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# FUNDING BANK CUSTOMERS IN THE CURRENT SECURITIZATION MARKET:

Some Thoughts for Multi-Seller ABCP Conduit Sponsors and Customers  
After 2008 Presents Additional Challenges and as 2009 Begins

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March 4, 2009

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# WHERE WE'VE BEEN

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## The Early Years

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- Origins of the market in the 1980s.
- Market dominated by multi-seller bank-sponsored conduits with traditional bank liquidity facilities and second loss program enhancement in the form of sponsor bank letters of credit or surety bonds from “AAA” monoline insurers.
- Favorable regulatory treatment for conduit sponsors.
- ABCP attractive to investors - exposure “secured” by diversified receivables pools, however ABCP provided a slight premium above comparably rated, unsecured corporate commercial paper.

# From “Plain Vanilla” to Product Diversification - Single Seller Conduits, Arbitrage Conduits, SIVs and Extendible Notes

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- As is the case with many financial products, the early success and stability of the ABCP product led to expansions of the use of the product for other purposes, alternative liquidity and capital structures, and structural variations on the commercial paper itself.

## SINGLE SELLER CONDUITS -

Companies with large volumes of their own securitizable assets created ABCP conduits dedicated solely to the financing of these assets. Credit enhancement is often solely provided through subordinate tranches, overcollateralization and excess spread protection without second loss program enhancement. Highly rated banks are recruited to provide traditional liquidity facilities.

# From “Plain Vanilla” to Product Diversification - Single Seller Conduits, Arbitrage Conduits, SIVs and Extendible Notes (Cont’d)

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## SECURITIES ARBITRAGE VEHICLES -

Conduits established by sponsors that still issue only traditional ABCP but are set up to purchase securities (typically asset-backed securities) that are expected to provide yields that are higher than the ABCP discount plus other fees and costs necessary to maintain the conduit program.

# From “Plain Vanilla” to Product Diversification - Single Seller Conduits, Arbitrage Conduits, SIVs and Extendible Notes (Cont’d)

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## STRUCTURED INVESTMENT VEHICLES (SIVs) -

Conduits that generally serve the same purposes as Securities Arbitrage Vehicles, but that do so with more complicated capital and funding structures. In addition to ABCP, SIVs also normally issue medium term notes and subordinated debt and equity securities. Importantly, unlike traditional ABCP conduits, liquidity for SIVs is primarily based upon the ability to sell financed assets in the market if necessary to pay maturing CP Notes. Traditional bank liquidity facilities are normally only sized at a fraction (typically 10%) of the SIV’s outstanding commercial paper notes.

# From “Plain Vanilla” to Product Diversification - Single Seller Conduits, Arbitrage Conduits, SIVs and Extendible Notes (Cont’d)

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## EXTENDIBLE NOTES -

In the last few years, single seller and multi-seller conduits began issuing an ABCP - like product normally called “extendible notes.” Extendible notes are issued with expected maturity dates of 1 to 270 days, like traditional ABCP, but are subject to extension to a later final maturity date if they can not be repaid on their expected maturity dates with proceeds of new extendible notes. Final maturity dates for extendible notes normally do not exceed 390 days so that such notes are eligible for purchase by money market mutual funds.

## From “Plain Vanilla” to Product Diversification - Single Seller Conduits, Arbitrage Conduits, SIVs and Extendible Notes (Cont’d)

While some extendible note programs continue to rely on traditional liquidity facilities, other extendible note programs for which notes cannot be repaid by their expected maturity dates rely for liquidity on some combination of the following depending upon the assets financed:

1. Ability to sell the assets at a price at least equal to the extendible notes prior to note final maturity plus, in some structures, a market value swap from a highly rated bank that covers the difference between the sale price of non-defaulted assets and the outstanding notes (“market value” programs).

## From “Plain Vanilla” to Product Diversification - Single Seller Conduits, Arbitrage Conduits, SIVs and Extendible Notes (Cont’d)

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2. Cash flows from assets expected to liquidate prior to note final maturity plus, in some structures, a partial liquidity facility issued by a highly rated bank sized at an amount satisfactory to the rating agencies (“cash flow” programs).

## ABCP Market Survives Potential Disruptions - Y2K and 9/11

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- Y2K and 9/11 both presented challenges to ABCP markets for drastically different reasons. The market survived both of these challenges well: Y2K through a combination of the problem being much less significant than was feared and proactive management of maturities by ABCP conduit sponsors, and 9/11 through impressive cooperation between dealers, investors and conduit sponsors through a short but challenging period of real market disruption.

