

The Fundamentals of Asset-Backed Commercial Paper

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OVERVIEW

This report provides the reader with a comprehensive introduction to asset-backed commercial paper (ABCP) programs. It focuses on the basic ABCP structures, the risks and mitigants found in these structures, and typical assets purchased or financed by these structures. It is a significant update to and revision of the 1993 Moody's article entitled "ABCP: Understanding the Risks." We have extended the contents of that article with information about new developments in ABCP programs driven both by market factors and regulatory pressures. We have also added a discussion of the ABCP investor base. An initial Executive Summary provides a concise overview of the article and may be read separately from the rest of the paper.

Moody's publishes information on each rated ABCP conduit on a quarterly basis as well as articles of interest to market participants in [Moody's Global Asset Backed Commercial Paper Market Review](#). All publications may also be found on the www.moodys.com website.



NOTE TO THE READER

"The Fundamentals of Asset Backed Commercial Paper" is intended to be a comprehensive introduction to the ABCP market. It covers essentially the same material that Moody's presents in its half-day seminar, "The ABCs of ABCP," which has become a popular annual event in New York and London.

Those new to ABCP may wish to read this publication in its entirety. The *Executive Summary* provides a seven-page overview of the material that may be read either as an end in itself or to orient the reader before starting the body of the document.

Those with experience in ABCP may simply wish to review a particular topic. The *Table of Contents* provides a guide to the structure of the document. The *Index* provides quick access to specific items. The annotated *Bibliography* provides references for in depth coverage of particular subjects. An updated *Glossary* includes most of the terms in common use by ABCP market participants.

Conventions Used in the Text

This document focuses primarily on general-purpose multiseller conduits. There are a number of different types of ABCP programs used to fund a wide variety of assets. These programs comprise approximately 60% of the ABCP market. Unless otherwise stated, the discussion in the text refers to a typical ABCP conduit of this type. Other conduit types are discussed in more detail in other special comments, referenced in footnotes, and in the bibliography. Each conduit that Moody's rates likely differs from this general description in some detail. Readers should refer to the report, updated quarterly, in *Moody's Global Asset-Backed Commercial Paper Market Review*, or on Moody's web site, www.moody.com, for details on a specific program.

The discussion in the text generally assumes Prime-1-rated ABCP. The ABCP market is almost entirely rated **Prime-1**. There are a few programs that issue **Prime-2** paper, but they are not a significant factor in the market.

Capitalized terms may be found in the Glossary. They are defined at least once in the text, but that definition may not be found easily.

Acknowledgement

This Special Comment is a major revision of Moody's 1993 Special Comment, Asset-Backed Commercial Paper: Understanding the Risks. We wish to acknowledge our debt to this earlier work, much of which has been incorporated in this update. We also wish to acknowledge Claire Robinson, Senior Vice President at Moody's, for her many suggestions and editing help.

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EXECUTIVE SUMMARY

Asset-backed commercial paper (ABCP) is a form of senior secured, short-term borrowing, in contrast to corporate commercial paper, which is senior unsecured short-term corporate debt. Asset-backed commercial paper programs offer low-cost financing to companies that could not otherwise directly borrow in the commercial paper markets .

GROWTH OF THE ABCP MARKET

ABCP programs first appeared in the mid-1980s. Initially, ABCP conduits were primarily sponsored by major commercial banks as a means of providing trade receivable financing to their corporate customers. Over the past decade ABCP programs have grown to serve a wide variety of needs such as: asset-based financing for companies that cannot access the term market, warehousing assets prior to term securities issuance, investing in rated securities for arbitrage profit, providing leverage to mutual funds, and off-balance sheet funding of selected assets. In general, any asset class that has been funded in the term market has been funded in a conduit, and there are a wide variety of assets that are unique to the conduit market (See Sidebar: Growth of the ABCP Market).

ABCP programs issue commercial paper as their primary liability. However, some have diversified their funding sources to include other types of debt. Some ABCP programs issue extendible commercial paper, medium-term notes (MTNs), and, in some cases, subordinated debt to provide credit enhancement. Moody's expects this diversification to continue as the market grows in size and sophistication.

THE MEANING OF A PRIME-1 RATING

Moody's short-term ratings are based solely on the risk of default, which is the failure to make full and timely payment. Failure to repay in full, even by a small amount, is considered a default. A delay in repayment, even by a few days, is considered a default. For a corporation, a **Prime-1** short-term rating may be consistent with a long-term debt rating from **Aaa** to **A2**, and, for some financial firms, **A3**.¹

Moody's long-term ratings are based on expected loss, and include a consideration of the recoveries likely to be received by investors in the event of a default, as well as on the likelihood of default itself. A few ABCP programs that issue MTNs have long-term ratings—typically **Aaa**. However, the majority of ABCP programs carry only a **Prime-1** short-term rating. There are a few ABCP programs with **Prime-2** short-term ratings, but these are not a significant factor in the ABCP market.

ABCP programs may purchase or fund assets that carry Moody's short- or long-term ratings. However, many of the assets included in ABCP conduit portfolios do not carry explicit Moody's ratings. Moody's **Prime-1** rating on an ABCP program refers only to the commercial paper notes issued by the ABCP program, not to any of the individual transactions funded by the program. In assigning or confirming the rating of an ABCP program, Moody's reviews the credit quality of each transaction in the context of the program as a whole. A transaction funded by an ABCP program does not have an implicit **Prime-1** rating or an implicit term rating: it is unrated unless explicitly rated by Moody's.²

CATEGORIZING RISK IN ABCP PROGRAMS

For the investor, ABCP is a high-quality security typically backed by diversified assets. The **Prime-1** rating of an ABCP program expresses Moody's opinion of the probability that investors will receive full and timely repayment. The **Prime-1** rating is based primarily on an assessment of four risks associated with ABCP programs: structural, credit, liquidity and operational.

Structural risk is the danger that an ABCP program becomes entangled in a bankruptcy or similar proceeding. An ABCP program is essentially a limited purpose specialty finance company structured to minimize the risk of insolvency. A special purpose trust or corporation (SPC) is set up by a legal owner under the direction of a sponsor (typically a major commercial bank). The SPC, for accounting and regulatory reasons, is generally not owned by the sponsoring bank. The SPC has no employees, and its purposes are limited

¹ See Sidebar 1: *Moody's Short Term Rating Definitions* on page 12, and Sidebar 2: *Short-Term Ratings, Long-Term Ratings and ABCP* on page 14 for more details about Moody's rating categories.

² See Sidebar 4: *What Does an ABCP Conduit Prime-1 Rating Cover?* on page 18 for a discussion of this issue.

to acquiring and funding assets. All counterparties that deal with the SPC agree to non-petition and other language designed to limit the risk of bankruptcy.

Credit risk is the likelihood that the assets financed through the program will suffer credit-related losses. The rating of a partially-supported ABCP program depends on the performance of the program's assets. It also depends on the amount of credit support and credit strength of the counterparties providing credit, liquidity, hedging or other forms of support. The rating of a fully-supported ABCP program is directly linked to the credit strength of the guarantor.

Liquidity risk arises from the timing mismatch between cash flow from the assets held by ABCP programs and funds needed to make payments on maturing ABCP. ABCP programs typically have liquidity backup facilities equal to the amount of ABCP outstanding. These facilities are usually provided by **Prime-1**-rated banks, primarily through liquidity back-up loan or purchase commitments, but also through letters of credit, cash collateral accounts, swaps or similar facilities. The cost of liquidity facilities has been rising over time in recognition of the associated credit risk and increased regulatory scrutiny of banks' contingent liabilities. The increased cost of bank liquidity has led conduit managers to seek ways of reducing the amount of bank liquidity required to maintain a **Prime-1** rating. Non-bank liquidity providers, extendible ABCP, and cash collections from assets and asset sales are just some of the techniques that have been used to reduce the reliance on bank liquidity lines.

Operational risk arises from the need to properly manage the conduit's assets and liabilities on a day-to-day basis, from facilitating the purchase of assets to issuing and repaying ABCP. Operational risk is related largely to the administrator responsible for running the program, most often a **Prime-1**-rated commercial bank. Typically the sponsor of the conduit is also the administrator, and may also act as the liquidity agent, lead liquidity bank, credit enhancement provider and hedge counterparty. The assets sold to or financed by the conduit are often originated by companies that are clients of the sponsoring bank under other lending facilities.

FULLY AND PARTIALLY-SUPPORTED ABCP PROGRAMS

ABCP programs can be either fully-supported or partially-supported. A program is fully-supported when ABCP investors are insulated from asset performance deterioration and rely on a third party to ensure timely repayment of ABCP. Typically a single external support facility provides 100% coverage against credit risk and liquidity risk. The support facility absorbs any losses on the assets and provides cash to cover any timing differences with respect to repayment. Moody's analysis of a fully-supported program is based on the financial strength of the support provider, rather than on the quality of the assets. If the rating of the support provider is lowered, the rating of the ABCP program will most likely be lowered.

The rating of partially-supported programs depends on a joint analysis of the quality of the assets and the credit strength of the support facilities. The underlying asset is generally structured with some form of first-loss credit enhancement—usually overcollateralization—similar to a term asset-backed transaction. In fact, many assets in conduits come from the same master trusts as existing term deals and are identically structured. In the conduit, the asset further benefits from a liquidity facility that often absorbs some forms of credit risk and a program-wide credit enhancement facility that is increased by an amount equal to 5% to 10% of each transaction.

LIQUIDITY SUPPORT IN ABCP PROGRAMS

ABCP programs are often used to fund long-term assets, such as auto loans or corporate loans. Even when funding short-term assets such as trade receivables, ABCP programs still face the inherent timing mismatch between cash received on the assets and cash needed to repay maturing ABCP. Most maturing ABCP is repaid with the proceeds of newly issued ABCP, a process called "rolling." However, to protect investors in case of a market interruption, ABCP programs typically have liquidity backup lines equal to the face amount of ABCP outstanding. These are usually provided by commercial banks in the form of a loan or purchase agreement. However, some liquidity backup facilities have been provided by non-bank, highly-rated counterparties that are able to provide funds on a same-day basis. Alternative liquidity sources have

included letters of credit, derivative contracts, and funding commitments from non-bank financial firms, or, rarely, other highly-rated corporations. Liquidity commitments are usually specific to particular transactions in a conduit, though some programs have liquidity facilities that cover a particular group of assets or are available program-wide.

Partial Liquidity

Over the past few years, regulatory scrutiny and increased capital requirements have raised the cost of bank liquidity lines, while bank mergers have contributed to decreased availability. ABCP program sponsors have looked for ways to reduce the amount of liquidity support and still maintain a **Prime-1** rating. Some programs have added the ability to issue longer-term liabilities such as medium term notes. Others have developed “partial liquidity” programs, where backup liquidity is less than 100% of outstanding ABCP.

The gap between maturing ABCP and the size of the liquidity facility may be bridged in a number of ways. First, some assets, such as credit card and trade receivables, have intrinsically high cash flows. Liquidity may be sized to cover the gaps between the ABCP maturity schedule and the expected timing of cash collections from the receivables. Second, some assets, such as highly-rated securities and residential mortgages are highly liquid and can be sold at a price close to par on short notice. The market value risk may be covered by credit enhancement or by a market value swap.

Some programs issue extendible ABCP. Extendible ABCP gives the issuer the option to extend the scheduled maturity of the ABCP for an additional period — usually 90 days — as long as certain conditions are met. Extendible ABCP gives the issuer additional time to marshal the cash flow from portfolio assets or to sell assets in order to repay ABCP at its final maturity date. This structural feature is often associated with fast paying or liquid assets such as credit card receivables, trade receivables, or marketable securities.

Finally, a program may manage its assets and liabilities to minimize the mismatch between cash inflows from its assets and cash outflows to repay maturing ABCP. In this way a program sponsor can minimize the size of the required liquidity facility. This is commonly done with structured investment vehicles, a form of securities arbitrage ABCP program discussed below.

TYPES OF ABCP PROGRAMS

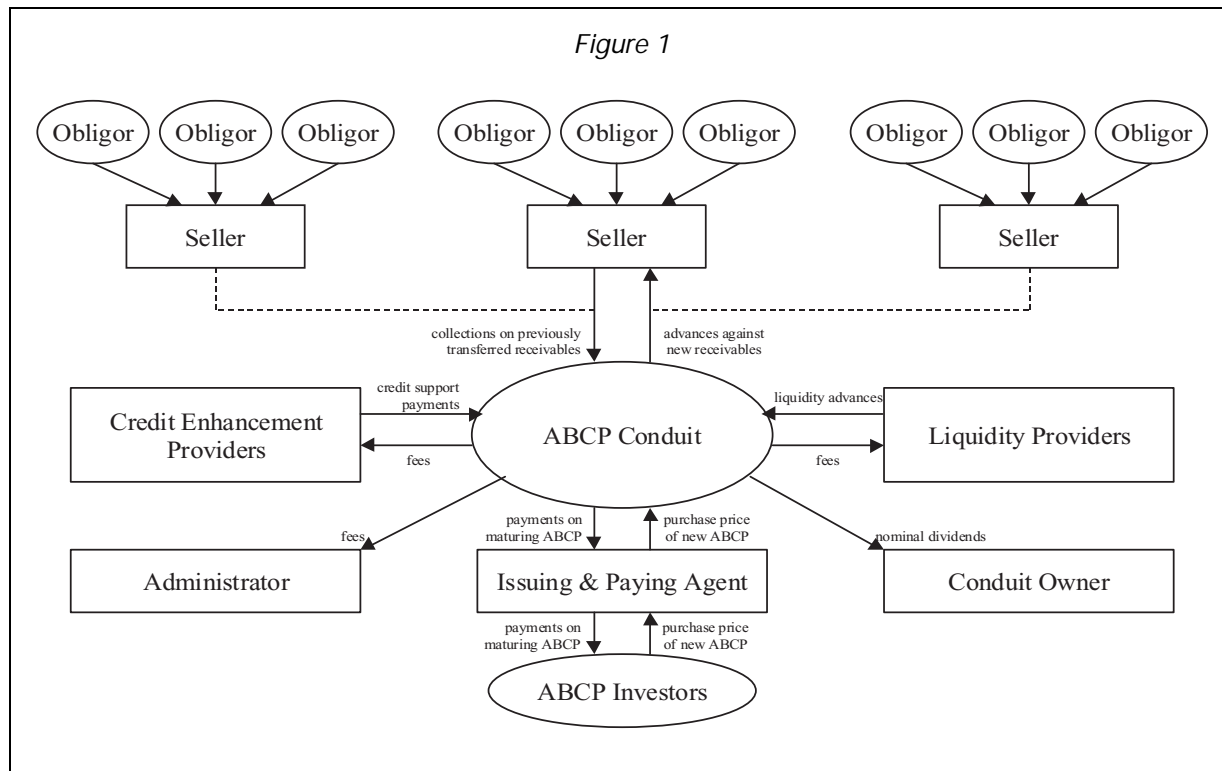
There are five principal types of ABCP program:

- General purpose multiseller
- Credit arbitrage
- Structured investment vehicle (SIV)
- Single-seller
- Loan-backed

Hybrid programs, which combine the features of two or more of these programs, constitute a sixth type. Hybrid programs typically include multiseller, credit arbitrage, and loan-backed features. Information on the number of programs and the ABCP outstanding in each category may be found in Sidebar 5: *The ABCP Market Today*, on page 22.

At present, the largest and most visible ABCP programs are *partially-supported bank-sponsored multiseller programs*. These programs generally provide working capital financing to the sponsoring bank’s corporate clients. The conduit provides financing by purchasing or advancing against receivables generated by corporate clients. However, these programs also fulfill a variety of other financing needs: securities purchases, asset warehousing prior to term transaction execution, unsecured corporate loans with some form of guarantee, and so on. Most assets have first-loss credit enhancement provided by overcollateralization, though others will have reserve accounts, insurance or partial guarantees. Some transactions may be fully-supported. Most transactions have a liquidity facility sized at the maximum purchase commitment plus some additional amount to cover interest on ABCP. These programs also tend to have program-wide credit enhancement in a “second-loss” position, equal to approximately 5% to 10% of the purchase commitment.

Credit arbitrage programs are bank-sponsored programs that invest in securities rated **Aa3** or higher. The programs are similar to a cash flow CDO, but funded with short-term liabilities instead of term debt. They generally have no credit enhancement because the securities are highly-rated and the program administrator must sell the securities or provide credit enhancement if the assets are downgraded. The liquidity facility is sized at the face amount of ABCP outstanding and purchases assets at book value, implicitly protecting investors from market value risk. These programs exist largely because the initial BIS regulatory capital regulations for commercial banks do not distinguish between highly-rated and lower-rated securities. By funding off-balance sheet, banks obtain regulatory capital relief. The program also serves to diversify the bank's sources of financing.



Structured investment vehicles (SIVs), another form of securities arbitrage program, are almost as old as multiseller programs. SIVs issue **Prime-1**-rated ABCP, but also issue **Aaa**-rated MTNs typically provide one-half to two-thirds of the SIV's funding. The proceeds are invested in highly-rated securities with an average credit quality of **Aa** or higher. Investors are protected by significant credit enhancement, typically 6% to 10% in the form of subordinated capital notes. A partial liquidity facility supports timely repayment, and is sized based on an analysis of cash inflows and outflows over a one-year time horizon. SIVs operate on a market-value basis. They are similar to market-value CDOs in that they must maintain a dynamic over-collateralization ratio determined by an analysis of the potential price volatility in the portfolio. SIVs are monitored on a daily basis, and must meet strict liquidity, capitalization, leverage and concentration guidelines.

Single-seller programs are generally set up to fund the assets originated by a single corporation. There are a number of reasons that a company might choose to establish its own ABCP program instead of participating in a multiseller conduit. Some companies desire more control over the management of ABCP issuance. Others may find cost advantages or more advantageous accounting or tax treatment. In evaluating these programs, Moody's reviews the business reasons for the program as well as the various credit risks enumerated above. A single-seller program should have a sound business purpose and committed support at a high level in the sponsoring corporation. Moody's also reviews the program with the corporate analyst responsible for the firm's rating.

Loan-backed programs were a more significant part of the market in the early and mid-1990s than they are today. They are bank-sponsored programs and fund direct loans to the bank's corporate customers. These loans are generally closely managed by the bank, and have a variety of covenants designed to reduce credit risk. Historically, the credit performance of these short-term loans has been quite good, even though most of the borrowers are unrated or rated non-investment grade. However, given the typical borrower profile, these programs are heavily enhanced in order to receive a **Prime-1** rating. Several sponsoring banks have closed their programs in the past year due to regulatory and accounting changes, and Moody's expects these programs to largely disappear.

MOODY'S RATING PROCESS

Conduits are usually rated in two steps. First, Moody's assigns a rating to the conduit structure. Then, Moody's confirms the conduit's rating as transactions are added to the conduit's portfolio. This process reflects the fact that conduits are revolving structures with a changing portfolio of funding commitments as new deals are added and old deals pay down.

Initial Program Rating Assignment

The initial rating assignment focuses on the conduit sponsor and the business purpose of the program, on the legal structure of the program, on the documentation that specifies the duties of the various support parties, on the type of assets to be funded, on the support facilities needed to maintain the desired rating, and on the capability of the program administrator. The financial strength of the sponsor and the sponsor's commitment to the capital markets are important qualitative considerations. The sponsor is typically also the program administrator. Because of the administrator's central role in overseeing the proper functioning of the program, Moody's generally conducts an operations review at the administrator's offices to see first hand how the program will be managed. Moody's concerns include origination and underwriting of assets, procedures for issuing and repaying ABCP, procedures for ensuring compliance with the program documents, and staffing and information systems to support all of these.

Confirming Conduit Purchases

Once the conduit rating is assigned, the administrator identifies and structures transactions to be funded. Moody's typically reviews each transaction in the context of the portfolio of assets funded by the conduit to determine whether the addition is consistent with the conduit's rating. The administrator provides Moody's with its underwriting and credit approval analysis to facilitate this process. The rating analysis of any transaction is very similar to that conducted for a term asset-backed security, and Moody's ABCP analysts often work closely with Moody's term and corporate analysts in this process. As noted above, conduit funding usually means the transaction will benefit from a liquidity facility, program credit enhancement, and supervision by the administrator. Moody's rating analysis incorporates these additional investor protections, if present.

Post-Review Programs

Some conduits are permitted to acquire assets on a "post-review" basis, often subject to specific limits by asset type, transaction size and structural protections. This means the administrator may add a new deal within these limits without Moody's prior review. This is common for programs investing exclusively in rated securities. It is less common for programs funding term and trade receivable transactions. Post-review programs are subject to an ongoing credit monitoring process.

Monitoring ABCP Programs

Moody's rating process is not limited to reviewing new programs and transactions. Moody's receives performance information on each conduit typically on a monthly basis and sometimes more frequently. Moody's monitors transaction and conduit performance as presented in these reports, and maintains regular contact with the administrator to discuss any noteworthy items. Generally a conduit administrator informs Moody's proactively of any anticipated problems, and, if necessary, proposes a remedy to protect investors and maintain the program's rating. Moody's and the administrator meet periodically to review conduit performance and discuss planned changes and additions.

ABCP INVESTORS

ABCP is a high quality short-term investment secured by an interest in a diversified pool of assets. Most ABCP programs are rated **Prime-1**. ABCP is generally issued at a discount at a rate close to the London inter-bank offer rate (LIBOR). Money market funds are major purchasers of ABCP. ABCP has become more attractive to these funds in recent years due to its high quality and increased availability.³

FOR MORE INFORMATION

Moody's currently rates nearly all ABCP programs in the market. Moody's publishes individual reports on the programs that it rates that are updated quarterly. Moody's also publishes special reports that explore credit issues affecting the ABCP market. Investors are invited to call Moody's analysts with any questions concerning ABCP, and to visit Moody's website, www.moodys.com, for further information.

3 See Investors—Who Are They and Why Do They Buy ABCP? on page 56 for more details on money market funds and ABCP.

THE FUNDAMENTALS OF ABCP

The remainder of the special comment revisits the topics in the *Executive Summary* in greater depth. The focus of the presentation is the *general-purpose multiseller ABCP program*. There is some discussion of other types of ABCP programs, but these are better covered in other special comments referenced in the annotated Bibliography.

An *Appendix* presents the issues involved in structuring particular assets for funding by an ABCP conduit. Trade receivables and securities purchased are discussed in some details. The Bibliography contains references to Moody's special comments that discuss other asset types.

WHAT IS AN ABCP PROGRAM?

Commercial paper is a senior unsecured obligation generally issued by a corporation to provide working capital funding. In the 1980's, parallel with the development of the term asset-backed market, commercial banks developed a commercial paper product issued by a special purpose entity and secured in repayment by defined pools of assets. The initial assets were trade and term receivables, and the purpose was to provide working capital funding to the firm selling the receivables. Though still under \$50 billion outstanding as late as 1992, by 2002 the ABCP market has grown to over \$700 billion and now exceeds the amount of corporate CP outstanding. ABCP is used to finance almost every type of asset that has been successfully securitized.

Basic Structure

An ABCP program, also called conduit, is a special purpose vehicle (SPV) established to fund a portfolio of assets through the issuance of commercial paper. An Administrator⁴ is responsible for the overall activities of the conduit: recommending assets, arranging for purchase, issuing and repaying ABCP as needed, monitoring and servicing the assets and so forth. The structure and key players in a typical conduit are discussed below on page 25, Conduit Structure and Support Providers.

Each transaction funded by the conduit is structured similarly to a term securitization: an originator or Seller of the assets sells them to a special purpose vehicle in a true sale. In some cases conduits fund the purchase of rated securities rather than receivables. The purchasing SPV is funded by a loan from the ABCP conduit. The amount of funding depends on the amount of "good"—non-defaulted, non-delinquent—assets available, usually financed at a haircut or percentage of face value to provide credit enhancement. Like a term transaction, the conduit transaction will have certain performance triggers to cause early amortization or otherwise limit investors' exposure to deteriorating assets. Transaction structures are discussed in the Appendix: Asset Purchase Structures on page 61.

Liquidity and Credit Enhancement

The conduit funds the loans it has made by issuing ABCP. Typically, the conduit applies the proceeds of new ABCP issuance to repay maturing ABCP, a process called "rolling" ABCP. This permits the conduit to fund even long-term assets on a continuing basis. To ensure repayment in the event new ABCP cannot be issued, and to guarantee funding to the Seller, each transaction usually has a backup liquidity facility sufficient to cover the Face Amount—principal plus interest to maturity—of ABCP issued to fund the transaction. The liquidity facility may also absorb a variety of risks. The liquidity facility often absorbs risks associated with the bankruptcy of the seller, but not those associated with the obligors on the individual receivables. This means liquidity is generally available in an amount equal to that of non-defaulted assets. Liquidity is discussed below in Liquidity Risk on page 41.

In addition to these protections at the transaction level, the ABCP conduit has certain program-level facilities: credit enhancement, hedging arrangements, and possibly a swing-line of credit for unforeseen expenses. These facilities are available as needed to see that ABCP is repaid on time and in full, regardless of which, if any, transaction may be causing a problem. Credit enhancement is discussed in Credit Risk on page 38, while hedging arrangements are covered in Interest Rate Risk and Foreign Exchange Risk starting on page 45.

Security Law Considerations

In the United States, two major laws govern the issuance of securities and the companies that issue them: the Securities Act of 1933 and the Investment Company Act of 1940. These acts govern registration, disclosure and reporting requirements, among other things.

⁴ Capitalized terms may be found in the Glossary of Terms on page 69.

Moody's Short-Term Rating Definitions

Moody's Short-Term Debt Ratings

Moody's short-term debt ratings are opinions of the ability of issuers to punctually repay senior debt obligations that have an original maturity not exceeding one year. Obligations relying upon support mechanisms such as letters-of-credit and bonds of indemnity are excluded unless explicitly rated. Moody's employs the following three designations, all judged to be investment grade, to indicate the relative repayment ability of rated issuers:

Prime-1

Issuers rated **Prime-1** (or supporting institutions) have a superior ability for repayment of senior short-term debt obligations.

Prime-1 repayment ability will often be evidenced by many of the following characteristics:

- Leading market positions in well-established industries
- High rates of return on funds employed
- Conservative capitalization structure with moderate reliance on debt and ample asset protection
- Broad margins in earnings coverage of fixed financial charges and high internal cash generation
- Well-established access to a range of financial markets and assured sources of alternate liquidity

Prime-2

Issuers rated **Prime-2** (or supporting institutions) have a strong ability for repayment of senior short-term debt obligations. This will normally be evidenced by many of the characteristics cited above but to a lesser degree. Earnings trends and coverage ratios, while sound, may be more subject to variation. Capitalization characteristics, while still appropriate, may be more affected by external conditions. Ample alternate liquidity is maintained.

Prime-3

Issuers rated **Prime-3** (or supporting institutions) have an acceptable ability for repayment of senior short-term obligations. The effect of industry characteristics and market compositions may be more pronounced. Variability in earnings and profitability may result in changes in the level of debt protection measurements and may require relatively high financial leverage. Adequate alternate liquidity is maintained.

Not Prime

Issuers rated **Not Prime** do not fall within any of the Prime rating categories.

ABCP programs are structured to avoid the registration requirements of these acts, both the requirement to register the conduit itself under the Investment Company Act and to register the commercial paper notes under the Securities Act. Registration is expensive and time consuming, and limits the flexibility of the program. In order to qualify for an exemption under either of these laws, the conduit must meet certain restrictions set down in the laws or in rules put forward by the Securities and Exchange Commission (SEC) by its authority under the law.

The most important restriction has to do with limiting the sale of commercial paper to investors with certain qualifications, “qualified purchasers” as defined in Section 3(c)(7) of the Investment Company Act and “Qualified Institutional Buyers” or QIBs as defined by Rule 144a under the Securities Act.⁵ Investors who qualify under these rules tend to be more sophisticated than individual investors. They are typically corporations, institutions, investment funds or wealthy individuals with substantial capital or funds to invest.

Money market funds comprise the largest single class of investors in ABCP.⁶ These funds are governed by the Investment Company Act of 1940. ABCP programs will structure themselves and limit the assets funded so that the commercial paper qualifies for purchase by money market funds under Rule 2a-7. This rule has implications for disclosure by conduits. ABCP programs typically do not disclose the names of the Sellers of the assets funded by the program. Under Rule 2a-7 a conduit must disclose any asset that comprises 10% or more of the total investments made by the conduit. Typically ABCP programs will diversify their assets so they are not affected by this requirement.

