

Federal Banking Regulators' Final Regulatory Capital Changes Affecting US Bank ABCP Conduit Sponsors

Key Takeaways

1. Many banks will be required to consolidate ABCP conduits they sponsor for accounting purposes under FAS 167.
2. No capital relief will be given for support facilities provided by sponsor banks to these consolidated conduits.
3. Internal assessment approach will not be available to calculate capital when Basel II rules are applicable to those bank sponsors.
4. Transition rules may be applied by qualifying sponsors that (a) delay implementation of the new capital rules for two quarters and (b) phase in application of the new rules during an additional two quarter period.

On June 12, 2009, FASB finalized changes to the accounting standards affecting special purpose entities through the adoption of FAS 166 and FAS 167, which are generally effective as of January 1, 2010 for US banks. Please [click here](#) for material from a July 22, 2009 presentation by Ernst & Young and Chapman and Cutler LLP regarding FAS 166 and 167. One result of the adoption of these accounting rules could be the consolidation by US banks of asset-backed commercial paper (ABCP) conduits that they sponsor that are currently off-balance sheet (some US banks already consolidate their sponsored ABCP conduits for accounting purposes).

On August 26, 2009 each of the federal banking regulators* issued a notice of proposed changes to capital regulations in light of the FAS 166 and 167 changes. Please [click here](#) for a copy of the notice of proposal. On January 21, 2010 each of the regulators adopted the final rule (the "Final Rule"), which implements such proposed changes to such capital resolutions in light of FAS 166 and 167 changes. Please [click here](#) for a copy of the Final Rule. The Final Rule eliminates the existing provisions in the capital rules that (1) exclude an ABCP conduit's assets from the risk-weighted assets of a sponsor bank that consolidates the conduit for accounting purposes and (2) instead assess risk-based capital requirements for such a sponsor based upon its contractual exposures (liquidity and credit enhancement) to the conduit (the "Exclusion").** The regulators note in the proposal, and in the Final Rule, that the Exclusion was granted in 2004 based upon their perception that banks sponsoring ABCP conduits generally "faced limited risk exposures" confined to their liquidity and credit enhancement facilities and that those exposures were well protected. The regulators indicated in the proposal, and in the Final Rule, that increased incidences of banks

providing non-contractual support to ABCP conduits they sponsor and general credit risk concerns in the current environment led them to determine that the Exclusion is no longer justified. The regulators' analysis of ABCP conduits is on pages 16 and 17 of the proposal and is on pages 16-18 of the Final Rule. The analysis suggests concern not only with the practical operation of liquidity facilities but also with the credit quality of those exposures.

Capital requirements for US banks incorporate both leverage and risk-based measures. The Exclusion only applies to risk-weighted assets and thus to the risk-based measures. Banks currently required to consolidate sponsored ABCP conduits already include the assets of such conduits in their leverage ratio calculation and will continue to do so. To the extent that the changes in the accounting rules result in banks consolidating ABCP conduits that are currently off-balance sheet, the leverage-based capital requirements of such banks will increase. Importantly, the risk-based capital requirements for *all* US banks that consolidate ABCP conduits they sponsor for accounting purposes (both currently and as a result of the recent FASB accounting changes) will also increase.

Since at least a 100% risk weight is already imposed on program-wide credit enhancement exposures to conduits, the Final Rule's changes to the capital rules should not adversely affect the risk-based capital assigned by sponsor banks to these exposures. For liquidity exposures, however, the increase in required risk-based capital would be substantial. For example, unrated undrawn eligible liquidity facilities provided by sponsor banks to ABCP conduits with original maturities of one year or less are currently subject to a 10% credit conversion factor and, therefore, require risk-based capital of 80 basis points of the amount of the exposure. As a result of the Final Rule the portion of such unrated undrawn eligible liquidity facilities that does not overlap the program-wide credit enhancement provided by the sponsor bank would in effect be subject to a 100% credit conversion factor and, therefore, the risk-based capital requirement for the sponsor bank would increase to 8% of the same exposure as a result of the changes set forth in the Final Rule.

