

CONSOLIDATION OF COMMERCIAL PAPER CONDUITS

Objective

The objective of this paper is to discuss the application of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46(R)), by sponsors of commercial paper conduits, particularly as impacted by market conditions that currently exist in many segments of the credit markets, including illiquid (or less liquid) conditions in the commercial paper markets. The paper articulates existing requirements of generally accepted accounting principles (GAAP) related to the specific issues discussed, with the intention of helping preparers and auditors understand the application of existing GAAP consolidation principles in the context of illiquid market conditions.

This paper summarizes the (1) basic structures and risks of commercial paper conduits and (2) application of FIN 46(R) by their sponsors. This paper is not meant to be a comprehensive review of all considerations affecting the accounting for commercial paper conduits. A sponsor's accounting for its commercial paper conduit should be determined only after the conduit's specific terms and arrangements are fully understood and evaluated.

There are a variety of asset-backed commercial paper (ABCP) programs, including: multiseller, single seller, and arbitrage (including credit and market). Although the concepts in this paper apply to all types of conduits, this paper describes only one type—multiseller conduits—as a means to illustrate application of the concepts discussed below.

Background

ABCP programs provide cost-effective funding to a sponsoring bank's customers. They allow receivable sellers that otherwise cannot directly access the commercial paper market to finance their receivables at favorable rates. Even sellers that are able to access the commercial paper markets participate in ABCP programs because they provide alternative sources of funding and the seller generally remains anonymous in a multi-seller conduit; investors are protected through various program enhancements built into the structure of ABCP programs.

A bank also benefits from ABCP programs. Instead of lending to its customers through its own balance sheet, the bank is able to refer its customer to the ABCP conduit, avoiding higher regulatory capital charges. A bank earns fees for the services it provides to its customers and the ABCP conduit.

An ABCP program functions similar to a term securitization. Each seller transfers receivables to the conduit, which is typically a variable interest entity (VIE), usually in a two-step transfer. (The accounting for the transfer is outside the scope of this paper.) The seller receives cash at a discount to the receivables' face values in order to provide credit support to the conduit and to cover payment of the conduit's funding costs. Each seller is provided a facility limit and term. Many ABCP programs are revolving in nature. For example, interests in new receivables or other financial assets meeting pre-determined eligibility criteria can be sold to the conduit when

previously transferred interests are repaid by their related obligors. Other ABCP programs involve static amortizing pools of assets.

Risks in an ABCP Program

Among the risks in an ABCP program are credit risk, liquidity risk, and basis risk. Credit risk refers to the chance that the receivable will not be collected. Liquidity risk occurs because there is a chance that the conduit will be unable to repay its maturing commercial paper by issuing new commercial paper (conduit commercial paper usually has a shorter average term to maturity than its receivables). Basis risk occurs because of the difference in interest or currency rates between the ABCP program's assets and its liabilities.¹ Conduits typically are not designed to create and pass along interest rate risk (although there may be circumstances in which an analysis under FASB Staff Position No. FIN 46(R)-6, *Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R)* (FSP FIN 46(R)-6), indicates that interest rate variability should be considered).

Credit risk is typically absorbed through a combination of (1) individual sellers through their overcollateralization (that is, each seller was paid a discount from the face amount of transferred receivables) and (2) a highly-rated bank (which may be the sponsor), which provides a program-wide letter of credit to absorb a specified amount of conduit losses. The highly-rated bank, which generally has a rating no less than that of the commercial paper, receives a fee for its service.

Rating agencies typically require ABCP programs to have liquidity facilities in order to receive the highest available credit rating on the commercial paper. The liquidity facility provides a source of financing to the ABCP program if the conduit cannot issue new commercial paper due to defined market disruptions. The liquidity facility may take the form of (1) a liquidity loan program, in which the provider makes a loan to the ABCP program, which is collateralized by its assets, or (2) an asset purchase agreement, in which the provider purchases the ABCP program's assets. The sponsoring bank typically provides the program-wide credit enhancement, serves as the conduit administrator, and may also be a liquidity provider.² In exchange, the sponsoring bank typically receives fees for providing such services. The aggregate fees paid for credit enhancement, administrative services and liquidity facilities will often equal the net earnings of the conduit. Liquidity facilities can generally be drawn upon only to the extent the conduit has "good assets" (as that term is defined in the program's legal documents) at the time of the draw.

