Financial Markets Briefing

Revitalizing the Short-Term ABS Market: Possible New Structures

December 14, 2010

Moderator:
Jim Croke, *Orrick, Herrington & Sutcliffe LLP*

Panelists:
Hans Bald, *20 Gates Management*
Robert Crowe, *Citigroup Global Markets Inc.*
Joseph Johnson, *Goldman Sachs & Co.*
Blanton Neil, *DB Advisors*

Background – Challenges to the ABCP Market

Asset-Backed Commercial Paper (ABCP) has for many years been used by banks as an important funding source for both customer and proprietary assets.

BUT:

- The balance of outstanding ABCP has dropped precipitously. In July 2007 (height of the market) the principal amount of outstanding US ABCP was approximately $1,162 billion. At November 30, 2010 it was $384 billion.
- Certain products that until the fall of 2007 comprised a significant portion of overall ABCP volumes are no longer viable (e.g., CDO and SIV commercial paper, extendable commercial paper and market value structures).
- In times of market stress the market value of certain ABCP structures has been more volatile than unsecured bank debt.
- Certain major ABCP conduit sponsors have consolidated issuance vehicles, have exited the ABCP business and/or have announced their intention to exit the business.

ORRICK

Background –
Challenges to the ABCP Market (continued)

NONETHELESS, banks and their customers continue to need access to cost-effective short-term financing. In this regard, a number of bank-sponsored "multiseller" conduits operated throughout the credit crisis and continue today to provide short-term financing at attractive rates.

Indeed, during the height of the credit crisis the Federal Reserve recognized the importance of ABCP to the overall economy by sponsoring several initiatives to support the ABCP market (i.e., the ABCP Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility and the Money Market Investor Funding Facility).

Revitalization of the ABCP market therefore could be of significant benefit to the broader economy.   ABCP growth could derive from (i) the increased use of multiseller conduits to fund customer assets, and/or (ii) the market reintroduction (under "improved" documentation) of "specialized" ABCP conduits such as securities arbitrage conduits.

Background –
Challenges to the ABCP Market (continued)

At the same time, a number of regulatory changes (existing and proposed) could restrict the growth of the ABCP market. Conduit structures will need to evolve to comply with the new regulations and to minimize the associated costs to conduit sponsors.

These regulatory issues include:

- **Accounting Consolidation**. Bank sponsors of ABCP conduits traditionally were not required to consolidate the conduits or their assets ("first loss" notes and FIN 46R). This is no longer the case; under FAS 167 (effective for periods after November 15, 2009) consolidation generally is required. This change in accounting treatment eliminates one of the prime incentives for banks to finance assets through ABCP conduits.
- **Enhanced Capital Requirements**. U. S. banks are now required to hold risk capital based on their GAAP balance sheet assets. The Basel 2 Capital Accord increases the capital charges associated with certain bank exposures to ABCP conduits. In particular, resecuritization exposures will be assigned higher "risk weights" and certain ABCP liquidity facilities will be assigned higher "credit conversion factors." These changes make it less capital efficient for banks to
finance certain assets (particularly ABS) through ABCP conduits.

Background –
Challenges to the ABCP Market (continued)

- **Proposed Liquidity Coverage Requirements**. The Basel Committee on Banking Supervision has proposed to adopt a "Basel 3" Capital Accord that would, among other changes, require banks at all times to hold high quality liquid assets in amounts that equal or exceed their "net cash outflow" (calculated over a 30-day timeframe). The coverage requirement would make it more difficult and/or expensive for banks to provide liquidity support to ABCP conduits and would particularly increase the cost of issuing short-dated ABCP notes.
- **Changes in Money Market Fund Regulation**. Money market funds form much of the investor base for ABCP. In 2010, the SEC amended Investment Company Act Rule 2a-7 (governing the operation of money market funds) to require MMFs to (i) limit the weighted average maturity of their investment portfolios to 60 days (reduced from 90 days), and (ii) maintain specified percentages of their portfolios in very short-term liquid assets (ABCP held to satisfy this requirement must mature with seven days or, in some cases, one day). The Rule 2a-7 changes make longer-dated ABCP notes less attractive to MMFs.

