endgame Could Impair Securitization Markets and Harm US Businesses and Consumers," November 28, 2023. Available at: https://www.sifma.org/resources/news/how-the-basel-iii-endgame-could-impair-securitization-markets-and-harm-us-businesses-and-consumers/.

will need to review the text of the re-proposal itself. In addition, we would encourage the regulators to recognize the risk mitigation benefits of safe collateral to better reflect counterparty credit risks.

9. **Operational risk:** We welcome the apparent decision to revise the operational risk framework to provide for the netting of income and expenses related to fee-based capital markets services. While we will need to review the details, this type of change would better incentivize sound risk management practices and diversified business models. This is particularly important to critical functions such as retail financial advisory services and investment banking. The agencies should address other issues that arise from the application of standards that are designed for top-tier entities to subsidiaries, an example of which is the operational risk framework's treatment of inter-affiliate reimbursements, which unduly penalizes the subsidiaries of foreign banking organizations ("FBOs") that are crucial to the strength of the U.S. capital markets.[10]

10. **Implementation Timeline:** Finally, the agencies should provide clarity around the Basel III implementation timeline in their re-proposal. We have called on the regulators to provide at least 18 months from completion of the final rule for firms to begin implementing the new framework.

Additional Reforms to the Stress Testing Process

In addition to the above changes to the Basel III Endgame, SIFMA has long highlighted[11] the importance of reforming the stress testing process more generally to not only remove overlaps with the risk-based capital standards, but to ensure that the GMS component is based on "severe but plausible" market shocks. Developing more plausible scenarios and providing the public with an opportunity to provide input into their development would help to reduce excessive year-over-year volatility in firms' Stress Capital Buffer ("SCB") requirements, ensure calibration is tied to the underlying risks, and add transparency to what is currently an opaque process. We welcome indications that the Federal Reserve may be thinking about these issues; in particular, I would point the Committee to remarks made by Federal Reserve Governor Michelle Bowman earlier this month where she laid out a series of sensible improvements to the stress testing process, including steps to reduce volatility, rethink its link to formal capital requirements, increase transparency, and reduce the overlaps I just mentioned.[12] We hope that the Federal Reserve will act on these issues as soon as possible and seek public input on potential changes to the stress testing framework.

---

[10] For more on the vital role that FBOs play in the U.S. capital markets, see SIFMA Insights, "The Importance of FBOs to the U.S. Capital Markets," April 2019. Available at: https://www.sifma.org/wp-content/uploads/2019/04/SIFMA-Insights-The-Importance-of-FBOs-to-US-Capital-Markets.pdf.

[11] See, for example, SIFMA's Submission for the Record before the U.S. House of Representatives' Financial Institutions and Monetary Policy Subcommittee Hearing entitled "Stress Testing: What's Inside the Black Box?," June 26, 2024. Available at: https://www.sifma.org/wp-content/uploads/2024/06/240625-FI-Subcommittee-Stress-Test-Hearing-SIFMA-Written-Testimony.pdf.

[12] Michelle Bowman, "The Future of Stress Testing and the Stress Capital Buffer Framework," remarks at the Executive Council of the Banking Law Section of the Federal Bar Association, Washington, DC, September 10, 2024. Available at: https://www.federalreserve.gov/newsevents/speech/bowman20240910a.htm. See also SIFMA, "Global Market Shock and Large Counterparty Default Study: Recommendations for Reforms Based on a Statistical Analysis of Stress Testing," August 2019. Available at: https://www.sifma.org/wp-content/uploads/2019/09/SIFMA-GMS-LCD-Study-FINAL.pdf.

GSIB Surcharge and Long-Term Debt Proposals

As I noted earlier, the banking regulators must consider the important interactions between the Basel III Endgame and the two other outstanding capital proposals dealing with the GSIB surcharge and long-term debt requirements. Regarding the GSIB surcharge: we generally welcome the changes that Vice Chair Barr outlined in his speech, though we believe additional changes are needed, including a reweighting of the short-term wholesale funding indicator in calculating GSIB scores.[13] Regarding the long-term debt proposal: we have been deeply concerned that the proposal as written would drive up the supply of long-term debt while simultaneously constraining investor demand, increasing bank funding costs and reducing liquidity in these markets, with knock-on consequences for businesses and consumers. We have made a series of recommendations for reform of the proposal that would reduce these negative impacts and ensure the final rule is more appropriately calibrated.[14]

