



**Federal Deposit Insurance Corporation**

550 17th Street NW, Washington, D.C. 20429-9990

Division of Risk Management Supervision

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January 2, 2014

**TO:** Executive Secretary

**FROM:** Phillip E. Sloan  
Counsel, Legal Division

**SUBJECT:** Meeting with Structured Finance Industry Group (“SFIG”) and Certain Companies relating to Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Proposed Option for ABCP

Please include this memorandum in the public file on the Notice of Proposed Rulemaking relating to Credit Risk Retention (RIN 3064-AD74), 78 Fed. Reg. 57927.

On December 16, 2013, FDIC staff (Suzanne Clair, Rohit Dhruv, Tom Lyons, Rae-Ann Miller and Phil Sloan), SEC staff (Katherine Hsu, Arthur Sandel, David Beaning, Lulu Cheng, Sean Wilkoff and Igor Kozhanov), OCC staff (Jamey Basham, Joe Smith, Kevin Korzeniewski and Carter Evans) and staff of the Board of Governors of the Federal Reserve System (David Alexander and Sean Healey) participated in a meeting with representatives of SFIG (Sairah Burki), Mayer Brown (Carol Hitselberger), Citigroup (Bryan Detric and Jane Chwe), J.P. Morgan Securities (John Kuhns), Societe Generale (Jim Ahern and Helen Jones), RBC Capital Markets (Eric Wise and Roger Pellegrini), Falcon Capital Advisors (Armando Falcon), BlackRock (Mark Schnell) and Fidelity Investments (Matt Healy and Hannah Sullivan).

The discussion focused on matters relating to asset-backed commercial paper conduits.

The attached document was distributed in connection with the meeting.

# Risk Retention Re-Proposal: Application to ABCP Conduits

December 16, 2013



# Overview

- ABCP Conduit overview
- Application of Re-Proposal to ABCP arrangers
- Re-Proposal challenges
  - Liquidity support requirements
  - Asset restrictions
  - Disclosure
  - ABCP tenor
  - Compliance outside safe harbor
  - Grandfathering
- Appendix
  - Representative example of funding support
  - Application of our proposed revisions
  - Proposed text

# What do we mean by an ABCP Conduit?

- In a nutshell, it is a “conduit” between the short-term debt capital markets and Bank clients
  - ABCP Conduits finance Bank clients’ financial assets using securitization technology
    - Securitization technology turns an ordinary secured loan into a safer more bankruptcy-remote investment for the Bank or the ABCP conduit, as applicable
  - Banks also finance clients’ financial assets using securitization technology directly
    - Whether ABCP Conduits or Bank financings, the Bank clients are predominantly clients that are critical to the real economy (such as manufacturers, auto companies, and other industrials)
  - ABCP Conduit transactions are underwritten by Banks and indistinguishable in form and credit from similar transactions funded directly by Banks
- All Bank sponsored conduits provide coverage for ALL outstanding ABCP (whether in the form of a fully supported liquidity facility or a partially supported liquidity facility, together with program-wide credit enhancement equal to at least 5% of the ABCP Conduit’s assets)
- ABCP Conduits typically have simple capital structures, specifically, nominal equity and pari passu ABCP

# Illustrative Multi-Seller ABCP Conduit Overview

**Step 1:** XYZ Company (“XYZ”) originates \$100million of trade receivables in the ordinary course of its business

**Step 2:** XYZ transfers \$100MM receivables to a bankruptcy-remote special purpose vehicle (“XYZ SPV”)

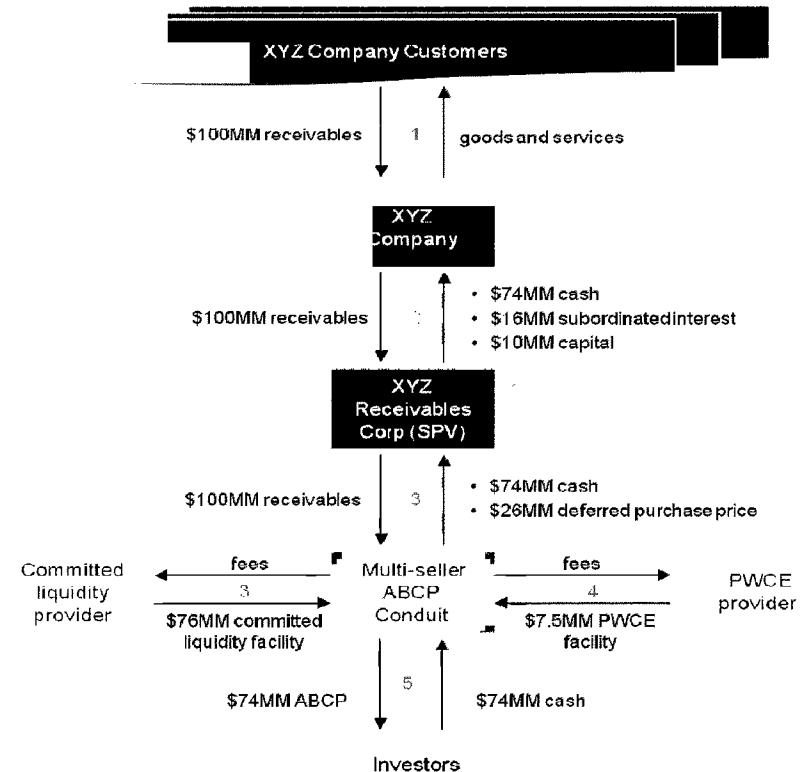
- The receivables transfers are typically arranged as ‘true sales’ at law
- XYZ receives
  - \$74MM of cash (financing from the ABCP conduit)
  - \$10MM capital investment in wholly owned subsidiary
  - \$16MM subordinated interest

**Step 3:** XYZ SPV transfers \$100MM of receivables to a Multi-seller ABCP Conduit (“ABCP Conduit”) administered by a Bank administrator in exchange for \$74MM cash and \$26MM deferred purchase price (which is non-recourse to ABCP Conduit and provides credit enhancement to ABCP Conduit’s cash investment)

