Board of Governors of the Federal Reserve System
Washington, DC 20551

June 5, 2024

Mr. Michael Petrie
Chairman and Chief Executive Officer
Merchants Bancorp
410 Monon Boulevard
Carmel, Indiana 46032

Dear Mr. Petrie:

This is in response to your correspondence, most recently of May 21, 2024, to the Board on behalf of Merchants Bancorp ("Merchants"), the parent of state nonmember bank Merchants Bank of Indiana ("Merchants Bank"), both of Carmel, Indiana, requesting relief under the Board's Regulation Q (the "capital rule").[1] Specifically, Merchants requests authorization to treat the transaction by Merchants Bank named "Merchants Bank of Indiana Reference Notes, Series 2023-1" (the "CLN transaction") as a synthetic securitization for purposes of calculating Merchants' risk-weighted assets under the capital rule.

In the CLN transaction, Merchants Bank has issued debt obligations, the principal and interest payments on which are calculated based on the performance of a pool of loans held by Merchants Bank. Specifically, payments on the obligations are calculated as if a financial guarantee were in place. Merchants Bank has received cash from purchasers in consideration for the issuance of these debt obligations.

To be a securitization exposure under the capital rule, an exposure must arise from or reference a "traditional securitization" or a "synthetic securitization," as defined in the capital rule.[2] If the transaction meets certain operational criteria, a Board-regulated institution may, in the case of a traditional securitization, exclude the underlying exposures from the calculation of its risk-weighted assets or, in the case of a synthetic securitization, recognize for risk-based capital purposes the use of a credit risk mitigant to hedge the underlying exposures.[3] A Board-regulated institution that meets

[1] 12 CFR part 217.

[2] 12 CFR 217.2 s.vv. securitization exposure, synthetic securitization, traditional securitization.

[3] 12 CFR 217.41(a) and (b); .141(a) and (b).

these conditions must hold risk-based capital against any credit risk of the exposures it retains in connection with the securitization.[4] Merchants requests that the Board permit it to compute its risk-weighted asset amount under the capital rule as if the CLN transaction were a synthetic securitization that met the operational criteria for synthetic securitizations.

For a transaction to be a synthetic securitization under the capital rule, at least a portion of the credit risk of one or more underlying exposures must be transferred to one or more third parties through the use of one or more "credit derivatives" or "guarantees," as defined in the capital rule.[5] Moreover, to meet the operational criteria for a synthetic securitization, a Board-regulated institution must use a qualifying credit risk mitigant in the form of "financial collateral," a guarantee that meets certain requirements, or a credit derivative that meets certain requirements.[6] Merchants has not demonstrated that the CLN transaction satisfies each of these elements of the capital rule.

Under the CLN transaction, as represented by Merchants, a portion of the credit risk of the underlying exposures is transferred to the obligation holders by use of contractual provisions that, in the opinion of counsel of Merchants, create an enforceable obligation on those holders to absorb credit losses. In addition, Merchants Bank received the value of the purchased credit protection at issuance in the form of cash proceeds; the proceeds serve to mitigate credit risk of the protection providers. The amount of cash that Merchants Bank owes to the obligation holders depends on the credit performance of the pool of reference assets. Thus, the credit protection is pre-funded rather than backed by collateral. Merchants contends that the CLN transaction meets all other definitional requirements and operational criteria for synthetic securitizations under the capital rule.[7] It is expected that the capital requirement produced under the securitization framework under the capital rule would be commensurate with the risk of the exposures that arise from the transaction if the CLN transaction as represented by Merchants were treated as a synthetic securitization that meets the operational criteria for a synthetic securitization.

Based on all the facts of record, the Director of the Division of Supervision and Regulation, acting pursuant to section 217.1(d)(3) of the capital rule under authority delegated by the Board,[8] and after consultation with the General Counsel, has determined that Merchants may calculate its risk-weighted asset amount under the

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[4] Id.

[5] 12 CFR 217.2 s.vv. credit derivative, guarantee, synthetic securitization.

[6] 12 CFR 217.41(b)(1); .141(b)(1); see also 12 CFR 217.2 s.vv. eligible credit derivative, eligible guarantee, financial collateral.

[7] Under the CLN transaction, Merchants Bank has the right to terminate the transaction early under certain circumstances. Merchants has committed to cause Merchants Bank not to exercise these early termination rights unless 10 percent or less of the principal amount of the reference portfolio of underlying exposures (determined as of the inception of the securitization) is outstanding. See 12 CFR 217.2 s.vv. clean-up call, eligible clean-up call.

[8] 12 CFR 265.7(k)(1)(ii)(C).

capital rule as if the CLN transaction were a synthetic securitization that met all the operational criteria for a synthetic securitization. This action also permits Merchants to treat other credit-linked-note transactions as synthetic securitizations for purposes of calculating risk-weighted assets under the capital rule, so long as any such other credit-linked-note transactions are structured and documented in a substantially identical manner to the CLN transaction and do not deviate from the definitional requirements and operational criteria for synthetic securitizations in the capital rule other than with respect to the use of a "guarantee" and the presence of a qualifying credit risk mitigant. In addition, this action applies only to the CLN transaction and other substantially identical CLN transactions up to an aggregate outstanding reference portfolio principal amount of the lower of 100 percent of Merchants' total capital or $20 billion. Merchants may not apply this treatment to less than the entirety of all the exposures arising out of any given CLN transaction.

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

Very truly yours,

(Signed) Benjamin W. McDonough

Benjamin W. McDonough
Deputy Secretary of the Board