Brokered Deposits

Finally, beyond capital issues, we are concerned about the FDIC's recent proposal to revise the regulations surrounding brokered deposits, which would make it more difficult and costly for broker-dealers to provide sweep accounts to their customers. Sweep accounts are an important component to retail financial advisory services for tens of millions of individual investors and provide a stable source of funding to banking organizations and deliver risk-free returns to millions of Americans. They are not brokered deposits and do not have the run risks associated with the types of deposits Congress and policy makers envisioned. Beyond the substantive policy issues, we have also raised procedural concerns about the recent proposal. The proposal would largely reverse a 2020 rule designed to modernize existing brokered deposit restrictions - an effort that was based on a rigorous study of brokered deposit risks and the result of significant public input - and would do so without offering any clear policy rationale for making these changes and without the support of any new empirical evidence. SIFMA has therefore called on the FDIC to withdraw and reconsider this proposal in light of these procedural issues. Absent that, we will be making a series of recommendations that we believe would reduce the negative impacts of the proposal on broker dealers and their retail clients.

Conclusion

As I noted at the outset of my remarks, bank capital requirements have a significant impact on the vibrancy of our capital markets and the strength of the broader economy. It is crucial therefore that

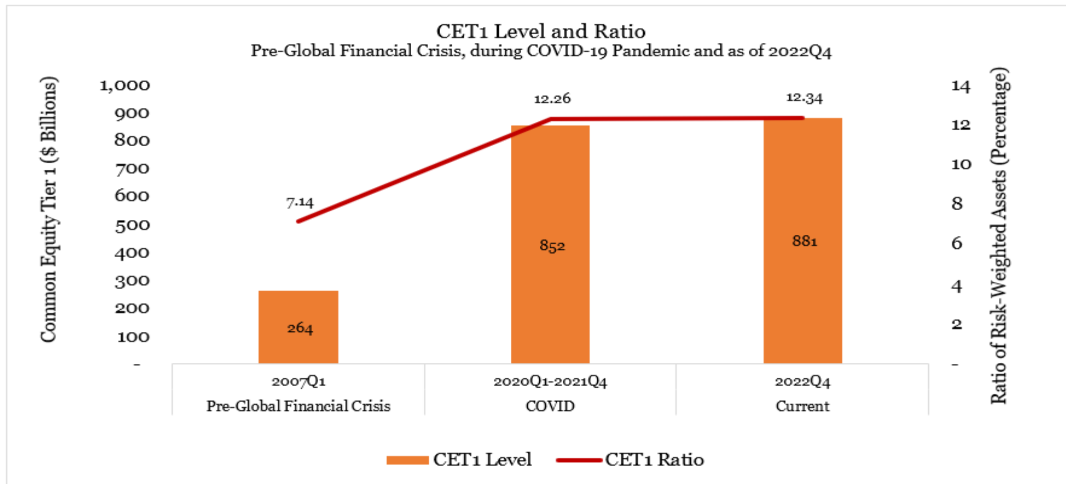
---

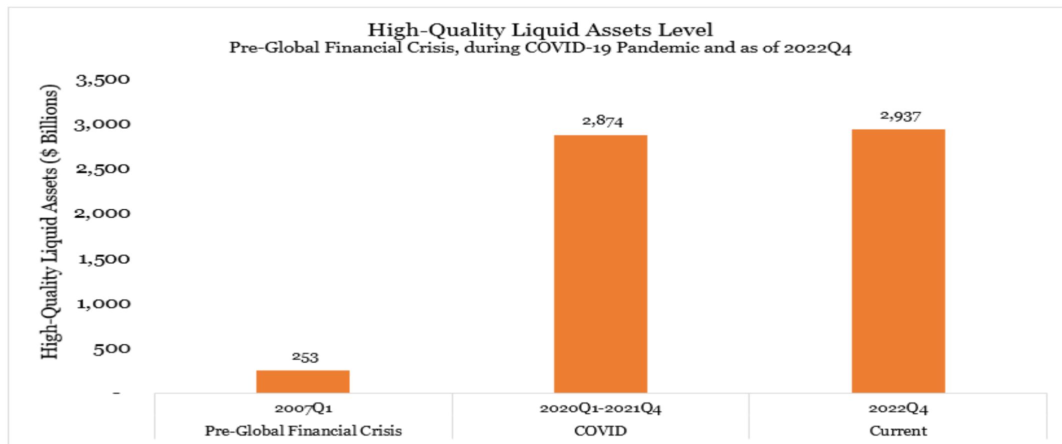
[13] See SIFMA, ISDA Comments on the GSIB Surcharge Proposal, January 16, 2024. Available at: https://www.sifma.org/wp-content/uploads/2024/01/ISDA-SIFMA-GSIB-Surcharge-Comment-Letter-January-16-2024.pdf. See also Guowei Zhang, Sean Campbell, and Francisco Covas, "The Federal Reserve Should Revise the U.S. GSIB Surcharge Methodology to Reflect Real Risks and Support the Economy," October 11, 2023. Available at: https://www.sifma.org/resources/news/the-federal-reserve-should-revise-the-us-gsib-surcharge-methodology-to-reflect-real-risks-and-support-the-economy/.

