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MEMORANDUM

To: Clients & Friends

From: Cadwalader, Wickersham & Taft LLP

Date: September 16, 2003

Re: Risk-Based Capital Treatment of ABCP Programs and Possible Capital Charge For Early Amortizations

In January of this year, the U.S. Financial Accounting Standards Board (“FASB”) issued interpretation No. 46, “Consolidation of Variable Interest Entities” (“FIN 46”), requiring the consolidation (for U.S. GAAP purposes) of variable interest entities (“VIEs”) onto the balance sheets of U.S. GAAP reporting companies deemed to be the primary beneficiaries of such entities. The application of FIN 46 could result in the consolidation of many securitization transactions, including asset-backed commercial paper (“ABCP”) programs, onto the balance sheets of bank sponsors of such transactions beginning in the third quarter of 2003. U.S. bank sponsors of ABCP programs have been concerned about the amount of additional risk capital they would have to hold as a result of any such consolidations.

Interim Capital Relief for ABCP Programs

In a joint notice of proposed rulemaking, the U.S. bank regulators (consisting of the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (collectively, the “Agencies”)) have adopted an interim rule to permit banks that sponsor ABCP programs and are required by FIN 46 to consolidate such programs to remove such consolidated ABCP program assets from their risk-weighted asset base for the purposes of calculating their risk-based capital ratios.¹ The Agencies have also amended their risk-based capital standards to exclude from tier 1 and total capital any minority interests in ABCP programs that are consolidated by banks under FIN 46. However, under the interim rule, bank sponsors of such programs must continue to include in risk-weighted assets the credit equivalent amount of any exposures, such as credit enhancements, that

¹ A banking organization is considered to be the “sponsor” of an ABCP program for these purposes if it establishes the program, approves the sellers permitted to participate in the program or approves the asset pools to be purchased by the program or administers the ABCP program by monitoring the assets, arranging for debt placement, compiling monthly reports or ensuring compliance with the program’s documents and credit and investment policy.

they provide to ABCP programs. In addition, banks will be required to include all the assets of such consolidated ABCP programs when calculating their tier 1 leverage capital ratios. This interim risk-based capital treatment will expire on April 1, 2004.

Extension of Interim Capital Relief and Proposed Capital Charge for Liquidity Facilities in ABCP Programs

The Agencies have proposed to further amend their risk-based capital standards by removing the April 1, 2004 expiration date in the interim rule so that ABCP program assets consolidated under FIN 46 and any associated minority interests would continue to be excluded from risk-weighted assets and tier 1 capital, respectively, when bank sponsors calculate their tier 1 and total risk-based capital ratios. At the same time, the Agencies have expressed concern that the existing risk-based capital rules do not adequately reflect the risks assumed by banks that provide short-term liquidity facilities to ABCP programs. Accordingly, the Agencies have stated that they will make the interim rule permanent only in conjunction with certain proposed amendments (described below) to the risk-based treatment of ABCP liquidity facilities.

Currently, liquidity facilities provided to ABCP programs attract no risk capital if they have an original maturity of one year or less while liquidity facilities with an original maturity of more than one year are converted to an on-balance sheet credit equivalent amount using a 50 percent credit conversion factor. The Agencies are now proposing to require banks to hold risk-based capital against ABCP liquidity facilities with an original maturity of one year or less (the capital charge currently required for longer-term facilities would remain in effect). The capital charge for ABCP liquidity facilities generally would apply even if FIN 46 would not require the program to be consolidated. However, a separate capital charge on liquidity facilities provided to an ABCP conduit would not be required if a banking organization consolidates the program for the purposes of risk-based capital.

The Agencies' proposal would require banks to convert short-term liquidity facilities provided to ABCP programs to on-balance sheet credit equivalent amounts utilizing a 20 percent credit conversion factor. This amount would then be risk-weighted based on the risk weights of the underlying assets or the obligor, after considering any collateral or guarantees, or external credit ratings. For example, if a short-term liquidity facility provided to an ABCP program covered an asset-backed security (ABS) externally rated AAA, then the amount of the security would be converted at 20 percent to an on-balance sheet credit equivalent amount and assigned to the 20 percent risk category appropriate for AAA- rated ABS.

A bank would be required to hold risk-based capital only once for any exposure covered by overlapping facilities provided by the bank. The bank would be required to hold risk-based capital based on the highest amount of risk-based capital assessed against any such overlapping facility. For example, if a bank provides a program-wide credit enhancement covering 10 percent of the underlying asset pools in an ABCP program and pool-specific liquidity facilities covering 100 percent of each of the underlying asset pools the bank would be required to hold capital against (i) 10 percent of the underlying asset pools because it is providing the program-wide credit enhancement and (ii) 90 percent of the liquidity facilities it is providing to each of the underlying asset pools.

If different banks provide overlapping exposures, however, each bank would be required to hold capital against the entire maximum amount of its exposure. As a result, duplication of capital charges could occur where multiple banking organizations have overlapping exposures to the same ABCP program.

The Agencies have also proposed that banks subject to the market risk capital rules would not be permitted to apply those rules to any liquidity facilities held in the trading book. Rather, banks would be required to convert the notional amount of all liquidity facilities to ABCP programs, regardless of the facilities' maturities, using the appropriate credit conversion factor to determine the credit equivalent amount for liquidity facilities that are structured or characterized as derivatives or other trading book assets. Thus, for example, all liquidity facilities to ABCP programs with an original maturity of one year or less will be subject to a 20 percent conversion factor as described above, regardless of whether the exposure is carried in the trading account or the banking book. The Agencies have requested comment on this proposal.

