BOARD OF GOVERNORS

OF THE

FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

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Mr. Nazareth Festekjian
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Mr. William Aprigliano
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Dear Mr. Festekjian and Mr. Aprigliano,

This letter is in response to your inquiry on October 5, 2007, regarding the regulatory capital treatment of the liquidity facilities to be provided to a structured finance vehicle, the Master Liquidity Enhancement Conduit (M-LEC). You describe two types of liquidity facilities that would support M-LEC and request confirmation that each liquidity facility would be an eligible asset-backed commercial paper (ABCP) liquidity facility with an original maturity of one year or less under the Board's risk-based capital guidelines for bank holding companies and state member banks (Capital Guidelines), [1] and that unused portions of each liquidity facility would therefore be subject to a 10 percent credit conversion factor and to a risk weight based on the underlying assets of M-LEC.

M-LEC would purchase AAA and AA rated assets from existing structured investment vehicles and would fund those purchases by issuing ABCP, medium-term notes (MTNs), and subordinated tranches in the form of senior capital notes and junior capital notes. None of the assets purchased by M-LEC would be 90 days or more past due, in default, or externally rated less than investment grade. M-LEC would be supported by liquidity facilities that would collectively cover 100 percent of the ABCP issued by M-LEC and any MTNs issued by M-LEC with less than 365 days to maturity. M-LEC would have the right to draw on the liquidity facilities if needed to repay maturing ABCP or MTNs. The amount of ABCP and MTNs issued

[1] 12 CFR parts 208 and 225, Appendix A.

by M-LEC would decrease over time as M-LEC's assets mature or are sold, and the amount of the liquidity facilities would decrease correspondingly.

Under the proposal, banking organizations may provide one of two forms of liquidity facility to M-LEC: (1) a loan funding facility or (2) a securities funding facility. The same banking organization may provide both types of liquidity facility to M-LEC.

Under the loan funding facility, a participating liquidity bank would make a 364-day commitment to lend to M-LEC. If M-LEC draws on the facility, the liquidity bank would be obligated to extend a term loan to M-LEC. The loan would rank *pari passu* with the ABCP and MTNs issued by M-LEC and would be backed by M-LEC's assets. If, at the end of 364 days, the liquidity bank chooses not to renew its commitment, M-LEC would have the option to draw on the loan commitment, resulting in a term loan to M-LEC with a maturity, for example, of three years. The loan would rank *pari passu* with the ABCP and MTNs issued by M-LEC and would be backed by M-LEC's assets.

Under the securities funding facility, a liquidity bank would make a 364-day commitment either (1) to purchase a short-term note issued by M-LEC that is externally rated or (2) to enter into securities borrowing transactions with M-LEC. The liquidity bank would choose the form in which it would provide funding at the time of a draw by M-LEC on the commitment. If the liquidity bank chooses to purchase a short-term note issued by M-LEC, the note would rank *pari passu* with the ABCP and MTNs issued by M-LEC and would be backed by M-LEC's assets. If the liquidity bank chooses to enter into securities borrowing transactions with M-LEC, M-LEC's collateral agent would designate the specific securities that the bank would borrow. The credit quality of the securities borrowed by the liquidity bank would be representative of the overall credit quality of M-LEC's assets. The securities borrowing transactions would be documented under standard industry documentation. If, at the end of 364 days, the liquidity bank chooses not to renew its commitment, M-LEC would have the option to draw on the securities funding facility. If M-LEC exercises this option, the liquidity bank would have the choice of (1) purchasing an externally rated debt security issued by M-LEC with a maturity, for example, of three years or (2) entering into a securities borrowing transaction with M-LEC with a term, for example, of three years.

The Capital Guidelines define an eligible ABCP liquidity facility as a liquidity facility supporting ABCP, in form or in substance, that is subject to an asset-quality test at the time of draw that precludes funding against assets that are 90 days or more past due or in default.[2] In addition, if the assets that an eligible ABCP liquidity facility is required to fund against are externally rated assets at the inception of the facility, the facility can be used to fund only those assets or exposures that are externally rated investment grade at the time of funding.[3]

SR letter 05-13 further provides that the Federal banking agencies (agencies) will deem an ABCP liquidity facility to be in compliance with the 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

[2] See 12 CFR parts 208 and 225, App. A § III.B.3.a.iv.
[3] Id.

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.[4] SR letter 05-13 explains that "funded" credit enhancements that the liquidity provider may access to cover delinquent, defaulted, or below investment grade assets—such as overcollateralization, cash reserves, subordinated securities, and funded spread accounts—are generally acceptable credit enhancements for purposes of satisfying this test.