Finally, the Employee Retirement Income Security Act of 1974 (ERISA) places restrictions on investments purchased by “employee benefit plans” as defined in the act. In order to avoid these burdens, ABCP programs typically require that the commercial paper notes not be sold to employee benefit plans.

⁵ Rule 144a covers U.S.-based investors. Non-U.S. investors are governed by Regulation S.

⁶ See Investors—Who Are They and Why Do They Buy ABCP? on page 56 for more information on money market fund investment in ABCP.

Sidebar 2

Short-Term Ratings, Long-Term Ratings and ABCP

Moody's long-term ratings and short-term ratings measure credit quality in different ways. A long-term rating is based on the expected loss to investors. It includes consideration both of the likelihood that the rated asset will default and of the recoveries in the event of default. A short-term rating is based purely on the likelihood of default, ignoring eventual recoveries. Short-term investors typically have need of their cash on the maturity date of the asset, and Moody's short-term ratings reflect this concern. Long-term investors are generally less sensitive to timing and more sensitive to the total return of the asset.

	Long-Term	Short-Term
Investment-Grade	Aaa	Prime-1
	Aa1	
	Aa2	
	Aa3	Prime-2
	A1	
	A2	
	A3	Prime-3
	Baa1	
	Baa2	
Baa3		
Speculative-Grade	Ba1	Not Prime
	Ba2	
	Ba3	
	B1	
	B2	
	B3	
	Caa1	
	Caa2	
	Caa3	
	Ca	
C		

Because short- and long-term ratings both consider the probability of default, there will be a relationship between the two. The chart shows that relationship for corporations that carry both types of ratings. The Prime ratings overlap and each span a number of long-term rating levels. Most ABCP programs are rated **Prime-1**, but have no assigned long-term rating. When reviewing an ABCP conduit portfolio to assign or confirm a **Prime-1** rating, Moody's generally looks to see a default probability equivalent to that of **Aa**-rated assets. This is approximately the mid-point of the **Prime-1** range. It also provides rating stability, in that a small change in credit quality would not pull the rating below the **Prime-1** level.

WHY ABCP PROGRAMS DEVELOPED⁷

The emergence of ABCP programs is attributable to a combination of competitive and regulatory factors affecting the banking industry. ABCP allows commercial banks to offer their corporate customers low-cost, off-balance sheet funding. ABCP provides corporations with an alternative to direct debt issuance and term ABS. Finally, ABCP provides distinct advantages with respect to variable funding needs.

ABCP Is a Low-Cost, Off-Balance Sheet Funding Source

As banks competed to provide low-cost financing to commercial and industrial customers, funding through ABCP programs became popular. Banking clients without a **Prime-1** rating found the ABCP programs particularly attractive. Few companies rated below **Prime-1** are able to access the corporate CP market reliably and at favorable rates. A company that becomes a Seller in an ABCP program can finance its receivables at rates comparable to prevailing rates for **Prime-1**-rated unsecured commercial paper. Companies that cannot issue their own commercial paper at comparable rates often find that a bank-sponsored ABCP program provides the lowest cost working capital financing.

ABCP programs also offer advantages to their bank sponsors. The programs are typically structured and accounted for by the banks as an off-balance sheet activity. If the bank were to provide a direct corporate loan, even one secured by the same assets, it would appear on the bank's balance sheet as an asset and the bank would be obligated to maintain regulatory capital for it. An ABCP program permits the Sponsor (i.e., the commercial bank) to offer receivable financing services to its customers without using the Sponsor's balance sheet or holding incremental regulatory capital.

ABCP Provides an Alternative Funding Source

Even a Seller that can issue its own commercial paper at attractive rates may be drawn to bank-sponsored ABCP programs as an alternative source of financing. Typically, Sellers to ABCP conduits remain anonymous to investors. The Administrator reports asset type, industry, funding amount, credit enhancement levels, performance data and so on for each deal, but not the name of the Seller. Investors are protected by a secured interest in a diversified portfolio of assets and also by the additional protections—liquidity, program credit enhancement, pro-active management by the Administrator—provided by the ABCP program structure. ABCP investors are not directly exposed to the credit risk of the Seller. This means that conduit funding is not likely to be subject to the event risk that might be associated with corporate CP.

Also, a Seller may be able to achieve off-balance sheet accounting treatment for receivables financed through a bank-sponsored ABCP program. Although most Sellers are not subject to the same regulatory accounting constraints as are sponsoring banks, off-balance sheet accounting may be desirable for other reasons.

ABCP Accommodates Variable Funding Needs

Finally, ABCP funding is short-term, and the amount of funding can be quickly increased or reduced depending on need. A company in a highly seasonal business may prefer ABCP financing because its borrowings can be matched to its seasonal needs. A company in a growing business may prefer ABCP because it is relatively easy and cost-effective to increase the facility size, rather than issuing additional term ABS.

Frequent issuers of term asset-backed securities also actively use ABCP programs as warehousing facilities. Assets can be financed in a conduit prior to term execution. The funding amount increases during the accumulation phase, and then is quickly reduced when the assets are packaged into a term asset-backed security.⁸ These warehouse facilities are very common for auto loans, auto leases, residential mortgages and other mortgage-related assets.

7 For a more detailed discussion of many of these issues, see Moody's Special Report, *Pros, Cons and Considerations in Introducing an ABCP Conduit*, October 2002.

8 See *Moody's Approach to ABCP and Mortgage Financing Taking a New Look at an Old Favorite Rating Perspectives from the U.S., Europe and Australia*, Moody's Special Report, April 2001

Sidebar 3

Growth of the U.S. ABCP Market

The ABCP market started in the 1980s, but only became a significant source of funding in the 1990s. At the end of 2001, after a decade of double-digit annual growth rates, the outstanding amount of **Prime-1** asset-backed commercial paper exceeded that of corporate commercial paper for the first time. The **Prime-1** corporate CP issuance actually peaked in November 2000, and has fallen by almost one-third since then, as issuers have lost their **Prime-1** ratings and withdrawn from the direct issue market. Many of those “fallen angels” have turned to asset-backed financing, many using ABCP conduits.

The graph shows the amount of ABCP and corporate CP from 1995 to the present, based on data from the Federal Reserve. Also included is the size of the U.S.\$ prime money funds. These funds are the largest single class of investors in ABCP, and their growth clearly parallels the growth of ABCP volume.

The table below shows the number of new conduits by conduit type, and the total number of ABCP conduits, annually from 1999 through 2002. This table is based on all conduits rated by Moody’s, and includes both U.S.-based and non-U.S.-based ABCP programs. (For more information on ABCP program types see Types of ABCP Programs on page 17).

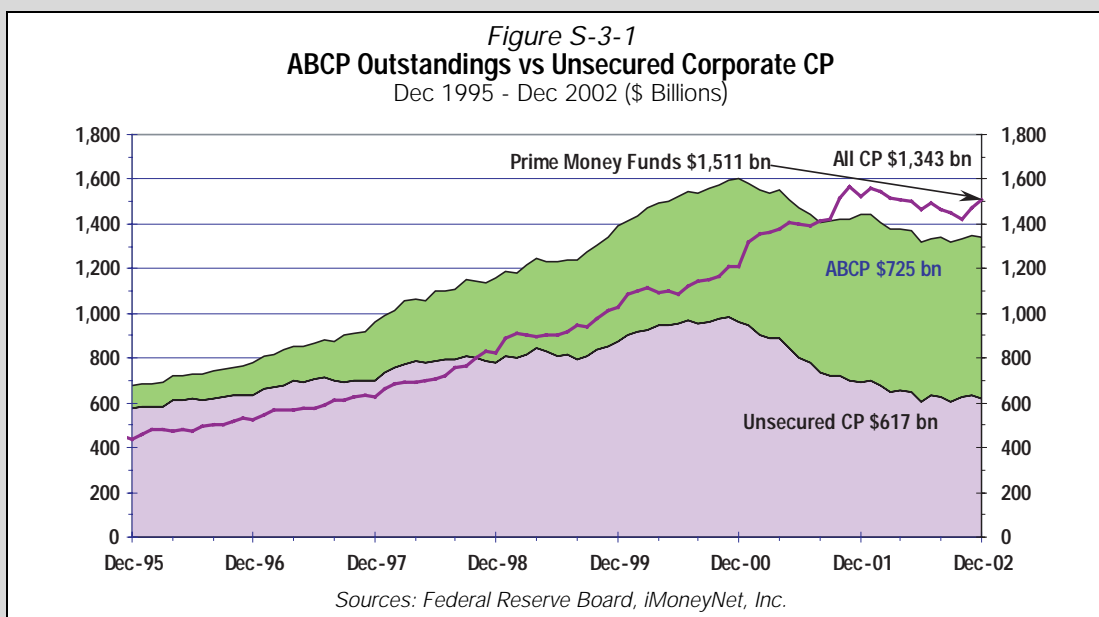


Figure S-3-2
New ABCP Programs by Type

Type	1998	%	1999	%	2000	%	2001	%	2002	%
Hybrid*	0	0	1	2	4	8	4	13	4	31%
Loan-Backed	1	2	2	3	3	6	-	-	-	-
Multiseller	26	51	25	41	16	33	10	31	9	69%
Other	5	10	-	-	-	-	-	-	-	-
Securities Arbitrage	10	20	20	33	16	33	6	19	11	85%
Single-Seller	9	18	13	21	9	19	12	38	7	54%
Total	51	100%	61	100%	48	100%	32	100%	31	100%
Total Conduits	269		323		339		358		363	

* A hybrid ABCP program combines the capabilities of 2 or more classifications of conduits. Usually it combines features of securities arbitrage facilities with multiseller and/or loan-backed programs.

TYPES OF ABCP PROGRAMS⁹

Moody's classifies ABCP programs in two ways. The first is by the type of credit support. ABCP programs may be fully-supported, in which case repayment depends primarily on the credit strength of a third party, or partially-supported, in which case repayment depends to a greater degree on asset quality.

The second way that Moody's categorizes ABCP programs is by program type. The major program types are multiseller, securities arbitrage—comprising credit arbitrage and structured investment vehicles—single seller and loan-backed. A sixth type, hybrid programs, combines the features of two or more program types. Hybrid programs most commonly combine the capabilities of multiseller, credit arbitrage and loan-backed programs. (See Sidebar 5, "The ABCP Market Today" on page 22 for the number of programs and the amount outstanding for each of these types.)

Fully-supported versus Partially-supported Programs

The concepts of *credit risk* and *liquidity risk* are fundamental to an understanding of ABCP programs. Credit risk addresses the likelihood that the receivables will suffer losses and ultimately not be fully collectible. Liquidity risk is the danger that collections on receivables will not be received in time to provide funds for the payment of maturing ABCP. *Moody's analysis of an ABCP program encompasses the credit risk, the liquidity risk, and other factors discussed below.*

Typically, maturing ABCP is repaid by issuing new ABCP in an amount sufficient to make the needed payments. This is called "rolling" ABCP. If it is assumed that ABCP can always be "rolled over," then there is no liquidity risk. However, an assumption that ABCP can always be rolled over is not consistent with a **Prime-1** rating in light of the many factors that might trigger a disruption in the commercial paper markets in general or in the markets for ABCP in particular. An analysis of liquidity risk must start with the assumption that new ABCP cannot be issued to provide funds for the repayment of maturing ABCP.

Most ABCP programs benefit from a variety of support facilities. Each transaction is likely to have some form of first-loss credit enhancement such as overcollateralization. Timely repayment of ABCP and funding of the assets is ensured by liquidity facilities equal to the purchase commitment and greater than or equal to the amount of ABCP issued. The conduit may also have swing-line loan facilities available to cover unforeseen expenses or other cash shortfalls on a temporary basis.

The distinction between fully and partially-supported programs has to do with the primary source of credit protection provided to investors, or equivalently, the primary source of credit risk borne by ABCP investors. In fully-supported ABCP programs, investors are primarily exposed to the risk of a third party that guarantees repayment of the assets, and not to the risk of the assets themselves. In a partially-supported ABCP program, investors are primarily exposed to the risk of the assets themselves, though they may benefit in part from a variety of forms of third-party support.

Fully-supported Programs

The earliest ABCP programs included a support facility that *directly* and *fully* ensured the full and timely payment of maturing ABCP. In such programs, which still exist today, the support facility typically consists of a letter of credit issued by a highly-rated bank (the Support Provider), which, in effect, directly guarantees the ABCP. Holders of ABCP issued under such an arrangement have the right to seek payment directly from the Support Provider if the Issuer fails to fully retire ABCP at its maturity.

The Support Provider in such a program bears the risk that collections on the receivables in which the Issuer has acquired an interest will ultimately be insufficient to fully reimburse the Support Provider for payments made to holders of the ABCP. That risk is referred to as the *credit risk* of the receivables. The Support Provider in such a program also bears the risk that collections on the receivables, although ultimately received, will not be received quickly enough to provide funds to retire maturing ABCP on its scheduled maturity date. That risk is referred to as *liquidity risk*.

The fact that the Support Provider bears both the credit risk and the liquidity risk insulates holders of the ABCP from both risks. The rating of such a program is, in most circumstances, the same as the short-term rating of the Support Provider. Moody's rating of a fully-supported ABCP program is based primarily on an analysis of the credit strength and liquidity of the Support Provider. The rating process does not typically include an analysis of the assets funded by the conduit.

⁹ See Sidebar 5: *The ABCP Market Today* on page 22 for information on the number and size of the programs rated by Moody's.

Sidebar 4

What Does an ABCP Conduit Prime-1 Rating Cover?

Moody's **Prime-1** rating typically applies only to the ABCP notes issued by that conduit. Typically, Moody's rating is initially assigned to an ABCP structure that has no commercial paper notes outstanding and is not funding any assets. At this point the **Prime-1** rating indicates what the rating of the notes would be if assets were funded under the terms of the program documents. For prior review conduits this includes the requirement that Moody's review all asset purchases and confirm the **Prime-1** rating prior to issuance. For post-review conduits this means that the assets are funded in strict compliance with the program credit and investment policy, and that all required support facilities—liquidity, credit enhancement and hedging in particular—and operational procedures are in place. But in all cases the **Prime-1** rating applies solely to the ABCP notes issued by the program unless otherwise explicitly stated by Moody's.

Some Conduit Assets May Carry Explicit Ratings

There is often some confusion among investors and even program Sponsors regarding the rating of the assets funded by conduit. In some cases, a conduit will purchase an asset that already carries a Moody's rating. In other cases the conduit sponsor or some other party to the transaction will request Moody's assign an explicit rating to the transaction at the time Moody's reviews it for inclusion in the conduit portfolio. In both of these cases the asset will have an explicit Moody's rating independent of the rating of the ABCP program.

Prior Review Does Not Necessarily Assign a Rating to the Asset

In many cases, however, Moody's will review the credit quality of the asset as part of the process of confirming the **Prime-1** rating of the conduit upon funding that asset. In these cases no explicit rating will be assigned, even though Moody's may perform the same level of analysis as it would if assigning an explicit rating to the asset. Based on the credit assessment of the asset, a review of the conduit funding provisions and support facilities, and a review of the entire portfolio of assets then funded by the conduit, Moody's will confirm the **Prime-1** rating assigned to the commercial paper issued by the conduit. The ABCP carries an explicit rating; the asset does not.

Asset Ratings Cannot Be Inferred from the Conduit Rating

In particular, it is incorrect to conclude that the asset has a **Prime-1** rating. The commercial paper notes issued by the conduit carry a **Prime-1** rating based on a review of the entire conduit portfolio and its support facilities. The commercial paper notes may benefit from liquidity facilities, program credit enhancement, hedging, various funding triggers designed to remove assets if their credit quality deteriorates, and from the management attention provided by the Administrator and Sponsor. If the conduit were to sell the asset, subsequent investors would not necessarily benefit from any of these support facilities. Without an explicit Moody's rating, no conclusion can be drawn about the stand-alone rating of an asset funded by an ABCP program. The **Prime-1** rating applies only to the conduit as a whole, and not to any particular asset!

Partially-supported ABCP Programs

The rise of bank risk-based capital standards around the world in 1988 imposed significant costs on Support Providers in fully-supported ABCP programs. Risk-based capital standards required Support Providers to hold regulatory capital for the entire face amount of ABCP outstanding under certain ABCP programs because the support facility has been viewed as a “direct credit substitute” and not merely as a loan commitment. The increased costs associated with providing direct credit substitutes motivated banks to find a more cost effective way to structure ABCP programs. The result was the creation of partially-supported ABCP programs, which were eligible for more advantageous treatment under the risk-based capital standards, and could continue to offer funding at attractive rates to Sellers.

The primary distinguishing feature of a partially-supported ABCP program is that investors bear a portion of the credit risk. The support facilities are not intended to fully insulate investors from the credit risk associated with the receivables. Investors must rely, to some degree, on the performance of the receivables in which the conduit has acquired an interest. However, if a partially-supported ABCP program has been assigned a rating of **Prime-1**, the magnitude of the credit risk borne by investors must be extremely small to be consistent with that rating.

Transaction Support in Partially-supported Programs

In a partially-supported ABCP program, there are generally a number of supporting facilities. Each transaction funded will typically have some form of first-loss credit protection. This is usually provided by overcollateralization, but might be in the form of a third-party guarantee or letter of credit. The second, which primarily addresses liquidity risk, is called the *liquidity facility*. The common practice today is to have a separate liquidity facility for each transaction in the conduit, but some programs have a program-wide liquidity facility that is available for all or for a subset of deals. Liquidity is typically available only to the extent that there are non-defaulted (“good”) receivables available as collateral, though some liquidity facilities absorb a variety of risks associated with the assets or the Seller.

Finally, partially-supported programs have a secondary credit enhancement facility, often referred to as the *program-wide credit enhancement facility*. The credit enhancement facility is intended to cover any losses on the receivables in excess of the deal-specific enhancement. Program-wide credit enhancement is usually sized as the greater of a fixed dollar minimum amount and a percentage (*e.g.*, 8% or 10%) of the total amount of funding commitments made by the conduit.¹⁰⁰ In many programs, the credit enhancement facility may be drawn whenever there are insufficient funds available to repay maturing ABCP, in which case it may be used by the Issuer to obtain funds necessary for liquidity purposes as well as to cover credit risk.

Rating Analysis for Partially-supported ABCP Programs

Moody’s analysis of a partially-supported ABCP program is much more demanding than the analysis of a fully-supported program. The credit enhancement—both the transaction-specific first-loss enhancement and the program-wide facility—provides investors with only partial protection against losses on the underlying receivables. Therefore, Moody’s considers and analyzes:

- The credit quality of the receivables relative to the available credit enhancement, both within the transaction and at the program level
- The quality of the Seller of receivables with respect to underwriting, servicing, and the ability to meet its support commitments
- The structure of the transaction, especially with respect to securing the conduit’s interest in the receivables and terminating the transaction if performance deteriorates
- The support provided by the liquidity facility, if any, beyond pure timing mismatch between payments due on ABCP and cash received from the receivables

The analysis of each transaction in a partially-supported ABCP program is very similar to that of a term ABS transaction with the same type of collateral, and Moody’s ABCP analysts work closely with their colleagues in term ABS as well as the corporate analysts in rating these transactions.

¹⁰⁰ In some cases, program-wide credit enhancement may be specified as a percentage of the total ABCP outstanding, which will be less than the total funding commitments if not all facilities are fully drawn.

Fully-supported Deals in Partially-supported Conduits

Often a partially-supported ABCP conduit funds one or more fully-supported transactions, though the majority of the transactions are only partially-supported. There are a number of means commonly employed to provide full credit support to a transaction. These transactions may benefit from a surety bond or "wrap," or be protected by a letter of credit equal to the size of the funding commitment. Some transactions are protected through a liquidity facility that funds for the amount of ABCP outstanding for the transaction without regard to the level of defaulted collateral. For the fully-supported transactions, though not for the entire conduit, investors are exposed to the risk of the highly rated support provider, not the credit quality of the underlying assets. Moody's rating analysis of these transactions is directed at the credit strength of the support facility and not that of the assets.

Conduit Sponsors structure transactions to be fully-supported for several reasons. Sometimes a conduit sponsor wishes to close a transaction quickly. Since the credit analysis of a fully-supported transaction is focused on a structural review rather than an asset review, a fully-supported transaction can typically be reviewed and closed more quickly than a partially-supported one. A fully-supported transaction can subsequently be restructured as partially-supported at a later date. Sometimes transactions are fully-supported because the credit quality of the deal is not consistent with the rating of the conduit, and full support is the only way that conduit funding is possible. A similar situation may arise if the Sponsor wishes to offer the Seller an advance rate that is higher than would be consistent with the conduit's rating. By insulating the conduit from the credit risk associated with the assets financed, the Sponsor gains flexibility in negotiating the terms of the transaction with the Seller.

Conduits Classified by Program Type

ABCP conduits are classified by the purpose of the program and the type of assets funded. The major program types are multiseller, securities arbitrage, single-seller, and loan-backed. Within securities arbitrage there are two major categories, credit arbitrage and structured investment vehicles (SIVs). Finally, hybrid programs combine the features of two or more of these types, most commonly multiseller, credit arbitrage and loan-backed. Note that the classification by full or partial support cuts across all of these program types, in that within each there are instances of both fully and partially-supported programs.

Multiseller ABCP Conduits

More than half of the outstanding ABCP in the market is issued by traditional partially-supported multiseller ABCP conduits.¹¹ These conduits are typically sponsored by a commercial bank for the purpose of providing low cost, off-balance sheet working capital financing to its clients. Each multiseller conduit typically provides financing to a wide variety of industries, companies and asset types, offering ABCP investors a well-diversified pool of supporting assets. Each transaction funded by the conduit usually has some form of first-loss protection and benefits from a separate liquidity facility¹². The liquidity facility typically funds only for non-defaulted assets, so that investors are exposed to the risk of asset performance. However, as noted above, some transactions may be fully-supported by a surety bond, letter of credit, liquidity facility, or other form of guarantee.

Each transaction in a multiseller program is usually structured similar to a term securitization or a secured loan and is collateralized by a pool of assets. In many cases a conduit actually purchases a rated term asset-backed security or an unrated series issued by a master trust that is structured identically to publicly rated series issued by that master trust. The conduit makes advances against the asset at less than par, thus creating a level of overcollateralization that serves as pool-specific credit enhancement. Alternatively, pool-specific credit enhancement may be provided by a cash reserve, letter of credit, credit insurance or partial guarantee, in each case in a form and of a credit quality consistent with the rating of the conduit.

Most partially-supported multiseller conduits also have credit enhancement at the conduit level. This program-wide credit enhancement is typically sized at the greater of a minimum fixed amount and a percentage of the funding commitments. It may be drawn up to its full amount for any asset funded by the conduit, providing an additional degree of protection to investors by effectively cross-collateralizing the asset portfolio.

Single-Seller ABCP Conduits

Unlike multiseller conduits, single-seller ABCP conduits provide financing for assets originated by only one com-

¹¹ Fully-supported multiseller conduits support the same variety of assets, but Moody's rating analysis is directed at the support provider, and not the credit quality of the assets.

¹² Some multiseller conduits employ a program-wide liquidity facility provided by the sponsoring bank.

pany, or related to one company's business operations. Such conduits represent a smaller percentage of the ABCP market than multiseller programs.

The company whose assets will be financed usually sponsors single-seller conduits. If the company is highly rated, then the sponsoring company may provide both liquidity and credit enhancement to the conduit. In this case the investors are exposed entirely to the risk of the sponsoring company. Single-seller programs may also be fully-supported by some form of third-party guarantee, either alone or in combination with a liquidity facility. In this case investors are exposed to the credit risk of those support providers.

If the company's credit quality is not high enough to support the transaction on its own, or if the company wants to achieve off-balance sheet treatment and does not guarantee the program, then the rating will depend on the credit quality of the assets and the support facilities. Typically the assets are credit-enhanced using overcollateralization, either alone or in combination with some other form of support such as a letter of credit from a highly rated bank. A liquidity facility from a syndicate of **Prime-1**-rated banks is available to fund for non-defaulted assets and to bridge any timing differences between the assets, funding requirements and ABCP maturities.

Securities Arbitrage ABCP Conduits¹³

Securities arbitrage conduits are established to invest in various fixed income securities such as government and agency securities, asset-backed securities, mortgage-backed securities, corporate bonds, and bank loans. These conduits use the proceeds of low-cost ABCP to fund the purchase of higher yielding, longer-term marketable securities. The resulting spread is passed on to the sponsoring institution.

Securities arbitrage conduits typically have a credit and investment policy that describes the type of securities that may be purchased, the required ratings, and other parameters such as concentration limits, diversification requirements, interest and exchange rate risk sensitivity and so forth. These guidelines are designed to accommodate the business purpose of the sponsoring organization and also Moody's requirements with respect to maintaining the desired rating on the program. The guidelines may also specify the type, size and credit quality of various support facilities consistent with the program rating.

Some securities arbitrage programs are fully-supported; in which case the rating analysis focuses on the credit quality of the guarantor. But most securities arbitrage conduits can be further classified by whether they expose investors to the credit risk or to the market value risk of the underlying securities. Securities arbitrage programs that primarily expose investors to the credit risk of the underlying securities are similar to cash flow CDOs. Credit arbitrage programs are the largest class of this type of program. Securities arbitrage programs that expose investors to the market value risk—recognizing that credit risk is an important factor in price volatility—are similar to market value CDOs. Structured Investment Vehicles (SIVs) are the largest class of this type of program. Both credit arbitrage programs and SIVs typically invest in highly rated securities.

Credit Arbitrage ABCP Conduits¹⁴

Credit arbitrage conduits offer banks a method of establishing a securities portfolio with the advantages of off-balance sheet accounting treatment and reduced regulatory capital charges. The securities are generally rated at least **Aa2** when purchased. The program liquidity facility is available to fund for the face amount of ABCP issued unless a security is defaulted or rated in the Caa category. This structure protects investors against any changes in the market value of security up until the security defaults.

Credit arbitrage programs typically operate with no program-wide credit enhancement. Instead they rely on the high credit quality of the securities purchased along with a requirement to add credit enhancement or sell a security after it has been downgraded below the **Aa** level. The required amount of credit enhancement is sized dynamically based on the ratings of the securities in the conduit's portfolio. If after a downgrade the required credit enhancement increases, ABCP cannot be issued unless the available credit enhancement equals or exceeds the required amount. If ABCP cannot be issued, the liquidity facility will be drawn upon to purchase the downgraded security at par. The proceeds will then be used to repay maturing ABCP, thus removing any increased risk to investors. Some programs require the downgraded security be sold at par value to the liquidity provider after a short period, but prior to any CP maturity, if credit enhancement hasn't been increased.

¹³ See Moody's Special Report, *Comparing and Contrasting Credit Arbitrage ABCP Programs and Structured Investment Vehicles*, January 2002.

¹⁴ See Moody's Special Report, *Moody's Approach to Evaluating Credit Arbitrage ABCP Programs*, August 2002.

Sidebar 5

The ABCP Market Today

In 2002, the U.S. ABCP market failed to show growth in either outstandings or new programs for the first time since the inception of the market. Outstandings were down slightly from year-end 2001: \$720 billion versus \$745 billion. Program terminations exceeded new conduit formation. Economic weakness limited the need for funding, and regulatory uncertainty, especially potential accounting changes, discouraged new deal flow.

The European ABCP market continued to grow rapidly, ending the year with \$178 billion outstanding as compared to \$135 billion at year-end 2001.¹ New conduits exceeded terminations, and a record 6 new structured investment vehicles came to market. There are fewer regulatory concerns in Europe than in the U.S., since European banks are not directly affected by proposed FASB regulations.

Moody's has ratings on over 360 conduits worldwide. Table S-2 lists the number of programs and aggregate outstanding ABCP by program type. Moody's publishes a quarterly "ABCP Market Review," both as a separate document and as the lead article in "Moody's Global Asset-Backed Commercial Paper Market Review." Annual year-in-review publications for both the global ABCP market and for the European ABCP market appear in January.

