

UNDERSTANDING ASSET BACKED COMMERCIAL PAPER STRUCTURES

The functioning of the asset-backed commercial paper (ABCP) market was severely disrupted during the recent market turmoil. This market lies at the crossroads between the cash money market and the structured credit markets. From a bank's perspective, ABCP programmes create a means of removing assets, which have a risk-weighted capital requirement, from their balance sheet while retaining some economic interest through income generation from the management of the special purpose vehicle (SPV) which issues the securities.¹ ABCP programmes typically involve the setting up of a funding structure to issue the commercial paper (CP). This box provides an overview of some of the ABCP structures which exist, and it outlines some of the vulnerabilities that became more evident with the various types of structure during the recent disturbances.

There are a variety of ABCP structures and, from a financial stability perspective, the most important differences between structures relate to the type of collateral, the liability structure and the amount of third party liquidity/credit enhancement required (see Figure A). At one end of the spectrum, there are traditional cash-flow structures such as ABCP conduit issues with close to complete liquidity support, credit enhancement, short-term funding and no

¹ This is the case when regulatory capital rules allow the entity to remain off-balance sheet.

marking-to-market of assets. At the other end are structured investment vehicles (SIVs) and SIV-lites which issue paper which depends primarily on the market value of assets for both liquidity and credit enhancement and consequently mark their assets to market.

Traditional ABCP conduits may invest in a broad variety of assets including both structured finance securities and other assets, such as trade receivables and commercial loans, thereby diversifying the collateral portfolio. Credit arbitrage structures are set up for banks and other institutions to invest in highly rated securities – usually but not exclusively structured finance securities – to earn a spread through higher expected returns on the assets than the funding cost of the liabilities.² Overall, the portfolio composition of SIVs is quite similar to credit arbitrage with one important difference: SIVs tend to invest much more in financial institution debt, including banks' senior and subordinated notes and hybrid capital instruments. Finally, SIV-lites have tended to have a high concentration of residential mortgage-backed securities (RMBSs), including those backed by US sub-prime mortgages, with only a small portion of their collateral diversified into other assets such as collateralised debt obligations (CDOs) and commercial mortgage-backed securities (CMBSs).

The recent market upheaval vividly illustrated the nature of the funding liabilities of these vehicles and it drew attention to the maturity mismatches between assets and liabilities in the structures as well as the fact that some of these structures did not have their own equity capital. To some extent, all of the ABCP structures have a maturity mismatch. Traditional ABCP conduits funded themselves solely in the CP market, usually with short-term issues, exposing them to liquidity risks in the event of disruption in the functioning of the short end of the CP market. Credit arbitrage conduits tend to have a similar funding profile. By contrast, SIVs fund their own capital base through the issuance of capital notes as well as senior and junior medium term notes (MTNs). Therefore, they have slightly different funding structures as they can issue both CPs and MTNs, the maturity of which is typically longer than one year. SIV-lites typically had a similar funding structure except that CPs were the most important funding source, followed by MTNs. Traditional ABCP conduits are not capitalised as they depend totally on liquidity provision to solve any funding problems. Market value structures have their own capital. For example, SIV-lites had taken on more leverage in terms of their investment assets (sub-prime RMBSs and CDOs) as well as having slightly less capital (5-7%) compared with SIVs (7-9%).³ SIV-lite structures and some SIVs have built-in features – including weighted average life (WAL) targets for their liabilities and market value tests – that could prevent new issuance of ABCPs or even lead to an orderly deleveraging of some collateral to provide liquidity.

Problems in assessing the vehicle's collateral default risk and an attendant evaporation of investor confidence in the collateral backing the outstanding commercial paper prevented fresh issuance of ABCPs. In the case of traditional conduits, this required liquidity support. This is available in several forms, such as credit lines, letters of credit, cash-reserve accounts or swaps, and is usually provided by the sponsor of the vehicle which is often a bank with a high credit rating. As can be seen in Figure, back-up funding from credit lines becomes progressively less prominent as the structure moves towards a market value structure. In these partially funded structures, sponsoring banks have used other methods to mitigate liquidity risk, such as extending the maturity profile of the ABCPs outstanding by exercising options to extend the

² The term securities arbitrage is also used in industry reports on the topic. However, securities arbitrage vehicles can also refer to a broader range of programmes including market value structures that invest in any rated security.

³ See Bear Stearns (2007), "Asset-Backed Commercial Paper (ABCP) Conduits and SIVs: What are the issues?", August.

papers' maturity date. For SIVs and SIV-lites, liquidity line availability was limited as they are structured to have much lower requirements for liquidity from sponsoring banks. Instead, these vehicles were forced to sell highly rated assets such as credit card and car loan ABSs in order to fund maturing liabilities before embarking on more widespread asset sales, or the winding-down or restructuring of some of these types of instruments.

Overall, the impact of the 2007 market turmoil has affected these conduits in differing ways. In some cases, traditional conduits were provided with funding by the sponsoring bank or a syndicate of banks or in some instances taken back onto the sponsoring bank's balance sheet. However, it is an open question how long some sponsoring banks will support some of these programmes if the deterioration in funding conditions persists and alters the economic benefit of the programmes. Credit arbitrage conduits also drew on liquidity facilities, especially if they were bank-sponsored conduit programmes, which alleviated their difficulties to some extent. SIVs have longer funding maturity profiles but they too will have to refinance their MTN debt at some stage in the coming months and will face increased funding costs when doing so. Some SIVs had already faced funding difficulties in late August.⁴ Finally, SIV-lites appeared to have large concentrations of single types of structured finance asset, some of which were sub-prime assets. These were among the first types of structures to be affected, and they could only draw on very limited liquidity, which proved to be crucial during the turmoil, leading to downgrades and, in some cases, defaults. Overall, the full impact of the market turmoil has yet to work its way fully through the various types of structures in the ABCP market.

4 Cheyne Finance triggered an enforcement event on 28 August 2007.

Figure ABCP Structures

Name	Structure	Underlying assets	Funding of liabilities	Liquidity
SIV-Lites/SIV CDOs	<i>Market value structures</i>	RMBSs, small amount of CDOs/CMBSs	Senior debt – Usually CPs, MTNs and repos; Junior debt	Liquidity through market value of assets
SIV		Financial institution debt and ABSs including CDOs/CLOs, RMBSs/CMBSs, credit card receivables.	Junior debt Unrated/Rated capital notes	Market value swaps with counterparties
Credit arbitrage			Senior debt – MTNs usually, then CP market Junior debt Unrated/Rated capital notes	
		ABSs including CDOs/CLOs, mortgage-backed, commercial mortgages, credit card receivables.	Short-term in CP market	Extendible ABCPs
ABCP conduits	<i>Cash-flow structures</i>	Includes assets under repos, trade receivables, structured finance securities, commercial loans, residential mortgages, car loans, credit card receivables.	Short-term in CP market	Bank liquidity loans or liquidity asset purchase agreements for performing assets

Source: ECB.