- Each transaction funded by the ABCP Conduit is generally supported by a committed transaction-specific liquidity facility (‘CTLF’) provided by a regulated liquidity provider
  - The CTLF provides contingent funding in the event that the ABCP Conduit is:
    - Unable to roll-over maturing ABCP
    - An event occurs (a liquidity event) that obligates the ABCP Conduit to make a draw on the CTLF

**Step 4:** the Bank sponsor provides a program-wide credit enhancement facility in an amount at least equal to 5% of the ABCP Conduit’s assets

**Step 5:** ABCP Conduit issues ABCP in its own name to finance the purchase of the senior transaction interest and continually rolls commercial paper throughout the life of the securitization transactions that are being funded



## Observations:

1. The securitization transaction in steps 2 and 3 would not meet the requirements for the types of assets that an eligible ABCP conduit could purchase
2. There is liquidity support  $\geq 100\%$  of outstanding ABCP and unconditional credit support  $\geq 5\%$  of the ABCP Conduit’s assets that oftentimes represents a multiple of any single transaction funded by the ABCP Conduit
3. All committed facilities (CTLF and PWCE) must have maturity dates that occur after the longest dated ABCP

# What we do NOT mean by an ABCP Conduit

- An SIV (Structured Investment Vehicle) is not an ABCP Conduit
  - SIVs no longer fund in the ABCP market
  - SIVs were aggregators of securities (typically CDOs, corporate bonds, RMBS and ABS) in secondary market
  - SIVs invested at the discretion of an investment manager
  - The investment manager and equity investors in a SIV intended to make money through market value gains in the SIV's portfolio
  - The capital structure of SIVs was complicated and multilayered with ABCP comprising only a portion of the senior most capital layer
  - Bank provided liquidity support for a SIV covered only a fraction (typically 10-20%) of the outstanding ABCP
  - No Bank provided credit support was in place to support SIV ABCP

# Application of Re-Proposal to ABCP Arrangers

- The risk retention requirement applies to the “**sponsor**” of a securitization. This term is defined to include any person who “organizes and initiates a securitization transaction by **selling or transferring assets...** to the issuing entity”
- Banks or non-bank arrangers (“**arrangers**”) who organize and administer ABCP conduits, but who don’t themselves transfer any assets to the ABCP conduits, do not fall within the definition of “sponsor”\*
- However, the Agencies appear to intend to impose the Re-Proposal’s risk retention requirements on arrangers of ABCP conduits
- Assuming that ABCP arrangers are subject to the risk retention requirement, they have 2 options for compliance:
  - 1) Retain credit risk in the form of a **Standard Risk Retention**; or
  - 2) Invoke **Safe Harbor** for Eligible ABCP conduits (which eliminates need for arranger to retain risk)

*\* If a non-bank arranger organizes an ABCP conduit, Banks still refer their own Bank-underwritten client transactions to be funded by the conduit and provide 100% liquidity support for the ABCP that funds its client transactions. Throughout these slides, we include as Bank “sponsors” any Bank that accesses such an ABCP Conduit arranged by a non-bank.*

# What are the challenges presented by the Re-Proposal?

## The Safe Harbor:

- 100% fully supported, unconditional liquidity coverage is not market standard and unnecessarily penalizes Bank sponsors relative to other risk retainers
- There should be no limit on the number of liquidity providers for a safe harbored ABCP Conduit, so long as the Bank “sponsor” maintains unconditional credit support\* equal to at least 5% of such ABCP Conduit’s assets
- The tenor limit for ABCP is too short
- ABCP Conduits engage in more business than narrowly investing in asset-backed securities (*e.g.*, loans)
- Given 100% Bank liquidity coverage and unconditional Bank credit support equal to at least 5% of the ABCP Conduit’s assets, the focus should be on the Bank’s (rather than the originator-sellers’) compliance with the risk retention requirements

*\* Throughout these slides, references to unconditional support mean that there are no conditions to the Bank funding other than delivery of a funding request and that the issuer is not party to an actual bankruptcy proceeding.*



# What are the challenges presented by the Re-Proposal? (cont.)

## **Compliance outside the Safe Harbor:**

- Although Banks can acquire 5% of the ABCP Conduit's assets (vertical retention), why force Banks to do so when they already have coverage for all outstanding ABCP and unconditional credit support equal to at least 5% of such ABCP Conduit's assets?
- Banks should be able to satisfy risk retention for an ABCP Conduit on an unfunded basis

## **Grandfathering Mechanics are inadequate to deal with ABCP Conduit logistics**

# The ABCP Safe Harbor

**ABCP Conduits provide coverage for all outstanding ABCP through various types of support, but a significant portion of ABCP Conduits would not meet the 100% fully supported liquidity coverage requirement.**

## Types of ABCP Conduit Support

### 1. Backstop liquidity

- Banks provide this in a contractual amount at least equal to the face amount of all ABCP outstanding
- It covers timely payment of ABCP principal and discount when due if funds are not available at ABCP maturity (which is fundamentally different from a monoline bond insurance policy)

### 2. Partially supported liquidity

- A subset of backstop liquidity that includes a funding formula that can be reduced by the amount of non-performing assets that exceed client-provided first loss protection
- Client deals are Bank underwritten to at least investment grade so likelihood of any actual funding formula reduction is extremely remote

# The ABCP Safe Harbor (cont.)

## 3. Fully supported liquidity

- A subset of backstop liquidity that does not include a funding formula
- The full amount of the facility is always (i) available in the amount of outstanding ABCP Conduit investments (which amount equals all ABCP) and (ii) unconditional

## 4. Program Wide Credit Enhancement (PWCE)

- Bank provides credit support that is unconditional in an amount at least equal to 5% of the ABCP Conduit's assets (which may be included in liquidity if such liquidity is fully supported liquidity)
- Unlike surety bonds that pay only after evidence of an actual loss, PWCE is available on a same day basis when needed to pay ABCP
- Can be in the form of fully supported liquidity

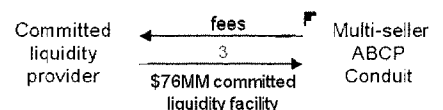
# Illustrative multi-seller ABCP Conduit overview: the role and obligations of the liquidity providers providing partial support

