

Clients & Friends Memo

New Capital Requirements for Liquidity Facilities in Asset-Backed Commercial Paper Programs

July 7, 2004

Summary

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Office of Thrift Supervision (together, the "Agencies") are expected shortly to announce final amendments to their risk-based capital rules as they apply to liquidity facilities provided by banking institutions to asset-backed commercial paper programs. The final rule of each Agency will increase the capital requirement applicable to most short-term (i.e., one year or less) liquidity facilities that support asset-backed commercial paper ("ABCP") by increasing the credit conversion factor from zero percent to 10 percent. The final rule will also set forth certain eligibility criteria that short-term liquidity facilities must satisfy to qualify for the 10 percent credit conversion factor.

The final rule is expected to become effective on September 30, 2004. At that time, all short-term liquidity facilities (whether or not they satisfy the eligibility criteria described below) will be subject to the 10 percent credit conversion factor. As of September 30, 2005, liquidity facilities that don't satisfy the eligibility criteria will become subject to a 100% credit conversion factor. Liquidity facilities with an original term exceeding one year will remain subject to the 50 percent credit conversion factor that currently applies (but any such facilities that fail to satisfy the eligibility criteria will be treated as direct credit substitutes or recourse obligations and will become subject to the 100 percent credit conversion factor as of September 30, 2005).

The credit equivalent amount determined in respect of any liquidity facility under the final rule will be risk-weighted pursuant to the Agencies' existing capital regulations. Accordingly, in most cases the capital charge for an ABCP liquidity facility will increase as the credit quality of the ABCP conduit's investment portfolio decreases.

Background

In January 2003, the U.S. Financial Accounting Standards Board ("FASB") issued interpretation No. 46, "Consolidation of Variable Interest Entities" (as amended through the date hereof, "FIN 46"),

requiring the consolidation (for U.S. GAAP purposes) of variable interest entities 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 onto the balance sheets of the banks sponsoring such transactions. In particular, absent capital relief from the Agencies, FIN 46 could require the bank sponsor of an ABCP program to maintain risk capital against the ABCP conduit's investment portfolio.

The Agencies previously concluded that consolidation of ABCP program assets onto a sponsoring bank's balance sheet generally would not reflect the actual risks faced by the bank and would overstate the amount of risk capital that should be required. Accordingly, in October 2003 the Agencies adopted an interim rule that permits banks that sponsor ABCP programs and are required by FIN 46 to consolidate such programs to remove the consolidated ABCP program assets from their risk-weighted asset base for the purposes of calculating their risk-based capital ratios.¹ The Agencies 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.

In April 2004, the Agencies extended the stated expiration date of the interim rule to July 1, 2004. The Agencies nonetheless 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 stated in a release accompanying the publication of the interim rule (the "Prior Release") that they would make the interim rule permanent only in conjunction with amendments to their risk-based capital rules that would require banks to maintain regulatory capital against all ABCP liquidity facilities. The Agencies are now expected shortly to adopt final rules that will (i) make permanent the interim rule that grants capital relief to banks that are required by FIN 46 to consolidate ABCP conduits, and (ii) impose in respect of ABCP liquidity facilities the capital charges described below.

The Final Rule

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 final rule will eliminate the partial exemption for short-term ABCP liquidity facilities and will, for the first time, 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

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.

longer-term facilities would remain in effect).² The capital charge for ABCP liquidity facilities generally will 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 will not be required if a banking organization consolidates the program for purposes of computing its risk-based capital requirements.

The final rule will require banks to convert short-term liquidity facilities provided to ABCP programs to on-balance sheet credit equivalent amounts utilizing a 10 percent credit conversion factor. The 10 percent credit conversion factor represents a decrease from the 20 percent factor that the Agencies had proposed in the Prior Release. The final rule then provides for the credit equivalent amount so computed to be risk-weighted based on the risk weights of the underlying assets or the underlying obligors, 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 10 percent to an on-balance sheet credit equivalent amount and assigned to the 20 percent risk category appropriate for AAA-rated ABS.