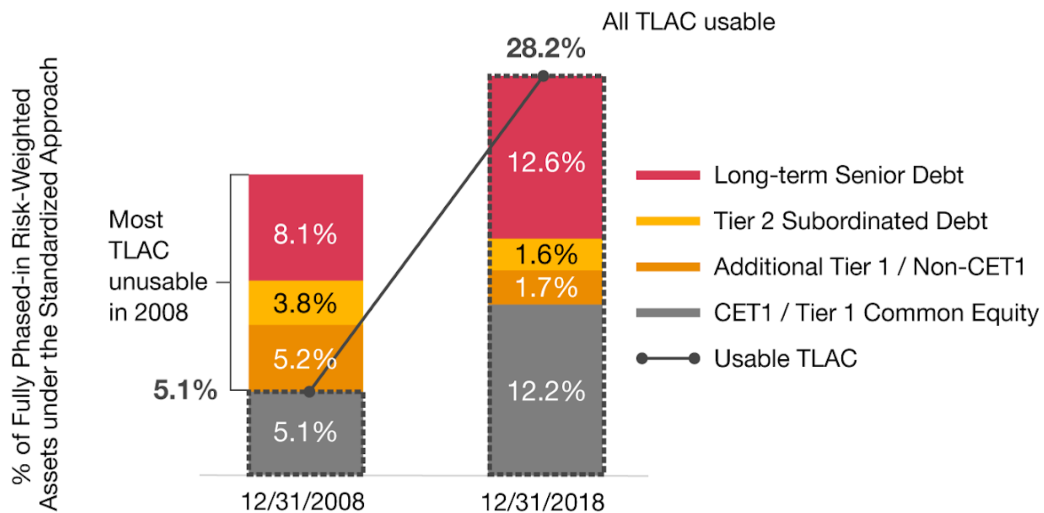
[14] SIFMA, SIFMA AMG Comments on Long-Term Debt Requirement Proposal, January 11, 2024. Available at: https://www.sifma.org/resources/news/sifma-sifma-amg-comment-on-long-term-debt-requirement-proposal/. See also SIFMA, SIFMA AMG Supplemental Comments on Long-Term Debt Requirement Proposal, June 24, 2024. Available at: https://www.sifma.org/resources/submissions/long-term-debt-requirements-for-large-bank-holding-companies-certain-intermediate-holding-companies-of-foreign-banking-organizations-and-large-insured-depository-institutions-sifma-and-sifma-amg/.

policy makers get them right. I commend the Subcommittee for taking the time to focus on these and other important prudential rulemakings. Thank you, and I look forward to answering your questions.

APPENDIX 1: U.S. GSIB Capital and Liquidity Increases Since 2007/8







APPENDIX 2:

The U.S. Basel 3 Endgame Proposal Could Have Detrimental Effects on U.S. consumers and businesses by impairing Securitization Markets

- The U.S. Basel 3 Endgame ("B3E") proposal related to securitization prescribes the most restrictive approach to set capital requirements for banks' securitization exposures in the developed world. At the same time, securitization markets are central to the majority of credit being extended in the U.S. economy, including mortgages, credit cards, auto loans, equipment and other small business financing, and other retail consumer assets. Punitive changes in the securitization capital framework will impact the cost of credit for virtually every consumer and business in the U.S.
- As proposed, the US rules will, in many cases, result in significantly more capital for securitized assets than what is required under the current rules. This contradicts the proposed changes to the risk weighting for retail exposures which reduce the amount of capital in most cases, that banks will have to hold against retail loans. Additionally, because the rules are not risk sensitive (i.e., they do not take into consideration the expected performance or riskiness of the underlying loans), in many cases, more capital is required for securitizations of loans that are expected to experience relatively lower losses than for loans expected to experience higher losses.
- Taken together, this will result in more capital (read "higher cost") for banks to finance securitized assets. Consequently, the U.S. B3E proposal could have severe detrimental impacts on the ability of banks to finance consumer, business, and other credit, and to make markets in securitization bonds, increasing interest rates and reducing the availability of credit, thereby harming main street as well as U.S. financial markets' global competitiveness.