Table S-5-1
ABCP Market by Program Type
Moody's Rated Programs as of June 30, 2002

Program Type	Number	% by Number	ABCP Outstanding	% by Outstanding
Multiseller	147	45%	\$400,891.70	57%
Sec. Arbitrage	79	24%	131,920.70	19%
Single-Seller	58	18%	86,078.40	12%
Hybrid	17	5%	32,300.10	5%
Structured Investment Vehicles	15	5%	32,946.00	5%
Loan-backed	11	3%	15,263.50	2%
Other	1	0%	8,073.90	1%
Total	328		\$707,474.30	

Figure S-5-2
20 Largest ABCP Programs
3Q02 Average ABCP Outstandings

Rank	Program	\$ million
1	Edison Asset Securitization LLC	\$32,127
2	Amstel Funding Corporation	\$23,417
3	Sheffield Receivables Corporation	\$15,010
4	Falcon Asset Securitization Corporation	\$13,550
5	Atlantis One Funding Corporation	\$13,317
6	Sigma Finance Corporation / Sigma Finance, Incorporated	\$12,530
7	DAKOTA CP Notes Program	\$12,500
8	FCAR Owner Trust	\$11,808
9	Pennine Funding LLC	\$11,247
10	Preferred Receivables Funding Corporation	\$10,587
11	Galaxy Funding, Incorporated	\$9,940
12	Variable Funding Capital Corporation	\$9,912
13	Compass Securitisation Limited / Compass Securitization LLC	\$9,641
14	CXC Incorporated	\$9,581
15	Windmill Funding Corporation	\$9,022
16	Mont Blanc Capital Corporation	\$8,917
17	Jupiter Securitization Corporation (formerly International Securitization Corporation)	\$8,852
18	Scaldis Capital Limited / Scaldis Capital LLC	\$8,405
19	Corporate Receivables Corporation	\$8,224
20	New Center Asset Trust	\$8,034

¹ See Moody's Special Comments, "2002 Review and 2003 Outlook: A Rising Star: The Uninterrupted Growth of the European ABCP Market," January 7, 2003.

The combination of a dynamic credit enhancement requirement and a liquidity support facility narrows investors' credit exposure considerably. Effectively, investors are only exposed to the risk of a precipitous decline in a security's rating, from **Aa** or higher to **Caa** or default, in a relatively short period. The probability of such a precipitous decline for a security rated **Aa2** or higher is very low and consistent with the conduit's **Prime-1** rating. If the program holds securities rated below **Aa** then credit enhancement is necessary in order to bring the portfolio to a level of credit quality consistent with a **Prime-1** rating.

Structured Investment Vehicles¹⁵

Market value ABCP conduits are generally established by investment managers in order to secure a stable source of financing for a securities portfolio. Because these programs rely on third-party support providers, they are structured to minimize the use of credit enhancement and liquidity facilities. The primary risk to investors is that the market value of the securities purchased falls below the amount needed to repay the debt issued by the conduit.

Structured Investment Vehicles or SIVs are the most prevalent type of market value ABCP program. SIVs issue **Aaa**-rated medium-term notes and **Prime-1**-rated ABCP to fund their investment portfolio. The issuance of MTNs reduces the amount of liquidity support required to ensure timely repayment. SIVs have strictly enforced operating guidelines with respect to asset types, ratings, concentration limits and diversification.

SIVs also require substantial analytic resources on the part of the program administrator. Potential portfolio volatility with respect to interest rate and exchange rate movements must be analyzed daily and maintained within tight limits. Required credit enhancement, provided by subordinated capital notes, is determined by modeling the potential market value risk over the time horizon that would be required to liquidate the portfolio and repay all outstanding ABCP and MTNs. Liquidity is provided both by the securities themselves as well as by a liquidity facility sized to be a fraction of outstanding ABCP. The required amount of liquidity is determined by analyzing the difference in cash received from the assets and payments due on maturing liabilities over a one-year horizon. All of these tests—sensitivity, credit enhancement, liquidity—are run daily, and any violation must be corrected in a relatively short period of time. Failure to correct a violation leads to a variety of limitations on the SIVs operations. Initially no new assets may be purchased. If a cure is not effected after a certain period, then no further CP and MTNs may be issued. Ultimately the portfolio is liquidated and the outstanding debt is defeased in order to prevent further deterioration and to insure that investors are repaid.

Loan-Backed ABCP Conduits¹⁶

Loan-Backed ABCP conduits were established to fund portfolios of bank loans made to corporate customers, and are similar to CLOs. Credit enhancement is based on the number and size of the loans funded, and the credit quality of the obligors. Liquidity in loan-backed conduits is provided by the loans themselves, as they are maturity-matched to the ABCP issued to fund them. Investors are exposed to the risk that the obligor does not repay the loan in a timely fashion, due either to bankruptcy, default or late payment.

As the loan-backed ABCP programs evolved, they have tended to finance mostly companies with low investment grade or non-investment grade ratings, and unrated companies. Since required credit enhancement is a function of the borrowers' ratings, the required credit enhancement levels are quite high. With the increase in costs associated with ABCP support facilities, these programs have become expensive to maintain. In addition, loan backed programs are vulnerable to pending changes in FASB accounting regulations regarding consolidation of certain ABCP conduit exposures with sponsoring banks' balance sheets.¹⁷

As a result of the higher costs and adverse accounting changes, these programs have declined in importance. Banks with loan-backed programs have been winding them down, and new ones are not being created to replace them.

Hybrid ABCP Conduits

Hybrid ABCP conduits are those that feature characteristics of more than one type of ABCP program. They are typically combine features of partially-supported multiseller and securities arbitrage ABCP conduits, although a few programs also incorporate a loan-backed component as well.

15 See Moody's Special Reports, *An Introduction to Structured Investment Vehicles*, January 2002, and *Structured Investment Vehicles—Recent Developments*, January 2003.

16 See Moody's Special Report, *Rating Commercial Paper Programs Backed by Maturity-Matched Loans*, September 1999.

17 See Moody's Special Reports, *ABCP 2002 Year in Review: Maturity and a Pause in the U.S., Youth and Rapid Growth in Europe*, January 2003., and *The FASB Consolidation Proposal: The End of ABCP as We Know It?* October 2002.

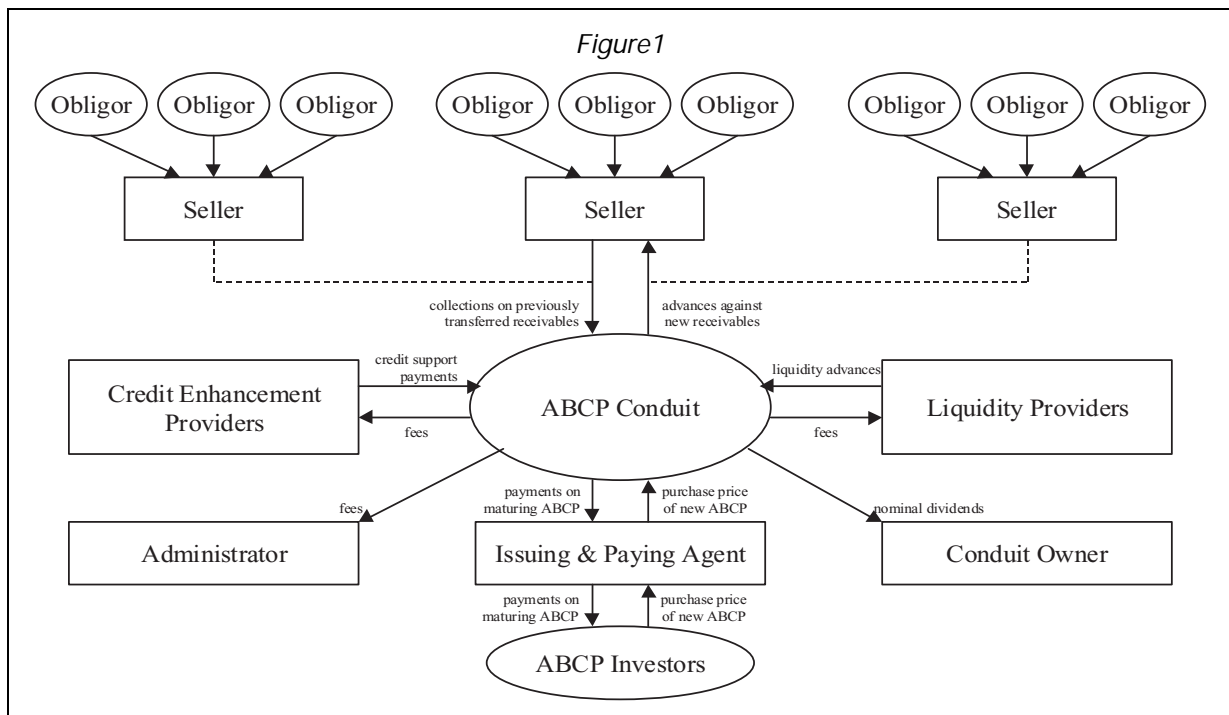
One of the reasons for the appearance of hybrid programs is that investors prefer to purchase ABCP issued by conduits that issue paper on a regular basis and that maintain a minimum of \$1 to \$2 billion outstanding at any given time. The challenge faced by smaller bank sponsors or new ABCP programs is that building a portfolio of receivables is a time-consuming process. Marketing, structuring and funding a receivable-backed transaction can involve months of lead time. Smaller sponsors may not be in a position to assemble a multi-billion dollar receivable portfolio at all. By combining the properties of a multiseller conduit with those of a securities arbitrage program, a sponsor can grow the conduit's portfolio more quickly.

While a hybrid program offers greater efficiency in terms of issuance, it does suffer from the disadvantage of agglomeration. Many investors prefer single-purpose conduits. They are easier to understand and they allow investors to easily choose a particular type of conduit exposure. However, a number of conduit sponsors find that the advantages of a hybrid program outweigh the disadvantages in terms of market acceptance.

CONDUIT STRUCTURE AND SUPPORT PROVIDERS

Overview

A typical ABCP program contains a number of components: the conduit special purpose vehicle itself, a variety of support providers playing well-defined roles in the conduit operations, and the transactions funded by the program. *Figure 1* illustrates some of these relationships.



In the center of the diagram is the conduit special purpose vehicle (SPV) itself. The SPV is typically limited in purpose, is minimally-capitalized and has no employees. The SPV is owned by the “Conduit Owner”, which is usually a service company formed for the purpose of owning and providing management and officers for SPVs. The owner’s role is actually minimal. The Administrator, usually also the Sponsor of the program, has true responsibility for the conduit’s strategic and day-to-day operation. In most cases the Administrator is a commercial bank, though in some cases other experienced parties act as Administrator or share the role with a third party. The Administrator negotiates support arrangements, structures and oversees the transactions funded by the conduit and manages the funding through the issuance and repayment of ABCP.

The various Sellers—originators of the funded assets—are shown at the top. The structure of these transactions is discussed in detail in the Appendix: Asset Purchase Structures on page 61. Typically these transactions are structured in a manner similar to a term ABS transaction. The Seller transfers assets in a true sale to a purchasing SPV. The SPV funds its purchases with a loan from the ABCP conduit. The Seller is usually the servicer of the assets. The Administrator monitors asset performance, and often has the right to name a replacement servicer if the Seller defaults in its obligations as servicer.

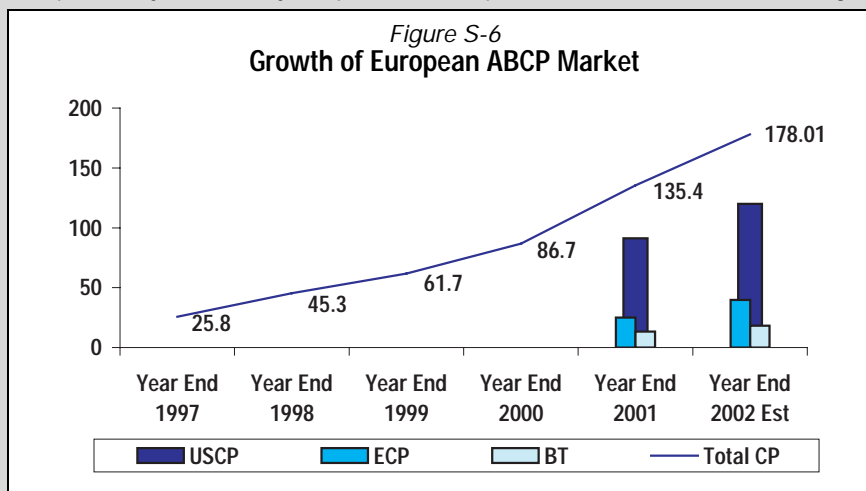
Many, but not all conduits grant a security interest in the conduit’s assets to ABCP investors. If this is the case, the ABCP program structure includes a Collateral Agent or a Custodian to hold assets in trust for the benefit of the investors.

A multiseller conduit often has program-wide credit enhancement and usually has deal-specific liquidity backup lines, as noted in the diagram to the left and right of center. The liquidity backup serves to bridge timing mismatches between the repayment of maturing ABCP and either cash payments from the transactions or the proceeds of newly issued ABCP. Liquidity draws are typically available to the extent the conduit has good—non-defaulted—assets to sell to liquidity providers or to post as collateral for a liquidity loan. The program credit enhancement serves as a final backstop. Typically program credit enhancement is available to cover any ABCP repayment shortfalls after all other sources of funds (including liquidity draws) have been exhausted. A conduit may also have a Hedge Counterparty (not shown) if interest rate or currency mismatches are material.

Sidebar 6

The European ABCP Market

The European ABCP market continued to grow rapidly in 2002, increasing to \$178 billion outstanding issued by 58 conduits at year-end from \$135 billion at the start of the year.¹ In addition, fifteen structured investment vehicles (SIVs) rated and monitored by Moody's London office had \$41.5 billion of ABCP and \$49.6 billion of MTNs outstanding. *Figure S-6* shows the growth of ABCP in Europe for the past five years. Moody's expects the European ABCP market to continue to grow.



European programs issue in a number of currencies. In fact, some 69% of issuance is U.S.\$ CP. Approximately 21% is Euro CP², and the remaining 10% are Billets de Trésorerie (BTs, see Sidebar 8 on page 32, "Billets de Trésorerie—the French CP"). The Euro CP market has been growing rapidly—by 77% last year alone—due in part to sellers' preferences for match funding assets and liabilities in the same currency. Many U.S.-based ABCP conduits are adding the ability to issue Euro CP in order to allow for access to more than one market.

There are many similarities between U.S. and European ABCP programs. European conduits are typically created by a sponsor to fund receivables generated by their clients. Historically European conduits initially funded themselves in the U.S.\$ CP market to benefit from that market's depth and low funding costs. Increasingly, however, European conduits are electing to issue in both the U.S. and European market, or exclusively issue in the European market.

Each country has a preferred way of organizing a conduit as a special purpose vehicle, much as Delaware-based entities are preferred in the U.S.. The Jersey Channel Islands and other offshore English-law jurisdictions are commonly used for tax purposes. The SPV is established as a limited purpose corporation owned by a charitable trust. All assets are required to be held outside of the jurisdiction, and all investors must be non-residents.

Overall, European conduits demonstrate more differences than similarities to their U.S. counterparts. The legal, tax, and accounting requirements of the seller's country, and lack of historical precedent often dictate that most structures are tailored to adapt to the specific circumstances. In response to some of these restrictions, many European conduits use a distinct issuer/purchaser structure, whereby the issuer does not directly hold assets. Historically, the European market has adapted some of the structural innovations first debuted in the U.S. However, the widespread use of synthetics recently seen in the European market suggests that the European market will foster innovations as well.

European conduit transactions have been structured more cleanly than in the U.S.. Borrowing bases in liquidity facilities are less likely to fully support the repayment of ABCP, or absorb risks such as dilution, which is commonly seen in the U.S. There tends to be less program credit enhancement than in the U.S., set at a lower percentage of funding commitments and with lower or no floor amount. Post review has currently only been granted in limited incidences.

Moody's provides detailed reporting on the European ABCP market. There is a monthly "European ABCP Market Summary" which presents information on the size of the market, the largest sponsors and portfolio composition. Moody's "Performance Overviews," also published monthly, provides detailed information on a conduit basis, including asset purchases and terminations, support providers and performance. The "European ABCP Market at a Glance: Moody's ABCP Market Snapshot" summarizes the main structural features of each conduit. In January of each year there is a year-in-review piece summarizing important trends and prospects for the coming year. Finally, like all Moody's rated ABCP programs, each European conduit is covered in detail in "Moody's Global Asset-Backed Commercial Paper Market Review," published quarterly.

1 See Moody's Special Comment, 2002 Review and 2003 Outlook: A Rising Star-The Uninterrupted Growth of the European ABCP Market, January 2003.

2 Euro CP is issued from Europe. It may be denominated in many other currencies besides Euros, and may be issued to investors in continents within, or outside of, Europe.

The actual issuance and repayment of ABCP is handled by an Issuing and Paying Agent (IPA) also called a Depository. The IPA issues ABCP, in the form of formal notes or electronically, to investors. The IPA also makes payments to investors when the ABCP matures. The IPA usually has the right to request funds directly from the liquidity banks or from the credit enhancement providers if funds from the issuance of new ABCP or cash collections from the assets are insufficient.

One or more Placement Agents (not shown) broker the sale of ABCP. Placement Agents are typically investment banks that specialize in the sale of ABCP for a commission. The Placement Agents consult with the Administrator on the amount, maturity and interest rate of ABCP to be issued. The Placement Agents coordinate with the IPA in seeing that funds are received from investors in return for the ABCP delivered.

The Conduit Special Purpose Vehicle

The heart of an ABCP program is a minimally capitalized special purpose vehicle that is limited in its activities to purchasing assets and funding those purchases through the issuance of ABCP. In the United States, the SPV often takes the form of a limited purpose company, established and organized under the laws of Delaware. However, an SPV may be organized as a cooperative corporation, a trust, a limited liability corporation or partnership, or a limited partnership.

In Europe, the typical conduit is organized as a limited purpose corporation under Jersey, Channel Island law, with charitable trust as owner. Similar structures are possible in other English law jurisdictions such as Bermuda, the Bahamas or the Cayman Islands. In France, the SPV may be organized as a Société Anonyme.

In its rating process, Moody's reviews the corporate structure of the conduit SPV in order to determine that it is organized to promote "bankruptcy remoteness." A bankruptcy-remote entity is not immune to the risk of bankruptcy, but is structured so as to render the risk of bankruptcy highly unlikely. The risks that bankruptcy presents to ABCP investors are discussed in Structural Risk on page 36.

There are several components that are necessary in order to minimize the potential for an SPV bankruptcy. First, the legal structure should isolate the SPV from any entity likely to enter bankruptcy. The owner of the conduit should itself be unlikely to enter bankruptcy and the SPV should be unlikely to be consolidated into the owner's bankruptcy should it occur. Jurisdictions that are commonly used to domicile securitization vehicles typically have one or more structures, like those mentioned above, which achieve this goal.

Second, the structure should make it unlikely that the SPV itself will enter into bankruptcy voluntarily, except in the gravest circumstances. This goal is generally achieved by requiring the SPV to have independent directors or owners, and by requiring that these independent directors consent to any voluntary bankruptcy filing. In some cases the SPV's constituent documents may prohibit it from declaring voluntary bankruptcy, or strictly limit the circumstances in which it may occur.

Third, the SPV should not have any employees, and the SPV's purpose should be limited to issuing commercial paper and using the proceeds to purchase or make loans against assets. Only those activities related to and necessary for that purpose should be permitted. This reduces the chance of insolvency from a liability unrelated to the conduits stated activities.

Fourth, all parties engaged to provide services to the conduit should do so in agreements structured to limit the risk of a claim by those parties. Typically, service providers agree not to petition the conduit into bankruptcy until all the ABCP has been repaid. In addition, they agree to abide by the priority of payments set out in the conduit's documents. Providers agree that they have no claim in a bankruptcy proceeding so long as all funds are distributed as agreed. The formation documents of conduit corporations typically restrict the ability of the conduit to enter into any other types of contractual relationships.

Finally, Moody's asks to receive notice of all amendments to the program documents. Moody's may revise its rating opinion of the conduit in accordance with the materiality of the amendment and its effect on the bankruptcy remoteness of the conduit. Conduit corporation documents typically restrict the ability of a conduit to enter into any contractual arrangement without notification to the rating agencies and require a confirmation of the rating for any material changes to the structure.

Using Corporations and LLCs as Conduit Structures

In the United States, ABCP sponsors have established conduits using the corporate form. Recently, however, the vast majority of conduits have been organized as limited liability companies (LLCs). Both entities are formed and their elements of corporate governance are established under the statutory provisions of state law, most often Delaware law.

Corporations have a long and venerable history as SPVs in the structured market.¹⁸ Their unique role as a perpetually existing entity and the judicial precedent that demonstrates strong protections against violation of corporate separateness from parent companies have made them ideally suited as bankruptcy-remote vehicles. Management is through a board of directors, with ownership interests held by shareholders.

LLCs are hybrid structures, sharing attributes of both corporations and partnerships. They offer limited liability to equity holders and generally pass through income without entity-level taxation to their equity holders. They provide significant flexibility from a tax and business perspective. As a consequence, nearly all new ABCP conduits are organized as LLCs. Equity ownership of LLCs consists of "membership" interests held by one or more natural persons or legal entities. For tax and accounting reasons, ABCP conduits and other SPVs organized as LLCs typically have a single member. However, as hybrid entities akin to partnerships, LLCs are subject to dissolution, which raises special concerns involving bankruptcy-remoteness, that are discussed in a later section.

¹⁸ See Moody's Special Report, *Handle with Care: Single Member LLCs in Structured Transactions*, March 1999.

Who's Who in an ABCP Program: Service and Support Providers

An ABCP program is a special purpose vehicle with no employees. All of the activities associated with the administration of the conduit are handled by one or more firms that are contractually obligated to perform certain tasks. As part of its rating process, Moody's reviews the conduit's documentation to determine that parties with the requisite expertise and resources undertake the conduit's administrative functions. The conduit's documentation must precisely specify the duties and responsibilities of each service provider. In addition, Moody's meets with major service providers and administrators in order to understand their resources, capabilities and commitment.

Table 1 lists the main parties involved in an ABCP conduit, the name of the agreement that documents their role, and a brief description of that role.

<i>Table 1</i> Conduit Service and Support Providers		
Name	Agreement Name	Responsibilities
Administrator	Administration Agreement	Overall responsibility for the management and operation of the conduit
Manager	Management Agreement	Management of SPV, provision of corporate officers, preparation of tax and regulatory filings based on information from the Administrator
Issuing and Paying Agent	Issuing and Paying Agent Agreement	Issuance and repayment of commercial paper.
Depository	Depository Agreement	Issuance and repayment of commercial paper in European programs.
Placement Agent	Placement Agency Agreement	Sale of commercial paper to investors
Collateral Agent	Security Agreement	Usually a trust department. Holds the security interest in all assets of the conduit for the benefit of the investors
Custodian	Custody Agreement	Usually the custody department of a commercial bank. Maintains physical, and more recently electronic, control of conduit assets.
Liquidity Agent	Liquidity Agreement, or Liquidity Asset Purchase Agreement, or Liquidity Loan Agreement.	Management of bank syndicate that provides backup liquidity lines to the conduit with respect to a single deal or for the entire program. Receives requests for funds from the conduit and passes them on to the liquidity banks, and returns funds from those banks to the conduit.
Liquidity Bank	Same as Liquidity Agent	Provision of a liquidity backup line to the conduit.
Credit enhancement provider	Credit Agreement, or Credit and Reimbursement Agreement, or various other	Provision of a credit enhancement facility. Often an irrevocable letter of credit provided by a commercial bank that may be drawn by the conduit at any time to repay ABCP.
Hedging Agent	Hedging Agreement	Arrangement of hedging agreements covering interest rate and foreign exchange rate risk for the conduit.

Sidebar 7

Figure S-7-1
20 Largest ABCP Program Administrators
 3Q02 Average ABCP Outstandings

Administrator	\$ Millions	# Programs	Market Share (%)
Citibank, N.A.	73,641	20	9.9%
ABN AMRO Bank N.V.	49,262	12	6.6%
Bank One, N.A.	39,545	7	5.3%
General Electric Capital Corp.	34,842	3	4.7%
Bank of America, N.A.	32,007	10	4.3%
WestLB AG	27,759	5	3.7%
Liberty Hampshire	27,591	11	3.7%
JPMorgan Chase Bank	24,322	6	3.3%
Barclays Bank PLC	20,341	4	2.7%
Rabobank Nederland	20,030	9	2.7%
Bayerische Hypo-und Vereinsbank AG	18,542	10	2.5%
Dresdner Bank AG	16,986	6	2.3%
Ford Motor Credit Company	16,808	3	2.3%
Bayerische Landesbank Girozentrale	16,577	5	2.2%
Deutsche Bank AG	16,489	8	2.2%
Bank of Tokyo-Mitsubishi, Ltd.	16,358	7	2.2%
Société Générale	16,208	9	2.2%
Firstar Bank, N.A.	15,265	2	2.0%
Canadian Imperial Bank of Commerce	14,345	6	1.9%
Wachovia Bank, N.A.	13,683	5	1.8%
All Other	234,524		31.5%
Total	745,124		100%

Administrator

The Administrator has the most important role in an ABCP program because it takes overall responsibility for the proper functioning of the program. Moody's considers the role of the administrator and the agreements governing the administrator's activities to be the heart of an ABCP program.¹⁹ Beyond the details specified in the documents, Moody's expects the Administrator to be committed to the smooth operation of the conduit and to be willing to take the necessary steps to see that the other parties perform as expected.

The administrator's main functions consist of:

- Identifying, reviewing, structuring, and recommending assets for purchase or funding by the conduit
- Arranging for liquidity, credit support, and hedging for assets funded by the conduit
- Presenting new transactions to Moody's for review and rating confirmation prior to funding
- Arranging to have ABCP issued in the appropriate amounts, maturities and discount rates consistent with the business purpose and program documents
- Arranging for the prompt repayment of maturing ABCP, either from the issuance of new ABCP, cash from the assets or by timely draws on liquidity, credit enhancement, or other support facilities
- Arranging for the prompt payment of all conduit expenses from funds available as provided for in the program's priority of payments
- Enforcing the terms of all asset funding agreements especially with respect to timely receipt or payment of funds due
- Monitoring the performance of the asset pools in the conduit's portfolio, relative to transaction borrowing bases, and performance triggers and other relevant collateral information
- Provide information on the status of the program and its funding commitments to investors, Moody's and the support providers as appropriate

¹⁹ See Moody's Special Report, *Moody's Approach to Reviewing Administrators The Importance of Being Earnest*, March 2001

- Monitoring required program credit enhancement level and amount of liquidity supporting ABCP issued and outstanding
- Monitoring contacts, ratings, and expiration dates of all credit and liquidity support facilities, and arrange for renewal or replacement as needed
- Monitoring ratings, payment dates, and other relevant information on securities held (for securities arbitrage programs)
- Daily mark-to-market of all securities in the portfolio (for market value securities arbitrage programs)
- Ensuring that all tax and regulatory filings and payments are made in a timely fashion
- Directing the activities of support providers by giving instructions or notice as necessary

In some programs these functions are divided among several parties. In others, the Administrator may take on additional duties such as arranging hedging agreements to deal with exchange rate risk. In some programs the Administrator may be called the Trustee or another title altogether. In all programs, there should be one party with overall responsibility for conduit administration.

Third-Party Administrators

The ABCP market has seen a growing use of third-party administrators—someone other than the sponsor of the ABCP program—running the day-to-day operations. These third-party administrators are often banks that have had years of experience managing their own ABCP programs. In other cases, the third-party Administrator is a management company that has been involved providing corporate services to ABCP programs and has expanded their activities to include the role of administrator.

Third-party administrators pose several concerns from a credit perspective. Third-party administrators may have less experience than traditional administrators may in managing an ABCP conduit. An unrated administrator may not have the financial resources to indemnify the conduit for losses stemming from its own negligence. Finally, third-party administrators typically do not have a financial stake in the conduit, either as a strategic part of their business, or as a provider of liquidity and credit enhancement. In evaluating a third-party administrator, Moody's focuses particularly on the administrator's experience and resources. In addition, the administration agreement is carefully analyzed to ensure that the administrator's duties and fees are clearly enumerated.

There are several reasons that an ABCP conduit sponsor might choose to use a third-party administrator. Some of the newer or smaller bank conduit sponsors do not have the experience or resources to run the day-to-day operations of a conduit. The bank may also have an expensive overhead structure that leads to a material cost for the incremental hires needed to run an ABCP program. Relying on an experienced administrator rather than establishing their own conduit management operations can result in lower costs. Typically, however, the sponsor retains all credit and administrative functions with regard to the assets, such as underwriting and credit approval for new sellers, as well as monitoring the performance of asset pools. The sponsor is generally required to indemnify the conduit for errors of the third-party administrator, especially if material administrative functions have been delegated, such as ABCP issuance, repayment, and hedging. If the program sponsor is a non-financial institution, lacking in experience, credit ratings, and financial resources to remedy any errors, the appointment of an experienced, rated third party to provide some amount of administrative services and to indemnify for performance would be considered a positive factor in Moody's rating analysis.