# ABCP in the Post-Enron World: Changes to Accounting Rules and Increased Regulation and Oversight

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- FASB adopts FIN 46r - accounting consolidation with sponsor bank becomes an issue for some conduits.
- US bank regulators revise capital rules for ABCP conduit liquidity facilities - defined “eligible liquidity facilities” for the first time - 10% credit conversion factor applied to undrawn commitments under eligible liquidity facilities of one year or less - ineligible liquidity facilities are treated as direct credit substitutes.
- US regulators also adopt guidelines for “complex structured finance transactions” - ABCP conduit transactions largely excluded from final guidance.

# The Basel II Saga: Nine Years in and Still in Progress - Revised “Final” Guidelines Adopted in November 2005

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- Basel guidelines provide two basic approaches for banks to calculate requirements:
  1. Standardized Approach-will apply to most banks and uses relatively simple ratings-based risk weights for calculating capital.
  2. Internal Ratings-Based (IRB) Approach-will apply to internationally active banks that have their internal ratings systems approved by their regulators-because it is more sophisticated, likely to result in lower capital charges for most exposures.

## As was already the case in the US, short-term liquidity facilities have a regulatory capital charge under Basel II

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- Under the Standardized Approach, liquidity commitments of less than one year will have a credit conversion factor of 20%.\*
- Under IRB, liquidity facilities are treated like any other on-balance sheet securitization exposure (no credit conversion factor). Banks using IRB, however, will generally be allowed to apply risk weights that are substantially lower than those that apply under the Standardized Approach.

\*Proposed amendments to the Basel II framework announced January 16, 2009 by the Bank of International Settlements would increase the CCF on liquidity commitments to 50% regardless of maturity.

## If a bank uses IRB for its securitization exposures, the following hierarchy of approaches applies

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1. Use external ratings of the exposure to calculate capital if available.
2. Use inferred ratings from subordinated exposures if available.
3. Use the Internal Assessment Approach for ABCP conduit exposures.
4. Use a supervisory formula.

## Many bank conduit sponsors expect to apply the Internal Assessment Approach to their ABCP conduit exposures

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- Under the IAA, the bank applies its own internal rating to an exposure to determine its risk weight.
- The risk weight is a function of the internal credit rating, the seniority of the position and its granularity (6 or more exposures is considered granular).
- The bank's internal ratings must be based on published rating agency criteria for the applicable asset class.

## Possible Post-Basel II Capital Regimes for US Banks

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1. Core banks must use US version of Advanced IRB Approach:  
“core bank” =
  - (i) consolidated total assets of \$250 billion or more, or
  - (ii) consolidated total on-balance sheet international exposure of \$10 billion or more
2. Other US banks may “opt in” (subject to regulator approval) to the Advanced IRB Approach, or :
  - a. Use existing Basel I capital rules; or
  - b. Use a US version of the Basel II Standardized Approach.

# 2007: WHAT HAPPENED?

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## Sub-Prime Meltdown Hits the ABCP Market

- Early August 2007, BNP Paribas announces that withdrawals would be halted from three money funds heavily invested in securitization products-stating it “couldn’t fairly price their holdings.”
- Announcement brought to light the substantial devaluation of sub-prime RMBS collateral constituting the primary source of repayment for many single-seller ABCP programs.
- Demand for ABCP from investors shrank dramatically, particularly for ABCP conduits perceived to be exposed to assets that could lose significant value.
- Several Canadian ABCP programs were soon forced to unwind as a result of market conditions.
- Several US and European arbitrage programs and SIVs were also forced to liquidate or cease issuing ABCP.
- Dramatic decrease of US ABCP outstandings from \$1.05 trillion at 12/31/2006 to \$780 billion at 12/31/2007.\*

## Some SIVs Unwind - Bank Sponsors Take Actions to Support Other Programs

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- Dependence of SIVs on the market value of purchased assets forced several SIVs to sell assets and unwind.
- IKBs Rhinebridge SIV appointed a receiver in October 2007 because it couldn't pay creditors - sells assets to raise cash.
- Cheyne Finance plc defaults on commercial paper and appoints receiver.
- Citigroup, HSBC, Societe Generale, HSH Nordbank and WestLB all provide credit support to sponsored SIVs sufficient to repay outstanding ABCP.
- Plans for a "super conduit" (M-LEC) that would have provided funding for certain highly rated SIV assets abandoned.

## Extendible Note Market Hits a Wall

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- Several single seller extendible note conduits extend paper due to lack of market liquidity and specific credit conditions (e.g. American Home Mortgage's Broadhollow conduit).
- Extendible note market virtually disappears for many programs and becomes prohibitively expensive for others.

