

# **Letter from the Editors**

Vol. 10, Nos. 1-4, 2003

## **C'est La VIE: FIN 46**

Financial Interpretation 46 (FIN 46) and its subsequent revision in January of 2003 (FIN 46 R) has changed the rules for the consolidation of variable interest entities (VIEs). An asset-backed commercial paper conduit is a VIE and thus affected by this accounting interpretation. A Qualifying Special Purpose Entity (QSPE) as defined by FAS 140 is exempt from the FIN 46 and need not be consolidated with another entity even though it satisfies the definition of a VIE. Securitization vehicles that are not QSPEs are constrained by Fin 46 R.

Sponsors of asset-backed commercial paper conduits are usually suppliers of credit enhancement and liquidity support to the conduits. Financial institutions that do not sponsor commercial paper conduits also supply credit and liquidity support to commercial paper conduits.

General Electric Capital Corporation sponsors several commercial paper conduits and supplies financial support to these conduits. At year end 2002 GE Capital had approximately \$16.9 billion in credit support outstanding to securitization vehicles and \$10.3 billion in liquidity support that can be drawn within the year. By placing itself in the position of being the primary financier of the credit risk embedded in the pool of assets funded by the asset-backed commercial paper program in terms of value the sponsor takes the position of being the primary risk bearer and thus the "primary beneficiary".

"The primary beneficiary of a variable interest entity is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests, which are the ownership, contractual, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets excluding variable interests." (FIN 46 R)

Even if each seller of assets to the program must fund the first 10% of credit losses the dispersion of risk across the individual sellers disqualifies any one seller from being designed as the primary beneficiary because no one

seller funds a majority of the conduit's expected losses or captures a majority of the residual gains on the program's assets. According to Fin 46 the primary beneficiary of a Variable Interest Entity must consolidate the VIE's assets with its own.

Let's assume that twenty sellers finance assets through an asset-backed commercial paper program. Each seller funds \$10 million of assets through the program at all times and each seller is required to finance the first 10% of losses on the outstanding asset pool (\$1 million in our case or \$10 million x 10%). A credit guarantee for 5% of the value of the assets financed by the program is issued by the bank which sponsors the asset-backed commercial paper program. While each seller is in the first loss position financing a multiple of expected losses on the specific pool of assets it finances through the program, the total risk funded by the sponsor is \$10 million (5% of \$200 million) which is 10 times as large as any single seller's exposure. In our example the asset-backed commercial paper program is a variable interest entity (VIE) and the \$10 million financial guarantee issued by the sponsor to fund losses is a "variable interest". We will refer to this hypothetical example as "*example 1*".

Financial Interpretation 46 (FIN 46) released by the Financial Accounting Standards Board in January of 2003 and revised in December of 2003 interprets Accounting Research Bulletin 51 (ARB 51), *Consolidated Financial Statements*, for its application to the consolidation of variable interest entities by business enterprises. While ARB 51 requires a business enterprise to consolidate subsidiaries in which it has a controlling interest, Fin 46 requires the primary beneficiary of a VIE to consolidate it. In ARB 51 controlling interests are measured in terms of voting rights while FIN 46 focuses on the rights to receive residual value and the obligation to fund expected losses.

FIN 46 defines a financial entity as a variable interest entity if it has equity that is insufficient to permit the entity to finance its activities without additional subordi-

nated financial support from other parties, or is financed by equity investors who can not make significant decisions about the entity's operations, or do not absorb the expected losses or receive the expected returns of the entity. Asset-backed commercial paper conduits generally meet the definitional criteria of a VIE. The equity of an asset-backed commercial paper conduit owned but entities unaffiliated with the sponsor is minimal. Asset-backed commercial paper conduits are capitalized well below the level of expected losses and the equity does not cede the owner any decision making capacity regarding the operation of the conduit. The sponsor/administrator of the asset-backed commercial paper conduit controls the decisions regarding day to day and long term management of the conduit. Without the credit enhancement and liquidity support which is generally supplied to the conduit by the sponsor/administrator possibly through a syndicate of financial institutions the conduit would not be financially viable. Fin 46 defines primary beneficiary of a VIE to be the entity which is exposed to the majority of the VIE's expected losses and/or the majority of expected residual returns.