Owner/Manager

The legal owner of the conduit is typically a third party independent of the sponsor. In the U.S. it is usually a shell company controlled by a service provider that also acts as Manager of the conduit. The most common third-party owners of U.S. ABCP conduits are Global Securitization Services LLC, Amacar Holdings, and Lord Securities. In English law jurisdictions a charitable trust often holds ownership of the conduit, and this trust is established and managed by a law firm that provides similar services as a Manager. In both cases these firms provide corporate officers and board members for the conduit.

The Manager is responsible for the corporate affairs of the conduit as a legal entity, not the operations with respect to commercial paper or assets. These duties typically include providing a board of directors, providing a legal address, maintaining corporate bookkeeping records, preparing tax returns and filing required regulatory statements. Although a third party not affiliated with the Sponsor often owns the conduit, the Sponsor actually controls the activities of the conduit by acting as the Administrator. A Management Agreement governs the relationship between the Administrator and Manager, while the corporate formation documents limit the actions of the Owner.

Sidebar 8

Billets de Trésorerie—the French CP

Almost all of the ABCP issued by French conduits are issued in the Billets de Trésorerie (BT) market. The largest conduits also have EuroCP capabilities, but do not frequently use them; some also issue in the U.S. CP market but amount is marginal. As of December 2002, there were 95 active issuers in the BT market, for a total outstanding of EUR 72 billion. ABCP issued by 18 active conduits represents EUR 21.8 billion, or approximately 30% of the BT market.

BTs are more heavily supervised than CP. Prior to issuance, the issuer must submit a Dossier de Presentations Financière (DPF) to the Banque de France, the French central bank. The DPF is similar to an offering circular, but must be updated every year. The issuer must have been in existence for at least two years, and have a minimum capital equal to EUR 230,000, compared to no prior existence and minimal capitalization for ABCP programs established elsewhere. A rating is not required, but BT programs without a rating from an approved rating agency must also receive approval from the Commission des Opérations de Bourse, the French counterpart to the U.S. Securities and Exchange Commission. The Banque de France monitors the market, and may suspend an issuer that does not comply with the provisions of various texts and decrees. BTs may be issued in all major currencies.

From a credit standpoint, BTs are quite similar to commercial paper. Currently French money market funds can invest only up to 10% in CP. However, BTs are considered a regulated instrument, and as such no such investment limit applies to BTs. BTs are very attractive to French money market funds and therefore preferred by issuers. The 10% limit is likely to disappear in 2003 which will likely increase French money market fund investment in Euro and U.S.\$ CP.

Issuing and Paying Agent or Depository

The Issuing and Paying Agent (IPA), sometimes called the Depository, is responsible for issuing ABCP, either electronically or in certificate form, and repaying maturing ABCP. This role is documented in an Issuing and Paying Agency Agreement, sometimes called a Depository Agreement. While the IPA may be part of the same bank as the Administrative Agent, a separate trustee group within the bank usually performs the IPA function. This role is more frequently performed by a third-party institution.

Almost all ABCP issued today is held in electronic book entry form and is cleared through one of the electronic clearing systems, either The Depository Trust Company (DTC) in the U.S. or Euroclear and Clearstream in Europe. ABCP is issued to investors upon instruction from the Placement Agent. ABCP is repaid at maturity when presented to the IPA for repayment with the holder of record at maturity based on payment instructions. The IPA typically has working arrangements with one or more of the electronic clearing systems so that it can administer these activities through those systems. The duties of the IPA are similar to those of a trustee.

The actual cash movement between the conduit and the ABCP investors generally takes place via a "Commercial Paper Account," which both receives the proceeds of newly issued ABCP and is used to repay maturing ABCP. Most ABCP is repaid from the proceeds of newly issued ABCP, a process called "rolling" ABCP. The IPA typically holds the Commercial Paper Account in trust for the benefit of the CP investors. As funds are received or paid at different times during the business day, the IPA may at its discretion advance funds on behalf of the conduit on an intraday basis, something known as a "daylight advance." The IPA will usually advance funds if it is certain that by the end of the day all cash inflows and outflows will match up.

In order to provide for timely repayment, the IPA is required to determine if the CP account has sufficient funds to repay maturing ABCP each day, either from the proceeds of new ABCP or amounts deposited by the Administrator. If not, the IPA gives notice to the Administrator and requests that additional funds be provided. In many programs the IPA has the obligation and right to draw on the liquidity and credit enhancement facilities directly, rather than through the Administrator, if it needs funds for timely repayment.

Placement Agents and Dealers

The CP Placement Agent serves as an ABCP dealer and provides the conduit access to investors, under the terms of a Placement Agency Agreement. A Dealer is usually an investment bank, or the investment banking arm of a larger financial corporation. Most Dealers maintain a trading desk that makes a market in the conduit's ABCP, and a marketing group that presents the conduit to prospective investors. An ABCP conduit typically uses two or three placement agents including an affiliate of the Sponsor, if the Sponsor has placement capabilities, in order to ensure that funding will be done on competitive terms.

The Placement Agent works closely with the Administrator and the IPA to facilitate the sale of ABCP. The Administrator determines the amount of ABCP required for funding new assets or repaying maturing ABCP. Either the Administrator or the IPA relays that information to the Placement Agent on a daily basis. The Placement Agent then informs the Administrator of the likely discount rate for ABCP issued at different maturities. The two then decide how much ABCP to issue at each maturity, based on cost, expected cash flow from the conduit's assets, and the currently outstanding ABCP. When the ABCP is sold, the Placement Agent informs the IPA of the amounts, maturities and the purchasers.

The Placement Agent also screens investors to be sure that they are qualified and eligible to invest in the conduit's ABCP. Almost all ABCP programs are structured to qualify as exempt from registration under the Investment Company Act of 1940 and are also structured so that the commercial paper notes issued qualify as exempt under the Securities Act of 1933. In order to preserve this status, ABCP can only be sold to "qualified purchasers" as defined by the Investment Company Act and "Qualified Institutional Buyers" or QIBs under Rule 144a²⁰ of the Securities Act of 1933. The Placement Agent typically requires new customers to provide certain information in order to confirm this status. The Placement Agent also evaluates a client's counterparty risk as a purchaser of ABCP.

Collateral Agent or Security Agent

ABCP investors often hold or benefit from a security interest in the assets of the ABCP program. In order to maintain that security interest, the conduit must have and maintain a perfected first priority lien, since the assets secure the financing provided. In partially-supported programs there is some degree of reliance on these assets to repay maturing ABCP. The Collateral Agent must ensure that inappropriate parties do not share a security interest or gain a priority interest in assets that are pledged to investors. In some programs, the loss of a first priority security interest could jeopardize repayment of ABCP.

The Collateral Agent, sometimes called the Security Agent or the Trustee, receives a security interest from the conduit in all of the conduit's assets, all rights and interests under all of the program documents, and all other accounts and investments. The Collateral Agent holds this security interest for the benefit and repayment of the investors, support providers and service providers. The Collateral Agent's role is documented by a Collateral Agency Agreement or a Security Agreement, sometimes called a Security and Intercreditor Agreement. That agreement broadly lists the assets and interests covered and the procedures to be followed for holding them and maintaining the necessary security interest.

The Collateral Agent, based on information provided by the Administrator, performs or verifies that the Administrator has performed, the tasks necessary to maintain a perfected first priority security interest in the purchased assets. The Collateral Agent typically has the authority to direct the Administrator to take any steps it deems necessary to maintain that interest. The Collateral Agent also exercises certain of the conduit's rights and interests in the assets on behalf of the secured parties. As assets are acquired, sold or transferred, the Collateral Agent takes possession of the assets or arranges proper transfer and holds the proceeds of sale in accounts held in trust for the conduit. Normally this will be done according to instructions received from the Administrator. However, during an ABCP program liquidation event, the Collateral or Security Agent may also have the right or obligation to take control over the assets on behalf of investors and arrange for their orderly sale, repaying investors and other creditors from the proceeds.

Not All Programs Are Secured

Not all ABCP programs grant a security interest in assets to ABCP investors. In many cases the ABCP investors are unsecured, relying on repayment from liquidity banks and credit enhancement providers. Those providers, in turn receive a security interest in the specific asset pools that they are supporting. This means that ABCP investors would be unsecured creditors in the unlikely event that the conduit enters bankruptcy. Structural provisions in ABCP program documents are intended to make them bankruptcy remote to a **Prime-1** level of certainty.

Moody's does not view the presence of a security interest as critical to maintaining the **Prime-1** rating of most ABCP programs. The **Prime-1** rating is an opinion as to the likelihood of full and timely repayment of ABCP. Since most ABCP programs make little if any attempt to match asset collections with CP maturities, the timely repayment of ABCP relies ultimately on a draw under the liquidity facility. Moody's identifies the presence or lack of a security interest for investors in its program research reports published in Moody's Global ABCP Market Review.

20 Rule 144A pertains to U.S.-based investors. Non-U.S. investors must qualify under Regulation S. See Security Law Considerations on page 11.

Custodian

A Custodian maintains actual possession of certain assets, or the documentation representing certain types of assets. In some cases the Custodian and the Collateral agent are the same, governed by a single agreement. In others they are separate parties. Typically a conduit that invests in securities has a Custodian in addition to the Collateral Agent to hold the securities for the benefit of the secured parties, in a Securities Account. The Custodian Agreement details the procedures for handling of securities so as to maintain a perfected first priority security interest in them.

Liquidity Agent

The liquidity facility is typically provided by one or more commercial banks on a transaction-by-transaction basis through a Liquidity Loan Agreement, or a Liquidity Asset Purchase Agreement. In some cases the liquidity facility covers multiple transactions or the entire conduit, and is governed by a Global Liquidity Loan Agreement or Global Liquidity Asset Purchase Agreement. In every case there is a Liquidity Agent who is responsible for managing the syndicate of banks providing the facility.

If the conduit needs funds to repay maturing ABCP or to fund an asset purchase, the Administrator or IPA sends a funding request to the Liquidity Agent. The Liquidity Agent verifies that the conditions precedent to drawing on the facility are met and then notifies the syndicate members of the amount they will be required to provide. In particular, the Liquidity Agent verifies the amount of liquidity funding available relative to the assets' purchase price using the "Purchase Price" or "Borrowing Base" formula stated in the liquidity agreement. Liquidity banks typically remit funds to the Liquidity Agent who then passes them on to the conduit. In reverse, the conduit remits facility fees, interest and principal payments to the Liquidity Agent who then pays the liquidity banks in proportion to their commitment or to their advanced amount, as specified in the liquidity agreement.

Along with acting as the Administrator, the bank Sponsor often acts as the Liquidity Agent for most of the liquidity facilities associated with its conduit. Sponsors of single-seller programs (who are not typically banks) appoint a Liquidity Agent who then syndicates the facility to a group of banks.

Liquidity Banks

The Liquidity Banks typically sign the liquidity agreement on a page or schedule indicating the dollar amount of their commitment. Generally the Liquidity Agent is also a Liquidity Bank. A Liquidity Bank should understand the precise notice and timing requirements, and limited conditionality for a draw on the liquidity facility. It is expected that a Liquidity Bank will fund upon proper notice by the Liquidity Agent, with that notice serving as a representation that all of the conditions necessary for a draw have been fulfilled, and that none of the "outs" to funding are present. The same-day payment requirement does not leave time for independent verification by the Liquidity Bank.

A Liquidity Bank also represents that it has independently evaluated the risk associated with the transaction and its commitment under the terms of the liquidity agreement. It may accept terms that permit its commitment to be drawn and placed in escrow if it does not renew the commitment in a timely fashion or if its credit rating is lowered or withdrawn. The Liquidity Bank may also agree to "non pro rata draw" provisions, permitting its commitment to be drawn to cover the failure to pay by another liquidity bank.

For bank-sponsored conduits, the sponsoring commercial bank typically provides the bulk of the liquidity for every transaction. Liquidity facility syndicates—multiple banks providing liquidity for a single deal in a single conduit—used to be fairly common. However, with bank mergers and higher liquidity pricing, often the sponsoring bank is both the Liquidity Agent and the sole Liquidity Bank. Liquidity facility syndicates in multiseller conduits have been largely replaced by "club" deals, a syndication of the deal itself with multiple conduits funding a portion of the deal, and each conduit sponsor providing liquidity for its share of the deal.

A Liquidity Bank is typically required to have a rating equivalent to that of the ABCP issued by the conduit. Most Liquidity Banks therefore have **Prime-1** ratings. Moody's considers the rating of parties providing liquidity or credit support to the conduit to be very important.²¹ The Liquidity Agreement will often provide a mechanism to provide for the downgrade of a Liquidity Bank, either by replacement or by having the downgraded Liquidity Bank put up cash to collateralize its funding commitment.

Credit Enhancement Providers

Credit enhancement may be provided in a number of ways. Deal-specific enhancement—the first-loss position—and overcollateralization are discussed in the Appendix: Asset Purchase Structures on page 61. At the

²¹ See Moody's Special Report, *Downgraded Support Providers in ABCP Programs: Grace Periods Don't Exist*, September 1998.

conduit level, the most common form of program-wide credit enhancement is an irrevocable letter of credit (LOC) from the sponsoring bank under the terms of a Credit and Reimbursement Agreement. Because an LOC may be drawn on a same-day basis, an LOC may provide liquidity in addition to credit support.

Program credit enhancement can also be provided by almost any type of arrangement where the amount available is not dependent on the credit status of the assets funded by the conduit. In addition to using LOCs from highly rated banks, program credit enhancement has also been provided in the form of a cash collateral account and a surety bond from a monoline insurance company. A liquidity facility may also provide credit support if the amount of available funding depends only on the amount of ABCP maturing and the facility commitment amount, and not on the default status of the assets.

As with Liquidity Banks, the rating of a credit enhancement provider must typically be consistent with the rating of the ABCP notes. Most program wide credit enhancement is provided by **Prime-1**-rated entities, or by entities with high term ratings fronted by a liquidity facility provided by **Prime-1**-rated entities.

Hedging Agent

Conduits typically use hedging arrangements or swaps to cover two types of risk. These are the basis risk associated with ABCP funding costs and asset yields, and the conversion risk when ABCP is issued in one currency and assets are denominated in another.²² Typical hedge arrangements include interest rate swaps (from fixed to floating) and currency spot-forward contracts (from non-U.S. dollars to U.S. dollars). The hedge counterparty is almost always the sponsoring bank of an ABCP conduit.

First, as assets are acquired, each asset purchase may include the hedge necessary to address currency or interest rate risk specific to that transaction. Moody's reviews the details of the hedging arrangements as part of the rating confirmation process.

Second, a Hedging Agent may take responsibility for seeing that the conduit enters into hedging arrangements that, in its judgement, are appropriate. Moody's does not review the specific hedges the Hedging Agent structures for the conduit, but instead relies on the rating of and an indemnity from the Hedging Agent. The indemnity says, in fairly broad language, that if the hedging arrangements are incorrect or insufficient, and as a result the conduit faces a shortage of funds to repay maturing ABCP or to pay conduit expenses, then the Hedging Counterparty will provide funds on a same-day basis to make up the shortfall. Documented in a Hedging Agency Agreement, this arrangement gives the conduit the greatest degree of flexibility in managing interest rate and currency risk. For a bank-sponsored conduit, the Hedging Agent is often the Administrator. In many cases the duties of the Hedging Agent may be specified in the Administration Agreement and there may be no separate Hedging Agent or Agreement.

The hedge counterparty utilized upon the direction and determination of the Hedging Agent or Administrator may be a third party. Hedge counterparties must have a rating consistent with the rating assigned to the conduit. The hedge counterparty must also be a firm that commonly engages in swap transactions. The Hedging Agent is typically not liable for the default of a hedging counterparty that meets these eligibility criteria.

Over the past couple of years, there has been an increased use of swaps as a form of program liquidity or credit enhancement. Total return swaps can be tailored to absorb a wide range of risks. If the swap counterparty has a **Prime-1** rating, and if payments are made whenever ABCP comes due, then the swap may also serve as a source of liquidity. Credit default swaps or market value swaps are utilized to either mitigate credit risk or cover any price differential of assets sold for less than their purchase price. Credit default swaps are a common form of credit enhancement. Market value swaps have become common for warehouse transactions, as price fluctuations may cause financial assets purchased by the conduit to be worth less than their purchase price by the time they are sold into a term securitization.

²² See *The Use of Swaps and Derivatives in ABCP Programs: Efficient Ways to Transfer Risk*, Moody's Special Report, reprinted from the Second Quarter Asset-Backed Commercial Paper Market Review.

GENERAL RISKS AND MITIGANTS

In reviewing ABCP programs, Moody's looks at four broad categories of risk: structural, credit, liquidity and operational. Structural risk arises from the organizational form and contractual arrangements of the program and takes the form of the potential insolvency or bankruptcy of the program. Structural risk is mitigated largely by proper legal documentation, particularly restrictions on permitted activities and agreements with third parties. Credit risk arises from the assets funded by the conduit and the support providers and appears as a failure to repay investors. It is mitigated by providing credit enhancement that is appropriate to the asset quality of the portfolio and by structuring amortization triggers. Liquidity risk arises from the inherent mismatch in cash payments received from the conduit's assets and cash payments required to be made to repay maturing ABCP and cover conduit expenses. It is mitigated by analyzing all of the conduit's sources of cash and all of the conduits required payments and sizing liquidity backup facilities to cover the difference. Finally, operational risk arises from the inherent complexity of a large financial program with multiple assets, support providers and investors. It is mitigated by having well qualified committed service providers with the staff, expertise and systems to perform at the highest levels and the financial strength to indemnify investors for any errors.

ABCP conduits issue high levels of debt with virtually no equity. Yet these conduits generally carry the highest short-term rating of Moody's and other rating agencies. These ratings are only achievable when each of the categories of risk present in an ABCP conduit is accounted for and mitigated with a high degree of certainty.

Structural Risk

ABCP conduits are structured as bankruptcy remote special purpose vehicles. In order for investors to be secured in the assets for repayment, there should be little risk that the conduit or the assets will be consolidated into the bankruptcy of a third party. Investors are faced with two types of bankruptcy risk in ABCP conduits. First, that the conduit, itself, becomes bankrupt, and second, that a seller whose assets are funded by the conduit files for bankruptcy. These risks cannot be eliminated, but they can be significantly reduced. A properly structured conduit is highly unlikely to be subject to bankruptcy.²³

Conduit Bankruptcy

A conduit could be bankrupt because it does not have sufficient assets to pay all claims against it, or because it is illiquid and has a shortage of cash relative to payments due.

In either case, the bankruptcy court is likely to impose an automatic stay that would temporarily prevent the conduit from making any payments to creditors. The automatic stay gives the court time to determine the validity of and priority of claims against the bankrupt's estate. Even if the assets are sufficient to repay ABCP investors, they are unlikely to be repaid on time.

Bankruptcy may release many support parties from their commitments to the conduit. Generally, one cannot be compelled to lend money to a bankrupt entity. If a conduit is bankrupt, then liquidity facilities may be unavailable to provide timely repayment as ABCP matures. Other agreements with support and service providers may also be conditional on the conduit's solvency.

Limiting the Risk of Conduit Bankruptcy

A conduit can enter bankruptcy voluntarily or involuntarily. A voluntary bankruptcy is one in which the conduit files a bankruptcy petition on its own behalf. An involuntary bankruptcy filing is one in which a third party has filed a petition against the conduit. In order to reduce the probability of these events, the conduit must be set up in a way that prevents it from entering bankruptcy voluntarily, and makes it unlikely that a third party will have sufficient grounds to file.

The first step in achieving bankruptcy remoteness is to establish the conduit as a special purpose vehicle (SPV) with a third party as the majority shareholder. The conduit must meet the legal standards required to maintain its existence as a distinct entity: for example, separate records, books, stationary, and offices. The Administrator and the Manager are generally charged with operating the conduit in a way that will not jeopardize its status as an independent entity.

²³ See Moody's Special Reports, *Handle with Care: Single Member LLCs in Structured Transactions*, March 1999, and *Bulletproof Structures Revisited: Bankruptcies and a Market Hangover Test Securitization*, August 2002, for a more detailed discussion of bankruptcy issues and asset-backed finance.

Sidebar 9

The Australian ABCP Market

Since its genesis in 1984, the Australian ABCP market has experienced steady year-on-year growth. As of June 2002, the total assets financed by Australia ABCP conduits was approximately U.S.\$17 billion.

The ABCP market in Australia is comprised of a variety of mostly **Prime-1** rated, bank-sponsored conduits. Approximately 85% of the CP outstanding has been issued by partially-supported programs. Australian conduit universe contains a large number of small-sized single-seller ABCP programs with average outstanding of less than U.S.\$200 million. Such programs account for over 35% of all programs by number, but they contribute to less than 15% of aggregate outstanding ABCP.

A number of large programs have the capacity to access offshore ABCP markets. To date, all offshore funding has been obtained from the U.S.. As at June 30, 2002, 32% of ABCP has been issued into U.S. ABCP market. These programs generally prefer to maintain a minimum 'floor' level of cross-border issuance and switch their ABCP issuance from one market to another depending on the available cost of funds.

Over 25% of the programs have been structured as serialized ABCP programs, but only a few have more than one series outstanding. As opposed to the U.S., Australian bankruptcy regime has been relatively friendly to serialized structures. Though untested in courts, the weight of legal opinion provides comfort that limited recourse provisions would insulate investors in one series from any bankruptcy provisions brought as the result of default of any other series.

Some conduits extensively utilize risk shifting to liquidity, but others shun it completely. As many sponsor banks are foreign – and so subject to the regulatory regimes in their home countries –their approach to liquidity is driven by the attitude of the relevant regulatory body. Most conduits abstain from full support through structured liquidity, but consider absorbing seller-specific risks, such as servicer risks or dilution risks.

Mortgage financing is an integral part of ABCP conduit activity in Australia. Given the dominance of mortgage assets in Australian structured finance securities, mortgage assets are convenient for some ABCP conduits to finance, as they can achieve economies of scale in a relatively short period. Most ABCP conduits provide mortgage financing through two primary means: (1) mortgage warehousing facilities, which involves the financing of a revolving pool of eligible mortgage loans, and (2) the purchase of highly rated mortgage-backed securities. These two asset types comprise about 50% of the total asset pool funded by Australian ABCP conduits.

The next largest asset classes are trade leases at 16% is margin loans with around 9%. Most of term securities purchased by conduits are highly rated RMBS.

The third party that owns the conduit is itself an entity that is unlikely to enter bankruptcy, and the ownership relationship structured so the conduit is unlikely to be consolidated with the owner if the owner did become bankrupt. Generally Moody's reviews a "non-consolidation opinion" from a law firm providing a reasoned argument to this effect with respect to the applicable laws. The conduit is almost never a subsidiary of the sponsor, so that it is unlikely to be consolidated with the sponsor's bankruptcy, should it occur. This is not a critical issue to investors when the sponsor is a highly-rated commercial bank. Most bank sponsors provide support to the conduit through liquidity facilities or credit enhancement. The credit quality of the conduit is closely related to that of the sponsoring bank, and a downgrade of the bank would likely lead to a downgrade of the ABCP issued by the conduit.

The precise legal form of the SPV depends on the jurisdiction. The SPV's bylaws usually require that 100% of the SPV's board of directors vote in favor in order to file a voluntary bankruptcy petition. The bylaws further require that at least one member of the board be independent of any party with an economic interest in the conduit. This limits the possibility that the SPV's board may feel pressure from the sponsoring bank, or any other interested party. In some jurisdictions, the bylaws may not permit a voluntary bankruptcy petition under any circumstances.

Reducing the Risk of Third-Party Bankruptcy Filings

The second step in achieving bankruptcy remote status is to reduce the likelihood that others will petition the conduit into bankruptcy. A conduit's bylaws and other documents limit its activities to issuing commercial paper and funding certain kinds of assets, and anything necessary to support those activities. Moody's generally asks for notice of any changes to the conduit documents, and prior review of any material changes.

A conduit enters into a number of service and support agreements with various third parties. A conduit also enters into a variety of loan and asset purchase agreements as it funds assets. To protect ABCP investors from

the risk that a third party forces an involuntary bankruptcy, each party should agree to certain terms that reduce the likelihood that the relationship will end with a bankruptcy petition. Moody's reviews a conduit's agreements with third parties in order to assess whether appropriate provisions are in place.

First, each party should agree to respect the priority of payments that is set out in the conduit's documents. As long as available funds are distributed as agreed, failure to receive payment should not constitute a claim in a bankruptcy petition. This is referred to as "excess funds" language: amounts owed to third parties are due and payable only to the extent the conduit has funds in excess of those required to repay maturing ABCP. (ABCP repayment ranks at or near the top in payment priority.) Second, each party should agree that it will have no recourse for repayment beyond the funds and assets of the conduit. And finally, each party should agree that it will not file a bankruptcy petition against the conduit for some period, usually at least one year and one day, following the maturity of the final outstanding ABCP. The period should be chosen to prevent funds paid to investors from being "clawed back" as a consequence of any bankruptcy claim.

Seller Bankruptcy

Seller bankruptcy may affect the conduit in four ways. First, the bankruptcy of the seller may have an effect on the credit quality of the assets owned or funded by the conduit. Second, collections on the receivables due from the bankrupt seller may be subject to an "automatic stay" by the court and may not be remitted to the conduit in a timely fashion. Third, payments owed by the seller to the conduit may also be stayed or may not be paid at all. For example, the seller may be liable to the conduit for the repurchase of ineligible receivables, reimbursement for billing adjustments for returns and volume discounts, and credits to obligors, such as cooperative advertising. Fourth, monies already transferred to the conduit by the seller may be considered "preferential transfers" and can potentially be "clawed back" by a bankruptcy court. The bankruptcy trustee would hold clawed back amounts until the court determines where the monies rightfully belong.

Limiting the Impact of Seller Bankruptcy

A conduit cannot prevent a Seller bankruptcy. However, given the prevalence of non-investment-grade-rated Sellers, the risk of a Seller bankruptcy is a real concern. Generally, the risks associated with seller bankruptcy—other than the credit quality of the assets—are assumed by the liquidity facility supporting the transaction. Most liquidity facilities are structured to fund against a defined borrowing base or include a funding formula that determines the amount that may be drawn by the conduit against the assets of a given transaction. Typically, that borrowing base includes all non-defaulted assets and all funds due from the seller that have not been received by the conduit. This means that the liquidity banks may not deduct from the borrowing base amounts that have been stayed, clawed back, or are owed by the seller to cover receivable dilution. The reasoning is that a properly structured transaction will eventually receive payment for these items, but not in time to repay maturing ABCP. Therefore the liquidity banks, if they have done their due diligence, are taking timing and not credit risk with respect to these items. However, liquidity facilities typically do not fund for defaulted assets, so ABCP investors bear the credit risk associated with the collateral.

Term versus Conduit Transaction Structures

One major difference between a term transaction and a conduit transaction is that a term transaction typically does not have a liquidity facility to take seller risk. Both a term transaction and a conduit transaction typically have a dilution reserve sized to cover payments due from the seller.²⁴ A term transaction may have more stringent cash handling procedures to limit the risk that funds will be trapped in a seller bankruptcy, though conduit transactions are generally careful to limit this risk also. Finally, a term transaction often requires a reserve fund or letter of credit to bridge any expected delay in receiving funds during the resolution of a seller bankruptcy. This reserve will be sized to cover interest and any other payments due investors, plus servicing and trustee fees.

Credit Risk

Credit risk arises primarily from the assets funded by the conduit, and secondarily from the quality of the support and service providers. This section focuses on the likelihood that the assets supporting the repayment of ABCP perform so poorly that losses to those assets could affect repayment of ABCP.

²⁴ Moody's generally expects ABCP investors to benefit from the dilution reserve in the liquidity funding formula, even though liquidity banks take dilution risk. Bankruptcy may result in a decline in servicing quality, and dilution may not be recognized in a timely fashion. Until dilution is recognized, it may appear as a defaulted asset. See Appendix: Asset Purchase Structures on page 61 for more details.

First-Loss Protection

ABCP investors typically benefit from two layers of credit protection. First, each transaction funded by the conduit has a level of first-loss protection associated solely with that transaction. This first-loss protection typically takes the form of overcollateralization, but may be a reserve fund, credit insurance, letter of credit, third-party guarantee or provided by the liquidity facility.