Background – Challenges to the ABCP Market (continued)

- **Proposed Changes in Disclosure Requirements (Regulation AB II)**. ABCP conduits typically issue their notes in reliance upon the registration exemptions provided by Regulation D and/or Rule 144A under the Securities Act of 1933. The SEC has proposed to make Regulation D and Rule 144A unavailable for offerings of asset-backed securities (including ABCP) unless the issuer discloses the same information that would be provided if the securities were registered with the SEC. This requirement - if implemented as proposed - would greatly increase the amount of disclosure made in ABCP offering documents. The associated costs (particularly because of the need to continually update the disclosure as the assets financed by the program change) could make many ABCP programs impractical.
- **The Volcker Rule**. With limited exceptions, the "Volcker Rule" included in the Dodd-Frank Act prohibits banks from "sponsoring" private funds. As defined, the term "private fund" includes most ABCP conduits. A bank that retains management control of an ABCP conduit could be viewed as the conduit's "sponsor". If so, when the Volcker Rule becomes effective (likely to occur in mid-2012) banks will not be permitted to sponsor new ABCP conduits and over time will need to narrow and/or terminate their connections to certain existing conduits. The Volcker Rule similarly could prohibit or restrict banks from effecting transactions with sponsored conduits (e.g., provision of liquidity or credit support to the conduit or purchases of commercial paper or assets from the conduit).

ORRICK

Background –
Challenges to the ABCP Market (continued)

- **Changes to Federal Reserve Act**. Sections 23A and 23B of the Federal Reserve Act impose certain restrictions on transactions between banks and their affiliates. ABCP conduits have traditionally not been considered bank "affiliates" for purposes of these restrictions. However, in mid -2012 the Dodd-Frank Act will expand the scope of Sections 23A and 23B to possibly apply to transactions between a bank and any ABCP conduit that it sponsors, advises or manages. Banks would find it very difficult to comply with Sections 23A and 23B in operating conduits. Accordingly, certain ABCP structures (unless the issuer is a bank subsidiary) may not be viable if regulators apply Sections 23A and 23B to bank/conduit transactions
- **Risk Retention Rules**. The Dodd-Frank Act requires the SEC and federal banking regulators to establish by April 2011 risk retention requirements for securitizers. In general, the securitizer will be required to retain credit risk of at least 5% of each asset it transfers. Asset originators that securitize assets through ABCP conduits will be required to comply with these regulations. The securitization safe harbor rule approved by the FDIC in September 2010 imposes similar risk retention requirements (the FDIC requirements will automatically conform to the SEC rule when the latter is adopted). The risk retention rules may increase the regulatory capital charges and/or other costs that banks incur in securitizing assets.

Background –
Challenges to the ABCP Market (continued)

- **Investment Adviser Registration.** United States banks generally are exempt from registration as "investment advisers" under the Investment Advisers Act. Foreign banks (including U.S. branches of foreign banks) that manage U.S. ABCP conduits have relied upon a "private advisers" exemption that permits them to provide investment management services to a limited number of U.S. clients without registering with the SEC. However, the Dodd-Frank Act has repealed the private advisers exemption, effective as of July 2011. Accordingly, non-U.S. banks that sponsor U.S. ABCP conduits will need to register as investment advisers.
- **Other Regulatory Changes**. Other recent regulatory changes may not require fundamental changes in ABCP structures but will increase compliance costs. As an example, Exchange Act Rule 17g-5 requires conduits and/or their sponsors to make information concerning the conduit available on a continuing basis to rating agencies *other than* the rating agencies actually engaged by the conduit to rate its notes. This rule and similar regulatory developments to some degree could make conduits less profitable to operate.