¹ Basis risk is typically addressed through the use of hedges, which are typically entered into with the sponsor. The hedges may consist of both interest rate and currency swap agreements. Such arrangements should be evaluated under the provisions of FASB Staff Position No. FIN 46(R)-6, *Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R)*; however, this paper is intended to highlight how current market conditions related to credit risk and liquidity risk should be considered in the FIN 46(R) analysis and does not focus on differences in interest or currency rates between the ABCP program's assets and its liabilities.

² In many instances the sponsoring bank is one of several liquidity providers to the conduit.

Accounting by Sponsors of ABCP Programs

As noted above, ABCP conduits are generally VIEs as defined in FIN 46(R), because their equity investment at risk usually is non-substantive (that is, nominal) and the holders of the equity investment at risk usually lack the ability to make substantive decisions affecting the success of the conduit.

Pursuant to the guidance in FSP FIN 46(R)-6, sponsors of commercial paper conduits must study the design of the conduit and ascertain both (a) which risks reside in the conduit and (b) the purpose for which the entity was created. Once the sponsor has done so, it is possible to determine the variability that the conduit is designed to create and pass along. The interests in the conduit that absorb variability that the conduit is designed to create and pass along are considered variable interests. FIN 46(R) requires that all cash flows related to interests that are variable interests be excluded from the computation of expected losses.

As previously mentioned, conduits are typically not designed to create and pass along interest rate variability. Thus, variability associated with changes in benchmark interest rates is not typically considered in modeling conduit cash flows that will form the basis of a FIN 46(R) expected loss calculation. Depending on the individual facts and circumstances surrounding a conduit, basis risk may or may not be considered variability that the conduit is designed to create and pass along to its variable interest holders.

Sponsors of commercial paper conduits generally develop models to determine which party's variable interests (if any) will absorb a majority of a commercial paper conduit's expected losses (or expected residual returns if no party absorbs a majority of the conduit's expected losses). That party is deemed the primary beneficiary of the conduit and, thus, is required to consolidate the commercial paper conduit. The models developed by conduit sponsors project conduit cash flows that would be generated by those assets (and in some instances liabilities) that have been identified as creators of variability. Projections of cash flows are made for multiple scenarios. Each scenario is then probability weighted with the resulting probability-weighted, scenario-specific cash flows being discounted to derive the present value of the cash flows associated with each scenario. The sum of these probability-weighted, scenario-specific discounted cash flows represents the expected outcome of the cash flows associated with a conduit's creators of variability.

Paragraph 2(b) of FIN 46(R) states in part that "*Expected losses and expected residual returns* refer to amounts derived from expected cash flows as described in FASB Concepts Statement No. 7...Paragraph 8 specifies which amounts are to be considered in determining expected losses and expected residual returns of a variable interest entity." Paragraph 8 of FIN 46(R) states:

A variable interest entity's expected losses are the expected negative variability in the *fair value* of its net assets exclusive of variable interests. A variable interest entity's expected residual returns are the expected positive variability in the *fair value* of its net assets exclusive of variable interests. Expected variability in the *fair value* of the net assets includes expected variability from the operating results of the entity. [Emphasis added.]

Paragraph 2 of FSP FIN 46(R)-6 states

The variability that is considered in applying Interpretation 46(R) affects the determination of (a) whether the entity is a variable interest entity (VIE), (b) which interests are variable interests in the entity, and (c) which party, if any, is the primary beneficiary of the VIE. *That variability will affect any calculation of expected losses and expected residual returns, if such a calculation is necessary.* [Emphasis added, footnote omitted.]

