



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

January 26, 2004

Mr. Dwight Jenkins
American Securitization Forum
360 Madison Ave.
New York, NY 10017-7111

Dear Mr. Jenkins:

This responds to your memorandum dated October 22, 2003, and to your letters dated October 30 and December 12, 2003, to the Board concerning the relationship between certain of the Board's regulations and Interpretation No. 46, "Consolidation of Variable Interest Entities" (FIN 46), issued by the Financial Accounting Standards Board (FASB). Specifically, you requested confirmation from Board staff that the implementation of FIN 46 by certain depository institutions does not result in creating (1) liabilities of the depository institution that are subject to reserve requirements under the Board's Regulation D (as defined herein) or (2) demand deposits of the depository institution under the Board's Regulation Q (as defined herein). For the reasons and under the conditions discussed more fully below, Board staff believes that the application of FIN 46 in and of itself does not make the liabilities in question "deposits" or "reservable liabilities" or "demand deposits" of the depository institutions in question.

In connection with your request for confirmation, Board staff reviewed your memorandum and letters described above, and also had telephone conversations and a meeting (on October 24) with representatives of the American Securitization Forum ("ASF"). Based on the foregoing as well as on other sources cited herein, we understand the relevant facts to be as follows. Under the asset-backed commercial paper ("ABCP") programs you described, a depository institution ("DI") establishes or "sponsors" a bankruptcy-remote special purpose entity (an "ABCP Conduit") that purchases asset pools from, or extends loans to, the DI's corporate customers.^{1/} An ABCP program raises cash to provide funding through the ABCP Conduit's issuance of liabilities, usually commercial paper, into the market. A DI that sponsors an ABCP Conduit generally provides liquidity and credit enhancements to the ABCP Conduit, which aids the conduit in obtaining strong external credit ratings that facilitate the issuance of the commercial paper.

^{1/} "ABCP Conduit" as used herein also includes structured investment vehicles ("SIVs") that issue commercial paper and medium-term notes and use the proceeds to purchase investments in highly-rated debt securities. This letter does not address cases where a sponsoring DI sells its own assets to its sponsored ABCP Conduit.

FASB issued FIN 46 in January 2003, and a revised FIN 46 on December 24, 2003.^{2/} FIN 46 generally requires an enterprise that is the “primary beneficiary” of a “variable interest entity” (“VIE”) to consolidate the VIE’s assets and liabilities onto the enterprise’s balance sheet. FIN 46 defines a “primary beneficiary” as “the party that absorbs a majority of the [VIE’s] expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests . . .” FIN 46, Summary at p. 3. “If one enterprise will absorb a majority of a [VIE’s] expected losses and another enterprise will receive a majority of that entity’s expected residual returns, the enterprise absorbing a majority of the losses shall consolidate the [VIE]” FIN 46 at 10 (emphasis added). “Variable interests” are defined as “contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of the entity’s net assets exclusive of variable interests.” FIN 46 at 2. Under FIN 46, a DI that provides liquidity facilities and credit enhancement to an ABCP Conduit would likely be the “primary beneficiary” and thus required to consolidate the ABCP Conduit’s assets and liabilities onto the DI’s balance sheet. FIN 46 has thus brought many of the liabilities of DI-sponsored ABCP Conduits on balance sheet for the purposes of those regulatory reports that are tied to GAAP, such as the “Call Report” (Form FFIEC 031, “Consolidated Reports of Condition and Income for a Bank with Domestic and Foreign Offices,” and Form FFIEC 041, “Consolidated Reports of Condition and Income for a Bank with Domestic Offices Only”).

Regulation D (“Reserve Requirements of Depository Institutions,” 12 CFR Part 204) implements Section 19 of the Federal Reserve Act (the “Act”) (12 U.S.C. § 461), which imposes reserve requirements on certain liabilities of DIs: “transaction accounts,” “nonpersonal time deposits,” and “Eurocurrency liabilities.”^{3/} Transaction accounts (primarily “demand deposits” and “NOW accounts”) are subject to a reserve requirement ratio of up to ten percent, while “nonpersonal time deposits” and “Eurocurrency liabilities” are subject to a reserve requirement ratio of zero percent. In addition, Regulation Q (“Prohibition Against Payment of Interest on Demand Deposits,” 12 CFR Part 217), which implements Section 19(i) of the Act, prohibits the payment of interest on “demand deposits” as defined in Regulation D.