Program-Level Credit Enhancement

Most conduits provide second-loss protection through a program-level credit enhancement facility. This program-level enhancement is usually sized as the greater of a minimum dollar amount and a percentage of the conduit's aggregate funding commitments. Older programs tend to set this percentage at 10% or higher. As credit enhancement has become more expensive and conduits have sought to reduce costs, this percentage has declined, and newer programs tend to use 8% or even 5%. The calculation of program credit enhancement may exclude "highly-rated" assets. Highly-rated assets are generally defined as those with explicit ratings of **Aa2** or higher, or assets that are fully-supported by the liquidity facility or by a guarantee from a similarly rated party. In most cases, these excluded assets still benefit from the program credit enhancement facility; in some cases they do not.

The amount of program credit enhancement is an important consideration in Moody's rating analysis. All other things being equal, a conduit with a lower percentage of program-level credit enhancement must structure individual transactions to a higher credit level. In every case the overall credit strength must be consistent with the rating assigned, usually **Prime-1**. However, some conduits may be deliberately over-enhanced. Conduits typically do not disclose the identity of the sellers or obligors underlying the transactions funded, and most conduit assets do not carry explicit term ratings from Moody's. ABCP investors may take comfort in seeing a substantial amount of program-level credit enhancement as second-loss protection. Conduit sponsors may maintain high levels of credit enhancement in order to obtain greater investor acceptance and lower funding costs.

Forms of Credit Enhancement

The most common forms of credit enhancement are overcollateralization, subordination, seller recourse, excess spread, structured liquidity, cash reserve account, letter of credit, third-party guarantee, and total return swap. Each form of credit enhancement comes with its own set of risks. These may be related to asset performance, credit risk of the provider, funding formula and availability in the event of bankruptcy. Overcollateralization, subordination, seller recourse, excess spread, structured liquidity and third-party guarantees are often seen at the transaction level providing first loss protection. Subordination, cash reserve accounts, letters of credit and third-party guarantees typically provide program-level credit enhancement.

Overcollateralization

Conduits obtain credit enhancement against potential losses in many transactions by advancing less than the full value of the pool of assets that are pledged to repay maturing ABCP. The portion of the asset pool that exceeds the advances outstanding is the overcollateralization. For example, a conduit might advance \$80 against \$100 in assets. The percentage funded is called the advance rate, which in this case is 80%. The extra \$20 constitutes overcollateralization. The 20% overcollateralization is sometimes referred to as the "haircut". The unfunded percentage is generally represented by a "seller interest" that is subordinate to the interest in the receivables held by the conduit. The seller will receive cash flow allocable to the seller interest to the extent that these funds are not required to repay ABCP.

The amount of overcollateralization is determined by examining the various factors that may cause an asset to default based on a review of the past performance of the specific and similar asset pools. For trade receivable transactions the advance rate follows a dynamic formula based on recent performance, subject to a minimum level. For other asset types, such as auto loans or mortgages, the advance rate may be fixed.

Subordination

Subordination is similar to overcollateralization, except that another investor may hold the subordinated tranche of a transaction. Conduits often fund tranches of public term securitizations or private transactions with identical structures. The holder of a senior or mezzanine tranche benefits from the cash flows allocable to the more subordinated tranches. As with overcollateralization, if losses on the assets exceed the available subordination, conduit investors may experience losses.

Seller Recourse

In some transactions ABCP investors benefit from recourse to the seller of the assets. That is, to the extent there are losses on those assets, the seller agrees to pay for those losses. This protection is in addition to any recourse to the seller for ineligible receivables or other dilutive items. The value of the recourse is a function of the credit quality of the seller. If the seller is rated **Prime-1** or an equivalent long-term rating, full reliance can be placed on this form of enhancement. However, there may be a high degree of correlation between asset performance and seller credit quality—a factor that Moody's rating analysis takes into consideration. For lower-rated sellers, recourse to the seller is not a negative factor, but it may not provide significant benefit. Seller recourse may also threaten the "true sale" of the assets and the ability of the seller to treat the financing as an off-balance sheet activity. For this reason, recourse to the seller for items other than ineligible receivables and dilution is not common.

Excess Spread

Some assets such as credit card receivables and other consumer loans carry a rate of interest significantly in excess of the CP funding costs and asset servicing costs. Some of this excess spread may be "monetized," if the conduit purchases the assets for more than their par value. Excess spread that is pledged to the transaction is available to cover some or all of the realized losses on the assets, usually on a "use it or lose it" basis. This means that to the extent interest payments exceed funding costs and servicing fees, the remaining excess can be applied as credit enhancement to cover charge-offs taken on the assets during the applicable collection period. If excess spread remains after covering charge-offs, it is released to the seller. Therefore, any excess spread not used in the current period is "lost" and cannot be applied against future losses. Transactions with excess spread are often structured with a "trapping" mechanism that requires a reserve account to be funded if excess spread declines below a certain level. This "spread account" is combined with an early amortization trigger that forces the transaction to cease purchasing new assets and wind down if excess spread falls even lower or becomes negative. (Negative spread occurs when expenses and losses exceed available spread.) Moody's rating analysis includes an evaluation of the benefit derived from excess spread based on asset performance and the effectiveness of the spread trapping mechanism. Like overcollateralization, the availability of excess spread is linked to the level of delinquencies and defaults in the asset pool.

Structured Liquidity²⁵

Liquidity facilities may be structured to absorb a variety of risks in addition to market disruption and cash flow timing differences. As previously noted, liquidity facilities typically absorb many forms of seller recourse risk, such as removal of ineligible receivables, cash collected but not remitted and other dilutive items. Liquidity facilities are sometimes structured to absorb other credit risks as well. A liquidity facility designed to bear all credit risk by paying the face amount of commercial paper upon maturity regardless of the credit quality of the assets is said to be a "fully supporting" liquidity facility. A liquidity facility may also be designed to purchase or refinance a transaction if certain performance triggers are hit. Depending on the trigger levels chosen and the time span over which liquidity purchases the assets, credit risk may be shared between ABCP investors and liquidity banks. Some liquidity facilities are structured with somewhat convoluted funding formulas and triggers that nevertheless result in virtually full credit support from ABCP investors' point of view.

The credit strength of structured liquidity facilities, like all liquidity facilities, is a function of the credit quality of the provider. Liquidity providers must have a rating consistent with the rating of the ABCP program. Moody's also carefully reviews the funding formula and the conditions precedent to funding in order to determine the amount and likely availability of funds. Finally, liquidity funding is typically not available if the conduit is bankrupt, as noted in the discussion of Structural Risk.

Cash Reserve Account

Some transactions have a cash reserve account that is either funded at closing or that funds over time by retaining excess spread. In relatively rare cases cash reserves have also been used as program-level credit enhancement or liquidity. The funds are usually kept in a trust account for the benefit of investors. The trustee is permitted to invest the funds, in high quality assets that mature before the next maturing ABCP. A cash reserve account can generally be drawn on a same-day basis, and is unaffected by the credit quality of third parties or the conduit.

25 See *Understanding Structured Liquidity Facilities in Asset-Backed Commercial Paper Programs*, Moody's Special Report, reprinted from the *Asset-Backed Commercial Paper Market Review*, First Quarter 1997

Letter of Credit

Program-level credit enhancement is most commonly provided in the form of an irrevocable direct pay letter of credit (LOC) from the sponsoring commercial bank as credit enhancement provider. LOCs are also used to enhance specific transactions. LOCs can be drawn on a same-day basis and typically have no conditions precedent to making a draw. The availability of funds under the LOC is not affected by the credit quality of the assets or of the conduit. However, the credit quality of the LOC is directly tied to the credit strength of the bank providing the LOC.

Third-Party Guarantee

Some transactions benefit from an insurance policy or guarantee whereby a highly rated counterparty agrees to pay losses, either in full or up to a specified limit. Aaa-rated monoline insurers are the most prevalent providers of guarantees in the ABCP market. The monoline financial guarantors' primary business is insuring financial transactions for a fee or premium. However Moody's has also reviewed guarantees from multiline insurers or from other highly rated parties. Trade receivable transactions sometimes include credit insurance that covers defaults by obligors. Credit insurance is more common in European deals than in U.S. transactions.

The value of a guarantee depends first on the credit quality of the guarantor, second, on the conditions and limits to funding that may affect availability, and finally on the willingness of the guarantor to pay. For example, monoline financial guarantors have a track record of making investors whole promptly according to the original payment terms. In contrast, the business model for multiline and credit insurers is to review and possibly challenge claims prior to payment.

Although the insurance policy may cover credit losses, it usually will not pay claims in time to repay maturing ABCP. Most transactions require a liquidity facility to "front" for the payment under the surety bond, insurance contract, credit insurance or other type of guarantee. The liquidity facility provides the conduit with funds until the guarantor reimburses the conduit for credit losses.

Total Return Swap²⁶

In the past few years, securities portfolios have become a more significant component of ABCP conduits' assets. With the growth of securities portfolios has come an increased use of derivatives to hedge various risks. Swaps typically exchange defined cash flows on certain specified payment dates. A swap may bear all risks in a transaction, i.e. interest rate, foreign exchange, liquidity and credit. Under a total return swap, the swap counterparty makes all payments of interest and principal required to repay ABCP and conduit expenses in return for receiving all payments from the underlying security. In some cases, if the swap counterparty has a **Prime-1** rating and the swap is written to require payment whenever the conduit needs funds, a total return swap may serve as a source of liquidity.

The credit quality of the swap counterparty is the primary concern in analyzing total return swaps. Moody's also carefully reviews the terms of the swap—typically based on standard ISDA (International Swap Dealers Association) documentation—to determine the payment amounts, payment dates and conditions to funding, if any. Total return swaps are most commonly seen enhancing single securities or a pool of securities. There are some conduits that are fully-supported with respect to credit and liquidity through a total return swap.

Liquidity Risk

Moody's short-term ratings address the likelihood that an investor will be repaid in full and on time. ABCP is a continuously offered product. Large programs are in the market every day issuing new ABCP and paying off maturing ABCP. Sometimes the pattern of ABCP issuance and maturity are closely matched to cash flows from the assets, but this is not necessarily the funding strategy of many ABCP conduits. In a typical ABCP program, maturing paper is repaid with the proceeds of newly issued paper so as to maintain uninterrupted funding of the conduit's portfolio. Liquidity risk arises from the imperfect matching of cash flows and the uncertainty of new issuance. Even though the conduit's assets are performing well, there may not be enough cash generated in a timely manner to repay maturing ABCP if new paper cannot be issued.

The ABCP market has been liquid throughout its history, in that no **Prime-1**-rated conduit has ever been unable to issue ABCP at some reasonable rate of interest. However, Moody's credit analysis of ABCP conduits does not assume that ABCP can always be "rolled". Most ABCP conduits require backup sources of liquidity.

²⁶ See Moody's Special Reports, *Understanding the Risks in Credit Default Swaps*, March 2001, and *The Use of Swaps and Derivatives in ABCP Programs: Efficient Ways to Transfer Risk*, reprinted from the Second Quarter 2000 Asset-Backed Commercial Paper Market Review, for a discussion of Moody's concerns with respect to the language in swap agreements.

Bank Liquidity Backup Facilities

Most ABCP conduits have bank liquidity backup facilities sized to cover the face value —interest and principal at maturity—of all ABCP outstanding. These facilities are usually provided on a deal-by-deal basis, though they may cover a pool of assets or the entire conduit. Some conduits have liquidity at both the transaction and the conduit level.

A traditional bank liquidity facility is provided by a syndicate of **Prime-1**-rated banks and is available to repay maturing ABCP to the extent that the assets supporting the ABCP are performing. Although some liquidity facilities assume the credit risk of the assets (see Credit Risk section above) most liquidity facilities fund according to a borrowing base that is adjusted for defaulted assets in a pool. The facility typically has a term of 364 days in order to qualify for zero risk capital weight under the first Basle Accord on bank regulatory capital.

Bank Syndication Risk

When a liquidity facility is provided by a large group of banks, a degree of operational risk may arise. In order to pay maturing ABCP the liquidity facility must fund on a same day-basis. The Liquidity Agent may have only a few hours to notify the liquidity banks and receive the funds. When many banks must be contacted in order for funding to occur, the probability of an error increases. The liquidity providers may be willing and able to fund, but if the funding notice is delivered to the wrong contact, or the payment instructions are incorrect, there may be a delay in marshalling all the funds required to repay maturing ABCP. In two instances known to Moody's, ABCP repayment was delayed for one day on a small amount of ABCP as a result of this sort of operational problem.²⁷

Large syndicated liquidity facilities are less commonly used by ABCP conduits than in the past. When a few large multiseller conduits dominated the market, large transactions were often funded by one conduit and a number of banks would agree to participate in the liquidity facility. Today, most major banks have their own conduits and liquidity is more expensive. Now, large transactions are usually syndicated among several conduits, a practice known as a "club deal." Each conduit funds a portion of the transaction and the conduit sponsor provides a liquidity facility for that portion.

Syndicated liquidity facilities are most often employed in single-seller conduits that are not sponsored by commercial banks. In reviewing these programs, Moody's scrutinizes the procedures for making liquidity draws, especially where the credit quality of the sponsor or the assets may be uncertain.

How Much Liquidity Is Enough?²⁸

A bank liquidity facility is typically sized at 102% of the transaction limit. The transaction limit corresponds to the maximum principal component of ABCP that may be issued. The additional 2% in liquidity commitments is meant to cover the interest component of the ABCP. In a low interest rate environment, 2% is enough liquidity to cover long-dated ABCP. In high-interest-rate environments it may only cover ABCP with very short maturities. Most conduits cannot issue ABCP unless there is sufficient available liquidity to cover the face amount at maturity. Moody's rating analysis relies on this coverage test, not on the precise size of the liquidity facility. The sizing of liquidity facilities affects the conduit's funding flexibility and conduit sponsors should carefully consider this when setting up the program.

Alternate Sources of Liquidity²⁹

Bank backup liquidity facilities have become scarcer and more expensive over the past few years for a number of reasons. First, bank mergers have reduced the number of liquidity providers. Second, events associated with Long Term Capital Management and Russia in 1998, and the weakened economy in 2000-01 led banks to increase liquidity pricing in line with the perception of increased risk. Finally, the Base III Accords will likely result in regulatory capital assessed against liquidity backup lines provided by banks.³⁰

Increased cost and reduced availability have prompted many sponsors to look for alternatives to bank backup facilities. These have included non-bank liquidity providers, reliance on cash flow from assets, maturity-matched funding, extendible notes, and medium-term notes (MTNs). Several of these methods may be used in combination, along with traditional liquidity backup lines, in order to achieve a cost-efficient liquidity plan.

27 See Moody's Special Report, *Often Confused Concepts: Related Commercial Paper and the 10 Bank Rule*, November 1995.

28 See Moody's Special Report, *Why Liquidity Facilities in ABCP Programs Equal 102%*, reprinted from the First Quarter 1999 Global Asset-Backed Commercial Paper Market Review.

29 See Moody's Special Report, *Alternative Liquidity Comes of Age: A Decade of Development*, reprinted from the Second Quarter 2001 Global Asset-Backed Commercial Paper Market Review.

30 See Moody's Special Report, *Entering a New Regulatory Environment: Proposed Revisions to the 1988 Basel Accord May Raise Costs and Squeeze Availability of ABCP Liquidity*, April 2001.

Non-Bank Liquidity Providers

In most jurisdictions, each bank has access to a central bank that is able to ensure that bank's own liquidity. In the United States, for example, the Federal Reserve acts as a lender of last resort to banks that need additional liquidity to meet their funding obligations. Banks' ready access to funds makes them ideal providers of liquidity backup lines. However, many other firms have both a **Prime-1** rating and the cash or near-cash resources to be acceptable liquidity providers, even if they do not have access to a central bank. Non-bank financial firms and insurance companies generally have high cash flow, highly liquid assets, and a business model that requires careful liquidity management. Derivatives products companies with **Prime-1** ratings may provide liquidity by a properly constructed swap agreement. Some non-financial corporations may also have significant liquid resources.

In reviewing a non-bank liquidity provider, Moody's looks to the firm's short-term rating, its business model and practices, its relationship to the program or the parties involved, and its likely willingness to pay. Moody's will also consult with the corporate rating analyst for the firm involved. In some cases, entering into an agreement to provide liquidity backup facilities may have a negative effect on the firm's short-term rating.

Relying on Assets for Liquidity

Conduit assets may provide funds in two ways. Some, like trade receivables and credit card receivables, may have very high repayment rates. Others, like whole loan mortgages and rated securities, may have liquid secondary markets, either through direct sale or securitization. Some conduits rely on collections or asset sales for part or all of their liquidity needs. However, reliance on asset collections or asset sales as a source of liquidity is subject to a variety of risks and complications that Moody's must consider in its evaluation of a conduit's sources of liquidity.

First, the liquidity of an asset is often a function of its credit quality. A decline in credit quality may result in slower payment rates or difficulty in selling the asset. A security with a lower rating may be worth significantly less than its book value, or may not have a ready market.

Second, a security may be subject to uncertainty as to the timing of its cash flow. Interest and schedule principal payments may be relatively certain, but prepayments may not be. Trade receivables have a payment due date, but tend to receive a significant percentage of payments late as companies manage their cash flow by choosing when and which suppliers to pay. Most traded securities require more than one day to settle; same-day settlement can be arranged but at higher costs, which results in lower sale proceeds. Buyers may take advantage of a forced sale by offering to pay less. Conduits may arrange for purchase commitments, or committed security repurchase ("repo") facilities. Moody's evaluates committed purchase or repurchase arrangements based on their terms and the credit quality of the counterparty.

Finally, relying on the cash flow of the conduit's asset portfolio, while technically feasible, can lead to negative side effects. Revolving transactions such as credit card and trade receivable facilities entail the continuous purchase of new receivables as old receivables are paid off. In order to use asset collections to pay down ABCP, the conduit must cease purchasing new receivables. The seller is then forced to replace the conduit with another funding source. A large, highly rated company with multiple funding sources would not be negatively affected, but a smaller or thinly capitalized firm could be forced into a liquidity crisis if the conduit ceased funding its receivables. At worst, a seller could file for bankruptcy, which could negatively impact the ability to collect repayments on the assets.

Maturity Matched Funding³¹

Short-term assets with fixed maturities can theoretically be financed with ABCP issued to mature on the same day or a day later. If the credit quality of the assets is consistent with a **Prime-1** rating, no backup liquidity may be needed. Alternatively, credit enhancement may be sized to cover the risk of default or late payment. The assets that fit this profile are short-term corporate loans or rated, short-term securities. Loan-backed programs finance short-term corporate loans on a maturity matched basis (see Types of ABCP Programs on page 17), but are less prevalent in the market than they once were. However, some conduits finance purchases of commercial paper, for example, with maturity-matched issuance of ABCP.

31 See Moody's Special Report, *Rating Commercial Paper Programs Backed by Maturity-Matched Loans*, September 1999.

Extendible Notes³²

A more recent development in the ABCP market is the use of extendible notes to mitigate liquidity risk. If ABCP cannot be re-issued, the conduit has the right to extend the scheduled maturity of outstanding ABCP to a later final maturity date. The issuer's option to extend is embedded in the security so investors' consent is not required in order to extend. Investors are compensated by receiving a higher interest rate, usually a positive spread to LIBOR, during the extension period. The extension period benefits the conduit by providing additional time to remarket its ABCP, and, failing that, to obtain cash from the assets by repayment or sale. In effect, the investor is providing liquidity to the conduit.

Extendible ABCP is common in two types of programs. It has been used in several single-seller programs that finance credit card receivables. The credit card receivables have relatively high and reliable payment rates. Moody's has evaluated the likelihood of repayment during the extension period and believes that receivable collections combined with a small bank liquidity facility provide liquidity consistent with the **Prime-1** rating. Mortgage warehouse conduits that finance newly issued mortgages prior to term securitization have also issued Extendible ABCP. Term mortgage-backed securities are issued very frequently. Since securitization is in effect a sale of the whole loan mortgages to new investors, these programs generally have a market value swap or other form of credit enhancement to cover the risk that the sale price may be less than the purchase prices. Both the credit card programs and the mortgage warehouse programs have credit enhancement sized to cover any credit risk on the funded portfolios.

Medium-Term Notes and Liquidity

Some conduits issue Aaa-rated Medium-Term Notes (MTNs) in addition to **Prime-1**-rated ABCP. MTNs are usually issued at a floating rate of interest at original maturities of six months or longer, often more than one year. By extending the maturity of the conduit's liabilities, MTNs can be used in conjunction with other measures to reduce the need for backup liquidity.

Combined Liquidity Management Strategies

In assigning short-term ratings to corporations, Moody's considers all sources of funds, all liabilities, and the company's strategy, experience and competence in managing its liquidity. As a result, not all corporate CP programs have full bank liquidity backup facilities.

ABCP programs are special purpose vehicles with limited resources. Unlike operating companies, they typically have only nominal capital and no additional sources of funds if problems arise. Moody's analysis of liquidity for ABCP programs reflects this difference. However, there is no reason that an ABCP conduit might not combine all of the methods listed above in a liquidity management strategy in order to reduce the required amount of bank liquidity, much as a corporation does.

Most conduits have a range of assets, from high to medium credit quality, from high to low cash flow, and from high to low marketability. Most conduits issue only fixed-rate ABCP with a fixed maturity—"plain vanilla" ABCP. But there are conduits that can issue a mix of conventional ABCP, extendible ABCP and MTNs. The securities arbitrage programs known as structured investment vehicles have long relied on both ABCP and MTN funding combined with a model of liquidity sources and uses to reduce their reliance on bank liquidity lines. A number of multiseller and other conduits use a similar combined approach to liquidity management. Moody's has reviewed the liquidity management strategies of these programs and determined that they provide for the repayment of ABCP to a **Prime-1** standard.

Operational Risk

Management of an ABCP conduit is a complex task. Among other things, conduit administrators manage the issuance and repayment of ABCP, the purchase, monitoring and collection of assets, and the coordination among all of the parties mentioned above (*Who's Who in an ABCP Program: Service and Support Providers* on page 29). Each asset may have a liquidity facility, a Liquidity Agent and one or more Liquidity Banks involved in the timing and amount of liquidity draws. The conduit may also have a global liquidity facility, program credit enhancement, and a swingline loan facility. The Depositary and Placement Agents must coordinate the sale, issuance and repayment of ABCP. Hedging services may be needed to deal with interest rate or currency mismatch. It is critical to the successful operation of a conduit that parties with administrative and decision-making responsibilities are well prepared and able to manage conduit operations. Operational risk consists of the possibility that procedures outlined in the conduit's documentation are not properly followed.

³² See Moody's Special Report, *Extendible Commercial Notes Extend Asset Allocation Choices for Money Market Funds*, August 2000, for a discussion of extendible CP in both the corporate and asset-backed markets.

Mitigating Operational Risk

Operational risk can be reduced in a number of ways. First, Moody's reviews the capability and commitment of the sponsor and support providers, especially the Administrator, when the initial rating is assigned. Most conduit sponsors assume several formal roles in the conduit operation, and provide some credit enhancement and liquidity. In its rating process, Moody's considers the degree to which the financial and reputational interests of the sponsor are aligned with those of the conduit.

Most conduit service and support providers have a proven track record in the market. They are typically large commercial banks. The conduit's operations are not dissimilar to a bank's credit, loan monitoring and funding areas. A conduit may be managed to the same standards as the sponsor's existing activities in these areas, often by the same people. In assessing a sponsor who is new to the market, Moody's undertakes an "operational review," in which Moody's analysts visit the company and review its infrastructure and staffing to determine whether the company's operational capacity is appropriate for the type of ABCP conduit that is contemplated. Some conduit sponsors who are small or new to the market engage an experienced third party to provide some or all of the needed services either directly or as a backup.

Second, Moody's monitors conduit activities over time. Conduits are usually active vehicles, and Moody's has regular interaction with sponsors and other parties when reviewing new transactions or program amendments. Moody's receives surveillance reports on asset performance and CP issuance at least monthly. Administrators are required to notify Moody's immediately if rating downgrades of sellers, servicers, support providers or rated assets held by the conduit occur or if certain performance triggers are hit. Moody's also conducts regular face-to-face reviews with program sponsors, during which conduit performance, future plans and industry issues will be discussed. Moody's also follows business activity in general and ratings actions in particular, and contacts program sponsors as events warrant.

Indemnification

Any entity involved in providing service or support to the conduit should be willing to provide a performance indemnity to the conduit covering any negligence or misconduct on its part. In particular, Moody's looks for a broad performance indemnity from the Administrator as the single party taking responsibility for the overall smooth operation of the program. To the extent a conduit and its ABCP investors are exposed to any loss as a result of the negligence of a particular entity, that entity will reimburse the conduit and/or investors for that loss.

Interest Rate Risk

Most ABCP is issued at a fixed rate of interest and for a short duration. The rate at which ABCP is issued fluctuates over time based on market conditions and investor appetite. ABCP rates tend to closely track the comparable LIBOR rate, but the two are not contractually linked.³³ The financial assets held by conduits carry a variety of interest rates including fixed rates, LIBOR-based rates and rates based on the conduit's own cost of funds. A conduit's exposure to interest rate risk consists of the risk that the rate of interest received by the conduit on its assets will be insufficient to cover the conduit's cost of funds and operating expenses.

Mitigating Interest Rate Risk

Most conduit assets are structured to pay a fee or rate equal to the conduit's funding costs plus fees and expenses. Assets that carry a fixed rate, or are pegged to a floating index are usually hedged with a swap or other agreement with a **Prime-1**-rated counterparty. Although hedges come in many forms—and some are structured to mitigate more than just interest rate risk--the most basic form is a simple exchange of interest payments. The conduit agrees to pay the hedge counterparty all interest generated by the asset, and the hedge counterparty agrees to pay a rate that covers interest on ABCP and conduit expenses.

Certain types of assets do not pay any interest at all. The most common example is a trade receivable. A trade receivable is a form of short-term financing in which a company selling a good or service allows its customers to delay payment for goods or services received. In a trade receivable transaction, a reserve is created to provide for interest by advancing less than the face value of the asset, that is, by purchasing the receivable at a discount. Other than factoring in the interest cost, sizing the discount requires an analysis of the terms of sale, obligor payment rate, and default rate of the assets.

33 If a conduit issues floating rate ABCP where the interest rate is reset at regular intervals, the index used is typically the corresponding LIBO rate. For a discussion of floating rate ABCP see Moody's Special Report, *Floating Rate ABCP: Issues and Answers*, December 1999.

Foreign Exchange Risk

Some ABCP conduits purchase assets denominated in one currency and issue ABCP denominated in another currency. With the introduction of the Euro, many conduits may issue both U.S.\$ and Euro-denominated ABCP in order to have maximum funding flexibility and access to the lowest funding costs. At any point in time, ABCP, asset payments, liquidity and credit enhancement may be denominated in one or more currencies that will have to be exchanged at reliable rates to provide for repayment of ABCP and transaction funding.³⁴

Foreign exchange risk is typically hedged via an agreement with a Prime-1-rated counterparty. Currency risk can be hedged with matching spot and forward contracts, or with more sophisticated foreign exchange rate swap agreements. Moody's reviews the credit quality of the counterparty and the terms of the hedging agreements with respect to timing, payment amounts and funding conditions.

A more recent development is to enter into a Hedging Agreement with a highly rated Hedging Agent. The Hedging Agent agrees to recommend hedging arrangements appropriate to the conduit's risk exposure with highly rated counterparties. If these arrangements prove insufficient for any reason other than the default of the counterparty or the underlying conduit asset, the Hedging Agent indemnifies the conduit by providing same-day funds to cover any shortfall. In this type of agreement, ABCP investors assume the credit risk of the counterparties and the assets, while the Hedging Agent assumes the risk of properly hedging the program. This type of agreement usually covers both foreign exchange and interest rate risk.

34 See "Asset-Backed Commercial Paper Programs in Europe: Implications of Currency Risk", *Special Report*, November 1995.

ABCP ISSUANCE AND PROGRAM TERMINATION

ABCP conduits have certain program-level protections in addition to program-wide credit enhancement. These protections set the conditions precedent to issuing ABCP, and under extreme circumstances may require the conduit to be wound down. The purpose of these features is to insure that there is sufficient support to protect ABCP investors at the time ABCP is issued by the conduit.

ABCP Issuance Tests

Several conditions should be met before ABCP is issued. First the conduit should be solvent. Most administration agreements have a net worth test requiring that the minimal net worth contributed to establish the special purpose vehicle not be impaired. This test may ignore mark-to-market calculations for conduits that are run on a cash flow basis or changes in market value of certain derivative contracts³⁵. Second, the principal value of the non-defaulted assets funded should equal or exceed the principal amount of ABCP outstanding, as ABCP principal must ultimately be repaid by the principal value of non-defaulted assets. Third, the program should not be running at a loss. The earnings on the assets funded should equal or exceed interest on ABCP and program expenses. Fourth, available liquidity should equal or exceed the face amount—principal plus interest at maturity—of ABCP outstanding. Available liquidity is determined by the funding formula in each liquidity agreement, and may be less than the liquidity facility commitment if the funding commitment is not fully drawn or if there are defaulted assets. Fifth, many programs require that the full amount of required program credit enhancement be available, or a material portion of it in order for the conduit to issue new ABCP.