Background

Put most simply, securitization is a means of providing cost-effective funding to originators of consumer and business credit whereby those originators use their loans as collateral for borrowing or the issuance of securities.

Securitization allows banks and other lenders to provide more credit to consumers and businesses, and at a lower cost, than would be possible if they instead held the loans on their balance sheets. The loans can be placed in a securitization, where investors exchange cash for the bonds that are created. This same structure can be used where a bank provides a loan which, given protections in the form of excess collateral, should require less capital and thus, can be provided at a lower cost than the bank providing the

consumer loans directly. In other words, securitization allows for a more efficient cycling of lending capital through the financial system. Securitization products are also used by banks and others to manage or hedge risk. Investors in securitization include mutual funds, pension funds, insurance companies, banks, hedge funds, corporate treasuries, sovereign wealth funds, and other foreign governmental entities.

According to SIFMA data, in 2022 over $1.5 trillion in mortgage-backed securities were issued, and over $200 billion in asset-backed securities were issued. Assets that are commonly securitized include residential and commercial mortgages ("mortgage-backed securities"), student loans, auto loans and leases, credit cards receivables, equipment, solar and cell phone tower lease cash flows, and other types of receivables (non-mortgage-backed securities are referred to as "asset-backed securities"). While it varies year to year, recently *70% or more* of residential mortgage loans in the US have been funded by securitization, and studies have quantified how securitization has lowered the cost of obtaining a mortgage.[15] This stands in contrast to Europe, where bank lending is a far greater component of consumer and commercial lending than securitization, and hence, the cost of consumer credit is generally higher.

Capital requirements play a key role in the ability of banks to participate in securitizations to fund lending. Higher capital requirements would force banks to hold less inventory leading to lower ABS liquidity and higher spreads which in turn raises costs for consumers and businesses.

How are capital requirements for securitization exposures calculated?

In 2016, the Basel Committee released the international standards for securitization capital framework,[16] which constitutes a part of the B3E standards published in 2017. The B3E offers four approaches to calculate capital requirements for securitization exposures – internal ratings-based approach ("SEC-IRBA"), external ratings-based approach ("SEC-ERBA"), internal assessment approach ("IAA"), and standardized approach ("SEC-SA"). The SEC-IRBA is the most risk-sensitive whereas the SEC-SA is the most conservative and least risk-sensitive approach.

In addition, in response to the global financial crisis the Basel Committee and the International Organization of Securities Commissions ("IOSCO") published "Criteria for

---

[15] See, e.g., "TBA Trading and Liquidity in the MBS Market", James Vickery and Joshua Wright (2013), available here: https://www.newyorkfed.org/medialibrary/media/research/epr/2013/1212vick.pdf
[16] See https://www.bis.org/bcbs/publ/d374.pdf

identifying simple, transparent and comparable securitisations" in July 2015. The goal of Simplicity, Transparency, and Comparability ("STC") was to help stakeholders (e.g., originators and investors) evaluate the risks and returns of a particular securitization exposure, thereby "lower the hurdles of assessing securitisations"[17] and incentivize healthy growth of securitization markets. Securitization exposures meeting the STC criteria would enjoy preferential treatment (i.e., lower overall capital charges) under the SEC-IRBA, the SEC-ERBA (external ratings-based approach) and the SEC-SA under the Basel standards. The STC framework and the four capital treatment approaches have been adopted by all other major jurisdictions.

In July 2023, the U.S. banking agencies released their proposal implementing the B3E in the U.S. ("U.S. proposal"). In contrast to other major jurisdictions, the U.S. proposal removes the internal ratings-based approach for credit risk and does not adopt the STC framework.[18] The Dodd-Frank Act prohibits the use of external credit ratings for bank capital requirements. Consequently the U.S. proposal does not implement the SEC-ERBA and adopts only the SEC-SA for capital charges on large banks' securitization exposures. The SEC-SA determines the applicable risk weight based only on standardized parameters reflecting the broad category of underlying pool of assets (e.g., mortgage, corporate etc.), the seniority of the securitization exposure, and an important multiplicative adjustment called the "p-factor". It completely ignores the expected performance of the underlying pool of loans in assessing capital requirements. As a result, the SEC-SA in the U.S. proposal could double or even triple the capital required on certain securitization exposures relative to the current U.S. capital rules and the securitization framework under the EU and Canada's B3E implementation, which Federal Reserve Board Governor Michelle Bowman worries could bring "potential harm to U.S. bank competitiveness in the global economy".[19]