## Multi-Seller Market Taken Along for the Ride

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- Despite significant structural differences between multi-seller programs vs. SIVs and single seller programs, multi-seller conduits are not immune from market conditions.
- ABCP rates increase substantially beginning in August of 2007, stabilize to close to pre-August levels only after a significant period of turmoil.
- ABCP market temporarily becomes largely an overnight market.
- Investor scrutiny of programs increases. Even small exposures to perceived “problem assets” turn investors away from certain programs.
- Some programs draw on liquidity facilities to pay maturing paper.
- Some programs shed assets perceived as risky by some investors, including ABS, CDOs, mortgaged-backed transactions.

## Multi-Seller Market Taken Along for the Ride (Cont'd)

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- Some sponsors curtail or suspend new transaction activity - analyze long-term effects of 2007 on the business.
- Pricing goes up for existing transactions.
- Some investors exit the market.

# 2008: MORE CHALLENGES

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- August/September/October 2008 - market concerns and state of financial institutions lead to additional illiquidity in ABCP market.
- Money fund investors look to redeem fund investments due to market/financial institution concerns.
- Multi-seller ABCP programs “tiered” by investors - term execution becomes difficult to impossible for some - other sponsors have difficulty placing ABCP altogether.
- Discount rates on ABCP fluctuate wildly as market turmoil continues.
- Difficulty in placing paper and “credit crunch” lead to dramatic slowdown in ABCP transaction activities.
- Increased pricing for existing transactions continues.

# GOVERNMENT AND REGULATORS TAKE ACTIONS TO ADDRESS MARKET CONCERNS

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# After Political Fuss, Congress Passes the Emergency Economic Stabilization Act of 2008 in an Attempt to Restore Confidence in Financial System

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- Troubled Asset Relief Program (TARP) established to purchase financial institution assets in an attempt to restore confidence in financial system and jump start credit markets.
- Treasury treats TARP as granting authority to make equity investments in financial institutions.
- U.S. begins to work with regulators from other G-7 countries to coordinate efforts to address the financial crisis.

# Federal Reserve Takes Significant Actions in an Attempt to Restore Confidence in the Commercial Paper Markets

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## 1. AMLF

- On September 19, 2008, the Federal Reserve Board announced the Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF).
- Under AMLF, U.S. depository institutions, bank holding companies (including broker-dealer affiliates) and U.S branches and agencies of foreign banks can borrow money from the Federal Reserve Bank of Boston to fund purchases of eligible ABCP from funds that qualify as money market mutual funds under Rule 2a-7 under the Investment Company Act of 1940.

## Federal Reserve Takes Significant Actions in an Attempt to Restore Confidence in the Commercial Paper Markets (Cont'd)

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- AMLF is currently in effect through October 30, 2009, subject to extension by the Fed.
- Eligible ABCP must be issued by a U.S. issuer and rated not lower than A1, F1 or P1 by at least two NRSROs.
- Loans made under AMLF bear interest at the Fed's Primary Credit Rate (currently 0.50%).
- Documents required to participate in the AMLF program are posted at [www.frbdiscountwindow.org](http://www.frbdiscountwindow.org).

# Federal Reserve Takes Significant Actions in an Attempt to Restore Confidence in the Commercial Paper Markets (Cont'd)

## 2. CPFF

- On October 7, 2008, the Fed announced the Commercial Paper Funding Facility (CPFF) program.
- CPFF will be established as an SPV that borrows money from the Federal Reserve at the overnight federal funds target rate.
- SPV will purchase directly from eligible issuers 3-month dollar denominated commercial paper at a spread over the 3-month overnight index swap (OIS) rate.
- Spread for ABCP is set at 3.00% per annum.
- Commercial paper (including ABCP) purchased must be rated at least A1/F1/P1 by one NRSRO and, if rated by more than one NRSRO, must be rated at least A1/F1/P1 by at least two NRSROs.

## Federal Reserve Takes Significant Actions in an Attempt to Restore Confidence in the Commercial Paper Markets (Cont'd)

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- Eligible commercial paper must be issued by a U.S. issuer (which may be a subsidiary of a foreign parent).
- Commercial paper that is not ABCP needs to be secured to the satisfaction of the Fed. *This requirement does not apply to ABCP.*
- Issuers must pay a one time fee of 10 bps on highest face amount outstanding CP of issuer during the period from and including January 1, 2008 through and including August 31, 2008.
- Maximum amount of CP purchased for an issuer is the highest face amount of outstanding CP during the period from and including January 1, 2008 through and including August 31, 2008.