**Funding obligations:** Regulated liquidity providers that provide committed liquidity support (with respect to partially supported liquidity facilities) are typically obligated to provide funding in two general categories of scenarios:

- **ABCP funding disruption event:** in the event that the ABCP Conduit is unable to roll-over commercial paper, the regulated liquidity provider is obligated to provide alternative financing, subject to the ABCP Conduit not being in bankruptcy (note: such entity is structured as bankruptcy remote);
- **Predetermined funding event:** Oftentimes, there are established events that obligate the ABCP Conduit to fund with Bank liquidity versus ABCP. These events are sometimes defined by the performance of the underlying collateral pool (e.g. 25% of the original transaction credit enhancement level is consumed)

**Risk obligations:** When an ABCP funding disruption event or predetermined funding event occurs, regulated liquidity providers are generally required to fund against performing receivables (e.g. non-defaulted receivables). Regulated liquidity providers sometimes build in an additional collateral cushion at the time of funding (in these scenarios, the collateral cushions may reduce the amount of required Bank funding)

- At the time of a funding event, the amount of funding required by the regulated liquidity provider is calculated based on the underlying collateral (the trade receivable portfolio in this example) and is often times referred to as the 'funding formula'
- Each CTLF will typically employ a 'funding formula' tailored to the specific transaction, but the general framework for 'funding formulas' is as follows:
  - Regulated liquidity providers are obligated to provide the lesser of (A) and (B), where
    - (A) = the ABCP Conduit's investment (which equals the face amount of related commercial paper)
    - (B) = eligible receivables balance\*\*



**\*\* Interaction between CTLF and program-wide credit enhancement:**

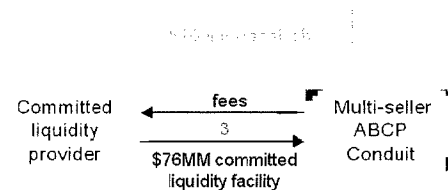
In the event that provision (B) results in a funding shortfall where the amounts received from the regulated liquidity provider are less than the face amount of maturing ABCP, the CTLF still funds the maximum amount permitted minus the funding formula shortfall, and the program wide credit enhancement makes up the shortfall (see the following pages for greater detail on the interaction of program wide credit enhancement and committed liquidity)

# Illustrative multi-seller ABCP Conduit overview: the role and obligations of the liquidity providers providing full support

**Funding obligations:** Regulated liquidity providers that provide committed liquidity support are typically obligated to provide funding in two general categories of scenarios:

- *ABCP funding disruption event:* in the event that the ABCP Conduit is unable to roll-over commercial paper, the regulated liquidity provider is obligated to provide alternative financing
- *Predetermined funding event:* Oftentimes, there are established events that obligate the ABCP Conduit to fund with Bank liquidity versus ABCP
- These events are sometimes defined by the performance of the underlying collateral pool (e.g. 25% of the original credit enhancement level is consumed)

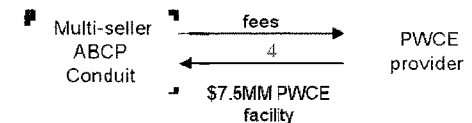
**Risk obligations:** When an ABCP funding disruption event or predetermined funding event occurs, regulated liquidity providers are required to fund an amount equal to the ABCP Conduit's investment (which equals the face amount of related commercial paper)



**Observation:**  
The funding and risk obligations of the liquidity provider and program wide credit enhancement provider are the same

# The PWCE facility obligates its provider to assume an even greater amount of tail risk than would be required in the base risk retention framework

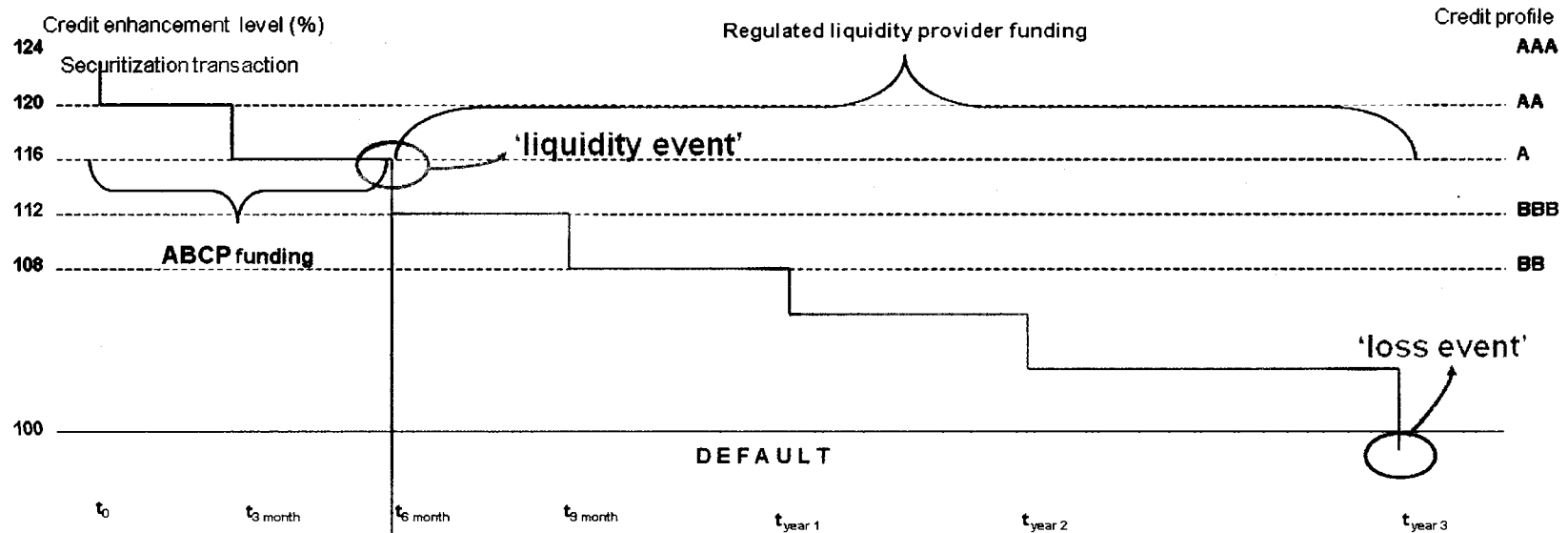
- ABCP Conduits generally secure a program-wide credit enhancement (“PWCE”) facility in an amount at least equal to 5% of the ABCP Conduit’s assets
  - the PWCE facility is almost always provided by the same Bank that provides all or virtually all of the CTLF
  - The PWCE facility is unconditional and has no funding formula
  - The PWCE facility is generally classified as a direct credit substitute for regulatory capital purposes
- The PWCE facility is generally maintained at a level that is equal to the greater of (C) and (D), where:
  - (C) = [5] % of the ABCP Conduit’s assets; and
  - (D) = a floor amount generally equal to at least \$100MM
- By design, the PWCE is in place to cover any funding shortfall that may arise due to the operation of the funding formulas found in the CTLFs
  - More specifically, the PWCE would fund against defaulted receivables to the extent necessary
- The PWCE is fungible across all securitization transactions financed by the ABCP Conduit
  - As a result, the provider of this facility is in a subordinated position relative to the ABCP investors and the CTLF providers



