

## **INTERAGENCY GUIDANCE ON THE ELIGIBILITY OF ASSET-BACKED COMMERCIAL PAPER LIQUIDITY FACILITIES AND THE RESULTING RISK- BASED CAPITAL TREATMENT**

### **Purpose**

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (the agencies) are issuing this interagency guidance to clarify the requirement for an asset quality test to determine the eligibility or ineligibility of an asset-backed commercial paper (ABCP) liquidity facility and the resulting risk-based capital treatment for banks, bank holding companies, and savings associations (banking organizations).<sup>1</sup> The agencies are providing this clarification to ensure that banking organizations hold regulatory capital for ABCP liquidity facilities commensurate with the credit support that these facilities may provide.

### **Background**

On July 28, 2004, the agencies published a final rule on the consolidation of asset-backed commercial paper programs (ABCP rule) that instituted a new capital charge for ABCP liquidity facilities.<sup>2</sup> ABCP programs typically are supported by liquidity facilities that are commitments to lend to, or purchase assets from, the ABCP programs if funds are needed to repay maturing commercial paper. Usually the need for liquidity results from a timing mismatch between cash collections on the underlying assets in the program and the scheduled repayments of the commercial paper issued by the program. Some liquidity facility agreements for ABCP programs also require a banking organization to provide funding for the underlying assets of the program as a result of deterioration in the credit quality of the asset pool. For these liquidity facilities, a draw on the facility exposes the banking organization to credit risk, and, accordingly, the agencies determined that a capital charge should be imposed. The new risk-based capital treatment for liquidity facilities set forth in the ABCP rule becomes fully effective September 30, 2005.

The ABCP rule bases the risk-based capital treatment of an ABCP liquidity facility, in part, on whether the facility is “eligible” or “ineligible.” Eligibility is determined based on whether a liquidity facility contains contractual provisions that preclude the purchase of certain low credit quality assets. Prior to September 30, 2005, the ABCP rule prescribes the same two-step capital calculation for eligible and ineligible liquidity facilities, i.e., the amount of the unused portion of

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<sup>1</sup> See 12 C.F.R. part 3, appendix A, § 3(a)(6)(ii)(A) (OCC); 12 C.F.R. parts 208 and 205, appendix A, § III.B.3.a.iv. (FRB); 12 C.F.R. part 325, appendix A, § II.B.5(a)(5) (FDIC); 12 C.F.R. 567.1 (OTS).

<sup>2</sup> 69 FR 44908 (July 28, 2004).

the facility is multiplied by a credit conversion factor (CCF) that depends on the facility's maturity, which is then multiplied by the risk weight of the obligor, taking into account the underlying assets and any external ratings. For maturities of one year or less, the CCF is 10 percent; for maturities greater than one year, the CCF is 50 percent.

As of September 30, 2005, the ABCP rule requires that eligible and ineligible facilities be treated differently. To be an eligible liquidity facility and qualify for the 10 or 50 percent CCF, the liquidity provider may not fund against assets that are 90 days or more past due<sup>3</sup>, in default, or below investment grade. If a liquidity facility is ineligible, it is treated as a recourse exposure or direct credit substitute for risk-based capital purposes.<sup>4</sup>

### **Risk-Based Capital Treatment**

In anticipation of the full implementation of the ABCP rule, the industry has requested clarification of the requirement for an asset quality test to determine the eligibility of an ABCP liquidity facility. The agencies reiterate their position that the primary function of an eligible ABCP liquidity facility is to provide liquidity—not credit enhancement. Further, the agencies emphasize their view, as stated in the ABCP rule, that an eligible liquidity facility should not be used to purchase or otherwise fund assets with the high degree of credit risk typically associated with seriously delinquent and defaulted assets and assets that are below investment grade.