As an illustrative example, banks lend to prime auto loan originators at an advance rate of c. 88% (i.e., the bank lends $88 collateralized by $100 of prime auto loans; losses on the loans would therefore need to exceed $12 for the bank to suffer any impairment on its loan). This lending would generally be rated AAA by the ratings agencies which is commensurate with the overcollateralization (i.e., the $12 in the prior example) being

[17] See https://www.bis.org/bcbs/publ/d332.pdf
[18] See https://www.sifma.org/resources/news/the-federal-reserve-should-remove-gold-plating-in-the-basel-3-endgame/
[19] See https://www.federalreserve.gov/newsevents/speech/bowman20231109a.htm.

sufficient to cover 4-5x historical losses. The table below compares the risk weight for this lending under the current U.S. capital rules, the U.S. B3E proposal and the approaches available to banks in other jurisdictions for the same lending.

Jurisdiction	**Approach**	**Risk Weight**
U.S.	Current Rules	21%
U.S.	*B3E NPR*	*45%*
Europe[1]	Internal Ratings Based	15%
Europe	External Ratings Based	18%
Canada	Internal Ratings Based	15%
Canada	External Ratings Based	15%
Canada	STC	10%

[1]STS for Europe is not included due to the requirement that securitization parties be EU domiciled which would not be met for a U.S. prime auto loan financing

For unsecuritized assets (e.g., loans), under the B3E proposal the broad category of the underlying pool of assets determines the capital requirements for holding them, but for securitized assets, the p-factor is an important additional parameter. The p-factor plays 2 main roles in the SEC-SA framework: (1) it controls the degree of capital penalty for securitization (i.e., it causes the aggregate capital required for holding all tranches of a securitization to exceed that for holding the underlying pool of assets alone, thereby disincentivizing the use of securitization as a credit risk transfer tool by banks) – often referred to as "securitization capital non-neutrality", and (2) it controls the allocation of capital across different tranches of a securitization.[20]

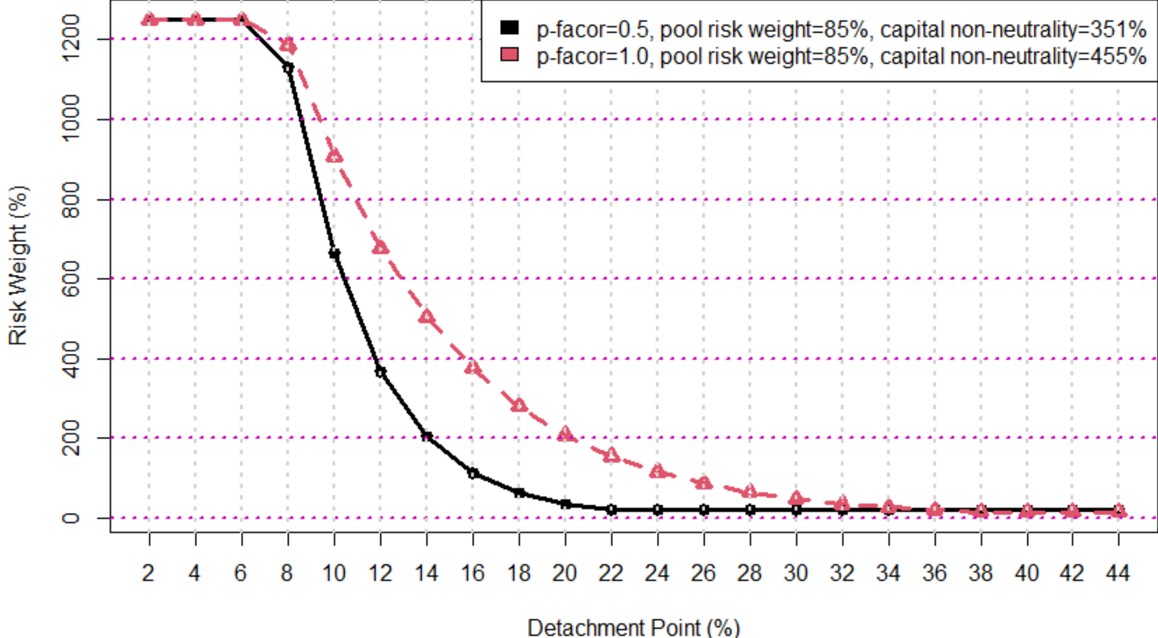
Figure 1 below illustrates the impacts of raising p-factor to 1 from 0.5 on securitization capital non-neutrality and the re-allocation of capital requirements across securitization tranches. It is clear the securitization is capital non-neutral since the securitization capital non-neutrality far exceeds 100%, a larger p-factor only exaggerates the securitization capital non-neutrality (from 351% to 455%) making it more expensive to securitize assets.