FSP FIN 46(R)-6 requires the variability to be considered in applying FIN 46(R) to be based on an analysis of the design of the entity. Under that approach, some risks that affect the entity may not be deemed to represent risks that, by design, are included in the entity's variability. As a result, the present value of the expected cash flows (expected outcomes) from which a conduit's expected losses and expected residual returns are derived may not *equal* the fair value of its net assets exclusive of variable interests. However, any differences between the fair value of a conduit's net assets exclusive of variable interests (i.e., its creators of variability) and the present value of probability-weighted expected outcomes of the conduit (both at inception of the conduit and upon each reconsideration event) should relate to risk factors (e.g., interest rate risk) that are reflected in fair value, but that are not considered to create variability within the conduit based on its design. The conduit's expected losses equal the probability-weighted negative deviation of each scenario's discounted cash flows from the expected outcome. Conversely, the conduit's expected residual returns equal the probability-weighted positive deviation of each scenario's discounted cash flows from the expected outcome.

"First loss notes" are contractual arrangements designed to absorb the majority of the ABCP conduit variability. First loss notes were issued by many conduits to independent third parties to permit sponsor nonconsolidation of ABCP conduits. (The sponsor typically absorbs conduit variability through its credit support agreements with the conduit, which are provided in exchange for fees from the conduit.) FIN 46(R) requires the conduit's status as a VIE and/or its primary beneficiary to be reevaluated upon the occurrence of certain events. Among others, such events include: a conduit's acquisition of new assets or new risks; a variable interest holder's acquisition or disposition of variable interests; or a combination of these events. A reduction in the conduit's assets coupled with changes in contractual arrangements among variable interest holders (e.g., rollovers of ABCP), may also result in a reconsideration event. Because reconsideration events may occur frequently, sponsors typically should reevaluate their model assumptions periodically to ensure ABCP conduit nonconsolidation remains appropriate.

Recent market events warrant that sponsors carefully evaluate the underlying assumptions used in calculating ABCP conduit expected losses when a reconsideration event occurs or a new structure is contemplated. As part of that reevaluation, sponsors should evaluate whether model assumptions reflect recent observable market data. For example, sponsors may use rating agency data to model projected credit losses. Given the rapid pace of developments in the financial markets over the past few weeks, rating agency data may not provide the most relevant data for the projection of credit losses. Because rating agency data often have a time lag, sponsors should ensure that the assumptions used in their models reflect all available information relevant in modeling future conduit cash flows, including current marketplace conditions. Recent market

events have suggested that some conduit assets may have unrealized losses, as evidenced by widening of credit spreads on both conduit assets and the commercial paper.

Specific facts and circumstances must be considered to identify the most relevant data for any particular consolidation analysis under FIN 46(R). To illustrate the potential impact of these recent observations on model assumptions consider that, under certain scenarios that form the basis for the conduit's expected loss calculation, a conduit may be projected to sell its assets prior to their maturity. In such instances, any potential variability associated with the recognition of previously unrealized losses should be reflected in modeling cash flows associated with the conduit's creators of variability (e.g., credit risk). Similarly, under certain other scenarios that form the basis for the conduit's expected loss calculation, the conduit may be projected to hold its assets through maturity. In such instances, potential variability associated with the markets' higher expectation of uncertainty in the timing and/or amount of cash flows (i.e., higher expectation of default and/or delayed receipt of cash flows as observed through an evaluation of widening credit spreads) should be reflected in modeling cash flows associated with the conduit's creators of variability. It is acknowledged that many factors affect spreads in the market. Sponsors must evaluate the specific facts and circumstances to determine whether and to what extent the widening of spreads is related to market participant assumptions about risks that, by design, are included in the conduit's variability (e.g., higher risk of default).

While some may suggest that the recent marketplace events (for example, spread changes between CP conduit assets and commercial paper) are an anomaly and are not expected to again occur, we do not believe it is reasonable for an ABCP conduit sponsor to dismiss recent events without giving consideration to the potential for their reoccurrence in modeling future ABCP conduit cash flows. That is, all things being equal, we believe recent marketplace events have demonstrated that events previously ascribed a low probability of occurrence may, in fact, occur. As a result, the modeling assumptions used to calculate and allocate expected losses upon either (a) an enterprise's initial involvement with a conduit or (b) a reconsideration event should incorporate a current assessment of the probability of adverse scenarios that previously may have been ascribed zero or low probability.