## Observation:

Because of the operation of provisions (C) and (D), the PWCE facility is often times large enough to cover  $\geq 100\%$  of the risk associated with multiple transactions funded by the ABCP Conduit

The CTLF and PWCE facility mechanics convey substantial risk exposure to the regulated liquidity providers through the entire life of the securitization transaction



- Upon the occurrence of an event requiring a draw on liquidity, the regulated liquidity provider advances funds to the ABCP Conduit
- Funds received from the regulated liquidity provider are used to pay related ABCP
- The applicable transaction now secures the regulated liquidity provider's advance and no longer secures outstanding ABCP
  - The ABCP holders have no exposure to loss associated with the liquidity funded transaction from this point forward
- The regulated liquidity provider's exposure to future losses continues until transaction maturity

# Our Proposal

- One or more regulated liquidity providers must provide some form of backstop liquidity covering 100% of the face amount of all ABCP and
- The Bank sponsor must provide PWCE (unconditional credit support, which may include fully supported liquidity) at least equal to 5% of the ABCP Conduit's assets



# Arguments in Support of Our Proposal

- Many ABCP Conduits utilize partially supported liquidity but always have PWCE equal to at least 5% of the ABCP Conduit's assets
- Section 941 of Dodd-Frank does not preclude unfunded but committed risk retention
- Bank regulators view unfunded commitments as the equivalent of funded exposure for regulatory capital purposes
- Liquidity coverage ratio requirements impose unencumbered cash collateral requirements for a large portion of unfunded liquidity commitments, whether partially supported or fully supported
- Throughout the credit crisis no Bank ever failed to fund under a liquidity facility when required
- Forcing Banks to provide 100% liquidity in the form of credit enhancement converts their 5% retention requirement to 100%
- No reason to limit backstop liquidity provider to be the Bank sponsor so long as Bank sponsor provides unconditional credit support equal to at least 5% of the ABCP Conduit's assets
- SEC proposed changes to 2a-7 diversification requirements would treat ABCP sponsors as guarantors

## ABCP Conduits engage in a broad array of financings involving assets other than ABS

- As a mere “conduit” for short term capital markets access for its real economy clients, an ABCP Conduit can include all varieties of secured and other asset-backed client financings
- Some may not be ABS or even securitizations
- Some may be acquired by other ABCP Conduits or Banks as part of an ordinary syndication
- Some may not include intermediate SPVs and, if they do, the intermediate SPV could be an “orphan”
- However, in all cases, the ABCP’s Conduit’s business mirrors that of its Bank sponsor using the same underwriting and credit approval procedures, and the liquidity providers’ funding and risk obligations do not change

# Our Proposal

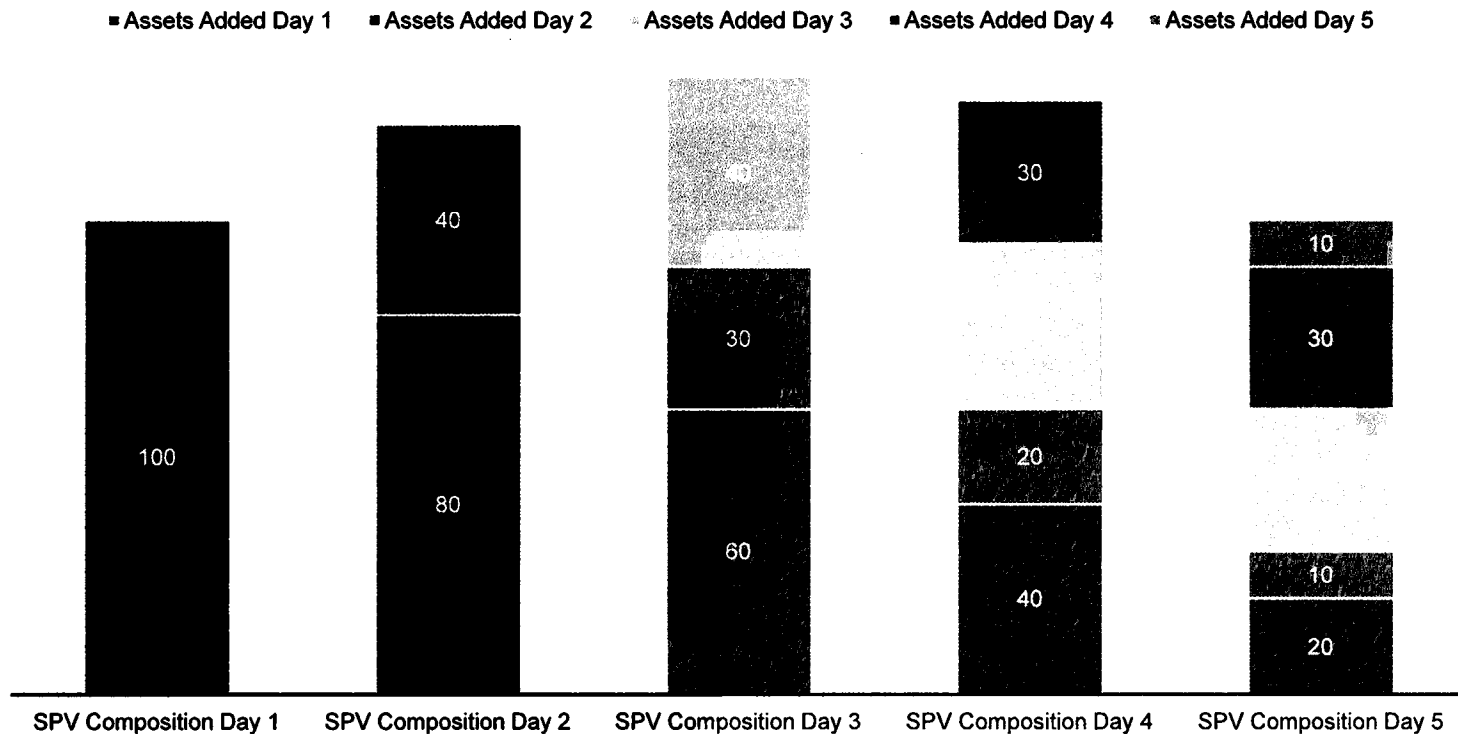
- If an ABCP Conduit benefits from coverage for all outstanding ABCP via Bank-provided liquidity support and Bank-provided PWCE equal to at least 5% of such ABCP Conduit's assets (unconditional credit support, which may be fully supported liquidity), the ABCP Conduit's assets should not be restricted (except with respect to aggregators of secondary market positions)
- At the very least, they should be permitted to be at least as broad as the Bank's own secured and asset-backed financing activities for its clients