Figure 1. The impacts of p-factor on securitization capital non-neutrality and risk weight across securitization tranches. Assuming tranche thickness equals to 2% with attachment

[20] In the SEC-SA and the SEC-IRBA, "the p-factor is calculated on a tranche basis with the senior tranche typically having a lower p-factor compared to subordinated tranches. All things being equal, a higher p-factor for the mezzanine tranche relative to the senior tranche would result in higher capital requirements for the mezzanine tranche." (https://www.bankofengland.co.uk/prudential-regulation/publication/2023/october/securitisation-capital-requirements#footnote-6)

point ranges from 0%-42% and detachment point ranges from 2%-44% respectively,[21] exposure amount of each tranche equals to $1mn, the securitization has no over collateralization, and the risk weight applicable to the underlying pool of assets is 85%.

P-factor, Tranche Risk Weight, and Securitization Capital Non-Neutrality



How does the U.S. proposal create perverse incentives for securitization exposures?

The U.S. proposal could create perverse incentives for securitization exposures due to (1) revisions to the p-factor and the risk weighting of underlying pool of assets, and (2) the lack of appropriate risk-sensitivity of the SEC-SA framework.

The SEC-SA calculates tranche risk weight base on four inputs – attach and detach points, the ratio of delinquent underlying exposures to total underlying exposures in the securitization pool (i.e., W), and the standardized capital requirements for the securitization pool (i.e., K_g), in addition to the p-factor. K_g is adjusted to account for the impacts of W via parameter K_A (defined as K_A=(1-W)*K_g+ 0.5W). That is, K_A effectively ascribes a 625% risk weight to delinquent exposures underlying securitization in contrast to a 150% risk weight held directly on balance sheet. This is further compounded by a higher p-factor.

---

[21] Attachment point for a securitization tranche represents the threshold at which credit losses will first be allocated to the tranche. And detachment point represents the corresponding threshold at which credit losses of principal allocated to the position would result in a total loss of principal.

The U.S. proposal would double the p-factor to 1 from 0.5 under the current U.S. capital rules leading to higher capital requirements for securitization exposures. The proposal would ascribe a lower risk weight to certain retail loans held on a bank's balance sheet (e.g., 85% for prime auto loan exposures) than the current U.S. capital rules (e.g., 100% for prime auto loan exposures) which ought to result in lower capital requirements for securitization exposures. The combined impacts of both changes however, tend to raise capital requirements for senior tranches while lowering capital requirements for the junior-most tranches as shown in Table 1 below.

Table 1. The SEC-SA risk weight applicable to prime auto loan (classified as regulatory retail exposures, i.e., assigned 85% risk weight under the U.S. proposal, but 100% risk weight under the current U.S. capital rules) securitization exposures with the p-factor=1 as proposed in the U.S. proposal.