Citicorp like many banks that sponsor asset-backed commercial paper programs are reacting to FIN 46 by either restructuring the conduits they sponsor, winding down current programs or evaluating the economics of sponsoring asset-backed commercial paper programs when they must consolidate the conduit's assets and liabilities.

Various restructuring possibilities exist that will enable the sponsor to avoid having to consolidate the asset-backed commercial paper program. One possibility is to compartmentalize a conduit that is a VIE into separate silos which are in turn considered VIEs. Each silo would purchase assets from a seller just as a traditional asset-backed commercial paper conduit does. Financings for each silo have to be structured so that essentially the only source of repayment of the silo's liabilities are the assets owned by the silo and any credit enhancement supplied by the seller. By supplying the credit enhancement the seller becomes the primary beneficiary of the silo because it funds the expected losses of the silo and captures the residual value of the silo. As the primary beneficiary of the silo the seller must consolidate it.

Other restructuring possibilities discussed in Fin 46: New Rule Could Surprise Investors, June 24, 2003, Equity Research, by Credit Suisse First Boston, are structuring the asset-backed commercial paper conduit as a QSPE, selling a majority of the credit risk of the VIE to a third party investor, or dispersing the risk and/or residual benefits of the VIE so that no single entity becomes the primary beneficiary.

What has been the impact of Fin 46? We present an excerpt from the *Bank One Corporation*, 10-Q for period

ending September 30<sup>th</sup>, 2003 in exhibit 1 to shed some light on the effects of Fin 46. Bank One is a significant sponsor of asset-backed commercial paper programs.

### Exhibit 1

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“Bank One Corporation, 10-Q for period ending September 30<sup>th</sup>, 2003- “The Corporation is an active participant in the asset-backed securities business where it helps meet customers’ financing needs by providing access to the commercial paper markets through special purpose entities, known as multi-seller conduits. These entities are separate bankruptcy-remote corporations in the business of purchasing interests in, and making loans secured by, receivables pools and other financial assets pursuant to agreements with customers. The multi-seller conduits fund their purchases and loans through the issuance of highly-rated commercial paper. The primary source of repayment of the commercial paper is the cash flow from the pools of assets. Investors in the commercial paper have no recourse to the general assets of the Corporation. Customers benefit from such structured financing transactions as these transactions provide an ongoing source of asset liquidity, access to the capital markets, and a potentially favorable cost of financing.

As of September 30, 2003, the Corporation administered multi-seller conduits with a total program limit of \$70 billion and with \$34 billion in commercial paper outstanding. The multi-seller conduits were rated at least A-1 by S&P, P-1 by Moody’s and F-1 by Fitch.

These multi-seller conduits are a type of variable interest entity (“VIE”), as defined by FIN No. 46. These entities historically have met all of the requirements to be accounted for as independent entities, and, prior to the issuance of FIN No. 46, were not required to be consolidated with the Corporation. Each of the multi-seller conduits administered by the Corporation prepares stand-alone financial statements, which are independently audited on an annual basis.

As administrator of the multi-seller conduits, the Corporation provides deal origination services, asset portfolio monitoring, treasury and financial administration services for these entities. The Corporation structures financing transactions for customers such that the receivables and other financial instruments financed through the multi-seller conduits are appropriately diversified and credit enhanced to support the conduits’ commercial paper issuances. As of the date hereof, the Corporation does not service these assets and does not transfer receivables originated by the Corporation into the multi-seller conduits it administers. Each conduit has pro-

gram documents and investment policies, which govern the types of assets and structures permitted by the conduit. Three of the multi-seller conduits principally purchase interests in, or make loans secured by, trade receivables, auto loans and leases and credit card receivables. One conduit makes loans secured by portfolios of publicly rated marketable investment securities.