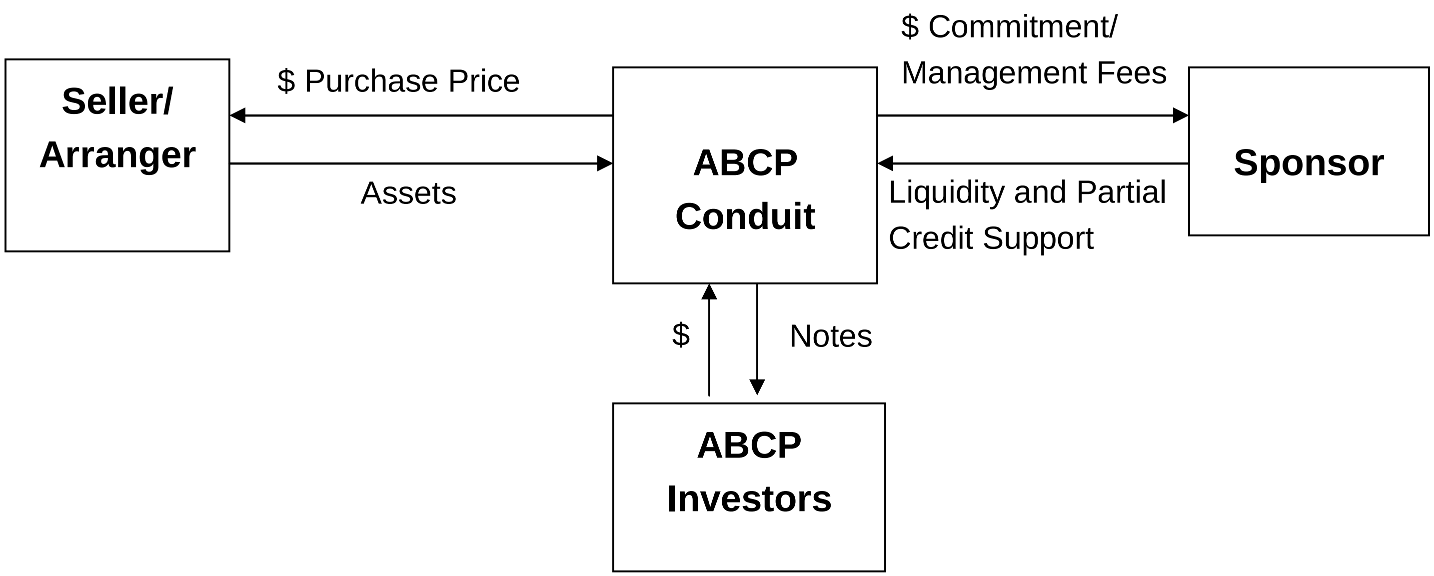
ORRICK

Background –
Challenges to the ABCP Market (continued)

- **Regaining Investor Confidence.** Although ABCP issued by "traditional" multiseller conduits performed well throughout the credit crisis, the same cannot be said of short-term notes issued by certain other structured issuers (including certain CDOs and SIVs) or of certain other ABS asset classes. Accordingly, any attempt to revitalize the ABCP market must address investor concerns in a number of important areas, including adequacy of disclosure, structural issues, reliability of ratings and sponsor conflicts of interest.
- **The Impact of Regulatory Uncertainty.** The scope of the recent regulatory changes affecting the securitization markets (including ABCP), and the fact that many regulations remain to be drafted or finalized, makes it difficult for market participants to plan new transactions or structures. As stated by Asset Securitization Report in a recent headline, ***"Shifting Regulatory Stance Stalls Securitization Market Restart***."

ORRICK

Traditional ABCP Structure



ORRICK

Traditional ABCP –
Advantages and Disadvantages

Advantages

1. $400 Billion market. Short term (≥ 1 year) maturities only.
2. European/Japanese sponsors receive favorable GAAP and RAP treatment.
3. Established treatment (and some relief from issuer concentration limits) under Rule 2a-7.
4. ABCP satisfies liquid securities requirements under Rule 2a-7.
5. Collateral generally not subject to "FDIC Safe Harbor Rules".