Regulation D also requires DIs to file reports of deposits for the purpose of administering the regulation. The primary report of deposits is Form FR 2900, “Report of Transaction Accounts, Other Deposits and Vault Cash” (the “FR 2900”). In certain circumstances, a DI must file a “consolidated” FR 2900 that reports not only the deposits of the DI itself, but also includes certain specified liabilities of the DI’s “affiliates” as well. As was the case before the implementation of FIN 46, an ABCP Conduit as described in your letters is not deemed an “affiliate” of its sponsoring depository institution under existing Regulation D definitions, and therefore its liabilities would not be subject to the “affiliate” consolidation requirements for purposes of the report of deposits.

The general definition of “deposit” in Regulation D is “the unpaid balance of money or its equivalent received or held by a [DI] in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to an account,

^{2/} “FIN 46” as used herein refers to the December 2003 revision.

^{3/} “Transaction accounts” and “nonpersonal time deposits” are subcategories of the general definition of “deposit.”

including interest credited or which is evidenced by an instrument on which the [DI] is primarily liable.” 12 CFR 204.2(a)(1). Regulation D excludes from the definition of “deposit” those liabilities that are “conditional” or “contingent,” and those liabilities “the proceeds of which are not used by the [DI] for purposes of making loans, investments, or maintaining liquid assets such as cash or ‘due from’ [DIs] or other similar purposes.” 12 CFR 204.2(a)(2)(ii)-(iii). As we understand the facts presented, a DI that sponsors an ABCP Conduit does not receive the proceeds of the commercial paper that the ABCP Conduit issues. Rather, those proceeds are received by the ABCP Conduit itself, which is by design contractually isolated from the DI.

Prior Board interpretations and staff opinions about whether a particular DI obligation constitutes a “deposit” under Regulation D focused on the extent to which the DI, having received the proceeds of the obligation, could be required to guarantee or repurchase the obligation out of the DI’s own funds.^{4/} If the holder of the obligation had sufficient recourse against the DI in the event of the insufficiency of the underlying assets, a “deposit” was created.^{5/} As we understand the facts presented, the purchaser of the commercial paper issued by a DI-sponsored ABCP Conduit does not have any direct recourse against the sponsoring DI under either the liquidity facilities or the credit enhancements in the event that the required payments to the purchaser are not made. Rather, the purchaser’s recourse is against the ABCP Conduit itself, which retains its separate corporate character notwithstanding FIN 46 consolidation. Although the purchaser of the ABCP Conduit’s commercial paper presumably knows that the ABCP Conduit has access to the DI’s liquidity facilities and credit enhancements, the commercial paper purchaser does not have any contractual right to obtain access to those facilities or enhancements directly in the event that the ABCP Conduit, for whatever reason, failed to draw upon them to make payments on the commercial paper. In addition, we understand that program documentation to which the commercial paper purchasers are subject expressly provides that the ABCP Conduit commercial paper is not a liability of the sponsoring depository institution. Staff believes that these factors support a determination, under the prior Regulation D Board interpretations and staff opinions, that the commercial paper issued by a DI-sponsored ABCP Conduit is not a “deposit” (or otherwise a reservable liability) of the DI for purposes of Regulation D. Since such commercial paper is not a “deposit” under Regulation D, it is also not a “transaction account” for purposes of Regulation D nor a “demand deposit” for purposes of Regulations D and Q.

^{4/} See, e.g., FRRS ¶2-260.5 (Board Interpretation of June 1, 1970) (mortgage-backed securities issued by member bank and guaranteed by GNMA were not “deposits” because the security holder had no right to require the bank to make payments on the securities out of the bank’s own funds); FRRS ¶2-260.57 (Board Interpretation of July 1, 1988) (DI’s short-term loan participation arrangements were “deposits” because the DI selling the loan or participation was in effect required to buy it back at the option of the purchaser).

^{5/} See, e.g., FRRS ¶2-324.1 (Staff Opinion of May 27, 1971) (participation in a pool of assets was not a “deposit” as long as purchaser relied on underlying assets for payments of interest and principal; “deposit” resulted if purchaser could require the bank to repurchase the purchaser’s participation); FRRS ¶2-325.14 (Staff Opinion of June 23, 1983) (member bank’s sale of bonds subject to put option was a “deposit,” also “deposit” if sale with letter of credit upon which bond purchasers could draw in the event of bond issuer default).

Board staff is mindful of the potential for using Regulation D interpretations and opinions to create arrangements not contemplated by the original interpretation or opinion and whose sole purpose is to evade reserve requirements and/or the prohibition against payment of interest on demand deposits. Board staff notes that this staff opinion is not intended to serve as a basis for regulatory evasion arrangements not otherwise related to legitimate market developments or financial innovations. This opinion is based on the facts and representations you have provided, and any material change in these facts or representations could result in a different conclusion. This opinion also is a staff opinion only, as the matter has not been presented to the Board for its determination.

Sincerely,

/s/

Stephanie Martin
Associate General Counsel

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