As described, each M-LEC liquidity facility—the loan funding facility and the securities funding facility—may be considered an eligible ABCP liquidity facility for risk-based capital purposes. Each liquidity facility would support the ABCP issued by M-LEC. Should M-LEC require liquidity to repay maturing ABCP, M-LEC would draw upon all liquidity facilities on a pro rata basis.

Moreover, at the inception of the transaction, each liquidity facility would be deemed to comply with the asset quality test for eligible ABCP liquidity facilities. At inception, the notional amount of M-LEC's funded credit enhancements (the junior and senior capital notes, overcollateralization, and any cash reserves) would exceed the amount of underlying assets that are 90 days or more past due, defaulted, or below investment grade. As long as M-LEC's funded credit enhancements continue to exceed its low-quality assets, consistent with SR letter 05-13 the liquidity facilities may be considered eligible ABCP liquidity facilities. If the amount of acceptable credit enhancements that support M-LEC's assets becomes less than the amount of M-LEC's assets that are 90 days or more past due, in default, or below investment grade, the liquidity facilities would no longer be considered eligible ABCP liquidity facilities and must be treated as recourse obligations or direct credit substitutes in accordance with the Capital Guidelines.

Under the Capital Guidelines, the credit conversion factor for an eligible ABCP liquidity facility is based on whether the facility has an original maturity of one year or less. Under the Capital Guidelines and the Board's interpretations thereof, original maturity is the length of time between the date the commitment is issued and the date the commitment terminates or the earliest date on which (1) the bank can, at its option, unconditionally (without cause) cancel the commitment and (2) the bank is scheduled to (and as a normal practice actually does) review the facility to determine whether or not it should be extended.[5] Each liquidity facility you describe has an original maturity of 364 days, with an option that allows M-LEC to draw upon the facility and receive funding with a maturity of up to three years should the bank providing the facility decide not to renew it. Under the Capital Guidelines and the Board's long-standing interpretations thereof, the term of any advances that can be made under a commitment is not taken into account in determining the commitment's original maturity.[6] Thus, the M-LEC liquidity facilities would have an original maturity of one year or less for risk-based capital purposes. Therefore, the credit conversion factor that would apply to the notional amount of the M-LEC liquidity facilities would be 10 percent.

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[4] SR Letter 05-13 (August 4, 2005); Interagency Guidance on the Eligibility of Asset-Backed Commercial Paper Program Liquidity Facilities and the Resulting Risk-Based Capital Treatment.
[5] 12 CFR parts 208 and 225, App. A, § III.D.2.b.
[6] See Federal Reserve Commercial Bank Examination Manual, section 3020.1.

The credit equivalent amount of the unfunded eligible ABCP liquidity facilities could be risk weighted according to the underlying assets in M-LEC. The Capital Guidelines do not specifically mandate or authorize a look-through approach to eligible ABCP liquidity facilities, nor do the Capital Guidelines specifically prohibit a look-through approach to eligible ABCP liquidity facilities. The agencies have taken the position, however, that a banking organization may risk weight the credit equivalent amount of an eligible ABCP liquidity facility by looking through to the underlying assets of the ABCP conduit.[7] Accordingly, under the Capital Guidelines, a banking organization that provides an M-LEC liquidity facility may risk weight the credit equivalent amount based on the weighted average risk weight of the assets held by M-LEC. Until such time as M-LEC acquires assets, a banking organization may risk weight its M-LEC liquidity facility at 20 percent—the risk weight appropriate under the Capital Guidelines for AAA and AA rated asset-backed securities—based on the representation that M-LEC will purchase only securities carrying such ratings.[8]

This interpretation is based upon the specific facts and circumstances described in your submissions to, and discussions with, Federal Reserve staff. Any material change in those facts and circumstances may result in a different view or in a revocation of the regulatory capital treatment permitted under this determination.

If you have any questions with regard to this letter, please direct them to Norah Barger, Associate Director, at (202) 452-2402, or Anna Lee Hewko, Senior Supervisory Financial Analyst, at (202) 530-6260, in the Division of Banking Supervision and Regulation, or to Mark Van Der Weide, Senior Counsel, at (202) 452-2263, or April Snyder, Senior Attorney, at (202) 452-3099, in the Legal Division.

Sincerely yours,

Norah Barger
Associate Director

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[7] 69 Federal Register 44911 (July 28, 2004).
[8] See 12 CFR part 225, App. A, § III.B.3.c.