

**Memorandum**

**To:** Clients & Friends

**From:** Cadwalader, Wickersham & Taft LLP

**Date:** February 3, 2004

**Re:** Federal Reserve Staff Opinion: Depository Institutions that Consolidate ABCP Conduits under FIN 46 are not Required to Treat the Related Commercial Paper Notes as “Deposits” under Regulations D or Q

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On January 26, 2004, the staff of the Board of Governors of the Federal Reserve System (the “Board”) issued an opinion letter confirming that certain depository institutions that sponsor asset-backed commercial paper conduits (“ABCP Conduits”), and that are required by Interpretation No. 46 (“FIN 46”) of the Financial Accounting Standards Board (“FASB”) to consolidate such ABCP Conduits for accounting purposes, will not be required to treat the commercial paper notes issued by the consolidated ABCP Conduits as either (1) liabilities of the depository institution that are subject to reserve requirements under the Board’s Regulation D, or (2) demand deposits of the depository institution that are subject to regulation under the Board’s Regulation Q. The staff instead stated that the application of FIN 46 does not by itself make the commercial paper notes “deposits”, “reservable liabilities” or “demand deposits” of such depository institutions. This memorandum summarizes the staff’s opinion.

The staff’s opinion expressly covers asset-backed commercial paper (“ABCP”) programs in which a depository institution (“DI”) establishes a bankruptcy-remote ABCP Conduit that issues commercial paper notes and uses the proceeds to purchase asset pools from (or extend loans to) the DI’s corporate customers. Although in most cases the ABCP Conduit will not sell securities into the market other than commercial paper, the term “ABCP Conduit” (as defined in the letter) also covers structured investment vehicles (“SIVs”) that issue both commercial paper and medium-term notes and use the proceeds to purchase highly-rated debt securities. The opinion states that it does not address cases where a DI sells its own assets to its sponsored ABCP Conduit.

## C A D W A L A D E R

FASB issued FIN 46 in January 2003 and a revised FIN 46 on December 24, 2003.<sup>1</sup> FIN 46 generally requires an enterprise that is the “primary beneficiary” of a “variable interest entity” (“VIE”) to consolidate the VIE’s assets and liabilities onto the enterprise’s balance sheet. FIN 46 defines a “primary beneficiary” as “the party that absorbs a majority of the [VIE’s] expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests...”. It further states that if “one enterprise will absorb a majority of a [VIE’s] expected losses and another enterprise will receive a majority of that entity’s expected residual returns, the enterprise absorbing a majority of the losses shall consolidate the [VIE].” “Variable interests” are defined as “contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of the entity’s net assets exclusive of variable interests.”

As noted by the staff in its opinion letter, most DIs that sponsor ABCP Conduits provide their ABCP Conduits with both liquidity facilities and credit enhancement. In many cases, the liquidity facilities and/or credit enhancement commitments will require the sponsoring DI to absorb a majority of the ABCP Conduit’s “expected losses” (as defined in FIN 46). In this situation, the DI will be the “primary beneficiary” of the ABCP Conduit and under FIN 46 will be required to consolidate the ABCP Conduit’s assets and liabilities onto its balance sheet. The staff states that FIN 46 has thus brought many of the liabilities of DI-sponsored ABCP Conduits on balance sheet for the purposes of those regulatory reports that are tied to GAAP, such as the “Call Report”<sup>2</sup>

Regulation D<sup>3</sup> implements Section 19 of the Federal Reserve Act (the “Act”)<sup>4</sup> which imposes reserve requirements on certain liabilities of DIs: “transaction accounts,” “nonpersonal time deposits,” and “Eurocurrency liabilities”.<sup>5</sup> Transaction accounts (primarily “demand deposits” and “NOW accounts”) are subject to a reserve requirement ratio of up to ten percent, while “nonpersonal time deposits” and “Eurocurrency liabilities” are subject to a reserve requirement ratio of zero percent. In addition, Regulation Q,<sup>6</sup> which implements

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<sup>1</sup> “FIN 46” as used herein refers to the December 2003 revision.

<sup>2</sup> Form FFIEC 031, “Consolidated Reports of Condition and Income for a Bank with Domestic and Foreign Offices,” and Form FFIEC 041, “Consolidated Reports of Condition and Income for a Bank with Domestic Offices Only”.

<sup>3</sup> “Reserve Requirements of Depository Institutions,” 12 CFR Part 204.

<sup>4</sup> 12 U.S.C. § 461.

<sup>5</sup> “Transaction accounts” and “nonpersonal time deposits” are subcategories of the general definition of “deposit.”