The final rule will require banks to hold risk-based capital only once for any exposure covered by overlapping facilities provided by the bank. In particular, 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 to an ABCP conduit, each bank will be required by the final rule 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 final rule will prohibit banks subject to the market risk capital rules from applying those rules to any liquidity facilities held in the trading book. Rather, banks will be required to convert the notional amount of all liquidity facilities provided to ABCP programs (including facilities that are structured or characterized as derivatives or other trading book assets and regardless of the facilities'

² The current exemption for short-term liquidity facilities applies only to "true" liquidity facilities that are not deemed to provide credit enhancement; liquidity facilities that also comprise credit enhancement facilities are treated as direct credit substitutes or recourse obligations and are subject to an appropriate capital charge.

maturities) to a credit equivalent amount using the appropriate credit conversion factor. Thus, for example, all eligible short-term liquidity facilities provided to ABCP programs with an original maturity of one year or less will be subject to a 10 percent credit conversion factor as described above, regardless of whether the exposure is carried in the trading account or the banking book.

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 90 days or more past due or in default, and (ii) provides that if the assets a bank would be required to fund pursuant to the facility are initially externally rated exposures, the facility can only be used to fund such exposures if they are externally rated investment grade at the time of funding (together, the "Eligibility Criteria"). The 90-day delinquency period permitted in the final rule represents an increase from the 60-day period the Agencies had proposed in the Prior Release. If the Eligibility Criteria are not satisfied, the relevant liquidity facility will (after the expiration of the phase-in period described below) be subject to a 100 percent credit conversion factor.³

The final rule is to become effective on September 30, 2004. At that time, all short-term liquidity facilities provided to ABCP conduits will be subject to the 10 percent credit conversion factor whether or not they satisfy the Eligibility Criteria. Long-term liquidity facilities will remain subject to a 50 percent credit conversion factor. As of September 30, 2005, any ABCP liquidity facility (whether short-term or long-term) that does not satisfy the Eligibility Criteria will be treated as a direct credit substitute or recourse obligation and will be subject to a 100 percent credit conversion factor. The Agencies have stated that the one-year phase-in period should provide sufficient time for bank sponsors to revise any ABCP liquidity facilities that don't currently satisfy the Eligibility Criteria.

As stated above, the final rule will make permanent the capital relief provided by the interim rule pursuant to which bank sponsors of ABCP programs that are required by FIN 46 to consolidate such ABCP programs are not required to hold risk-based capital against the conduit's assets. The final rule will specify, however, that this relief is available only to bank sponsors of "asset-backed commercial paper programs." This term is defined in the final rule to include asset-backed issuers that "primarily" fund themselves by issuing "externally rated commercial paper". The Agencies have stated that "primarily" means "more than 50 percent" and that the covered issuers generally should include (among other entities) structured investment vehicles and securities arbitrage programs. However, bank sponsors of programs that issue asset-backed commercial paper in amounts not greater than 50% of the program's total liabilities will not qualify for the capital relief and – to the

³ The Eligibility Criteria will not apply to the extent the assets supported by the liquidity facility are guaranteed, conditionally or unconditionally, by the United States government or its agencies or the central government of any other OECD country.

extent that they are required by FIN 46 to consolidate the program - will be required to hold risk-based capital against all of the program's assets.

As under the interim rule, the final rule will require banks that are required to consolidate an ABCP program under FIN 46 but that qualify for capital relief to exclude from tier 1 and total capital any minority interest in such programs. In addition, the final rule will not entitle banking organizations to exclude the assets of consolidated ABCP programs in calculating their tier 1 leverage capital ratios. The final rule will instead require banking organizations to include all assets of consolidated ABCP programs as part of on-balance sheet assets for purposes of such calculations.

The Agencies requested comment in the Prior Release on whether specific risk-based capital charges should be applied to certain types of securitizations of revolving pools of retail credit (for example, credit card receivables) that incorporate early amortization provisions. The final rule, however, will not impose any such capital charges. The Agencies instead have noted that the revised Basel Capital Accord sets forth specific guidelines to calculate risk capital requirements in such securitizations, and have concluded that any capital charges associated with such securitizations should be imposed only in conjunction with the implementation of the revised Basel Capital Accord in the United States. Accordingly, the Agencies have decided not to impose at this time a specific risk-based capital charge for securitizations of revolving credits.

The final rule has not yet been published by the Agencies and revisions to the final rule (as summarized above) could be made. However, any such revisions are not expected to be significant.

If you have any questions regarding the final rule, please contact Jim Croke at (212) 504-6139 or Peter Manbeck at (212) 504-6626.