Program Termination Events

If it becomes clear that the conduit is not performing as expected, then the best protection for ABCP investors may be for the program to cease issuing ABCP permanently and wind down. Clearly, if any of the issuance tests mentioned in the previous paragraph are not met for more than a short period, the conduit will begin to wind down naturally. Most conduits specify that if these issuance conditions are not met for some continuous number of days then the cease issuance is permanent. The inability to meet net worth, asset coverage, expense coverage or liquidity coverage tests may indicate a loss to investors or inability to pay on a timely basis.

Many ABCP programs have program-level credit enhancement providing second-loss protection to investors. If a significant amount of this enhancement is drawn to cover losses on funded assets, it may also be an indication of problems with the program. Most conduits with program-level credit enhancement are required to permanently cease issuing ABCP if more than a given percentage of that credit enhancement is drawn for longer than a fixed period of time, for example, more than 10% for more than 5 days. Other common program termination triggers include a downgrade of the program's rating, and when the bankruptcy remoteness of the SPV is compromised.

If a program termination is signaled, the Administrator is required to notify Moody's. Typically, the conduit is prohibited from acquiring assets or additional interests in existing transactions within its portfolio, and from issuing new ABCP. The issuer is required to apply collections on existing assets toward paying out maturing ABCP, and to the extent that such collections are not sufficient, to use liquidity facilities and any pool-specific credit enhancement facility to do so. If these amounts are insufficient then any remaining program credit enhancement may be drawn to pay investors. Note that some programs, particularly structured investment vehicles, may have more complicated wind down procedures reviewed by Moody's as part of the rating assignment.

35 See Moody's Special Report, *FASB 133's Impact on Nominally Capitalized ABCP Conduits: Should Investors Be Concerned?*, January 2002.

POST-REVIEW VERSUS PRIOR-REVIEW CONDUITS

ABCP conduits are dynamic structures. Moody's initially assigns a rating to the structural shell, consisting of a special purpose corporation and a collection of support parties bound by a set of legal documents. When Moody's first assigns a **Prime-1** rating to a conduit, it typically has no ABCP outstanding, and funds no assets. Over time assets are structured and recommended by the Administrator, and purchased or funded by the conduit using the proceeds of newly issued ABCP. Eventually the conduit may have a substantial portfolio of funded transactions and billions of dollars worth of ABCP outstanding. Even then the program will change over time, as some asset pools pay down, some mature and are not renewed, and new deals are added to take their place.

Prior-Review Conduits

Most multiseller conduits operate on a "prior review" basis. Prior-review ABCP conduits are required to submit each new transaction to rating agency scrutiny and receive written confirmation of the Prime-1 rating prior to funding. Moody's reviews each transaction on its merits, in conjunction with the other assets in the conduit's portfolio and the program-level support. Prior review is one way that Moody's can be sure that a new transaction is consistent with the credit quality of the already outstanding ABCP.

Post-Review Conduits³⁶

Prior review is not the only way to ensure that a conduit maintains its credit quality. Some conduits operate on a post-review basis. Post-review status means that the conduit may enter into and fund new transactions that conform to the conduit's credit and investment policy without Moody's prior review. Moody's is notified after the transaction is completed, and reviews the credit quality of the ABCP program as part of its ongoing credit monitoring and surveillance process.

Most single-seller, securities arbitrage, and fully-supported ABCP conduits are post-review programs. These types of conduits tend to be highly structured to limit the type and manner of assets funded, limiting risk to investors. Fully-supported programs expose investors only to the risk of the guarantor, so the credit quality of the assets does not affect the credit quality of the ABCP. Single-seller programs fund the assets related to one firm's activities, so the initial rating analysis of the program will continue to apply so long as the underlying business is sound. Securities arbitrage programs must act quickly in order to purchase assets when they are available on favorable terms. The securities they are permitted to purchase are subject to strict, clearly specified investment and credit enhancement guidelines.

Some partially-supported multiseller ABCP conduits also enjoy post-review status. These conduits have experienced administrators, and the ABCP conduit is an important banking product, offered to the sponsor's better clients. These administrators have a history of transactions that Moody's can evaluate for consistent and conservative underwriting as part of the process of evaluating post-review status. In addition the conduit's asset purchases are subject to a detailed credit and investment policy, with high standards of credit quality and strict divestiture requirements for pools that no longer meet those criteria. In addition to these factors each of the post-review programs has a high level of program credit enhancement, usually with a materially higher floor than is typical for prior-review programs.

The Administrator's operational capability is one of the most important considerations when Moody's considers post-review status for an ABCP conduit. The Administrator of a post-review program must have a well-staffed underwriting group for conduit transactions. It must be experienced, committed to the ABCP market, and have a conservative credit culture with respect to transaction selection and structuring.

Limited or Partial Post-Review Programs

A number of conduits have partial post-review status. Hybrid conduits—those combining the features of two or more types of program—generally operate on a post-review basis for securities purchases and funding maturity-matched loans. Credit arbitrage and loan-backed programs are subject to strict rules regarding asset quality, credit enhancement, liquidity support and funding, and are post-review on a stand alone basis. Permitting hybrids to operate these portions of their program on a post-review status is consistent with the ABCP market as a whole. The multiseller portion of these programs typically remains prior review.

³⁶ See Moody's Special Report, *Achieving Post Review Status for Partially-supported ABCP Programs*, published in the Third Quarter 1997 Asset-Backed Commercial Paper Market Review.

Some multiseller conduits have limited post-review status. Transactions funding certain asset types, where the transaction does not exceed a given size limit and is structured with particular features may be funded without Moody's prior review. Transactions that do not fall within these guidelines remain subject to review by Moody's prior to funding.

Moody's has also implemented a process of limited prior review with some program sponsors termed "Execution Light." In these cases, Moody's reviews a set of document templates and agrees to certain transaction criteria with the program sponsor. The sponsor presents a specific transaction to Moody's as a detailed term sheet with supporting information. If Moody's review of this material confirms that it falls within the agreed framework, then the transaction can be funded by the conduit without a full review.

As with full post-review programs, Moody's monitors the credit quality of these limited or partial post-review programs as part of its ongoing monitoring and surveillance activities.

MONITORING CONDUIT AND ASSET PERFORMANCE

Moody's ratings on ABCP conduits are public, monitored ratings. Moody's monitors the asset performance and overall structure of each ABCP conduit to insure that the risk borne by ABCP investors remains consistent over time with the **Prime-1** rating assigned to the ABCP. Conduits resemble operating companies in many ways. They have dynamic portfolios that change composition, and may grow or decline over time. A conduit's operating documents require transaction and portfolio monitoring, regular reporting, and rating agency notification of key events. Generally, the conduit's administrator is responsible for these activities.

There are a number of components to the monitoring process. First, Moody's maintains a relationship with the conduit's sponsor. Even before the conduit is created, Moody's works with potential sponsors to discuss the business purpose of the program and identify and resolve potential concerns. Moody's performs an operations review of each new conduit sponsor and/or administrator. In this review, Moody's seeks to determine that the administrator has the appropriate infrastructure and personnel to effectively manage conduit operations according to the program documents.

Once a conduit has been established, Moody's reviews each transaction prior to its inclusion in the conduit's portfolio if the conduit is operating on a "prior review" basis. No amendments can be made to a conduit's operating documents unless Moody's confirms that the program's rating will not be affected by the proposed change. Moody's analysts interact with conduit sponsors on a regular basis to discuss the conduit's performance, future activity and industry trends.

Monitoring Transaction Performance

The performance of individual transactions in a conduit's portfolio is monitored on several levels. The servicer of the assets is required to monitor receivable performance and report on it at least monthly to the conduit's administrator. Most deals also require that the servicer report any financial or operational problems that it may have, outside of the receivables' performance. The administrator is responsible for ensuring that the servicer's reports are received as required. The administrator also conducts regular due diligence on the servicer's operations. In some cases the administrator may have the right to act as backup servicer under the transaction documents. Should there be a problem with a particular transaction, the administrator notifies Moody's and works with the servicer to rectify the problem.

Each month the administrator is required to prepare a report for investors, dealers and rating agencies. This report will summarize the status of each transaction funded by the conduit. It will typically include key asset performance statistics vis-à-vis the related triggers, such as delinquencies, defaults, excess spread and so forth, depending on the type of asset funded. It also includes information about support facilities, ratings of the support providers, the amount of ABCP outstanding and the size of the program-level credit enhancement.

Moody's reviews each monthly report to determine that the transactions and program are in compliance with the documentation. Moody's also reviews asset performance to determine whether performance is in line with expectations at the time that the transaction closed. Loss levels are compared to indices published by Moody's for various asset classes to assess relative performance. Moody's also compares the current loss levels to current credit enhancement, both at the transaction and conduit levels. Moody's monitors the ratings of the liquidity and credit support providers and of large obligors. Moody's also tracks market conditions and industry trends that impact the securitization market. The credit opinions expressed by the ABCP rating team incorporate the views of Moody's corporate analysts and term ABS analysts.³⁷

Moody's Publications on Conduit Activity

Moody's publishes information on conduit performance quarterly in Moody's Global Asset-Backed Commercial Paper Market Review. These reports outline the structural features and business objectives of each conduit, and report on various portfolio characteristics. The reports can also be found on the Moody's.com website. The quarterly publication also includes special reports on topics relevant to the ABCP market and a review of the past quarter's market trends. In January of each year Moody's publishes a variety of annual review pieces covering ABCP markets around the world.

37 See Moody's Special Report, *ABCP's Song of the Sirens: Reporting Monthly Performance Data May Lure Investors onto the Rocks*, February 1999, discusses some of the issues with respect to conduit surveillance reports.

Moody's publishes ABCP market and conduit statistical information monthly in the *ABCP Snapshot* publication. More detailed information appears in an Excel spreadsheet-based publication, *ABCP Query*.

The ABCP group also publishes press releases documenting significant rating actions such as the assignment of new ratings and confirmations of existing ratings in light of a significant credit event. Moody's rating actions that relate to lesser events, such as conduit additions and amendments, are summarized in a weekly press release. These can be found on various news services and on Moody's web site.

Finally, Moody's conducts a number of educational seminars for investors, issuers and other industry participants. "The ABC's of ABCP" aimed at those new to the market has become a popular annual event. "The PhD's of ABCP" presents advanced topics and is expected to be as successful as its introductory counterpart. These seminars have been held in New York, London and other major cities in the U.S. and around the world.

Please see the Bibliography of Moody's Special Comments on page Bibliography of Moody's Special Comments for a detailed list of Moody's ABCP monitoring publications.

CONDUIT LIABILITIES: ABCP, FLOATING RATE CP, SLNS, ECNS AND MTNS

Most ABCP conduits issue fixed rate commercial paper at a discount and pay off of the face value on a single stated maturity date. However, some programs issue a variation on this “plain vanilla” CP, and others issue a variety of term notes. The only difference between commercial paper and asset-backed commercial paper is that the former is a senior unsecured obligation of a corporation, while the latter is issued by a special purpose vehicle and is secured by and repaid from pools of assets. Corporate issuers have pioneered many of the variations on ABCP described below.

Ordinary ABCP

Traditionally, commercial paper is a security with an original term to maturity of no longer than 270 days for U.S. CP and 364 days for Euro CP, though in some jurisdictions the maximum term is as short as 180 days and as long as 390. Most commercial paper is issued at a discount to face value, with a fixed rate of interest expressed on a 365-day basis. The only payment is that of the face value at maturity. The issuer has no right to prepay nor does the investor have a right to put the paper back to the issuer prior to its maturity date.³⁸

Interest Bearing ABCP

Sometimes CP is issued in interest bearing form, though this is usually just a cosmetic difference. All interest and principal is repaid at maturity, and no intermediate interest payments are made during the life of the note.

If an ABCP conduit were to issue commercial paper with periodic interest payments prior to maturity, then the program documentation would have to reflect that option. In addition to being sure that the liquidity facility is sized to cover the intermediate interest payments, the liquidity banks must agree to be drawn if needed to cover these payments. In addition, the Administrator or other appropriate party must be required to draw liquidity to cover the interest payments if cash is not available from other sources.

Floating Rate ABCP³⁹

The term of most ABCP issued is much less than the permitted maximum, typically under 90 days and often under 30. One reason is investor demand. Money market funds are often looking for a short maturity investment. The other is that depending on the interest rate environment, either investors or issuers are reluctant to hold or issue, respectively, fixed rate notes with longer maturities.

One solution has been for conduits to issue floating rate ABCP. The more expensive⁴⁰ conduits issue paper at 5 to 10 basis points below LIBOR, the cheaper programs at 5 to 10 basis points over LIBOR. Floating rate ABCP, issued at a spread to one-month LIBOR with the rate reset every 30 days, may be issued at long maturities at a similar spreads. Both issuer and investor may be reasonably certain that the interest rate will be close to that of newly issued shorter term paper.

Almost all ABCP conduits have an issuance test that requires that available liquidity exceed the outstanding face amount—principal plus interest due at maturity—of ABCP. For floating rate ABCP the interest portion obviously cannot be calculated at time of issuance, hence this test cannot be satisfied because one of the terms cannot be known. Also, as interest rates change during the life of the outstanding floating rate paper, rising rates may cause the program to violate the interest rate coverage test. Conduits that wish to issue floating rate ABCP must find a way to deal with the problem of maintaining adequate liquidity coverage and then amend their issuance test correspondingly.

Some programs have a liquidity facility sized to cover the fixed principal amount of their purchase commitments but an unspecified and unlimited amount of interest. Other programs have a liquidity facility sized to cover the fixed principal amount of the purchase commitments, but use an interest rate swap or equivalent hedging arrangement to cover the interest portion. In some cases the conduit works with Moody's to arrive at a liquidity coverage formula that covers extreme interest rate movements to a degree consistent with a **Prime-1** rating.

The final concern is that the conduit not operate at a loss. The funding costs must be covered by the assets or the risk otherwise transferred to a suitably rated third party.

38 See Moody's Special Report, *Introduction to Asset-Backed Commercial Paper Structures*, reprinted from the Fourth Quarter 1997 Asset-Backed Commercial Paper Market Review.

39 See Moody's Special Report, *Floating Rate ABCP: Issues and Answers*, December 1999.

40 “more expensive” in that investors pay a higher price, or equivalently, receive a lower rate of interest. ABCP with a lower discount or interest rate clearly provides lower cost funding to the issuer.

Extendible Commercial Paper

As backup liquidity facilities have become more expensive, corporate and asset-backed issuers have looked for ways to reduce the amount of backup liquidity required to support their commercial paper programs. Longer maturity CP locks investor funding in and eases the liquidity burden in much the same way, though not as effectively, as term debt or equity. A related innovation is to issue extendible ABCP. Extendible ABCP appears under several names depending on the sponsor: extendible commercial notes (ECNs), secured liquidity notes (SLNs) and MITTENS⁴¹.

Much like commercial paper, extendible commercial paper is initially issued as a discount security at a fixed rate of interest for an initial maturity. The primary difference is that at the scheduled maturity, the issuer may choose not to repay extendible commercial paper and extend its maturity for an additional fixed period. If extended, the extendible CP switches to a variable rate security, usually with a LIBOR-based rate that resets monthly.⁴² The spread or “go-to” rate is significantly above the normal ABCP spread of 5 to 10 basis points below LIBOR, typically on the order of 25 basis points above LIBOR. In addition, once extended, the extendible ABCP often has a call feature permitting prepayment by the issuer as funds are available.

Extendible commercial paper may be problematic for money market fund investors, or other investors who need to closely manage the maturities of their investment portfolios. The extendible feature creates uncertainty about the principal payment date of the CP notes. Should extendible ABCP be classified based on its scheduled maturity date or by its potential extended maturity date? To date, no extendible ABCP has ever actually been extended, though some corporate extendible CP has been extended.

Extendible Commercial Notes

The first ABCP programs to issue extendible ABCP, (ECNs) were programs funding credit card receivables. These include Citibank's DAKOTA CP Notes Program, MBNA's Emerald Notes Program and Discover Card's Newcastle Certificates Program. The ECNs issued by these programs have an initial scheduled maturity of 90 days and a maximum extension period of 300 days, for a maximum final maturity (original plus the extension period) of 390 days. This tenor limitation qualifies the notes as an eligible investment for money market funds under Rule 2a-7 to the Investment Company Act of 1940.

Typically, the ECNs are issued at a discount with an initial maximum term of not more than 90 days. Typically, the conduit pays maturing notes by issuing more notes. If, however, new notes cannot be issued, the maturing notes will automatically become extended. The effects of extension are that the ECNs will have a legal final maturity of 390 days from issuance, with a bullet payment of principal on the 390th day and monthly interest payments. Investors receive stepped-up pricing as compensation for waiting 300 days for repayment of the ECNs. During this extension period the conduit begins liquidating the assets that collateralize the ECNs in order to pay investors by the 390th day.

Conduits that finance assets with rapid and reliable payment rates, such as credit card receivables, are ideally suited for the issuance of ECNs. Typically the ECNs may be prepaid in part or in full upon 5 days' notice from the conduit, as funds become available. These programs have a small partial liquidity facility that may be used to avoid immediate extension, and they may also attempt to reissue the CP and prevent full amortization of the asset pools.

Secured Liquidity Notes

Extendible ABCP has also been issued under the name Secured Liquidity Notes or SLNs. They have most commonly been used for single-seller residential mortgage warehouse conduits such as Harwood Street Funding and Principal Residential Mortgage Capital Resources. The typical tenor for initial SLN issuance is no more than 65 days. As with conventional ABCP, maturing SLNs will be repaid either through collections from the asset interests or from the issuance of new SLNs. If new notes cannot be issued, the maturing SLN can be extended for a period up to 300 days so that the notes will mature no later than 365 days from issuance. Again the term qualifies under Rule 2a-7.

Residential mortgages are unlikely to amortize fully during the extension period, even at the most extreme prepayment rates. Whole loan mortgages are, however, highly liquid, and may be sold directly to third parties or securitized. In fact, term securitization is the intended “take out” for a mortgage warehouse program. In addition to the credit risk of default, the sale of assets may expose investors to market value risk. These mortgage

41 Name given to extendible issuances of GMAC's mortgage warehousing ABCP program – Mortgage Interest Networking Trust (MINT).

42 See Moody's Special Report, *Extendible Commercial Notes Extend Asset Allocation Choices for Money Market Funds*, August 2000.

warehouse SLN programs typically include a highly rated swap counterparty to provide coverage of the market value risk and to guarantee purchase of the collateral by the final maturity date.

Medium-Term Notes

Medium-term notes (MTNs) have maturities ranging from 180 days to 30 years, with a dollar-weighted average of about five years. MTNs are not a form of commercial paper and receive long-term, not short-term ratings. Those issued by ABCP programs have typically received **Aaa** ratings. Unless they mature in under a year, MTNs typically do not qualify as money market fund investments under Rule 2a-7. MTNs are typically floating rate, issued at a spread to monthly or quarterly LIBOR, and make regular interest payments while they are outstanding. By locking in long-term funding, MTNs are a powerful tool for managing liquidity needs.

An additional appeal of MTNs lies in the ability to issue them when there are favorable market opportunities. The terms may be arranged to take advantage of the status of the market and to meet particular funding requirements. Maturity, interest rate, currency, and other terms of MTN issuance allow programs to expand their funding mix. Many MTN structures are extremely complex, and can result in unusual credit and market risks for investors that Moody's identifies and analyzes when assigning a rating.

ABCP programs that issue MTNs are typically of the highest asset quality and have a reasonable level of cross-collateralized program credit enhancement to support the securities issued. SIVs, described above, are securities arbitrage programs that issue both ABCP and MTNs. In order to reduce the amount of required liquidity they tend to do more of their funding with MTNs than with ABCP, often a 2:1 mix. There are also a number of multiseller programs that are able to issue MTNs, such as Citibank's Eureka and CXC programs, though their use of MTNs is not as extensive as that of the SIVs.

MTNs issued by multiseller programs entail complicated analysis emphasizing strong asset quality, cash flow from assets, and a reasonable level of cross-collateralized program credit enhancement. An alternative, though a somewhat unwieldy one, is to "ring-fence" specific assets within a conduit and dedicate those assets to deal-specific MTNs or other liabilities issued by multiseller programs. This would entail re-documenting ABCP programs to isolate specific pools of collateral and associate them with specific liabilities. This would also entail intercreditor issues among the conduits' separate debt issuances. Conduits with a certain asset profile may benefit by splitting into separate entities housing asset pools that would be dedicated to specific MTNs, or serialized debt issuance. The disadvantage of this approach is that it weakens one of the historic strengths of traditional ABCP conduits: large, diversified portfolios financed by a single class of investor.

Serialized ABCP⁴³

In most conduits, all of the outstanding liabilities are equally and ratably secured by all of the assets. There are conduits (such as Perry Funding, and Prime Asset Vehicle (No. 2) Ltd.) that issue serialized commercial paper. In a serialized program, a single special purpose company issues different series of ABCP. A specific, identifiable asset portfolio, with its own credit enhancement and liquidity support backs each series. The liquidity and credit support facilities for one asset pool are not available to repay commercial paper issued in respect of another asset pool. Because there is no cross-collateralization, each series and asset pool must be structured to a **Prime-1** rating on its own.

Serialized ABCP may be a cost efficient way for issuers to reach a wider range of investors. However, merely offering different series of ABCP backed by different assets and supported by separate credit and liquidity support does not necessarily insulate investors from the risks of other series issued as part of the same program. Each series is fundamentally linked with every other series because the same special purpose vehicle issues them all. If there is a default in one series, the unpaid investors could force the company into bankruptcy.⁴⁴ While all investors typically agree not to file a bankruptcy petition until a year and a day after all series have been repaid, it is possible that a bankruptcy court judge could permit a filing to stand. Most of the other creditors of an ABCP conduit are insiders such as the administrator or the liquidity providers and a bankruptcy court judge is more likely to uphold the waiver of a right to file for insiders than for investors.

43 See Moody's Special Report, *Serialized ABCP: The Hidden Dangers*, reprinted from the First Quarter 1998 Global Asset-Backed Commercial Paper Market Review.

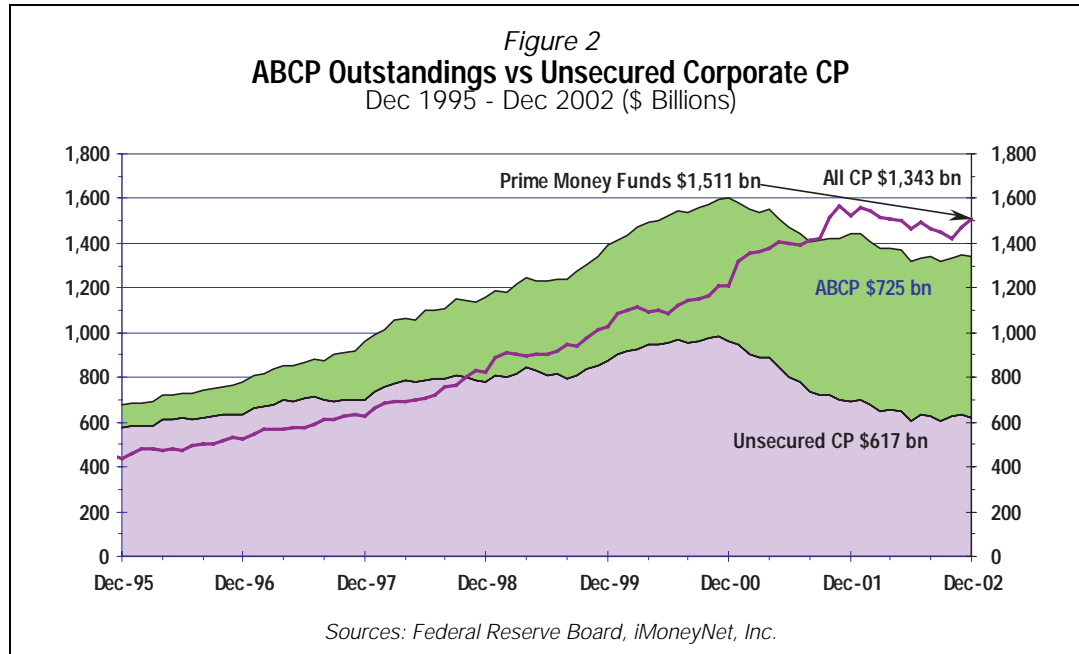
44 The unpaid investor has very strong economic incentive to force a bankruptcy especially when he is a unsecured investor. By having all other investors at the same playing field, a bankruptcy could increase an investor's prospects for recovery by having access to a large pool of assets.

In its ratings of the rare programs that issue serialized ABCP, Moody's typically holds all serialized issuers to the same stringent **Prime-1** rating standards. Downgraded counterparties of any of the serialized issuers could cause a downgrade of all the serialized issuers. Moody's is clear in its publications as to this risk and the counterparties involved.

INVESTORS—WHO ARE THEY AND WHY DO THEY BUY ABCP?⁴⁵

Traditional Investors

From the early days of ABCP issuance, the regular investors in ABCP have been securities lending groups and prime money market funds. Corporate treasurers, STIFs (short-term investment funds, essentially money market funds established for institutional investors), common funds, and public and private treasury managers have also become investors as they have become more familiar with ABCP.



At about 50% of outstanding ABCP, Prime Money Funds Represent the Largest Investor Segment

What's the Appeal of ABCP?

ABCP programs are designed to satisfy the investment requirements of short-term investors in the money market securities market. As with unsecured CP, ABCP programs are set up as SEC 3(a)3 or 4(2) public programs, or 144(a) eligible private placements. ABCP programs are careful to limit asset concentration so as to avoid disclosure and remain in compliance with 2a-7 rules. Additionally, the ABCP market has become very competitive to other money market instruments in terms of its high quality credit profile, exemption from SEC registration and focus on bankruptcy remoteness.

High-Quality Alternative to Unsecured CP

ABCP's popularity among short-term investors reflects the wariness of issuer-specific event risk – a credit risk by-product of unsecured CP. In the late 1990s and early 2000s, many portfolio managers were exposed to unsecured investment-grade securities that transitioned into non-investment grade securities within a short period of time. In a few instances, **Prime-1**-rated corporate CP actually defaulted.

In response to the volatile corporate credit environment, some portfolio managers expressed a greater interest in highly-rated secured ABCP. With their structural protections and portfolios of financial assets, ABCP conduits were less prone to event risk than some corporate borrowers. No ABCP program rated **Prime-1** has ever defaulted on its outstanding paper.

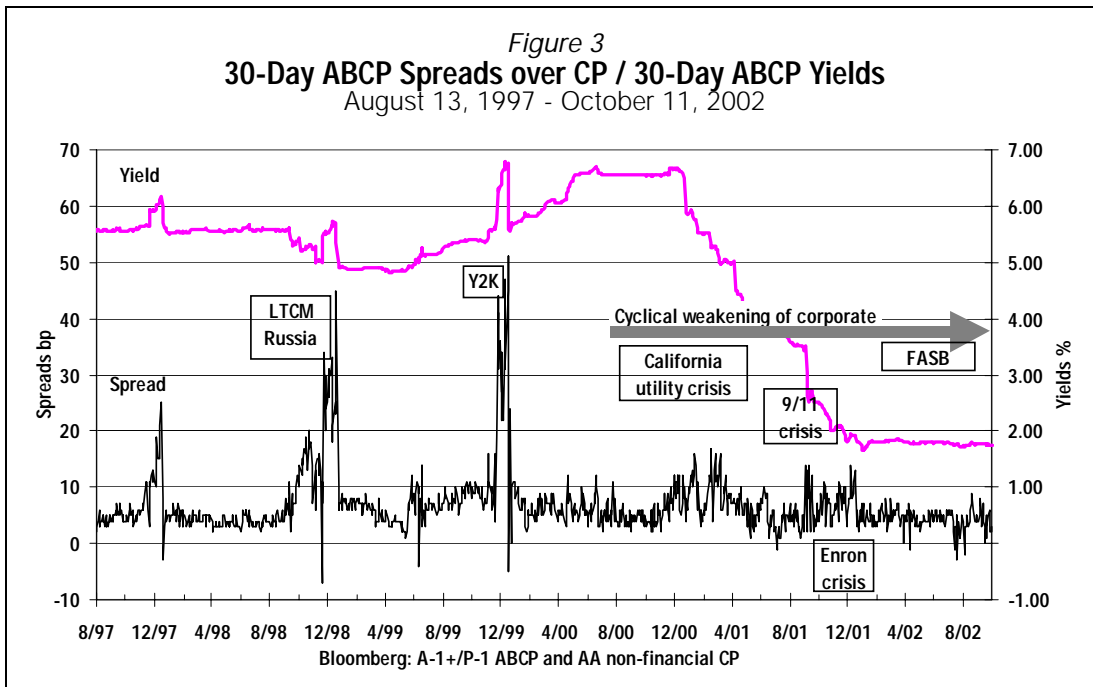
Diversification

ABCP programs offer portfolio managers a large asset class not completely correlated with corporate CP, bankers' acceptances, government securities and other short-term investments. Concentration risk and the basic supply of available money market securities are key for short-term investors due to their investment diversification restrictions and guidelines.