<sup>6</sup> “Prohibition Against Payment of Interest on Demand Deposits,” 12 CFR Part 217.

## C A D W A L A D E R

Section 19(i) of the Act, prohibits the payment of interest on “demand deposits” as defined in Regulation D.

Regulation D also requires DIs to file reports of deposits for the purpose of administering the regulation. The primary report of deposits is Form FR 2900, “Report of Transaction Accounts, Other Deposits and Vault Cash” (the “FR2900”). In certain circumstances, a DI must file a “consolidated” FR 2900 that reports not only the deposits of the DI itself, but also includes certain specified liabilities of the DI’s “affiliates” as well. The staff states in its opinion letter that the implementation of FIN 46 does not change its pre-existing view that an ABCP Conduit is not an “affiliate” of its sponsoring DI under existing Regulation D definitions, and therefore its liabilities are not subject to the “affiliate” consolidation requirements for purposes of the report of deposits.

The general definition of “deposit” in Regulation D is “the unpaid balance of money or its equivalent received or held by a [DI] in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to an account, including interest credited or which is evidenced by an instrument on which the [DI] is primarily liable.” Regulation D excludes from the definition of “deposit” those liabilities that are “conditional” or “contingent,” and those liabilities “the proceeds of which are not used by the [DI] for purposes of making loans, investments, or maintaining liquid assets such as cash or ‘due from’ [DIs] or other similar purposes.” 12 CFR. The staff noted that a DI that sponsors an ABCP Conduit does not receive the proceeds of the ABCP Conduit’s commercial paper. Rather, those proceeds are received by the ABCP Conduit itself which is by design contractually isolated from the DI.

Prior Board interpretations and staff opinions about whether a particular DI obligation constitutes a “deposit” under Regulation D focused on the extent to which the DI, having received the proceeds of the obligation, could be required to guarantee or repurchase the obligation out of the DI’s own funds.<sup>7</sup> If the holder of the obligation had sufficient recourse against the DI in the event of the insufficiency of the underlying assets, a “deposit” was created.<sup>8</sup> In this regard, the staff noted the purchaser of the commercial paper issued by a

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<sup>7</sup> See, e.g., FRRS ¶ 2-260.5 (Board Interpretation of June 1, 1970) (mortgage-backed securities issued by member bank and guaranteed by GNMA were not “deposits” because the security holder had no right to require the bank to make payments on the securities out of the bank’s own funds); and FRRS ¶ 2-260.57 (Board Interpretation of July 1, 1988) (DI’s short-term loan participation arrangements were “deposits” because the DI selling the loan or participation was in effect required to buy it back at the option of the purchaser).

<sup>8</sup> See, e.g., FRRS ¶ 2-324.1 (Staff Opinion of May 27, 1971) (participation in a pool of assets was not a “deposit” as long as purchaser relied on underlying assets for payments of interest and principal; “deposit” resulted if purchaser could require the bank to repurchase the purchaser’s participation);

## C A D W A L A D E R

DI-sponsored ABCP Conduit does not have any direct recourse against the sponsoring DI under either the liquidity facilities or the credit enhancements in the event that the required payments to the purchaser are not made. Rather, the purchaser's recourse is against the ABCP Conduit itself, which retains its separate corporate character notwithstanding FIN 46 consolidation. Although the purchaser of the ABCP Conduit's commercial paper presumably knows that the ABCP Conduit has access to the DI's liquidity facilities and credit enhancements, the commercial paper purchaser does not have any contractual right to obtain access to those facilities or enhancements directly in the event that the ABCP Conduit, for whatever reason, failed to draw upon them to make payments on the commercial paper. In addition, the staff noted that the documentation for ABCP programs will expressly provide that the ABCP Conduit's commercial paper is not a liability of the sponsoring DI. In view of these factors, and its review of prior Regulation D Board interpretations and staff opinions, the staff concluded that commercial paper issued by a DI-sponsored ABCP Conduit is not a "deposit" (or otherwise a reservable liability) of the DI for purposes of Regulation D. The staff further stated that, since such commercial paper is not a "deposit" under Regulation D, it also is not a "transaction account" for purposes of Regulation D nor a "demand deposit" for purposes of Regulations D and Q.

If you have any questions regarding this matter please contact either Jim Croke of Cadwalader's London office at +44 20 7170 8758 or Peter Manbeck of Cadwalader's New York office at 212 504 6626.

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and FRRS ¶ 2-325.14 (Staff Opinion of June 23, 1983) (member bank's sale of bonds subject to put option was a "deposit;" also "deposit" if sale with letter of credit upon which bond purchasers could draw in the event of bond issuer default).