## Some of the disclosure requirements are burdensome and provide no investor benefit

- Bank sponsors already provide investors with names of liquidity and PWCE providers, number of liquidity draws, types of financial assets and customers financed
- Disclosure of originator-seller compliance or non-compliance with Re-Proposal is unnecessary
  - The focus of the ABCP safe harbor is on Bank's retention vis-à-vis ABCP investors
  - Each originator-seller has an independent obligation to comply with its own risk retention requirements, if applicable, irrespective of the ABCP safe harbor
- Bank sponsors do not provide fair value calculations and cannot do so given dynamic nature of an ABCP Conduit's assets and liabilities

# Challenges to calculating fair value for revolving transactions

## Example of asset turnover in a trade receivables



In revolving deals fair value is challenging to calculate. For example in a trade receivables transaction, account receivables are collected every day, extinguishing those assets, and created every day, as sales occur and the newly created account receivables are sold into the SPV. The day after a fair value determination is made, it is not longer strictly accurate.

# Our Proposal

- Bank Sponsors will provide ABCP investors with periodic reporting that includes the information set forth on the next page
- If Bank sponsor's ability to rely on ABCP safe harbor hinges on customer compliance, Bank needs a reasonable time to facilitate cure with client or to remove the transaction from the ABCP Conduit

**ABCP Risk Retention Option Disclosure Proposal**

Section and Description of Proposed Disclosure	Currently Report	Could Report if Required	Issues with Reporting	Comments
<b>§_6(d) Periodic Disclosures to Investors</b>				
<b>(1) Liquidity</b>				
-Name of regulated liquidity provider	X			
-Form of organization of regulated liquidity provider		X		
-Description of form of liquidity coverage		X		
-Amount of liquidity coverage	X			
-Nature of liquidity coverage	X			
-Notice of failure to fund	X			
<b>(2) Deal Specific</b>				
(A) Asset Class	X			
(B) SIC Code		X		
(C) Description of the form of risk retention		X		
(C) Fair value			X	Reporting of fair values of underlying ABS would be extremely difficult if not impossible
(C) Nature of interest		X		
<b>§_6(e) Additional Disclosures to Regulators</b>				
-Name of organization of each originator/seller or majority owned OS affiliate that will retain		X		
-Form of organization of each originator/seller or majority owned OS affiliate that will retain		X		
<b>§_6(f)(2)(ii)(A) Notification of holders of ABCP in Case of Non-Compliance</b>				<b>§_6(f)(2)(ii)(A) notification obligations must be subject to a sponsor's actual knowledge standard</b>
<b>(1) If originator-seller fails to retain risk</b>				
- Name of each originator/seller that fails to retain risk			X	Identification of originators/sellers that breach risk retention would pose confidentiality/privacy issues
- Form of organization of each originator/seller		X		
- Amount of related asset backed securities held by conduit		X		
<b>(2) If originator-seller or majority-owned OS affiliate hedges risk retention (violation)</b>				
- Name of each originator/seller or majority owned OS affiliate that hedged its risk retention			X	Identification of originators/sellers that breach risk retention would pose confidentiality/privacy issues
- Form of organization of each originator/seller or majority owned OS affiliate that hedged its risk retention		X		
- Amount of related asset backed securities held by conduit		X		
<b>(3) Any remedial actions taken by the ABCP Conduit sponsor or other party</b>		X		

## There should be no limit on ABCP tenor

- Historical study of ABCP tenor predates impact of liquidity coverage ratio and net stable funding ratio
- Sponsors need flexibility in the face of these new regulations and others that may follow close behind
- So long as Banks provide liquidity coverage for 100% of outstanding ABCP, and the Bank sponsor provides at least credit support equal to at least 5% of the ABCP Conduit's assets (which may be included in liquidity if such liquidity is fully supported liquidity), why is tenor of ABCP relevant to risk retained by Bank sponsor?