⁴⁵ This section is based on Moody's Special Report, *U.S. Money Market Funds Hungry for Asset-Backed Commercial Paper*, April 20, 2001. See also the companion report, *U.S. Money Market Funds Carry a Big "Buy-Side" Stick with ABCP*, July 2002.

Yield Enhancement

ABCP programs have been offering money funds and institutional investors very competitive yields since they first appeared in the early 1980s. ABCP spreads over traditional CP continue to be a prime motivator for investors. In a study conducted by Moody's using reported yields from Bloomberg, ABCP spreads over CP have averaged 6.27 bps for the one-year period from February 2001 through February 2002.



It is not clear if this yield advantage will persist. Given the event risk seen in corporate CP in the 2001-2002 period, and given the greater understanding of ABCP among short-term investors, spreads may well narrow. As a result of a variety of economic and credit factors, the amount of corporate CP outstanding has declined by one-third from its peak, and the amount of ABCP outstanding exceeds the amount of corporate CP outstanding by about 10%. Already some of the best **Prime-1** ABCP programs trade through some of the weaker **Prime-1** corporate CP issuers.

Investor Acceptance and Comfort with ABCP

The mid-1990s brought ABCP into the mainstream of money market instruments as more institutional investors began to significantly increase their holdings. However, market cycles and risk events continued to concern some investors, and occasionally ABCP yield has jumped significantly above its average spread to traditional unsecured CP (see *Figure 3*). One reason is lack of understanding on the part of investors. Corporate CP is relatively easy to understand and explain: it is a senior unsecured obligation of a single corporation. ABCP is a senior obligation issued by an unfamiliar special purpose corporation and secured by a portfolio of assets originated by anonymous sellers.

A new trend began with the new millenium. Investors took note of the relative credit stability in asset-backed securities in general and ABCP in particular. Many investors made the effort to educate themselves and their credit committees about the risks and mitigants in ABCP programs and have them added to their lists of approved assets. For these and other reasons, the average ABCP spread to corporate CP has been more stable and the spikes seen in the 1990's have not recurred. This may be an indication that short-term investors have reached a new comfort level with this asset class.

Choice of Maturity

ABCP is typically issued with a maturity between 30 and 90 days. Although overnight and over 90-day maturities are available, they are utilized to a much lesser extent. These shorter maturities make ABCP well suited for managing portfolio liquidity using 'laddered' maturities. A laddered portfolio has equal amounts of ABCP at a series of maturities spaced into the future.

Money Fund Liquidity Requirements for ABCP Holdings

ABCP secondary market liquidity is very important for money market portfolio managers. Despite a money fund's typical buy-and-hold investment strategies, funds do hold most securities as "liquid" as interpreted by regulatory requirements. A security held by a money market fund is liquid if the fund can sell it in seven days or less at a price approximately equal to the amortized value of the security. This means each ABCP holding must have a "good price"⁴⁶ on it when the portfolio is marked-to-market for constant NAV tolerances.

Bear in mind, as with the liquidity of any security, an investment's liquidity is often a factor of the investor's business relationships with the dealers. Dealers often make a secondary market in ABCP as a concession to a large investor. A dealer is also more likely to make a secondary market in the ABCP for a larger ABCP program with a strong sponsor, as the dealer is likely to be able to resell the repurchased securities quickly. Hence the growth of the ABCP market improves the secondary market liquidity of the product and makes it more acceptable to money market fund managers.

The Illiquid Basket

Under the Investment Company Act 1940, a money market fund may invest up to 10% of its assets in illiquid securities or securities that are not readily marketable. Some smaller ABCP programs may be considered illiquid under money fund regulatory guidelines. In addition, the status of extendible ABCP may not be clear. Most money funds buy little or no illiquid ABCP.

Investors Comfortable, Yet Still Concerned

ABCP's historical credit and structural performance has been exceptional with no defaults on **Prime-1**-rated ABCP, and no downgrades as a result of the credit quality of the underlying assets. This record has given great comfort to short-term investors, especially when contrasted with the recent credit volatility of corporate CP. However, some investors feel the ABCP market has not been exposed to the full extent of market cycles or risks that would test the integrity of all the various assets and structures employed by ABCP conduits.

46 A "good price" refers to a quoted price that a dealer will stand behind. Regulatory requirements, in part, define liquid securities as those for which a fund has received independent price quotes from two dealers, or one quoted price if there is only one dealer for an ABCP program.

CONCLUSION

ABCP programs provide a valuable and flexible alternative for companies seeking short-term financing. Most ABCP programs are bank-sponsored multiseller entities. The form of these programs can either be fully or partially-supported. To a certain extent the form predetermines the type of risks and the kind of analysis that Moody's performs.

Moody's analysis of an ABCP program encompasses the credit risk, liquidity risk, structural risk, operational risk and other factors. Credit risk is the risk that losses will occur on the assets purchased by the program. Liquidity risk is the risk that collections on the assets will not be received quickly enough to provide funds needed to repay maturing ABCP (assuming that new ABCP cannot be issued to provide funds for that purpose). Structural risk refers to risks associated with the legal structure of the program. Operational risk arises from the complexity of an ABCP program and the need to follow documented procedures correctly. All these risks while distinct, are in fact interrelated. All these risks have to be adequately addressed in order for an issuer of ABCP to receive a **Prime-1** rating.

Moody's review of a program is different when it is fully or partially-supported. A fully-supported ABCP program uses a single external support facility to provide 100% coverage against credit risk and liquidity risk. There are three forms of support facility used -- a letter of credit or an irrevocable revolving commitment or a total return swap. In all cases, the amounts provided under the support facility are intended to fully protect investors from any credit and liquidity risks of the program's assets. Any credit losses on the assets are absorbed by the support facility, as well as ensuring timely repayment of ABCP if collections on the assets are not received quickly enough. The main risk to investors in such a program is that the rating of the support provider may be lowered, in which case the rating of the issuer of the ABCP might also be lowered. Moody's analysis of a fully-supported program is not based on the program's assets but primarily on the financial strength of the support provider, the obligations of the support provider are listed in the program documents and its legal structure.

On the other hand, a partially-supported ABCP program has two supporting facilities intended to address a specific type of risk. As the facilities only provide partial coverage against credit losses on the assets in the program, Moody's analysis of a partially-supported program focuses on the assets. The goal is to determine that the probability of losses on the assets exceeding the coverage of the credit enhancement facility is so remote as to be consistent with the rating assigned to the issuer. Because the credit enhancement facility provides only partial coverage, a separate liquidity facility is used to address liquidity risk. In most cases, the size of the liquidity facility are typically 100% or more of the amount of ABCP issued and the credit enhancement facility about 5% to 10% of the facility limit or the amount of ABCP outstanding with a floor amount.

The rating of a partially-supported ABCP program depends on multiple factors, including (1) the performance of the program's assets, (2) the rating(s) of the provider(s) of the credit enhancement facility, (3) the rating(s) of the provider(s) of the liquidity facility, and (4) the expertise of the program's administrator. The largest and most visible ABCP programs are partially-supported, bank-sponsored, multi-seller programs.

The ABCP market has grown and evolved in the last decade. In response to the growing scarcity of inexpensive available liquidity and the changing regulatory environment, new types of ABCP programs and the variety of instruments used to fund such programs have grown. Fortunately, investors' increased understanding of and comfort in investing in these instruments have grown as well. It also helps that there have been increased concerns with the credit risk of unsecured CP (i.e., corporate CP).

A **Prime-1** rating on a ABCP issuer conveys Moody's opinion that it is highly probable that investors will receive full and timely payment on the ABCP. Moody's plans to continue its present practice of rating nearly all ABCP issuers and of publishing special reports when appropriate. To reiterate, investors are invited to contact Moody's with any questions concerning ABCP.

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APPENDIX: ASSET PURCHASE STRUCTURES

Conduits fund a wide variety of transactions, but most of them employ structures that are very similar to term asset-backed securitizations. If an asset type has been securitized, it can most likely be found in some conduit's portfolio. *Sidebar 9* shows the asset mix for the largest multiseller programs. In many cases, conduits directly purchase rated ABS and other securities.

Trade receivable financing is much more prevalent in the conduit market than it is in the term ABS market. Given the importance of trade receivables to the ABCP market, this asset type is discussed in detail here. The structuring details and credit considerations described for trade receivables also apply to many other asset types. For the details of other asset classes, please refer to the Moody's special comments for specific asset types.

TRADE RECEIVABLE FUNDING BY CONDUITS⁴⁷

One of the most common asset class purchases made by a conduit is trade receivables. Trade receivables are short-term corporate obligations resulting from the purchase of goods or services in the ordinary course of business. The Seller of the goods and services, also called the Originator of the receivables, is typically a customer of the bank that sponsors the conduit. The Seller "sells" the receivables—the bills owed by its customers—at a discount to face value in order to obtain working capital financing. The discount provides overcollateralization as a reserve for funding costs, servicing, credit losses and dilutive items.⁴⁸

Most facilities are revolving in nature. Therefore, as receivables are paid down and new receivables are generated, the new receivables are sold to the transaction at a discount. If insufficient new receivables are generated, then funds are transferred to the conduit to repay maturing ABCP. If additional new receivables are generated, more ABCP may be issued—up to the facility limit—to purchase them. The amount of financing available to the seller fluctuates based on the available receivables and the facility limit. Depending on the deal, settlement may take place on a daily, weekly or monthly basis.

Trade receivables, with their varying balances and short –terms are ideally suited to financing with commercial paper. In fact, commercial paper is the traditional source of working capital financing for **Prime-1**-rated companies. By financing their trade receivables in an ABCP conduit, companies who cannot access the corporate commercial paper market are able to access the ABCP market at lower all-in rates than the available alternatives, such as a secured bank line.

Two-Step Sale Structure

The first tier of the transaction is the sale of receivables from the seller to a special purpose vehicle (SPV)⁴⁹ established to specifically purchase these receivables. The governing document is a receivable sale agreement between the Seller and the SPV.⁵⁰ The conduit then agrees to purchase the same pool of receivables from the SPV, or to fund that SPV's purchase by making a loan secured by the purchased receivables. This is generally documented through a Receivables Purchase Agreement between the conduit and the SPV.

Such a structure is known as a "two-step sale". The transaction is structured this way for two reasons. The first is to achieve off-balance sheet treatment for the seller. The more important reason is to obtain "true sale" status to reduce the risk that the assets would be consolidated with the Seller's estate should the Seller enter bankruptcy proceedings. A first priority perfected security interest is also obtained for the benefit of the conduit and the liquidity banks. The liquidity facility typically absorbs the risk of seller bankruptcy. But true sale status protects the liquidity banks and provides an extra layer of protection to ABCP investors.

Liquidity Backup Facility

The conduit's asset purchase is supported by a liquidity facility sized to the conduit's purchase commitment with an additional amount to cover interest on ABCP. In almost all cases, the conduit is not a committed purchaser of the assets. The liquidity banks in the backup facility are committed to purchase the assets should the conduit choose not to fund or be unable to fund, for example if CP cannot be issued. This arrangement is documented in a liquidity agreement.

47 The material in this section draws heavily from Moody's Special Report, *Moody's Approach to Rating Trade Receivables Backed Transactions*, July 2002.

48 Dilution, or dilutive items, are non-credit-related reductions in the receivable amounts, for example for volume rebates. In trade receivables transactions, there is typically recourse to the Seller for reimbursement of dilutive items.

49 The SPV in this case is generally a bankruptcy remote subsidiary of the originator of the receivables.

50 Also referred to as a "first tier agreement."

Sidebar 10
Assets Funded by ABCP Programs

The flexibility of ABCP conduits makes them an ideal vehicle for funding a wide variety of assets. The diversity is probably greater than in the term ABS market, because the ability to provide varying degrees of support permit conduits to fund assets that would be difficult or uneconomic in the term market. Often ABCP is used as a "training ground" for new asset types or new sellers. The program sponsor can provide the additional protection that investors require while gaining experience with the asset type or permitting the seller to become comfortable with the operational requirements of a securitization.

Table S-10-1 shows the asset mix funded by the 20 largest partially-supported multiseller programs, measured by ABCP outstanding as of the end of the third quarter 2002. These programs had a total of \$246.6 billion of ABCP outstanding on September 30, 2002. There was little change from mid-2001 to September 2002. While mortgages were the second-most common asset type purchased by conduits in the third quarter of 2002,¹ their presence in the top 20 multiseller conduits actually declined by 1%. Fluctuations of 1-3% are normal for an asset type concentration, as the addition and removal of sellers is routine in these large, well-diversified conduits. The largest-growing category among the top 20 multiseller conduits was "Other;" its 7% growth is partially due to a sizeable deal involving film receivables.²

Table S-10-1
20 Largest Partially Supported, Multiseller Programs
Percent of Outstanding ABCP by Asset Type¹

Asset Type	Percentage of Total			
	June 1999	June 2000	June 2001	September 2002
Trade Receivables	19	19	22	19
Credit Cards	27	23	22	20
Auto Loan/Leases	12	12	12	11
Equipment Loans/Leases ²	8	11	12	13
Mortgages ³	4	5	7	6
CLOs/CBOs	12	13	7	4
Consumer Loans	NA ⁴	5	4	6
Other ⁵	18	12	15	22
Total	100%	100%	100%	100%

1 Based on quarter-end ABCP outstandings
2 Includes aircraft financing
3 Includes residential and commercial
4 Historically combined into "Other" category
5 "Other" includes commercial loans, film receivables, insurance premiums, lottery awards, movie & TV finance, securities, student loans, synthetic finance

Table S-10-2 shows assets contained in the 50 largest multiseller conduits as of September 2002 by outstanding amount. The chart is taken from the Moody's new publication, *U.S. ABCP Market At A Glance: U.S. ABCP Multiseller Snapshot*. This product takes surveillance information provided by the 50 largest multiseller conduits and breaks it down by asset types, seller ratings, and other categories.³ These percentages are very similar to those in the previous table. In part this is because the business models of all the conduits are similar, and also because the 20 largest conduit comprise a significant fraction of the market.

Table S-10-2
Asset Types in ABCP Multiseller Programs
CP Outstanding
(Total: \$310.2 billion)
As of 9/30/02

Asset Type	%
Trade Receivables	19%
Credit Card Receivables	17%
Auto Loans	8%
Equipment Leases	7%
Mortgage Loans	7%
Securities	6%
Consumer Loans	5%
CBO & CLO	4%
Other	4%
Equipment Loans	4%
Commercial Loans	3%
Auto Leases	3%
Insurance Premiums	3%
Synthetic Leases	2%
Floorplan Financed	2%
Student Loans	2%
Home Equity Loans	1%
Aircraft and Engine Leases	1%
Franchise Loans	1%

1 See "ABCP Market Overview: Third Quarter 2002 - Walking In Place, Face to the Wind," December 10, 2002.
2 See "Moody's Rating Actions for the Seven Day Period Ended August 22, 2002."
3 From "U.S. ABCP Market At A Glance: U.S. ABCP Multiseller Snapshot, September," January 9, 2003

The liquidity support is typically sized at 102% or 103% of the facility limit. The extra 2 to 3% is intended to cover interest on the CP.⁵¹ Generally the conduit cannot issue ABCP unless available liquidity equals or exceeds the face amount—principal plus interest at maturity—of outstanding ABCP. The amount of liquidity available is determined by a funding formula that typically limits liquidity funding to “good,” i.e. non-defaulted, assets.

Incremental Program Credit Enhancement

Program-wide credit enhancement is typically increased by a percentage of each conduit asset purchase.⁵² This level of enhancement is in addition to the pool-specific or transaction-specific credit enhancement. Both types of credit enhancements are established to cover defaulted receivables. The pool-specific enhancement is used to cover defaulted receivables in a specific deal, while the program-wide credit enhancement is available to cover losses across most, if not all assets in the conduit’s portfolio. Program credit enhancement effectively provides cross-collateralization across all of the assets in the conduit portfolio. The administrator draws on the program-wide credit enhancement to repay maturing ABCP if no other funds are available, including funds from the liquidity facility.

If the purchased receivables are denominated in a different currency than that of the ABCP issued to fund them, a currency hedge is arranged to minimize exchange risks to ABCP investors.

Analyzing the Credit Risk of Trade Receivables

The conduit funds trade receivables at a discount to face value. That discount must cover losses due to obligor default, dilution, servicing and program costs, and, because trade receivables are non-interest bearing, interest on ABCP. In addition, the receivables are further refined through eligibility criteria designed to screen out less desirable receivables. Generally delinquent and defaulted receivables are excluded from purchase. Some receivables with a government or a foreign obligor may also be limited or excluded. In order to reduce concentration risk, the amount funded from any one obligor may also be limited. Moody’s analysis of the trade receivables focuses on whether the proposed discount rate, eligibility criteria and termination triggers provide sufficient investor protection.

Industry-Specific Risks

The performance characteristics of trade receivables vary greatly from one industry to another. Trade receivables originated by a clothing manufacturer selling to retail stores have different patterns of delinquency, default and dilution than do those originated by an equipment manufacturer selling to industrial firms. Moody’s first step in analyzing a trade receivable deal is to understand the business model of the seller and the standard terms of trade in that industry. Moody’s structured finance analyst probes the Seller for information on its trade practices and consults with Moody’s fundamental analysts for information on industry-wide practices.⁵³

Asset Performance Analysis

Moody’s reviews the historical performance of assets to understand trends and to determine whether the pool-specific credit enhancement is sufficient to cover potential losses in the transaction. Delinquency, default and payment rates are the primary indicators of asset performance. Moody’s also studies the amount of dilutions (which are commonly related to product returns or billing disputes), and the originator’s chargeoff practices, which can distort the receivables’ performance data. Typically three years of monthly performance data are needed in order to get a good measure of asset quality. Moody’s will analyze the performance data and compare its with other, similar transactions.

Obligor Quality and Concentration⁵⁴

Investor repayment depends greatly on the quality of the obligors. Moody’s is concerned with obligors’ size, credit quality and willingness to pay. Obligor concentrations in the receivable pool are a concern, since a default by a large obligor would affect a significant portion of the pool. Generally, strong trade receivable deals have a well-diversified pool of obligors with no significant concentrations.

51 See Moody’s Special Report, *Why Liquidity Facilities in ABCP Programs Equal 102%*, reprinted from the 1st Quarter 1999 Asset-Backed Commercial Paper Market Review.

52 For most conduits, the exemption to this requirement is when the asset is rated at least Aa2 or higher, is fully-supported by a Prime-1 rated financial institution or is covered under a policy provided by a Aaa-rated monoline or surety provider.

53 For example, see Moody’s Special Report, *A Guide to Collateral Quality Risks in Securitized Trade Receivable Transactions: Focus on the Contract-Related and Dealer-Network Risks*, April 1995.

54 See Moody’s Special Report, *Bigger Isn’t Better: The Risk of Obligor Concentrations in Trade Receivables Transactions*, September 1998.

More often than not, trade receivable transactions set obligor limits based on their ratings. The higher the obligor's rating, the larger the obligor concentration limit. However, even highly rated obligors pose significant risks in a trade receivable transaction. A highly rated obligor is unlikely to default due to bankruptcy, but its receivables may be subject to slow pay risk and dilution risk.

Trade receivables have a due date, but it is not uncommon in many industries for obligors to delay payment past the stated due date for a variety of reasons. Some retailers, for example are notoriously slow payers on receivables due to their suppliers. A company's rating, which indicates their willingness and ability to make payments on corporate debt, does not speak to a company's payment behavior on accounts payable. In some industries, trade receivable obligors have the market power to manage their cash flows at the expense of their suppliers by delaying payment on receivables. Slow payment reduces the cash flow to the transaction and may increase the risk of default. In a trade receivable transaction, liquidity banks typically fund against "non-defaulted" receivables. Receivables that are still unpaid after a specified time period are considered defaulted under the liquidity agreement and the banks will not fund against them. This then becomes a risk to ABCP investors.

Dilution Risks Vary by Industry in Trade Receivables Transactions⁵⁵

The sources of dilution risk vary greatly from industry to industry. Dilution comes about when the amount payable on a receivable is reduced for a non-credit-related reason, that is any reason other than default by the obligor. Product returns are an obvious source of dilution, but many other, less obvious sources of dilution exist. Sellers may grant volume discounts or advertising credits. These forms of dilution are more likely to be made available to large customers. Large customers may also have more leverage with respect to payment terms and returns. A large obligor may choose to take credits when it feels they have been earned and not necessarily when the Seller grants them. This may lead to late payments or disputed items that, as they age, are eventually considered "defaulted" under the liquidity agreement, resulting in a loss or reduction in liquidity funding.

Another significant source of dilution to trade receivables is the risk that obligors offset amounts they owe against receivables or liabilities of the Seller. Offset risk is most likely to materialize when the Seller's credit quality deteriorates. Concerned obligors may begin to offset amounts they owe against unearned receivables or warranty damages owed to them. The evaluation of the potential for offset is necessarily a qualitative analysis, since these amounts would generally not be evident in historical receivable performance.

Servicer Quality

In almost all trade receivable transactions, the Servicer of the asset pool is the Seller of the assets. The Servicer is responsible for credit underwriting of the obligors, origination, collection and performance monitoring. In most U.S. trade receivables transactions payments are made through a lock box unless the Servicer is an investment grade firm. While the Servicer typically can direct the cash received in the lock box while the deal is performing, the Trustee can take control in certain defined circumstances where the transaction performance is at risk, particularly if the Servicer's credit rating is lowered. In cases where lock boxes are not used, the Servicer is typically required to transfer payments to an account owned by the securitization on a regular basis, more frequently the lower the credit rating of the Servicer.

The Servicer handles any receivable disputes or payment delays through its ultimate settlement or write-off. Moody's reviews the Servicer's credit and collection policy, operations and results of any third-party audits done of the Servicer's operations. In some cases, a transaction may have a backup servicer to collect on the receivables if the primary servicer enters bankruptcy or fails to perform. In some cases a deterioration in servicer credit quality could be material to the performance of the receivable pool. This is usually due to selling practices and contingent obligations that the seller may have relative to its obligor base. Moody's considers these factors in its analysis of receivable pools in conduits.

Risk Mitigants in Trade Receivable Transactions

- The primary investor protections in trade receivable transactions are:
- Pool-specific credit enhancement provided through overcollateralization and funded by purchasing the receivables at a discount
- Eligibility criteria that limit the type of obligations purchased
- Performance triggers that force the transaction to amortize early and protect investors from future deterioration

⁵⁵ See Moody's Special Report, *Trade Receivables Update: Concentrating on Dilution—Focus on Capital Goods and Consumer Products Receivables*, January 1997

Pool-Specific Credit Enhancement

Pool-specific credit enhancement in a trade receivable transaction is set to cover the risk of loss and dilution, servicing costs and funding costs. Each transaction has a minimum level of pool-specific credit enhancement that is typically expressed as a percentage of eligible receivables. The minimum credit enhancement level may also be defined to cover the three or four largest obligors in the pool in order to reduce concentration risk. A dynamic formula tied to asset delinquency, default, and dilution, servicing fees and funding costs results in credit enhancement that fluctuates above the minimum level according to receivable performance. Reserve levels for trade receivable deals tend to be in the range of 10% to 25%, which means that the discounted purchase price or advance rate for receivables is in the range of 75% to 90%.

Reducing the Risk of Large Obligor Concentrations

There are a number of ways to mitigate the risk of large obligor concentrations. The most common is to limit the amount of funds advanced against any single obligor. Second, many transactions have “cross-aging” of delinquent or defaulted receivables, such that if a percentage of an obligor’s receivables are delinquent or defaulted, then all of that obligor’s receivables become ineligible for funding. Finally, credit enhancement may be sized to cover a certain number of obligors at minimum.

Asset Performance Triggers

Most transactions have asset performance triggers based on delinquency, default, dilution and payment rates. Almost every trade receivable transaction has a trigger related to the overcollateralization levels. If the amount of receivables eligible for liquidity funding (sometimes referred to as “good” receivables) is insufficient to cover the ABCP the conduit has issued to fund the transaction plus all of the required reserves, the transaction is said to be “out of formula”. This is also referred to as “failing the Asset Interest test”. The formula is generally expressed as the face amount of ABCP outstanding plus Required Reserves / Eligible Receivables. If this ratio is greater than 100% and remains uncured for more than one to five days, it is generally an automatic termination event.

Other Triggers

ABCP trade receivable financing is usually just one part of an overall financing strategy for an industrial corporation. Conduit receivable deals normally have triggers that require amortization upon any material default on other indebtedness of the Seller, particularly bank lines or public debt. There are frequently financial covenants in conduit receivable purchase agreements that mirror those in other bank lines. If the Seller or any material subsidiary files for bankruptcy protection it is always a termination event in a receivable securitization.

Any trigger may cause a “cease purchase” which means that no new receivables are purchased from the seller and the transaction amortizes as the existing receivables are paid down. Alternatively, a trigger may cause a “cease issuance” which means that no further ABCP may be issued to fund the transaction. Some triggers result in both a cease purchase and a cease issuance. If receivables pay quickly ABCP will be repaid from cash receipts; otherwise liquidity will be drawn to repay ABCP. A trigger may cause an immediate “put” to liquidity providers, which means that the liquidity facility is drawn immediately to purchase the conduit’s interest in the transaction and the funds are held in a trust account to repay ABCP as it matures. These triggers may be mandatory, or they may be “waivable.” Generally Moody’s receives notification when a trigger is hit in order to discuss transaction performance and remedies with the conduit sponsor.

SECURITIES PURCHASES BY CONDUITS

ABCP programs also purchase rated asset-backed securities, a practice that has become increasingly common in the last five years. The fact that a security is already rated makes a security purchase simpler to effect in some ways than a transaction structured solely for the conduit market. On the other hand, term structures lack short-term ratings and liquidity facilities. In addition, many ABS are pass-through securities and their ratings reflect the likelihood of ultimate payment, but not the timing of payment. In order to make sure that these issues are adequately addressed, Moody’s reviews the terms and funding arrangements of securities purchases prior to their implementation.

“Highly rated” securities (typically **Aa2** and higher) backed by a liquidity facility that funds for non-defaulted assets are typically consistent with a **Prime-1** rating. Lower rated securities may need additional enhancement. Credit enhancement may take any of the forms discussed under Forms of Credit Enhancement on page Forms of Credit Enhancement. The most common methods of enhancement are surety bonds, letters of credit,

and increased program-wide credit enhancement. Often, lower rated securities are enhanced through the liquidity facility, either by a more generous funding formula or by limiting the time investors are exposed to loss.

For example, credit card "C" pieces are often funded in conduits with a 30-day restriction on ABCP maturity, and a cease issuance if the underlying credit card master trust goes into early amortization. Investors are exposed to a 60-day window of risk exposure: one month to receive a performance report indicating amortization and a second month for outstanding ABCP to mature and be repaid by cash from the asset or draws on the liquidity facility. The enhancement supporting the C piece plus program credit enhancement may cover this 60-day risk of loss to a very high degree of certainty, consistent with **Prime-1**.⁵⁶

Some ABCP programs, credit arbitrage programs and structured investment vehicles in particular, only purchase highly rated securities⁵⁷. These programs are generally post-review, in that purchases can be made without Moody's prior review. The rating, enhancement and structural protections that are required by these programs are very detailed. Moody's reviews the program's credit and investment policy and the enhancement and structural features to determine that they are consistent with a **Prime-1** rating.

56 See Moody's Special Report, *Understanding Structured Liquidity Facilities in Asset-Backed Commercial Paper Programs*, April 1997.

57 See Moody's Special Reports, *Moody's Approach to Evaluating Credit Arbitrage ABCP Programs*, August 2002; and *An Introduction to Structured Investment Vehicles*, January 2002.