Capital One Prime Auto Receivables Trust 2023-2

									Basel 3 Standardized (current)	*new rule definition*		*1.0 for non-resec*	NPR		
			SSFA Inputs				Capital & RWA Calculations			Capital & RWA Calculations					
Deal Name	Description	Exposure	Attach	Detach	Seriously Delinquent	Kg	K_A Mod. Adj. K_G	p	Risk Weight	Kg	K_A Mod. Adj. K_G	p	Risk Weight	Risk Weight Delta (absolute)	Risk Weight Delta (relative)
COPA2302	A1	199,500,000	84.00	100.00	0.00%	8.00%	8.00%	0.5	20.0%	6.80%	6.80%	1.0	15.0%	-5%	-25%
COPA2302	A2A	217,880,000	11.20	84.00	0.00%	8.00%	8.00%	0.5	30.9%	6.80%	6.80%	1.0	61.1%	30%	98%
COPA2302	A2B	217,880,000	11.20	84.00	0.00%	8.00%	8.00%	0.5	30.9%	6.80%	6.80%	1.0	61.1%	30%	98%
COPA2302	A3	395,760,000	11.20	84.00	0.00%	8.00%	8.00%	0.5	30.9%	6.80%	6.80%	1.0	61.1%	30%	98%
COPA2302	A4	63,220,000	11.20	84.00	0.00%	8.00%	8.00%	0.5	30.9%	6.80%	6.80%	1.0	61.1%	30%	98%
COPA2302	B	11,270,000	10.27	11.20	0.00%	8.00%	8.00%	0.5	632.3%	6.80%	6.80%	1.0	701.3%	69%	11%
COPA2302	C	11,270,000	9.35	10.27	0.00%	8.00%	8.00%	0.5	796.8%	6.80%	6.80%	1.0	803.5%	7%	1%
COPA2302	D	11,270,000	8.44	9.35	0.00%	8.00%	8.00%	0.5	1001.6%	6.80%	6.80%	1.0	919.2%	-82%	-8%

Table 1 shows that the risk-weighted asset ("RWA") and, as a result, the required capital for the retaining Class A, AAA rated notes in the structure essentially doubles.[22] Take the A2A tranche for example, the risk weight would go up from 30.9% under the current U.S. capital rules to 61.1% under the U.S. proposal – an increase of 98%. But the capital increase bears no relation to the actual risks inherent in the underlying pool of prime auto loans. In fact, relative to the current capital rules the U.S. proposal would ascribe a lower risk weight to prime auto loans.

[22] The capital reduction for holding the most senior tranche is because of the lower risk weight floor (i.e., 15%) relative to the current rule (i.e., 20%), but in this case, relates only to a Money Market tranche which is structurally senior in order to qualify under Rule 2a-7 but is a short, relatively small part of the senior capital stack.

The overall securitization capital surcharge (i.e., non-neutrality) for this securitization would rise from 153% under the current capital rules to 172% under the proposal – a 2000 basis points increase, even though the underlying pool of assets are considered less credit risky (i.e., assigned a lower credit risk weight under the proposal). A capital surcharge of 172% indicates that the capital required for holding the securitization would have been over 1.7x of that for holding the underlying pool of prime auto loans. As a result, the U.S. proposal could make it more expensive for banks to transfer credit risk via securitization. In addition, banks could be incentivized to shift out of senior tranches in exchange for more junior and riskier tranches – a perverse incentive that counters the principle and practice of sound risk management.

Additionally, unlike the SEC-IRBA whereby the p-factor is dependent on the expected performance of the underlying securitization pool (including probability of default and loss given default), the SEC-SA fixed the p-factor at 1 ignoring the expected performance of the underlying securitization pool. Consequently, the SEC-SA under the U.S. proposal could require lower capital on a senior tranche backed by a subprime pool than a senior tranche backed by a prime pool despite the fact that expected losses on the subprime pool will erode more of the collateral balance than the expected losses on the prime pool. Table 2 shows that capital requirements for retaining most senior traches backed by a pool of subprime auto loans would decrease under the U.S. proposal. This is stark contrast to the capital increase for senior tranches backed by prime auto loans reported in Table 1. All else equal, this could result in banks either having to charge substantially more on the securitized loans to the prime auto lender than to the subprime auto lender, or to seek to lend more in subprime than prime.

Table 2. The SEC-SA risk weight applicable to subprime auto loan (classified as regulatory retail exposures, i.e., assigned 85% risk weight under the U.S. proposal, but 100% risk weight under the current U.S. capital rules) securitization exposures with the p-factor=1 as proposed in the U.S. proposal.

ACAR 2023-3

									Basel 3 Standardized (current)	*new rule definition*		*1.0 for non-resec*	NPR		
			SSFA Inputs				Capital & RWA Calculations				Capital & RWA Calculations				
Deal Name	Description	Exposure	Attach	Detach	Seriously Delinquent	Kg	K_A Mod. Adj. K_G	p	Risk Weight	Kg	K_A Mod. Adj. K_G	p	Risk Weight	Risk Weight Delta (absolute)	Risk Weight Delta (relative)
ACAC2303	A	179,502,732	67.48	100.00	0.00%	8.00%	8.00%	0.5	20.0%	6.80%	6.80%	1.0	15.0%	-5%	-25%
ACAC2303	B	48,400,000	58.43	67.48	0.00%	8.00%	8.00%	0.5	20.0%	6.80%	6.80%	1.0	15.0%	-5%	-25%
ACAC2303	C	90,200,000	41.57	58.43	0.00%	8.00%	8.00%	0.5	20.0%	6.80%	6.80%	1.0	15.0%	-5%	-25%
ACAC2303	D	74,250,000	27.69	41.57	0.00%	8.00%	8.00%	0.5	20.0%	6.80%	6.80%	1.0	24.7%	5%	23%
ACAC2303	E	41,800,000	19.88	27.69	0.00%	8.00%	8.00%	0.5	28.2%	6.80%	6.80%	1.0	108.6%	80%	285%