Disadvantages/Concerns

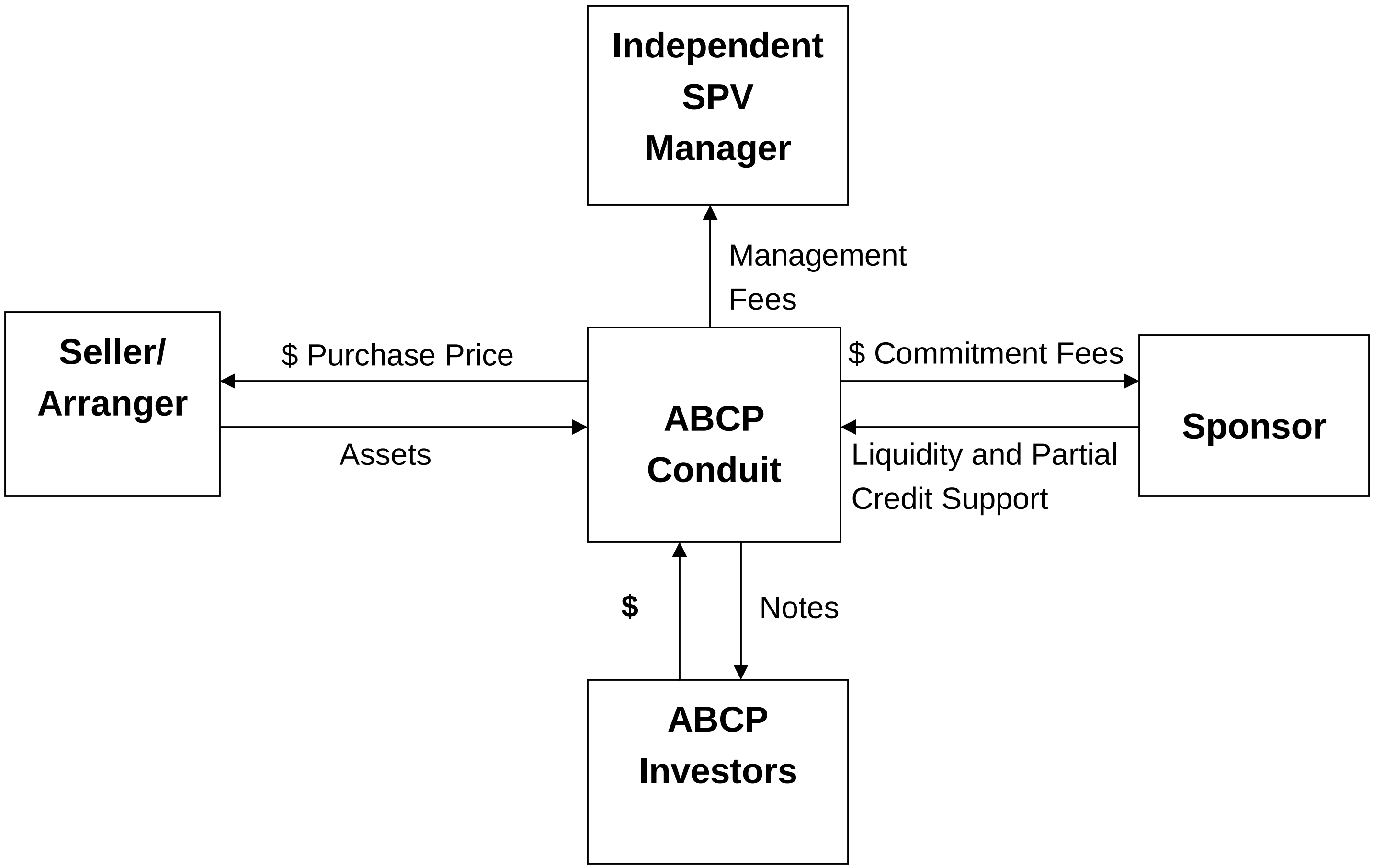
1. U.S. sponsors generally must consolidate the conduit under GAAP and RAP.
2. Certain categories of ABCP (particularly ABCP of "structured" issuers but not of "traditional" multiseller conduits) has exhibited greater market value volatility than bank debt during times of market stress. This has limited the ability of certain sponsors/issuers to fund longer-dated ABCP.