Accordingly, the agencies will deem an ABCP liquidity facility to be in compliance with the requirement for an asset quality test if (i) the liquidity provider has access to certain types of acceptable credit enhancements and (ii) the notional amount of such credit enhancements available to the liquidity facility provider exceeds the amount of underlying assets that are 90 days or more past due, defaulted, or below investment grade that the liquidity provider may be obligated to fund under the facility. In this circumstance, the liquidity facility may be considered “eligible” for purposes of the agencies’ risk-based capital standards because the provider of the credit enhancement generally bears the credit risk of the assets that are 90 days or more past due, in default, or below investment grade rather than the banking organization providing liquidity.

The agencies have determined that the following forms of credit enhancements are generally acceptable for purposes of satisfying the asset quality test:

- “Funded” credit enhancements that the banking organization may access to cover delinquent, defaulted, or below investment grade assets, such as overcollateralization, cash reserves, subordinated securities, and funded spread accounts;
- Surety bonds and letters of credit issued by a third party with a nationally recognized statistical rating organization rating of single A or higher that the banking organization

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<sup>3</sup> In the preamble to the ABCP rule, the agencies determined that the past due limitation is not a relevant asset quality test in the case of certain credit enhancements, such as a guarantee issued by the United States government, its agencies, or an OECD country. The preamble did not specifically address other types of credit enhancements discussed in this guidance. 69 FR 44908, 44912 (July 28, 2004).

<sup>4</sup> For the capital treatment for recourse exposures and direct credit substitutes, *see*, 12 C.F.R. part 3, appendix A § 4 (OCC); 12 C.F.R. parts 208 and 225, appendix A, § III.B.3.b (FRB); 12 C.F.R. part 325, appendix A, § II.B.5 (FDIC); and 12 C.F.R. 567.6 (b) (OTS).

may access to cover delinquent, defaulted, or below investment grade assets, provided that the surety bond or letter of credit is irrevocable and legally enforceable; and

- One month's worth of excess spread that the banking organization may access to cover delinquent, defaulted, or below investment grade assets if the following two conditions are met: excess spread is contractually required to be trapped when it falls below 4.5 percent (measured on an annualized basis), and there is no material adverse change in the banking organization's ABCP underwriting standards. The amount of available excess spread may be calculated as the average of the current month's and the two previous months' excess spread.

Recourse directly to the seller, other than the funded credit enhancements enumerated above, regardless of the seller's external credit rating, is not an acceptable form of credit enhancement for purposes of satisfying the asset quality test. Seller recourse—for example, a seller's agreement to buy back nonperforming or defaulted loans or downgraded securities—may expose the liquidity provider to an increased level of credit risk. A decline in the performance of assets sold to an ABCP conduit may signal impending difficulties at the seller itself.

If the amount of acceptable credit enhancement associated with the pool of assets is less than the current amount of assets that are 90 days or more past due, in default, or below investment grade that the liquidity facility provider may be obligated to fund against, the liquidity facility should be treated as recourse or a direct credit substitute. The full amount of assets supported by the liquidity facility would be subject to a 100 percent CCF.<sup>5</sup> The agencies reserve the right to deem an otherwise eligible liquidity facility to be, in substance, a direct credit substitute if a banking organization uses the liquidity facility to provide credit support.

A banking organization will be responsible for demonstrating to the relevant agency whether acceptable credit enhancements cover the 90 days or more past due, defaulted, or below investment grade assets that the organization may be obligated to fund against in each seller's asset pool. If a banking organization cannot adequately demonstrate satisfaction of the conditions in this interagency guidance, the agencies further reserve the right to determine that a credit enhancement is unacceptable for purposes of the requirement for an asset quality test and, therefore, deem the liquidity facility ineligible.

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<sup>5</sup> See 12 C.F.R. part 3, appendix A, section 4(b) (OCC); 12 C.F.R. parts 208 and 225, appendix A, III.B.3.b.i. (FRB); 12 C.F.R. part 325, appendix A, II.B.5(b) (FDIC); 12 C.F.R. 567.6(b) (OTS).