In addition, in order for a short or long-term liquidity facility provided to an ABCP program not to be considered a recourse obligation or a direct credit substitute, draws on the facility must be subject to a reasonable asset quality test that (i) precludes funding assets that are 60 days or more past due or in default, (ii) provides that if the assets a bank would be required to fund pursuant to the facility are initially externally rated exposures, the facility could only be used to fund such exposures if they are externally rated investment grade at the time of funding, and (iii) only requires the bank to fund against those assets that would meet the funding criteria under the liquidity facility's asset quality tests.

Possible Capital Charge for Certain Early Amortization Features

In addition to proposing changes to the risk-based capital treatment of liquidity facilities provided to ABCP programs, the Agencies are seeking comment on whether to propose a risk-based capital charge for certain types of securitizations of revolving pools of retail credit (for example, credit card receivables) that incorporate early amortization provisions. Virtually all securitizations of revolving retail credit facilities that include early amortization provisions rely on excess spread as an early amortization trigger. Early amortization generally commences once excess spread falls to or below zero for a given period of time. The early amortization provisions typically present in such securitizations may present bank sponsors with liquidity issues following the occurrence of an early amortization event because, after an early amortization provision is triggered, new receivables that are generated from the accounts designated to the securitization trust are no longer sold to investors, but instead are retained on the sponsor bank's balance sheet. In addition, the Agencies believe that such early amortization provisions may shift some credit risk to bank sponsors of such securitizations by increasing the likelihood that investors will be repaid before being subject to any risk of significant credit losses. For example, in certain transactions of this type if a securitized asset pool begins to experience credit deterioration to the point where the early amortization provision is triggered, then the asset-backed securities begin to pay down rapidly.

The Basel Committee on Banking Supervision (the Basel Committee) has already set forth a risk-sensitive proposal that would assess capital against securitizations of revolving exposures with early amortization features based on key indicators of risk, such as excess spread levels. The risk based capital charge now being proposed by the Agencies for this type of securitization is based on the current Basel Committee proposal and mirrors the Agencies' proposed treatment (in their July

2003 advanced notice of proposed rulemaking) of such securitizations by certain large internationally active U.S. banks.

The Agencies believe that since risk-based capital is already held against the on-balance sheet seller's interest, any additional capital charge should be assessed against only the off-balance sheet investors' interest and only in the event that the excess spread in the transaction has declined to a predetermined level. The capital requirement would assess increasing amounts of risk-based capital as the level of excess spread approaches the early amortization trigger (typically, a three-month average excess spread of zero). Therefore, as the probability of an early amortization event increases, the capital charge against the off-balance sheet portion of the securitization also would increase.

The maximum risk-based capital requirement that would be assessed under the Agencies' proposal would be equal to the greater of (i) the capital requirement for residual interests and (ii) the capital requirement that would have applied if the securitized assets were held on the securitizing bank's balance sheet. The latter capital charge generally is 8 percent for credit card receivables. For example, if a bank after securitizing a credit card portfolio retains a combination of an interest-only strips receivable, an on-balance sheet spread account, and a subordinated tranche that totalled 12 percent of the transaction, then under the Agencies' risk-based capital standards the bank would be assessed a dollar-for-dollar capital charge against the 12 percent of retained, subordinated securitization exposures, net of any associated deferred tax liabilities. Alternatively, if the amount of the retained exposures were less than 8 percent, which is the risk-based capital charge for credit card receivables held on the balance sheet, then the charge against the retained securitization exposures plus any early amortization capital charge would be limited to 8 percent. Potentially, if the exposure were limited by contract, the risk-based capital requirement could be limited to that contractual amount under the low-level exposure rule.

In order to determine whether a banking organization securitizing revolving retail credit facilities containing early amortization provisions must hold risk-based capital against the off-balance sheet portion of its securitization (that is, the investors' interest), the three-month average excess spread must be compared against the difference between (i) the point at which the securitization trust would be required by the securitization documents to trap excess spread in a spread or reserve account and (ii) the excess spread level at which early amortization would be triggered. If the securitization documents do not require excess spread to be trapped, then for purposes of this calculation the spread trapping point is deemed to be 450 basis points higher than the early amortization trigger based on diminishment of excess spread. Once the difference between the spread trapping point and the early amortization trigger is determined, this difference must be divided into four equal segments, each of which will be assigned a different credit conversion factor. If, for example, the spread trapping point is 450 basis points, the credit conversion factor for the outstanding principal balance of the investors' interest will be (i) zero if the three-month average excess spread of the securitization exceeds 450 basis points, (ii) 5 percent if such average excess spread is less than 450 but at least 337.5 basis points, (iii) 10 percent if it is less than 337.5 but at least 225 basis points, (iv) 50 percent if it is less than 225 but at least 112.5 basis points, or (v) 100 percent if it is less than 112.5 basis points. If any particular securitization does not employ the concept of excess spread as a transaction's determining factor of when an early amortization is triggered, then a 10 percent credit conversion factor is applied to the outstanding principal balance of the investors' interest at the securitization's inception, regardless of the level of the transaction's excess spread.

At this time, the Agencies are only requesting comment on whether to assess risk-based capital against securitizations of revolving retail credit exposures. They have not proposed to assess risk-based capital against securitizations of revolving corporate exposures, such as certain collateralized loan obligations. However, the Agencies are considering the appropriateness of applying an early amortization capital charge to securitizations of non-retail revolving credit exposures and have requested comment on this issue.

If you have any questions regarding the interim rule or the proposal to apply capital charges to ABCP program liquidity facilities and certain revolving securitizations with early amortization provisions please contact in London, Jim Croke at +44 20 7170 8758 or in New York, Peter Manbeck at +1 212 504 6626.