Traditional ABCP – Advantages and Disadvantages (continued)

Disadvantages/Concerns

3. Issuer does not always own bankruptcy-remote collateral.
4. Must comply with Rule 17g-5.
5. Basel 3 will require full collateralization of liquidity facilities and of ABCP with remaining terms to maturity of 30 days or less.
6. Reg AB amendments (Reg. D/Rule 144A) may impose burdensome disclosure requirements.
7. Potential exposure to preference risk in some programs.
8. Partially supported ABCP Notes are re-securitizations under Basel 2.
9. Structure may not be permitted under Dodd-Frank Act (Volcker Rule). Issues/problems under Sections 23A and B of Federal Reserve Act.
10. Non-U.S. bank sponsors will need to register as investment advisers.

Modified ABCP Structure

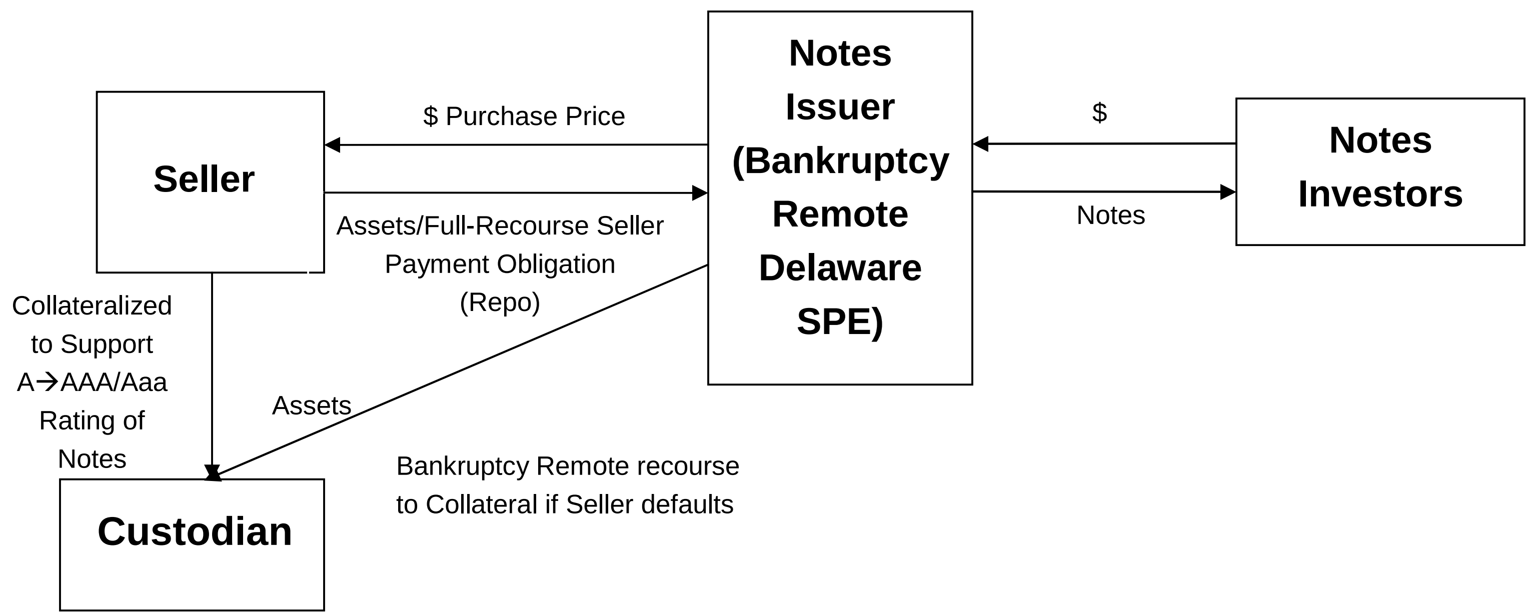


ORRICK

Modified ABCP Structure – Advantages and Disadvantages

The Advantages and Disadvantages/Concerns are the same as for Traditional ABCP, except that, because sponsorship/management control has been transferred to an independent sponsor/investment manager, (i) any U.S. bank that finances assets through the conduit will not be required to consolidate the conduit under U.S. GAAP and RAP, (ii) Volcker Rule limitations would not apply, and (iii) banks utilizing the conduit will lose control of the financed assets and will have to negotiate financing terms with the conduit on an arm's-length basis.

