

of each of the underlying asset pools. The banking organization would be required to hold capital against 10 percent of the underlying asset pools because it is providing the program-wide credit enhancement. The banking organization also would be required to hold capital against 90 percent of the liquidity facilities it is providing to each of the underlying asset pools. Moreover, if a banking organization had to consolidate ABCP program assets onto its balance sheet for risk-based capital purposes because, for example, the organization was not the sponsor of the program, the organization would not be required also to hold risk-based capital against any credit enhancements or liquidity facilities that cover those same program assets.

If different banking organizations provide overlapping exposures, however, each organization must hold capital against the entire maximum amount of its exposure. As a result, while duplication of capital charges will not occur for individual banking organizations, it may occur where multiple banking organizations have overlapping exposures to the same ABCP program.

The agencies also are proposing that banking organizations that are subject to the market risk capital rules would not be permitted to apply those rules to any liquidity facilities held in the trading book. Rather, organizations will be required to convert the notional amount of all liquidity facilities to ABCP programs using the appropriate credit conversion factor to determine the credit equivalent amount for liquidity facilities that are structured or characterized as derivatives or other trading book assets. Thus, for example, all liquidity facilities to ABCP programs with an original maturity of one year or less will be subject to a 20 percent conversion factor as described above, regardless of whether the exposure is carried in the trading account or the banking book. The agencies request comment on this prohibition and its implications.

In order for a liquidity facility, either short- or long-term, provided to an ABCP program not to be considered a recourse obligation or a direct credit substitute, draws on the facility must be subject to a reasonable asset quality test that precludes funding assets that are 60 days or more past due or in default. Assets that are past due 60 days or more generally are considered ineligible for financing based upon standard industry practice and rating agency guidelines for trade receivables. The funding of assets past due 60 days or more using a liquidity facility exposes the institution

to a greater degree of credit risk compared to the purchase of assets of a more current nature. It is the agencies' view that liquidity facilities that are eligible for the 20 percent or 50 percent conversion factors should not be used to fund assets with the higher degree of credit risk typically associated with seriously delinquent assets.

In addition, if the assets a banking organization would be required to fund pursuant to a liquidity facility are initially externally rated exposures, the facility can be used to fund only those exposures that are externally rated investment grade at the time of funding. Furthermore, the liquidity facility must contain provisions that, prior to any draws, reduce the banking organization's funding obligation to cover only those assets that would meet the funding criteria under the facility's asset quality tests. In other words, the amount of coverage provided by the liquidity facility must decrease as assets that meet the asset quality test decrease so that the liquidity facility would cover only those assets satisfying the asset quality test. If the asset quality tests were violated, the liquidity facility would be considered a direct credit substitute and would be converted at 100 percent as opposed to 20 or 50 percent.

Additional Risk-Based Capital Considerations

The agencies recognize that FIN 46 may affect whether consolidation is required of other VIE structures in addition to ABCP programs sponsored by banking organizations. While the current proposal would permit banking organizations to exclude from risk-weighted assets only sponsored ABCP program assets, the agencies seek comment on whether other structures or asset types affected by FIN 46 should be eligible for risk-based capital treatment similar to that proposed for banking organization-sponsored ABCP program assets. In addition, the agencies request feedback on whether banking organizations expect any difficulties in tracking these consolidated ABCP program assets on an ongoing basis. The agencies also request comment on any alternative regulatory capital approaches that should be considered, beyond what has been proposed.

II. Early Amortization Capital Charge

The Agencies also are seeking comment on the assessment of a risk-based capital charge against the risks associated with early amortization, a common feature in securitizations of revolving retail credit exposures (for example, credit card receivables). When

assets are securitized, the extent to which the selling or sponsoring entity transfers the risks associated with the assets depends on the structure of the securitization and the nature of the underlying assets. The early amortization provision often present in securitizations of revolving retail credit facilities increases the likelihood that investors will be repaid before being subject to any risk of significant credit losses. For example, if a securitized asset pool begins to experience credit deterioration to the point where the early amortization provision is triggered, then the asset-backed securities begin to pay down rapidly. This occurs because, after an early amortization provision is triggered, if new receivables are generated from the accounts designated to the securitization trust, they are no longer sold to investors, but instead are retained on the sponsoring banking organization's balance sheet.

Early amortization provisions raise several distinct concerns about the risks to selling banking organizations. First, the seller's interest in the securitized assets effectively is subordinated to the interests of the investors by the payment allocation formula applied during early amortization. Investors effectively get paid first, and, as a result, the seller's residual interest likely will absorb a disproportionate share of credit losses.

Second, early amortization can create liquidity problems for selling organizations. For example, a credit card issuer must fund a steady stream of new credit card receivables when a securitization trust is no longer able to purchase new receivables due to early amortization. The selling organization must either find an alternative buyer for the receivables or else the receivables will accumulate on the seller's balance sheet, creating the need for another source of funding and potentially the need for additional regulatory capital.

Third, the first two risks to the selling banking organization can create an incentive for the seller to provide implicit support to the securitization transaction—credit enhancement beyond any pre-existing contractual obligations—to prevent an early amortization. Incentives to provide implicit support are, to some extent, present in other types of securitizations because of concerns about damage to the selling organization's reputation and its ability to securitize assets going forward if one of its transactions performs poorly. However, the early amortization provision creates additional and more direct financial incentives to prevent early amortization through the provision of implicit support.