The U.S. proposal would subject a large bank's trading and market making activities to the Fundamental Review of the Trading Book framework ("FRTB"). The FRTB consists of two capital components – general market risk capital and issuer default risk capital ("DRC"). For the purpose of the DRC, the risk weight applicable to certain securitization exposures would be calculated using the SEC-SA framework.[23] Thus, these same perverse incentives would carry over even if the bank holds these tranches for the purpose of trading or market making.

How to mitigate the perverse incentives the U.S. proposal creates for securitization exposures?

The root cause of these perverse incentives is the lack of appropriate risk-sensitivity of the SEC-SA framework which could have detrimental effects on the functioning of the U.S. securitization markets. A few actions could be taken to mitigate such perverse incentives: (1) at the very least, revert the p-factor to 0.5 as in the current U.S. capital rules instead of doubling it as in the U.S. proposal, (2) adopt the SEC-IRBA, and (3) implement the STC framework.

The U.S. proposal should revert the p-factor to 0.5 from 1 to avoid the perverse incentives created by a higher p-factor and reduce the degree of securitization capital surcharge. Our concerns with the excessive securitization capital non-neutrality are shared by several major jurisdictions where mitigation actions are being taken. For example, considering that the "[risk-weighted amount] resulting from the application of the SEC-SA is not commensurate with the risks posed to the institution or to financial stability", the UK

[23] FRTB classifies securitization exposures into two groups – correlation trading vs non-correlation trading. The prime auto loan securitization transaction presented in Table 1 would be considered non-correlation trading. The risk weight applicable to non-correlation trading securitization exposures for the purpose of DRC is calculated using the SEC-SA.

Prudential Regulatory Authority published a discussion paper on "adjustments to the Pillar 1 framework for determining capital requirements for securitisation exposures".[24]

In addition, the U.S. proposal should adopt the SEC-IRBA. As explained earlier, the SEC-IRBA takes into account the expected performance of the underlying pool of assets in setting capital requirements for securitization exposures. The SEC-SA, however, ignores the expected performance of the underlying pool. As a result, it is the least risk-sensitive and most conservative securitization framework offered by the Basel standards. To ensure capital requirements that are commensurate with risks arising from securitization exposures, the SEC-IRBA should be adopted.

Finally, the U.S. proposal should implement the STC framework. The Basel standards set out the STC criteria to help mitigate the uncertainty related to asset risk, structural risk, governance, and operational risk associated with securitization. Less uncertainty and more confidence in the performance of STC transactions would justify a reduced degree of conservatism being built into the securitization capital frameworks through capital non-neutrality. The Basel Committee states explicitly that "[a]ll other things being equal, a securitization with lower structural risk needs a lower capital surcharge than a securitization with higher structural risk; and a securitization with less risky underlying assets requires a lower capital surcharge than a securitization with riskier underlying assets."[25] The STC framework would help lower the hurdles of assessing securitization exposures and incentivize healthy and responsible growth of the U.S. securitization markets.

Conclusion

The U.S. proposal requires large banks to set capital requirements for securitization exposures using the SEC-SA approach. This framework is the least risk-sensitive and most conservative amongst the four approaches offered in the Basel standards and adopted by other major jurisdictions. Additionally, the proposal does not implement the STC framework which was designed by the Basel Committee to support healthy and responsible growth of securitization markets. As a result, the proposal would result in capital requirements that are not commensurate with risks of the securitization, and could

---

[24] https://www.bankofengland.co.uk/prudential-regulation/publication/2023/october/securitisation-capital-requirements
[25] See https://www.bis.org/bcbs/publ/d374.pdf

create perverse incentives for banks' involvement in securitization markets. Securitization markets has been a cornerstone of the U.S. capital markets and a key source of funding for the broader U.S. economy. Without appropriate mitigative actions, the U.S. proposal could have detrimental effects on the securitization markets and the broader economy.