FURSTs Structure



ORRICK

FURSTs Structure – Advantages and Disadvantages

Advantages:

1. Greater flexibility in in setting the term of the Notes - Notes have legal final maturities of between 1 day and 30 years.
2. Bankruptcy remote collateral combined with full credit recourse to Seller (under repo). Combination mitigates market value risk.
3. Notes may achieve long and/or short-term ratings. Repo safe harbor permits “A”-“AAA” long term rating and/or (for short term Notes) short-term ratings of A-1/P-1/F1. Also possible for sponsors with lower short-term ratings to issue Notes with higher short-term ratings. Bankruptcy remoteness not dependent on “FDIC Safe Harbor Rules”.
4. Repo safe harbor also eliminates preference/fraudulent transfer risks.

ORRICK

FURSTs Structure – Advantages and Disadvantages (continued)

Advantages: (Continued)

6. Should be exempt from Rule 17g-5 requirements.
7. Should be exempt from (or eligible for "preferred" treatment under) Reg AB requirements.
8. Notes are debt for U.S. tax purposes, and ERISA eligible investments.
9. The structure permits compliance with taxable mortgage pool rules and does not require REMIC election.
10. Notes satisfy liquid securities requirements under Rule 2a-7.
11. Notes are not re-securitizations under Basel 2.
12. Structure permitted under Dodd-Frank ("Volcker Rule") and under Sections 23A and B of Federal Reserve Act.