## Federal Reserve Takes Significant Actions in an Attempt to Restore Confidence in the Commercial Paper Markets (Cont'd)

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- CP may only be sold to the program through a Federal Reserve Bank of New York primary dealer.
- CPFF program terminates on October 30, 2009 unless extended by the Fed.
- One time registration for the program, eligible issuers must register at least two business days in advance of the first purchase.
- Documents necessary to register for the CPFF can be found at [www.ny.frb.org/CPFF\\_Issuer\\_Registration\\_Process.html](http://www.ny.frb.org/CPFF_Issuer_Registration_Process.html).

# Federal Reserve Takes Significant Actions in an Attempt to Restore Confidence in the Commercial Paper Markets (Cont'd)

## 3. MMIFF

- On October 21, 2008, the Fed announced the Money Market Investor Funding Facility (MMIFF) program.
- Under MMIFF, the Federal Reserve Bank of New York will establish and provide funding to a series of SPVs that will finance the purchase of eligible assets from eligible investors.
- Eligible assets will include U.S. Dollar denominated CDs, bank notes and commercial paper issued by highly rated (A-1/P-1/F1) financial institutions with maturities of at least seven days and no more than 90 days.
- While eligible assets do not include ABCP, additional support provided to money market mutual funds by MMIFF is expected to have a positive effect on the ABCP markets.
- Expires October 30, 2009 unless extended by the Fed.

# Treasury Establishes the Temporary Guarantee Program for Money Market Funds

- Announced by the Treasury September 19, 2008 and opened September 29, 2008.
- The program is currently set to expire on April 30, 2009 and may be extended no later than September 18, 2009.
- Under the program, the Treasury guarantees the share price of eligible participating money market funds regulated under Rule 2a-7 of the Investment Company Act of 1940 (the deadline to apply to the program was October 8, 2008 for funds that sought to maintain a stable NAV of \$1.00 and October 10, 2008 for funds that sought to maintain a stable NAV greater than \$1.00).
- The guarantee is triggered when a MMF breaks the buck and its NAV falls to less than 99.5% of the fund's stable share price (the "Guarantee Event").
- Upon the occurrence of a Guarantee Event for a participating fund, the guarantee will cover the amount of shares an investor owns on that date **up to** the amount of shares the investor owned as of September 19, 2008.

## Market Effects of the Federal Programs

- An article in the *Financial Times* on October 31, 2008 indicated that issuance of commercial paper had risen for the first time in seven weeks. U.S. commercial paper further rose an additional 4.9% for the week ended January 7, 2009.\*
- U.S. commercial paper has since fallen for seven of the eight weeks since January 7 most recently falling 2.9% for the week ended March 4, 2009 to \$1.48 trillion.
- Fed held \$240 billion of U.S. commercial paper as of March 4, 2009, which represented 16% of the total U.S. commercial paper market.
- As of March 5, 2009, interest rates of highly-rated CP notes due in 30 days had decreased 86% to 0.39% since implementation of the CPFF program on October 27, 2008, according to data from Bloomberg.

\*Source: January 7, 2009 Article on [www.bloomberg.com](http://www.bloomberg.com)

# MORE POSSIBLE REGULATORY AND ACCOUNTING CHANGES

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## April 17, 2008 - Basel Committee Announces Steps to “Strengthen the Resilience of the Banking System”

- Reiterates importance of implementing the Basel II framework as better reflecting risks banks face in current market.
- Committee announces it will “strengthen the capital treatment of liquidity facilities extended to support off-balance sheet vehicles such as ABCP conduits.”
- Committee to publish for consultation “global sound practice standards for the management and supervision of liquidity risks.” Weaknesses witnessed in the markets by the Committee included: stress testing practices, contingency funding plans, and management of on- and off-balance sheet activity and contingent commitments.
- On January 16, 2009 the Committee announced its proposed enhancements to Basel II framework including higher risk weights of resecuritisation exposures and a narrowed definition of senior facilities under IRB and enhanced qualitative disclosures relating to ABCP conduits and other securitisation exposures.

# Could Basel II Give Way to Basel III Before Basel II is Completely Implemented?

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- The results of the current market turmoil have lead several commentators to recommend or speculate that risk-based capital requirements for banks need to be revisited yet again as part of a comprehensive regulatory response to current financial market issues.