The commercial paper issued by the conduits is supported by deal-specific credit enhancement, which is structured to cover more than the expected losses on the pool of assets. The deal-specific credit enhancement is typically in the form of over-collateralization, but may also include any combination of the following: recourse to the seller or originator, cash collateral accounts, letters of credit, excess spread, retention of subordinated interests or third-party guarantees. In a limited number of cases, the Corporation provides the deal-specific credit enhancements as a financial arrangement for the customer. As of September 30, 2003 and December 31, 2002, the Corporation provided such deal-specific enhancements to customers in the form of subordinated interests totaling \$154 million and \$203 million, respectively. These subordinated interest positions were included in loans on the Corporation's balance sheets as of September 30, 2003 and December 31, 2002.

For three of the multi-seller conduits, the commercial paper investors have access to a second loss credit protection in the form of program-wide credit enhancement. The program-wide credit enhancement consists of a subordinated term loan from the Corporation and a surety bond from an AAA rated monoline insurance company. The subordinated term loans from the Corporation to these conduits totaled \$1.0 billion as of both September 30, 2003 and December 31, 2002. One conduit has only deal-specific credit enhancements provided by other financial institutions.

As a means of ensuring timely repayment of the commercial paper, each asset pool financed by the conduits has a minimum of 100% deal-specific liquidity facility associated with it. In the unlikely event of a disruption in the commercial paper market or in the event an asset pool is removed from the conduit, the administrator may draw on the liquidity facility to repay the maturing commercial paper. The liquidity facilities are typically in the form of asset purchase agreements structured such that the bank liquidity is provided by purchasing, or lending against, a pool of non-defaulted, performing assets. Additionally, program-wide liquidity facilities and lines of credit are provided by the Corporation and other financial institutions to the multi-seller conduits to facilitate access to the commercial paper markets.

As discussed on pages 44-46, the Corporation is an active participant in the asset-backed securities business where

it helps to meet customers' financing needs by providing access to the commercial paper markets through special purpose entities known as multi-seller conduits. These multi-seller conduits are a type of VIE as defined by FIN No. 46. These entities historically have met the requirements to be treated as independent entities, and, prior to the issuance of FIN No. 46, were not required to be consolidated with the Corporation. The Corporation had previously announced its intent to consolidate certain VIEs related to its asset-backed conduit business in conjunction with the implementation of FIN No. 46. As a result of the Financial Accounting Standards Board's ("FASB") deferral, the Corporation expects to consolidate or restructure these entities in accordance with FIN No. 46 in the fourth quarter. During the third quarter, banking regulators issued interim regulations that provide risk-based capital relief for certain assets that would be consolidated under FIN No. 46."

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The Federal Banking Agencies, Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System (FRB), and Office of Thrift Supervision (OTS) have amended the risk-based capital rules regarding the risk-based capital banks must allocate to finance ABCP conduits that must be consolidated due to the implementation of Fin 46. The final regulatory rule, "Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Consolidation of Asset-Backed Commercial Paper Programs and Other Related Issues", became effective September 30<sup>th</sup>, 2004.

Without this amendment to risk based capital rules, banks would have had to allocate capital against the risk weighted assets of the conduit assets that were consolidated as a result of Fin 46. "Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Interim Capital Treatment of Consolidated Asset-Backed Commercial Paper Program Assets" does not exempt banks from counting the consolidated assets in their tier I leverage ratio. A bank's tier I leverage ratio is tier I capital divided by average total consolidated assets. Exhibit 2 lists the components of tier I and tier II capital.

Banks rated in the top tier of the Uniform Financial Institutions Rating System by regulators must maintain a minimum tier I leverage ratio of 3%. Banks that are receiving a rating below the highest must maintain a leverage ratio or at least 4%.