# Compliance Outside the Safe Harbor

## Our Proposal:

Banks should be able to satisfy risk retention for an ABCP Conduit “sponsored” by it on an unfunded basis

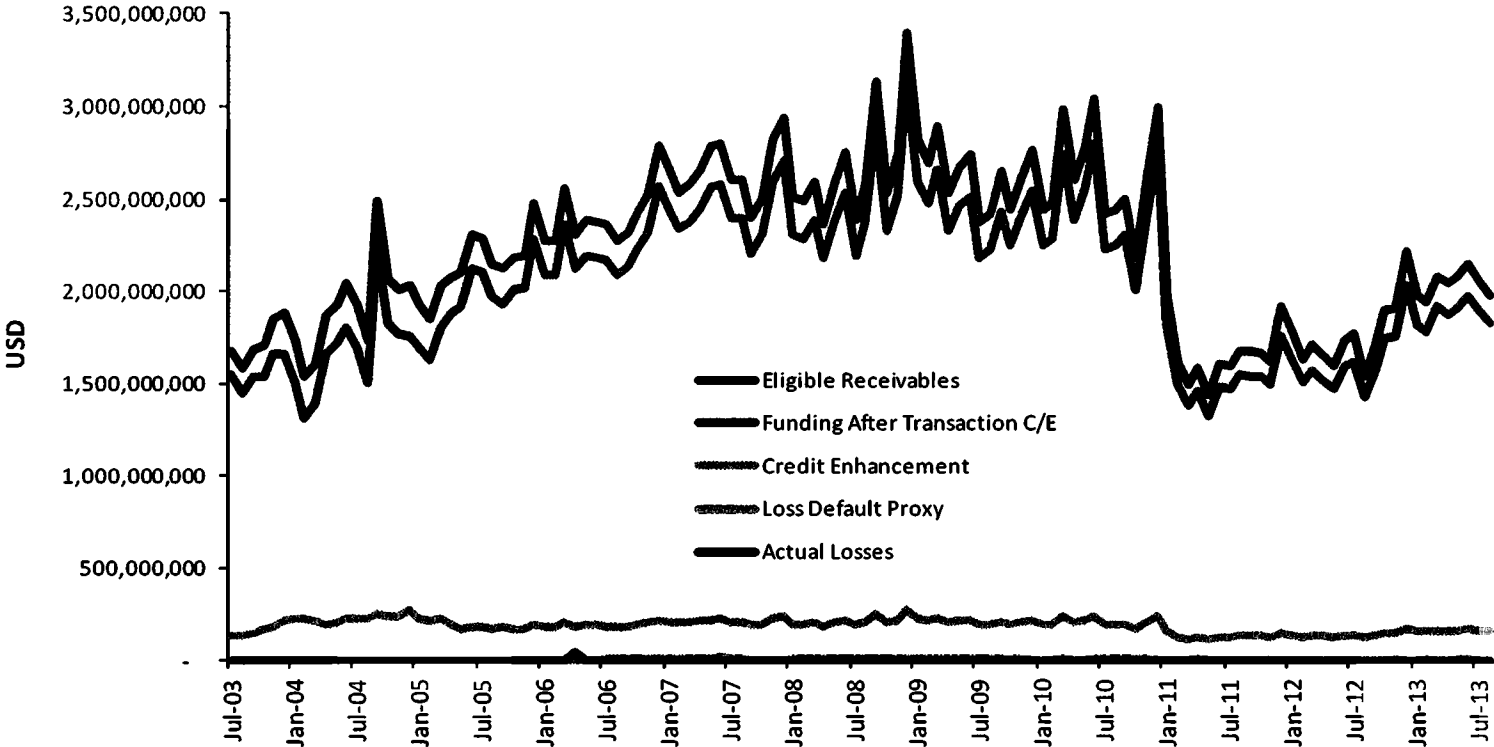
- Bank regulators require Banks to hold capital against these unfunded commitments in the same amount as funded exposures
- Bank commitments to ABCP Conduits are required to be irrevocable, unconditional and available on a same day basis to fund ABCP when due
  - This is dramatically different from surety bonds
  - Surety bonds did not fund until all financial assets had liquidated and the amount of losses had crystallized
  - When surety bonds had been used to provide credit support for any ABCP program, a separate Bank liquidity facility was required to front for such bond as a result of the funding delay

# Grandfathering Mechanics

- ABCP Conduits have commitments and provide customer financing for years at a time
- They have no contractual right to alter the terms of the deal during the life of the commitment
- Main street customers turn to ABCP Conduits for such committed funding that is not available in the term markets
- **Our Proposal:** ABCP Conduit can still meet safe harbor if Bank client transactions are not in compliance with Re-Proposal until renewal or extension of such transaction

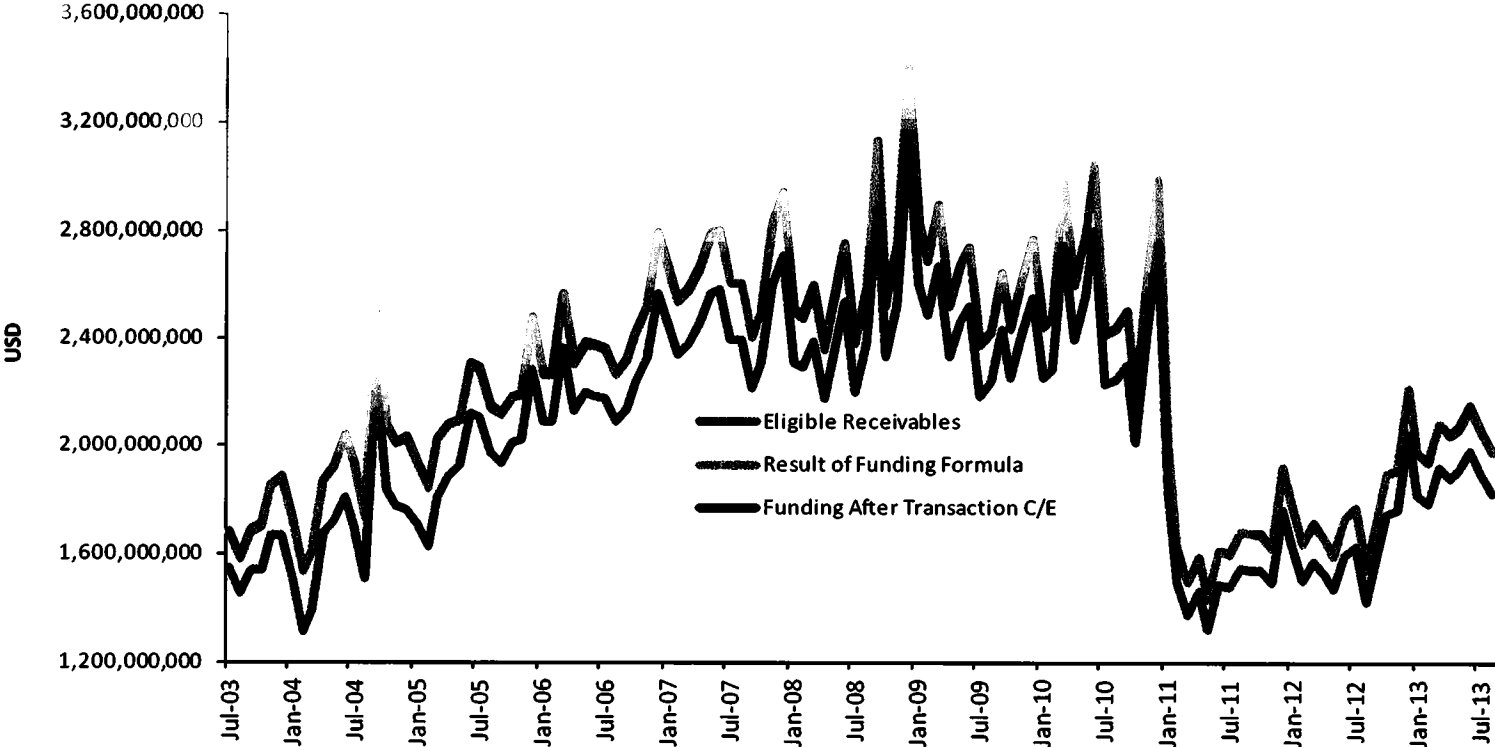
# Multi-seller ABCP Conduit – representative trade receivable securitization