As previously mentioned, in order to compute and allocate expected losses, conduit cash flows associated with creators of variability must be projected, probability weighted, and discounted to arrive at an expected outcome, which then forms the starting point for the calculation of expected losses and expected residual returns. To this effect, FIN 46(R) requires sponsors' computations at initial involvement with the conduit or upon a reconsideration event to reflect marketplace assumptions in the calculation and allocation of expected losses at the date of that calculation. This requirement to incorporate marketplace assumptions into the conduit's expected loss computation derives from the fact that FIN 46(R) itself describes expected losses and expected residual returns as referring "to amounts **derived** from expected cash flows as described in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*" (FIN 46(R) paragraph 2b, emphasis added).

Admittedly, FIN 46(R) modifies the concepts in CON 7 by focusing only on cash flows associated with "creators of variability." Additionally, in practice variable interest holders often use techniques such as a Monte Carlo simulation in lieu of a pure CON 7 calculation. A Monte

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Carlo approach at times considers hundreds of thousands of scenarios based on the primary factors that impact the cash flows and variability of the entity. Despite these differences, realizing that (1) the concepts expressed in FIN 46(R) were derived from CON 7, and (2) paragraph 8 of FIN 46(R) indicates a VIE's expected losses are the expected negative variability in the *fair value* of its net assets exclusive of variable interests, the guidance contained in CON 7 and FAS 157 regarding the use of marketplace participant assumptions in computing expected cash flows or fair value is relevant when computing both (a) a VIE's expected losses and (b) a variable interest holder's exposure to such expected losses.

To that effect, although CON 7 acknowledges that an entity may include its own information and assumptions in the computation of expected cash flows, paragraph 38 qualifies the use of entity specific information and assumptions by stating (in part):

The use of an entity's own assumptions about future cash flows is compatible with an estimate of fair value, as long as there are no contrary data indicating that marketplace participants would use different assumptions. If such data exist, the entity must adjust its assumptions to incorporate that market information.

Similarly, paragraph 7 of a FASB Statement No. 157, *Fair Value Measurements*, defines the objective of a fair value measurement as:

... The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price).

Accordingly, although a sponsoring bank may believe that the market is not properly valuing certain assets (or creators of variability), through operation of FIN 46(R)'s expected loss methodology (and methodology's derivation from CON 7), a sponsoring bank is required to use market assumptions of default at the date of the reconsideration event (i.e., the effective date of the expected loss calculation) – even if the sponsoring bank believes its own differing assumptions are correct.

Updating the assumptions used in modeling expected losses at a reconsideration date may lead to the conclusion that a majority of ABCP conduit expected losses are no longer absorbed by independent third parties. To the extent that the sponsor determines that it is absorbing a majority of the ABCP's expected losses, the sponsor would be required to consolidate the ABCP conduit unless and until further actions have been taken by the sponsor to reduce its absorption to a point where the sponsor is no longer absorbing a majority of the conduit's expected losses (or expected residual returns if no party absorbs a majority of the conduit's expected losses).

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Finally, some have noted that for a variety of reasons, a sponsor may take actions beyond those contractually committed to in order to support ABCP conduits. Any such action should be carefully evaluated in applying FIN 46(R)'s provisions.³

³ Actions taken by a sponsor beyond those that it is contractually committed to in order to support an ABCP conduit should be evaluated under the guidance in FASB Staff Position No. FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003)*, which discusses factors to consider in determining whether an implicit variable interest exists. Those factors include, but are not limited to whether there is an economic incentive for the reporting enterprise to act as a guarantor or to make funds available, whether such actions have happened in similar situations in the past, and whether the reporting enterprise acting as a guarantor or making funds available would be considered a conflict of interest or illegal.