The sum of tier I and tier II capital must be at least 8% of risk weighted assets. Risk weighted assets must be financed with a minimum of 4% of tier I capital. Minority interests in consolidated subsidiaries are generally included as a component of tier I capital.

## Exhibit 2. Components of tier I and tier II Capital

Capital components are distributed between two categories (Tier 1 and Tier 2). Tier 2 capital elements will qualify as part of a bank's total capital base up to a maximum of 100% of that bank's Tier 1 capital. Beginning December 31, 1992, the minimum risk-based capital standard will be 8.0%.

### Definition of Capital

#### Tier 1:

Common stockholders' equity;  
Noncumulative perpetual preferred stock and any related surplus; and  
Minority interests in the equity accounts of consolidated subsidiaries.

#### Tier 2:

Cumulative perpetual, long-term and convertible preferred stock, and any related surplus;<sup>5</sup>  
Perpetual debt and other hybrid debt/equity instruments;  
Intermediate-term preferred stock and term subordinated debt (to a maximum of 50% of Tier 1 capital); and  
Loan loss reserves (to a maximum of 1.25% of risk-weighted assets).

#### Deductions from Capital:

##### From Tier 1:

Goodwill and other intangibles, with the exception of identified intangibles that satisfy the criteria included in the guidelines.

##### From Total Capital:

Investments in unconsolidated banking and finance subsidiaries;  
Reciprocal holdings of capital instruments[.]

Source: Office of the Comptroller of the Currency, 12 C.F.R. Part 3, Appendix A

The Federal Banking Agencies amended the risk based capital regulations concerning asset-backed commercial paper programs because they believe that the capital bases of banks which sponsor asset-backed commercial paper programs are generally adequately protected from any losses that the assets financed by the program may experience. Regulators are confident that asset-backed commercial paper programs are structured with sufficient collateral and credit and liquidity enhancements at the seller and program levels so that the risk to the sponsoring bank's capital base can be adequately financed if capital is held against any recourse arrangements the sponsoring bank has with the asset-backed commercial paper program or any credit substitutes the bank has issued or invested in to enhance an asset-backed commercial paper program.

In summary, if the risk based capital rules governing asset-backed commercial paper programs had not been amended to deal with Fin 46, banks would have been required to count the consolidated assets as risk weighted assets. In our previous "example 1", assuming all of the assets funded through the asset-backed commercial paper program have a risk weight of 100%, the sponsor would have had to raise \$16 million in equity capital to support the addition of \$200 million of assets (8% x 100% x \$200

million). Any credit enhancement and liquidity facilities it issued to support the program must be converted into on balance sheet assets, assigned the appropriate risk weight and then capitalized with regulatory capital. Liquidity facilities issued by banks to support asset-backed commercial paper programs are generally structured to have maturities of less than one year so that the conversion factor is 0%. That is there is no capital charge on liquidity facilities that have maturities of one year or less. In conjunction with the interim risk based capital rules issued by the federal banking agencies to exempt sponsors of risk asset-backed commercial paper conduits from having to consolidate the assets of the program, the banking regulators are considering assigning a 20% conversion factor to liquidity facilities issued to support these asset-backed commercial paper conduits. Once converted to an on balance sheet credit equivalent, a risk weight that corresponds to the assets being enhanced is assigned to the liquidity facility. For a liquidity facility that supports a commercial paper program which funds trade receivables the risk weight would be 100% for the drawn amount of the facility. If the assets funded through the program were AAA rated classes of asset-backed securities the risk weight attached to the used portion of the

liquidity facilities would be 20%. An asset-purchase agreement issued to enhance the credit quality of an asset-backed commercial paper program is an example of a direct credit substitute. The conversion factor of this direct credit substitute is 100%. If the assets funded by the conduit have a 100% risk weight then the risk weight assigned to a direct credit substitute that has been converted to an

on balance sheet credit equivalent amount is 100%. The required risk based capital is  $8\% \times 100\%$  of the principal amount of the assets supported by the direct credit substitute.

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