Sample Trade Receivables Securitization



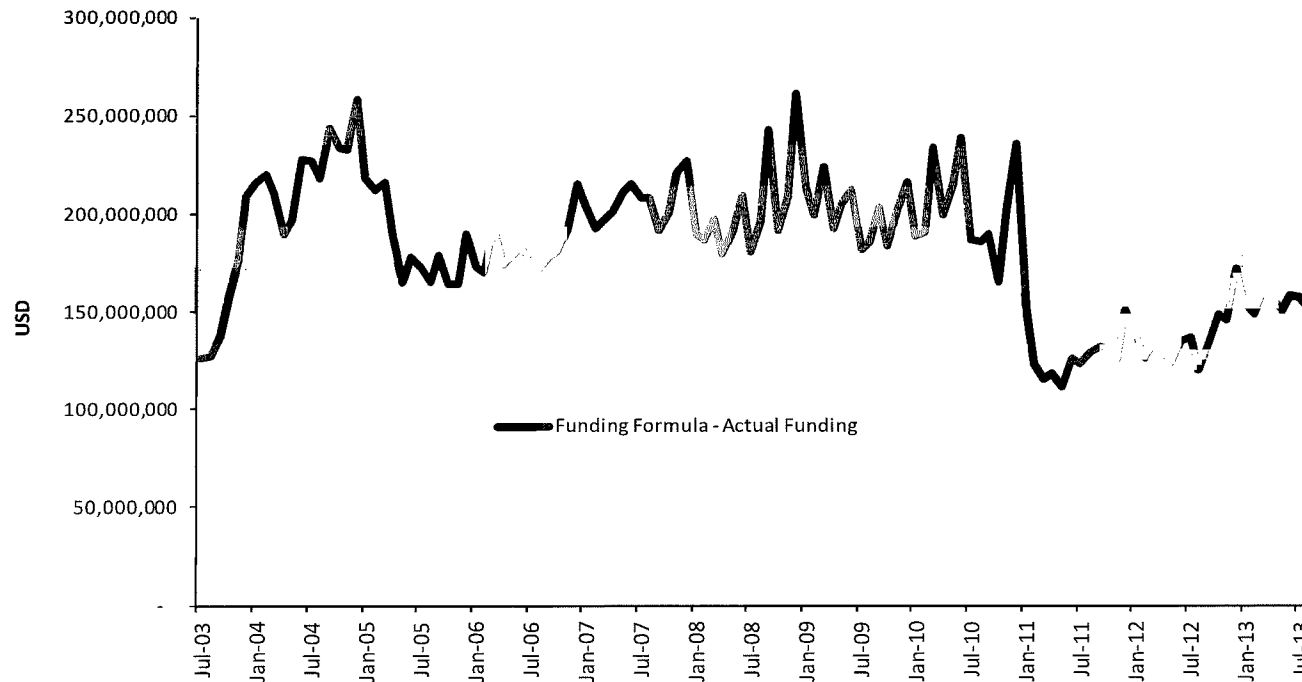
# Multi-seller ABCP Conduit – ‘funding formula’ application