## Possible Further Accounting Changes from FASB

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- FAS 140 - Revised Exposure Draft issued on September 15, 2008 -
  - Would remove QSPE concept from FAS 140.  
Scope exception for QSPEs would be removed from FIN 46r - SPEs formed in connection with asset sales would be analyzed like other variable interest entities (VIEs).
  - Sales of portions of assets - participating interests must be on *pari passu* basis to be eligible for derecognition under FAS 140.
  - Proposed to be effective for fiscal years beginning after November 15, 2009.  
Former QSPEs would be evaluated for consolidation as of the effective date.

## Possible Further Accounting Changes from FASB (Cont'd)

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- FIN 46r - New Exposure Draft issued on September 15, 2008 -
  - Staff proposes that primary beneficiary of a Variable Interest Entity (VIE) be the party, if any, that has "control" of the VIE.
  - Qualitative analysis required first to determine primary beneficiary. Quantitative analysis performed only if qualitative analysis yields no primary beneficiary.

## Possible Further Accounting Changes from FASB (Cont'd)

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- “Control” would be defined as both:
  1. The power to direct matters that most significantly impact the activities of the VIE, including, but not limited to, activities that impact the entity’s economic performance; *and*
  2. The right to receive benefits from the VIE that could potentially be significant to the VIE or the obligation to absorb losses of the entity that could potentially be significant to the VIE.
- Only if no party has “control” of a VIE would the primary beneficiary be determined using an expected loss analysis.
- Continuous evaluation of identity of VIE’s primary beneficiary would be required.
- Proposed to be effective for fiscal years beginning after November 15, 2009.

# THE FUTURE OF MULTI-SELLER CONDUITS

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## Possible Macro Effects of Market Changes

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- Fewer players and “tiering” of remaining sponsors - market may continue to gravitate toward established sponsors/support providers without real or perceived liquidity issues.
- Conduits more selective in assets financed - “back to basics” approach - percentage of trade receivables, credit cards, auto and equipment receivables transactions in conduits likely to increase.
- Transaction pricing continues to increase due to the shrinking market and greater conduit scrutiny.

# The Convergence of Basel II Capital Rules and Market Forces Could Yield Structural Changes

- For banks adopting the internal ratings based approach to the new Basel II capital rules, the difference between an “eligible liquidity facility” and a credit enhancement (direct credit substitute) for risk-based capital purposes. Capital for banks using this approach for conduit transactions is a function of credit quality, granularity and seniority of an exposure. Money market fund investors may still prefer the separation of bank-sponsored ABCP conduits from their bank sponsors due to concentration concerns.
- Appetite of investors for ABCP funding exotic assets through multi-seller conduits with liquidity facilities that reduce funding for defaulted assets is on the wane—perhaps permanently.
- Securitization still provides a better structure (and probably better capital treatment) than other possible methods (e.g. unsecured loans) available to fund certain bank customers.

## The Convergence of Basel II Capital Rules and Market Forces Could Yield Structural Changes (Cont'd)

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- The convergence of these three factors could yield the following:
  - (1) Conduits that rely on liquidity facilities that are actually or effectively letters of credit: they fund 100% of allocated ABCP regardless of the performance of the asset pool eliminating investor concerns with potential problem assets and probably also the need for program wide credit enhancement. Note that this may create classification issues for money market fund investors.
  - (2) Conduit groups that become “structuring groups” with both ABCP and bank on-balance sheet lending being possible funding options for their securitization structures.

# CHAPMAN AND CUTLER LLP ABCP CONDUIT SECURITIZATION GROUP

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When clients seek help structuring commercial paper conduit programs and asset acquisitions, Chapman and Cutler LLP's ABCP Conduit Securitization Group provides it. We have represented some of the largest bank sponsors of commercial paper conduits in connection with financings of such diverse assets as trade and credit card receivables, auto loans and leases, equipment loans and leases, corporate loans, CDOs, student loans, aircraft secured notes and motion picture rights.

Our attorneys have assisted clients in the formation of securitization conduits issuing commercial paper and extendible notes to finance assets around the world. We have represented one of the largest bank sponsors of ABCP conduits since the formation of their initial conduit and our bank sponsor clients are among the largest and most sophisticated financial institutions in the world.

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We regularly advise industry participants as to the legal and regulatory issues associated with doing business in the ABCP market. Our attorneys are currently spending significant time assisting our clients in assessing the effects of proposed regulatory changes and programs on the ABCP markets.

We also represent sellers and issuers in ABCP conduit transactions and have found that our substantial insights as to how conduits and conduit sponsors approach these transactions is of great assistance to these clients.

## ABCP Conduit Securitization Group Partners

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