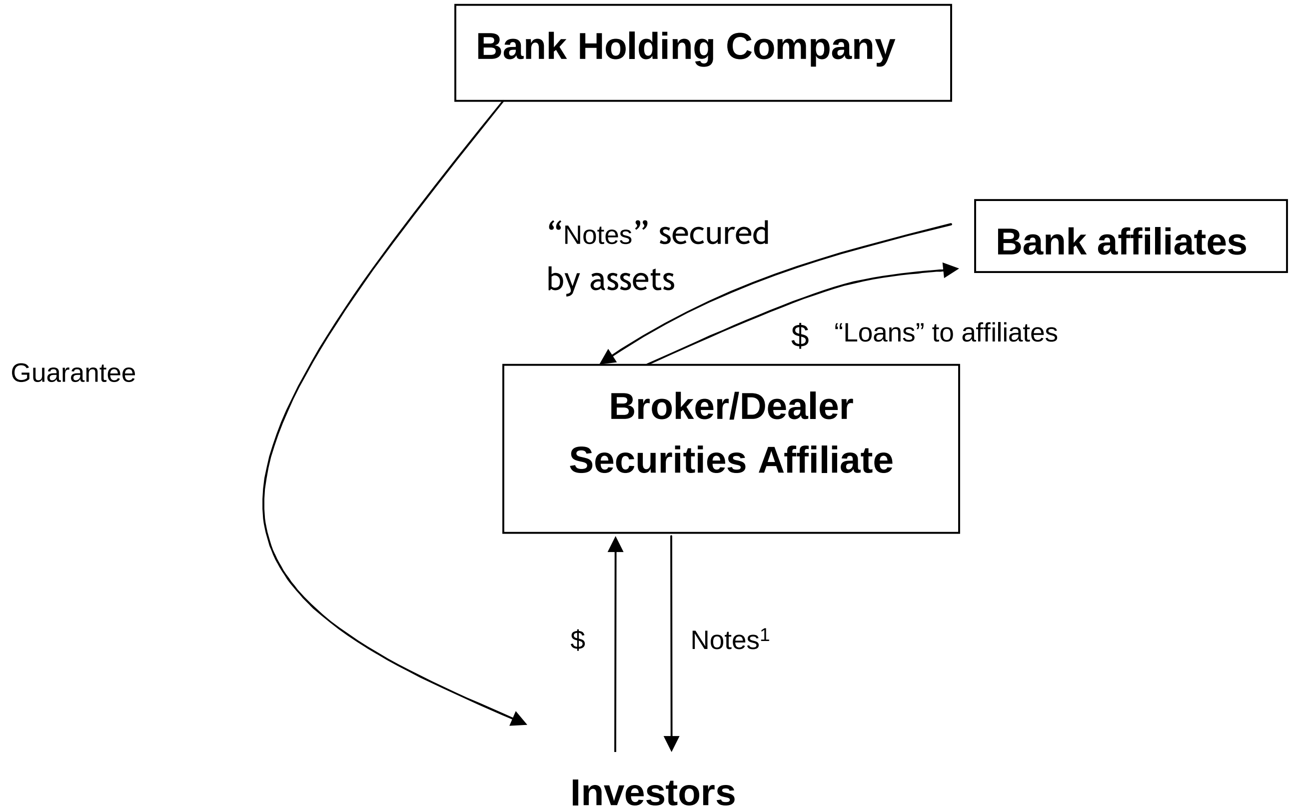
ORRICK

FURSTs Structure – Advantages and Disadvantages (continued)

Disadvantages/Concerns:

1. On balance sheet for GAAP and RAP.
2. Basel 3 will require full collateralization of sponsor's short-term repo commitments and of FURSTs with remaining terms to maturity of 30 days or less.
3. Non-U.S. bank sponsors will need to register as investment advisors.

Collateralized CP*



[1] Notes cross collateralized

*** A number of different structures may be described by their sponsors as "Collateralized CP"; the diagrammed structure represents only one possible approach.**

Collateralized CP – Advantages and Disadvantages

Advantages

1. New product – Enables 2a-7 funds to replace repo fundings with acquisitions of liquid securities. Issuance of longer dated "collateralized notes" is possible.
2. Unconditional bank payment obligation.
3. Not required to comply with Rule 17g-5.
4. Not required to comply with Reg. D/Rule 144A disclosure requirements in Reg AB.
5. Notes are debt for U.S. tax purposes, and ERISA eligible investments.
6. Notes satisfy liquid securities requirements under Rule 2a-7.
7. Notes are not re-securitizations under Basel 2.
8. Structure permitted under Dodd-Frank (Volcker Rule) and under Sections 23A and B of Federal Reserve Act.

ORRICK

Collateralized CP –
Advantages and Disadvantages (continued)

Disadvantages/Concerns

1. Basel 3 will require full collateralization of notes with remaining terms to maturity of 30 days or less.
2. On balance sheet for GAAP and RAP.
3. Bank is issuer for purposes of Rule 2a-7 issuer concentration limits.
4. Investor subject to bankruptcy risk of bank/sponsor – collateral is not bankruptcy remote.*
5. Collateral "lite"? Security interest in collateral and related security mechanics may be significantly weaker than what a secured lender would typically demand or expect.*

---

*These statements may not apply to certain structures characterized as "collateralized CP."

ORRICK

Summary Comparison of Funding Structures

	Traditional ABCP	FURSTs	Collateralized CP
Accounting			
On B/S for GAAP & RAP	• Yes(1)	• Yes	• Yes
Debt for Tax	• Yes	• Yes	• Yes
Legal			
Issuer owns Bankruptcy Remote Collateral	• No	• Yes	• No
Full Recourse to Seller	• No	• Yes	• Yes
Eliminates Preference / Fraudulent Transfer Risk	• Not in all cases	• Yes	• No
Regulatory			
Basel III Liquidity Coverage Required	• Yes	• Can be exempt	• For short-dated issuance
17g-5 Requirements Needed	• Yes	• No	• No
Reg AB Disclosure Required	• TBD	• TBD	• No
Subject to FDIC Safe Harbor Rules	• No	• No	• No
Qualify as 2a-7 Liquid Securities	• Yes	• Yes	• Yes
Re-securitization Treatment under Basel II	• Yes (for partially-supported programs)	• No	• No
Permitted Under Dodd-Frank	• No	• Yes	• Yes

Notes

1. More stringent in the U.S. vs Europe & Asia

ORRICK

Financial Markets Briefing

Revitalizing the Short-Term ABS Market: Possible New Structures

ORRICK

December 14, 2010

Moderator:

Jim Croke, *Orrick, Herrington & Sutcliffe LLP*

Panelists:

Hans Bald, *20 Gates Management*

Robert Crowe, *Citigroup Global Markets Inc.*

Joseph Johnson, *Goldman Sachs & Co.*

Blanton Neil, *DB Advisors*