Sample Trade Receivables Securitization



# Multi-seller ABCP Conduit – excess funding protection

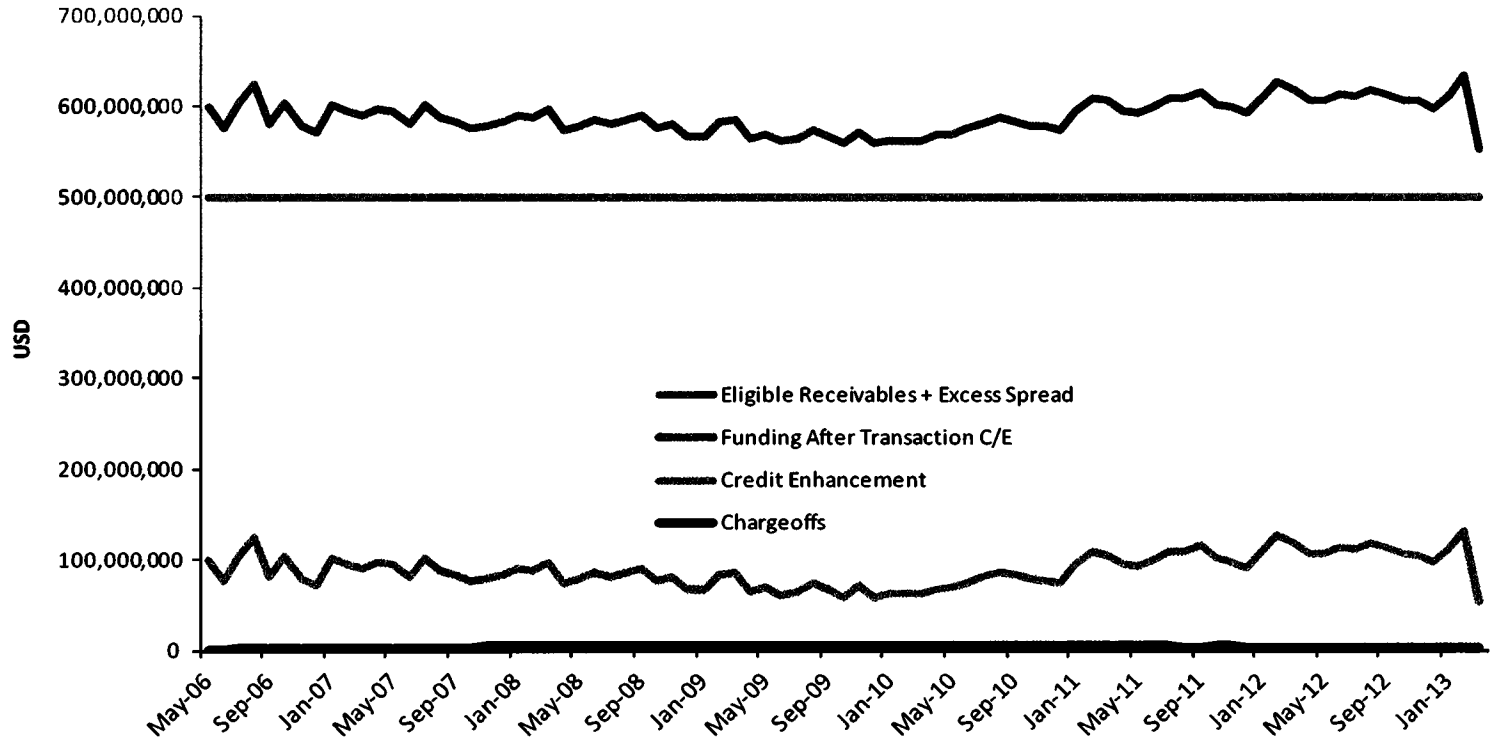
Liquidity Funding Obligation is the Lesser of Funding Formula and Actual Funding



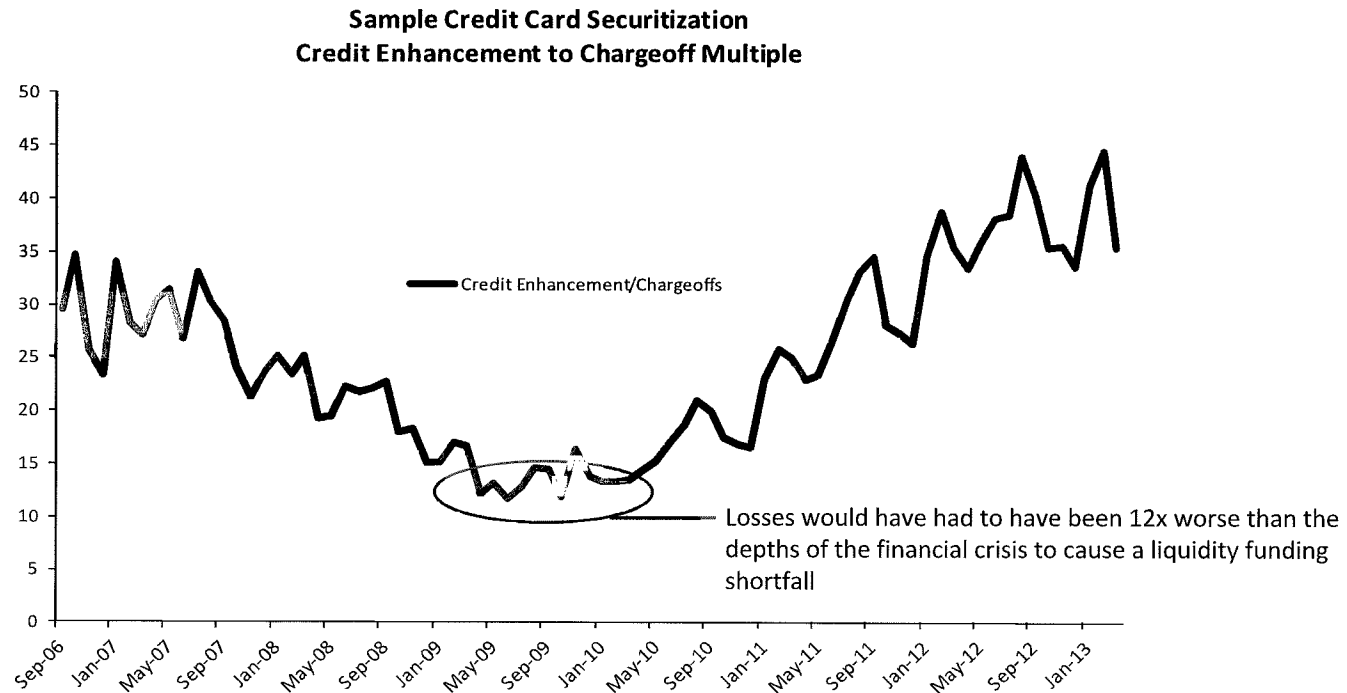
- Losses would have had to have been 12x worse than the depths of the financial crisis to cause a liquidity funding shortfall
- There would still have been the full 5% program-wide credit enhancement to absorb losses before the CP holders would have suffered any shortfall at all

# Multi-seller ABCP Conduit – representative credit card securitization

Sample Credit Card Securitization



# Multi-seller ABCP Conduit – ‘funding formula’ application



- The above graph displays the ratio of credit enhancement to charge-offs
  - Defines how much worse charge-offs would have had to have gotten in order for the funding formula to result in funding less than 100% of the face amount of CP
  - **There would still have been the full 5% program-wide credit enhancement to absorb losses before the CP holders would have suffered any shortfall at all**
  - The minimum value in the graph is 12, which occurs in the 2009 data