The possible competitive effects of the Final Rule's changes could be significant for US banks. Most non-US bank sponsors are already operating under Basel II-based risk-based capital rules, which assign risk-based capital to ABCP conduit contractual exposures based upon the credit quality, granularity and seniority of those exposures and permit a qualifying bank sponsor to assign internal ratings to the exposures based upon the bank's internal assessment of the exposures mapped to rating agency methodologies. While the US regulators have adopted similar rules, they have yet to take effect for US banks and will not be fully effective in 2010. In addition, the Final Rule provides that such internal ratings are "applicable exclusively to a banking organization's exposure to off-balance sheet ABCP programs and not to a program's underlying assets when reported on balance sheet." Therefore, after such similar rules take effect, the required risk-based capital for a US bank would generally continue to be significantly higher than that of its foreign counterpart for many equivalent conduit exposures.

In addition, the Final Rule includes a new reservation of authority for the risk-based capital rules specifying that a banking organization's primary Federal supervisor would have the authority to require the banking organization to treat an off-balance sheet entity as if it were consolidated onto

the banking organization's balance sheet and to hold capital against the entity's expenses for risk-based capital purposes. This reservation of authority must be based on the determination that the banking organization's exposure or other relationship to the entity is not commensurate with the actual risk relationship of the banking organization to the entity.

The Final Rule creates several ambiguities that will need to be resolved, including:

1. How should the portion of undrawn liquidity that is not currently supporting assets of the consolidated ABCP conduit be treated? Does the removal of the Exclusion mean that such "true unused" commitments should be treated like other (non-securitization) loan commitments or in some other manner?
2. Since the assets of a sponsored ABCP conduit that is consolidated for accounting purposes are now effectively treated as assets held by the sponsor bank, does it make any sense to apply the currently applicable internal rating approach to the portion of the exposure allocable to sponsor-provided program-wide credit enhancement, or should the program-wide credit enhancement exposures of such a sponsored conduit now be ignored?
3. What methodologies available under Basel II will sponsors avail themselves of (Ratings-Based Approach v. Supervisory Formula) if the Internal Assessment Approach will not be available under Basel II for consolidated conduits?

The Final Rule contains a transition mechanism (the "Transition Mechanism"), which provides an optional two quarter delay and an additional optional two quarter 50 percent phase in period. A bank sponsor generally would adopt the Transition Mechanism as of the date it implements FAS 166 and 167, which is the starting date of its first annual reporting period beginning after November 15, 2009.

During the optional two quarter delay through the second quarter after the implementation date of FAS 166 and 167 by such bank sponsor, such bank sponsor may (1) exclude from risk-weighted assets those assets held by its ABCP conduit that such bank sponsor consolidated as a result of FAS 167 (and the assets of its ABCP conduit that was previously consolidated but were excluded in reliance on the Exclusion) and (2) may include in its tier 2 capital the full amount of the allowance for loan and leases losses (ALLL) attributable to the assets its excludes pursuant to (1) above.

During the additional optional two quarter phase in period, a bank sponsor that has opted for the two quarter delay may (1) exclude from risk-weighted assets 50 percent of such assets held by its consolidated ABCP conduit and (2) may include in its tier 2 capital 50 percent of the ALLL attributable to such assets. The remaining 50 percent of ALLL attributable to such assets plus the ALLL not attributable to such assets may be included in its tier 2 capital subject to a 1.25 percent limit.

A bank sponsor that chooses to apply the Transition Mechanism must apply it to all of its ABCP conduits.

The Final Rule will take effect 60 days after the date the Final Rule is published in the Federal Register, which is expected shortly. A bank sponsor, however, may comply with the Final Rule, including the Transition Mechanism, as of the date it implements FAS 166 and 167.

We will be monitoring the industry's response to this issue and will keep you apprised of further developments.

* The US regulatory agencies are: Office of the Comptroller of the Currency, Department of the Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Department of the Treasury.

** The Final Rule also eliminates the associated provision in the general risk-based capital rules that excludes from Tier 1 Capital the minority interest in a consolidated ABCP program not included in a bank's risk-weighted assets.

Contact Us

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