Sidebar 11

Securities Funded by ABCP Programs

Over the past decade, two types of programs have evolved to finance securities through asset-backed commercial paper programs: credit arbitrage programs and structured investment vehicles (SIVs). The two program types have grown significantly. Credit arbitrage programs have an estimated \$131 billion of ABCP outstanding as of June 30, 2002. Many multiseller conduits have added securities purchase facilities structured to follow the credit arbitrage enhancement and liquidity coverage guidelines. These dual-purpose conduits have been called "hybrids." SIVs have issued approximately \$41.5 billion of ABCP and an additional \$49.6 billion of MTNs as of year-end 2002.

Data on the security holdings of the 18 largest U.S. credit arbitrage programs is presented in the accompanying charts. These programs account for approximately 95% of the ABCP issued by credit arbitrage conduits. As the accompanying figures show the holdings are overwhelmingly **Aaa** in credit quality. Most credit arbitrage programs do not hold securities rated below **Aa3**. The graphs show the distribution by asset type and industry type.

Moody's publishes this information monthly in the "U.S. ABCP Credit Arbitrage Snapshot."

Figure S-11-1
Asset Types in ABCP Credit Arbitrage Programs
CP Outstanding
(Total: \$66.6 billion)
As of 9/30/02

Asset Type	%
CBO & CLO	29.4%
Credit Card Receivables	13.8%
Home Equity Loans	13.4%
Residential Mortgage Loans	10.7%
Commercial Mortgage Loans	8.5%
Commercial Loans	5.2%
Bonds (Corporate/Municipal)	4.6%
Student Loans	3.6%
Other	3.5%
Auto Loans	2.6%
Auto Leases	1.3%
Aircraft and Engine Leases	1.0%
Trade Receivables	0.9%
Floorplan Financed	0.9%
Equipment Leases	0.4%
Consumer Loans	0.1%
Franchise Loans	0.1%
Equipment Loans	0.0%
Insurance Premiums	0.0%

Figure S-11-2
Industries in ABCP Credit Arbitrage Programs
CP Outstanding
(Total: \$66.6 billion)
As of 9/30/02

Industry	%
Commercial Finance	41%
Mortgage Finance	31%
Consumer Finance	18%
Other	5%
Automotive Finance	3%
Insurance	1%
Aerospace & Defense	1%
	100%

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GLOSSARY OF TERMS

ABCP: Asset-backed commercial paper.

ABS: Asset-backed securities.

Administrator: Entity that administers the ABCP program by monitoring receivables, compiling monthly reports, and ensuring that the issuer is in compliance with the program documents and with the credit and investment policy (if there is one). The administrator may be the party who draws under the credit and/or liquidity enhancement if needed. The administrator is often the program sponsor, although programs with multiple sponsors may have a single administrator.

Advance Rate: in an asset-backed transaction, the purchase price paid for new assets, usually less than par, to provide credit enhancement and yield. For example, if the transaction pays 80% of the par value of new assets, the advance rate is 80% and the haircut is 20%. See also, Haircut.

Asset Interest Test: a typical conduit feature, it specifies that the principal amount of ABCP issued by a conduit cannot exceed the amount of the assets available to support repayment of the ABCP. See also, Liquidity Coverage Test, Issuance Test.

Asset Purchase Agreement: Agreement to purchase a specified pool of receivables (provided that performance has not deteriorated beyond specified trigger levels). Asset purchase agreements provide liquidity for ABCP programs and permit the issuer to sell the receivables to the asset purchase provider at any time for any reason. Asset purchase agreements are especially useful with term receivable pools because those pools do not have inherent liquidity as do trade receivable pools.

Authorized Amount: Maximum authorized amount of an ABCP program. Actual program outstandings could be significantly less than the authorized amount. ABCP may be issued up to the authorized amount only if sufficient receivables, credit enhancement and liquidity support are available.

Automatic Stay: A feature of bankruptcy law in the U.S. and many other jurisdiction, that requires all funds of a bankrupt to be frozen pending court or trustee determination as to their fair and proper disposition. The "stay" is automatic in that it does not require any court action to be effective.

Backup Liquidity Facility: a liquidity facility that provides support for a commercial paper program. In some cases it may guarantee funding to a seller if an ABCP program cannot provide such funding.

Bank Syndication Risk: see Liquidity Syndication Risk.

Bankruptcy Remoteness: structural features of a special purpose vehicle that make it unlikely, though not impossible, that it will become bankrupt either voluntarily or involuntarily, or that it will be consolidated into the bankruptcy estate of a third party.

Basle Accord: an international agreement setting common standards for bank regulatory capital requirements. Basle I in 1988 established the blanket 8% standard, and exempted liquidity facilities of less than one-year duration. Basle II, currently under negotiation, will likely establish a risk-based capital requirement standard, and include some requirement for short-term commitments.

Borrowing Base: A calculation for determining how much a liquidity bank will fund. Typically, the borrowing base includes non-defaulted receivables and cash a seller has received but has not yet remitted to the conduit. It may include dilution but frequently does not.

CP: Commercial paper.

Cash Collateral Account: also known as a **CCA**, a support facility under which a cash or highly liquid securities are maintained in an account for the benefit of a securitization. A CCA may provide liquidity, credit enhancement or both.

Cease Purchase Event: in a revolving transaction, a situation that requires the special purchase vehicle to stop purchasing new assets, and retain cash as existing assets pay down. A Cease Purchase Event may be mandatory or waivable, and may be permanent or curable.

Clearstream: Clearstream Banking, s.a., a firm which provides book-entry security ownership and automated settlement services for European transactions, similar to the Depository Trust Corporation (DTC) in the U.S. and Euroclear in Europe.

Club Deal: See Syndicated Transaction.

Collateral Agent: a support provider in a structured finance transaction responsible for

Commercial Paper: or CP, a form of short-term senior unsecured corporate or asset-backed obligation, typically issued at a fixed discount, though sometimes on an interest bearing or floating rate basis. CP maturity is typically less than 270 days in the U.S. and 180 days in Europe, though in some cases may be as long as 390 days.

Collateral Agent: in a structured transaction, holds the security interest in all assets of the conduit for the benefit of the investors. Usually the trust department of a commercial bank.

Concentration Limit: in a structured transaction, a restriction on the amount of funding that may be provided against the receivables of any one obligor. Typically these limits will vary by the rating of the obligor, and may include exceptions for special obligors. See Special Obligor.

Concentration Risk: in a structured transaction, the concern that default by an obligor or obligors that make up a significant proportion of the receivables may jeopardize eventual repayment to investors.

Counterparty Risk: the risk of default or non-performance by the other party in a contractual arrangement, most typically a support provider in a liquidity, credit enhancement or swap facility.

Credit and Investment Policy: or C&I, for an ABCP conduit, a statement of the type and quality of assets the conduit may fund, including concentration restrictions. Typically the C&I will also specify the type of liquidity, credit enhancement, hedging and other structural features required for any asset funding or purchase.

Credit Arbitrage: a type of ABCP conduit that primarily funds highly-rated securities, and in which investors are only exposed to the risk of default, or credit risk, of those securities, and not the risk of market value or price change.

Credit Default Swap: a form of credit protection in which one party agrees to compensate the other in the event of a default by a specified entity or security—the reference entity or reference credit—for a fee.

Credit Enhancement: Used to cover credit losses, and often dilution, and may include external and/or internal support. It may be seller specific or program-wide.

Credit Insurance: an insurance policy, typically in a trade receivables transaction, that provides support payments to cover defaults by obligors. Typically subject to certain eligibility criteria and an overall payment limit.

Credit Support: see Credit Enhancement.

Cross-aging: an eligibility criteria in a trade receivables transaction that excludes the funding of all receivables from a given obligor if a certain portion of those receivables are delinquent. Cross-aging provides investor protection by removing obligors that begin to show deteriorating payment behavior before they actually default.

Custodian: in a structured transaction, maintains physical, and more recently electronic, control of assets. Usually the custody department of a commercial bank.

Daylight Advance: in an ABCP program, the provision of funds by an agent, such as the Liquidity Agent, Administrator, or IPA, in anticipation of the receipt of funds from other parties to the program, where those funds are due under the terms of the program documents. Daylight advances are typically not mandatory, but are commonly provided in practice for highly-rated counterparties or where the provider has reason to believe funds will be delivered by the end of the day.

Dealer: see Placement Agent.

Depository: see Issuing and Paying Agent.

Depository Trust Corporation: a firm which provides book-entry security ownership and automated settlement services for U.S. transactions, similar to the Euroclear and Clearstream in Europe.

Dilution: the reduction in the value of a receivable for reasons that are not credit related, such as default. Dilution is caused by events such as disputes, returns of sold goods, offsets, credits, rebates, and warranty claims that dilute the value of outstanding receivables. For example, if receivables totaling \$1 million are created when goods are sold, and \$50,000 of those goods are subsequently returned, the receivables have suffered 5% dilution.

DTC: see Depository Trust Corporation.

ECNs: Extendible Commercial Notes. See Extendible Commercial Paper.

Eligibility Criteria: see Eligible Receivable.

Eligible Receivable: Receivable that meets the issuer's eligibility criteria for purchases. Eligibility criteria typically include extensive provisions in addition to a receivable being a non-defaulted receivable.

Euroclear: Euroclear Bank, S.A/N.V., a firm which provides book-entry security ownership and automated settlement services for European transactions, similar to the Depository Trust Corporation (DTC) in the U.S. and Clearstream in Europe.

Excess Funds: in an ABCP program, funds that are not needed to repay maturing ABCP, and which therefor may be used to pay expenses or other amounts due without harming ABCP investors. ABCP programs typically have restrictions that permit certain expenses and other items to be paid only with excess funds.

Execution Light: a form of limited prior rating review for ABCP transactions that may be agreed between Moody's and a conduit sponsor. See also Post Review Status and Limited Post Review.

Expected Loss: the reduction in the return to investors based on an evaluation of the likelihood of default and the recovery in the event of default. Moody's method for determining the rating on long-term securities. See Probability of Default.

Extendible Commercial Paper: commercial paper issued with an initial scheduled maturity, but which may, at the option of the seller, be extended on the schedule maturity for some fixed period to a final maturity, usually at a higher rate of interest. Also called Extendible Commercial Notes or ECNs, and Secured Liquidity Notes or SLNs.

External Credit Support: Credit support supplied by a party other than a seller. May take the form of a cash collateral account, guarantee, letter of credit, or surety bond. May be provided at the program and/or seller level.

Face Amount: The principal amount of ABCP plus all interest due at maturity. For ABCP issued at a discount, this is literally the "face amount" on the note issued. For ABCP issued on a interest-bearing basis, it is the principal amount on the note issued, plus all interest that will accrue to maturity. Essentially, the Face Amount is how much is due to be paid to an investor at maturity.

FASB: the Financial Accounting Standards Board, the primary accounting regulatory body in the U.S..

First Loss Enhancement: in a structured transaction, credit enhancement that is the first to be drawn or written down to cover losses on the assets. Typically provided by overcollateralization.

First Priority Security Interest: a security interest that legally comes ahead of all others, often evidenced by the existence of a First Priority Lien. See Security Interest.

Floating Rate ABCP: ABCP that pays an interest rate that is periodically reset during the time the ABCP is outstanding prior to maturity, and specified by a spread to an interest rate index such as one-month LIBOR.

Floor: A minimum dollar amount below which the program-level credit enhancement cannot decline (unless it is reduced by credit losses).

Freeze: The program-level credit enhancement may “freeze” if a specified trigger event occurs. Effectively, a freeze in the credit enhancement means that a floor is established at the dollar amount of credit enhancement available at the time the related trigger event occurs. For example, the credit enhancement may freeze if it is reduced 20% by losses.

Fully-supported: indicates that the credit quality of a transaction or ABCP conduit depends solely on the rating of a support provider and not on the quality of the underlying assets. See Partially-supported.

Funding Cost: the all-in cost to the conduit of providing funds to a transaction. The Funding Cost will include the interest that must be paid on ABCP, and also the fees paid to liquidity and credit enhancement providers and a share of the operational expenses of the conduit.

Funding Formula: see Liquidity Funding Formula.

GLAPA: Global Liquidity Asset Purchase Agreement. See Global Liquidity Agreement.

Global Liquidity Agreement: a liquidity agreement that provides a backup liquidity facility for multiple transactions in a conduit, as opposed to a deal-specific liquidity agreement. Can be in the form of a loan agreement or a purchase agreement.

Global Liquidity Asset Purchase Agreement: Also referred to as a GLAPA. See Global Liquidity Agreement.

Guarantor: in a structured transaction, a third party, usually highly rated, that takes on the credit risk of an asset pool or of another party to the transaction. A monoline insurance company or a commercial bank is the most common guarantors seen in ABCP conduits.

Haircut: in an asset-backed transaction, the difference between par and the purchase price paid for new assets, usually to provide credit enhancement and yield. For example, if the transaction pays 80% of the par value of new assets, the advance rate is 80% and the haircut is 20%. See also, Advance Rate.

Hedge: a financial arrangement, usually executed through a swap agreement, to alter and typically reduce the risk of a transaction. For example, an interest rate hedge will often trade a floating rate liability for a fixed rate liability, or liability in one currency for a liability in another currency.

Hedge Counterparty: the entity taking the other side of a hedging agreement or swap. For ABCP conduit transactions, a Hedge Counterparty is considered a support provider and is typically highly rated.

Hedging Agent: in a conduit, the party responsible for managing interest rate and currency risk, among other. The Hedging Agent usually has wide latitude as to how it recommends the conduit manage these risks, and provides a performance indemnity should the arrangements prove insufficient.

Hybrid ABCP Conduit: an ABCP conduit that incorporates the structural features of two or more conduit types. Most Hybrid Conduits have Multiseller and Credit Arbitrage characteristics, and some include Loan-Backed.

Indemnification: a promise to make payments to cover losses in the event of an error or failure to perform properly. In an ABCP conduit, the Administrator typically agrees to indemnify the conduit for failure to perform its duties correctly.

Internal Credit Support: Credit support supplied by the seller, usually in the form of overcollateralization or seller recourse. Typically provided at the seller level.

International Swap Dealers Association: an industry organization that sets the standards and provides the templates for over-the-counter swap agreements.

Investment Company Act of 1940: one of the two main laws governing the securities industry, among other things it sets registration and disclosure requirements for investment companies, affecting both ABCP programs and their primary investor, money market mutual funds. See also Securities Act of 1933.

IPA: See Issuing and Paying Agent

ISDA: see International Swap Dealers Association.

Issuance Test: in an ABCP conduit, a condition that must be satisfied prior to issuing ABCP. Typical issuance tests are non-bankruptcy of the conduit, positive tangible net worth, sufficient performing assets to support the principal amount of ABCP outstanding, and sufficient liquidity coverage to support the face amount of ABCP outstanding.

Issuer: Party that issues ABCP. The issuer is typically a bankruptcy-remote, special-purpose vehicle or trust.

Issuing and Paying Agent: also IPA, the party that handles the mechanics of delivering ABCP notes to investors in return for payment, and redeeming them at maturity. In European transaction typically called the **Depository**. The IPA typically has a working relationship with the electronic clearinghouses such as DTC in the U.S. and Euroclear or Clearstream in Europe.

LAPA: see Liquidity Asset Purchase Agreement.

Legal Final Maturity: last day on which investors may be paid under the terms of a structured transaction in order to avoid default. Typically later than the Scheduled Maturity.

Legal Owner: the party that owns the equity of an ABCP conduit. This will vary by the corporate form of the conduit and the jurisdiction. In the U.S. it is typically a subsidiary of a specialized management company; in European transactions it is often a charitable trust.

Legal Structure: the corporate form of the ABCP conduit, as determined by its foundation documents. This will vary by jurisdiction.

Letter of Credit: a document issued by a commercial bank that guarantees payment up to a specified amount. In an ABCP program, typically used as a form of credit enhancement.

LIBOR: London Interbank Offer Rate, a commonly used reference interest rate set by commercial banks in London.

Limited Post Review: the ability of an ABCP conduit to enter into certain classes of transactions, typically limited by type, industry, size and rating, without prior review by Moody's. Also called Execution Light.

Limited Purpose Investment Corporation: or LIPIC. See Structured Investment Vehicle.

LIPIC: a Limited Purpose Investment Corporation. See Structured Investment Vehicle.

Liquidations: Collections on receivables, usually during a specified period of time, such as one month or one year.

Liquidity Agent: in a liquidity facility, the party responsible the operation of the facility under the terms of a Liquidity Agreement. The Liquidity Agent accepts notice of a request to draw and forwards it on to each Liquidity Bank, receives payment from the Liquidity Banks and forwards it on to the conduit, and receives interest and principal payments from the conduit and forwards them to the Liquidity Banks.

Liquidity Bank: a commercial bank that agrees to provide funding up to a specified amount under the terms of a Liquidity Agreement.

Liquidity Agreement: in an ABCP program, the document among the conduit, the Liquidity Agent and the Liquidity Banks that establishes the liquidity facility. Liquidity Agreements may be in the form of a loan agreement or a purchase agreement.

Liquidity Asset Purchase Agreement: a form of liquidity agreement, under which the liquidity banks agree to purchase assets, sometimes referred to as a LAPA.

Liquidity Facility: Covers liquidity or timing risk, which arises, for example, because ABCP is maturing but sufficient collections have not yet been received to pay maturing ABCP. Sometimes called a Liquidity Backup Facility.

Liquidity Funding Formula: in a liquidity agreement, the section that specifies how much funding the liquidity syndicate is required to provide. In a partially-supported transaction, the funding formula will

typically be limited to the value of non-defaulted assets plus any amounts due from the seller of the receivables.

Liquidity Risk: the potential for loss to investors from the failure to make timely payment on a security. Liquidity Risk typically arises in an asset-backed transaction from a timing mismatch between the payments due on the assets and those promised to investors.

LLC: limited liability corporation, a U.S. form of corporate organization.

Loan-Backed Conduit: an ABCP conduit whose primary purpose is to provide short-term corporate loans, typically on a maturity-matched basis.

LOC: see Letter of Credit.

Lock Box: a payment system under which an obligor sends his payments to an account controlled by a third party, typically a commercial bank, rather than to the seller. Lock Boxes are the typical method for payments in securitized transactions in the U.S., and are less common in other jurisdictions.

Losses: Credit losses due to an obligor's failure to pay what is owed on a receivable. Losses are often deemed to occur when receivables remain unpaid for a specified period of time past their due date, even though the seller may not choose to write them off. For example, a receivable may be deemed to have defaulted, and thus to have incurred a loss, if it is not paid 90 days following its due date.

Losses/Liquidations: The ratio of losses on receivables to collections on those receivables during a specified time period, such as a month or a year. This ratio is calculated somewhat differently by different issuers, so comparisons may be misleading. However, it does give a good indication of one program's performance over time.

Losses/Outstandings: The ratio of losses on receivables over a period of time, such as a month or a year, to outstanding receivables, preferably those outstanding at the beginning of the time period. This ratio is calculated somewhat differently by different issuers, so comparisons may be misleading.

Management Agreement: in an asset-backed transaction, an agreement with a support provider that covers the corporate existence of the special purpose vehicle, providing for officers, office arrangements such as phone, fax and mailing address, and filing of accounting and tax reports.

Manager: the third-party service provider under the Management Agreement, in the case of an ABCP conduit typically a firm that specializes in providing these services to special purpose vehicles.

Mark-to-Market: the process of pricing the assets of an asset-backed transaction, particularly for Market Value Conduits.

Market Value Conduits: ABCP conduits in which investors are subject to the risk of changes in the price of the assets funded by the conduit. The largest category of Market Value Conduits is the Structured Investment Vehicles or SIVs.

Maturity Matched Funding: the process of issuing ABCP with maturities that are identical to that of the assets being funded, so that cash flow from the assets repays ABCP as it becomes due. Typical of Loan-Backed programs.

Medium Term Notes: or MTNs, interest-bearing securities with an original maturity of one to ten years. Issued by some ABCP programs to reduce the required amount of liquidity by delaying repayment to investors to a point after the maturity of the program assets. MTNs receive long-term ratings based on an evaluation of expected loss.

Money Market Fund: a mutual fund that invests in high-quality short-term assets with the intention of providing a rate of interest with no risk to capital. Money Market Funds are the single largest class of investors in ABCP.

Monoline Insurance Company: in finance, an insurance company whose sole business is to provide a guaranty or surety bond to protect investors from loss, usually to the full value of the investment. Most Monoline Insurance Companies carry a **Aaa** rating from Moody's. See also Guarantor.

Multiline Insurance Company: an insurance company involved in more than one type or "line" of insurance, such as life, property/casualty, financial, etc. See Monoline Insurance Company.

Multiseller Conduit: an ABCP program structured to fund assets originated by a variety of sellers, typically all clients of the sponsoring commercial bank.

Non-Consolidation Opinion: a reasoned legal opinion as to the likelihood that a bankruptcy remote special purpose vehicle, such as an ABCP conduit, would be included in the bankruptcy estate of a third party under the bankruptcy laws of the relevant jurisdictions. See Bankruptcy Remoteness.

Non-Defaulted Receivables: Receivables that either have not defaulted or been deemed to have defaulted (see *Losses*). Liquidity agreements sometimes provide that a liquidity bank will only fund against non-defaulted receivables.

Non-Petition Agreement: a clause in an agreement in which one party agrees not to file a bankruptcy opinion against another for some specified period of time. Most parties agree not to file a bankruptcy petition against an ABCP conduit until at least a year and a day after the last ABCP is repaid in order to reduce the risk that money paid to ABCP investors will be considered a preferential payment in bankruptcy and subject to clawback. See Bankruptcy Remoteness.

Non-Pro-Rata Draw: a feature of syndicated liquidity facilities in which liquidity providers agree to provide funds to cover the failure of any bank in the syndicate to advance funds when requested. Normally banks are only required to provide their pro rata share of the amount requested, based on their share of the total commitment. Even with this feature, no bank is required to advance funds in excess of its stated liquidity commitment.

Obligor: Party who owes payment on a receivable to a seller.

Operational Risk: the possibility that investors will suffer a loss because a party to the transaction will fail to perform its duties according to the documents or at the necessary level of competence.

Operations Review: also called an "Op Review," Moody's process for visiting a program sponsor or support provider in order to review staffing, expertise, systems, support and other aspects of the party's role in a structured finance transaction.

Originator: the party that generates the assets being securitized, for example the firm selling product in a trade receivables transaction, or the bank offering credit card accounts, or the firm making mortgage loans. The Originator is usually initial Seller of the assets.

Out of Formula: in a receivables transaction, the situation in which the available amount of non-defaulted and eligible receivables is not sufficient to cover the principal amount of debt outstanding plus the required overcollateralization and reserves. When a transaction is "Out of Formula" it generally means that investors have less credit protection than they are required to have under the transaction documents.

Outstandings: May refer to outstanding ABCP or outstanding receivables. Outstanding ABCP is ABCP that is issued and not yet paid. Outstanding receivables are those that have been created and that are not yet paid.

Overcollateralization: A form of internal credit support that arises when an issuer purchases receivables from a seller at a discount. For example, a seller may pay \$100 for \$110 of receivables, generating overcollateralization of 10%. See Advance Rate and Haircut.

Partial Post Review: see Limited Post Review.

Partially-supported: a asset-backed transaction or ABCP program where investors depend on the credit quality of the assets for repayment. See Fully-supported.

Placement Agent: in an ABCP program, the party, typically the trading arm of an investment bank, that markets ABCP to investors.

Pool: Refers to a pool of receivables.

Pool Purchase Agreement: See Asset Purchase Agreement.

Post Review Status: for an ABCP conduit, the ability to enter into new transactions without prior review of the transaction by Moody's. See also Limited Post Review and Prior Review.

Preferential Transfer: a payment made outside of the normal course or priority of business. Under bankruptcy law, there is a presumption that payments made near to the event of bankruptcy are preferential and subject to review by the bankruptcy court.

Prior Review: for an ABCP program, the requirement that Moody's review new transactions before they are funded by the conduit. See also Post Review and Limited Post Review.

Priority of Payments: also called the Waterfall, language in a transaction that specifies the order in which parties to the transaction are to be paid from the cash available.

Program: Asset-backed commercial paper program. The program includes all the receivable pools from all the sellers who have sold receivables to the issuer.

Program-Level Credit Support: Credit support available to cover losses incurred by any pool of assets in the program.

Program-Level Liquidity Support: Liquidity support available to any and all asset pools in the program. See also Global Liquidity Agreement.

Program-Wide Credit Enhancement: see Program-Level Credit Support.

Purchase Agreement: in an asset-backed transaction, typically the agreement defining the terms of sale of assets between an Originator or Seller and a special purpose entity.

Purchase Price: in an asset-backed transaction the price paid for an asset, typically less than the par value of the asset. See Advance Rate, Haircut and Overcollateralization.

Qualified Institutional Buyer: or QIB, defined by Rule 144a under the Securities Act of 1933, it designates larger, more sophisticated investor. ABCP programs must restrict sales of commercial paper to QIBs to avoid registration requirements under the Securities Act.

QIB: see Qualified Institutional Buyer.

Receivable: Amount a seller is due to receive from an obligor as payment for goods, services, or other items under the terms of a contract.

Receivable Pool: A pool of receivables sold by a seller to an issuer. A single seller may sell more than one pool of receivables to an issuer, especially if it has heterogeneous product lines that are sold under different terms.

Related CP: A negative structural feature found in some ABCP programs that requires the issuer to track the use of the proceeds of each tranche of ABCP to a particular receivable pool and to limit which liquidity banks can be drawn upon when the related ABCP matures. The presence of a related ABCP structural feature in an ABCP program increases the probability that there will be delays in payment if unexpected operational or administrative problems arise in the liquidity funding process. Sometimes called Serialized ABCP.

Repo: See Repurchase Agreement.

Repurchase Agreement: a short-term funding arrangement, under which a borrower sells securities with a commitment to repurchase them at a fixed price at a certain point in the future. Sometimes used to provide liquidity in an ABCP conduit. Also called a Repo Agreement.

Rolling: the process of issuing new ABCP to repay maturing ABCP. Most ABCP is issued to repay maturing ABCP in order to maintain funding to the Seller, rather than requiring repayment or relying on the Liquidity Facility.

Rule 144a: under the Securities and Exchange Act of 1933, defines Qualified Institutional Buyer or QIB, among other things.

Rule 2a-7: under the Investment Company Act of 1940, governs investments by money market mutual funds.

Scheduled Maturity: the anticipated Termination Date of a transaction. Typically earlier than the Legal Final Maturity.

Section 3(c)(7): of the Investment Company Act of 1940, provides for exemption from the company registration requirements. ABCP programs often observe the requirements of this section in order to avoid registration under the Act.

Section 4(2): of the Securities Act of 1933, provides for exemption from the security registration requirements. ABCP programs often observe the requirements of this section in order to avoid having to register the commercial paper notes under the Act.

Secured Liquidity Notes: or SLNs. See Extendible Commercial Paper.

Securities Act of 1933: one of the two main laws governing the securities industry, among other things it sets registration and disclosure requirements for publicly issued securities. It also created the Securities and Exchange Commission. See also Investment Company Act of 1940.

Security Agreement: a document that establishes a security interest for investors. Typically present in ABCP conduits in which investors have a direct security interest in the funded assets.

Security and Intercreditor Agreement: see Security Agreement.

Security Interest: a legal right to the financial benefits of an asset such as interest and principal cash flow.

Seller: Party that sells receivables to an issuer.

Seller-Level Credit Support: Credit support provided to cover losses incurred by a particular pool of assets, and only by that pool. It does not cover losses incurred by other pools in a program. Typically it is in the form of overcollateralization or seller recourse, but may also include a seller-specific LOC, guaranty, or surety bond. It is usually the first form of credit enhancement to be tapped if losses arise.

Seller Recourse: Recourse a seller gives to an issuer to cover losses, dilution, or other offsets on that seller's receivables. The seller agrees to cover shortfalls up to the specified recourse percentage. The value of seller recourse is linked to the seller's credit quality. For that reason, seller recourse is often limited to sellers whose rating is at least as high as the rating assigned to an issuer's ABCP program.

Seller Reserves: Internal credit support.

Seller-Specific Liquidity Support: Liquidity support for a single seller or for a specified sub-group of the sellers in the program. Unlike program-level liquidity support, it provides liquidity only for the specified seller(s).

Serialized ABCP: see Related ABCP.

Service Provider: in an ABCP conduit, a third party that provides administrative, operational, credit, liquidity or some other form of service or support to the program.

Servicer: in an asset-backed transaction, the party responsible for overseeing the payment collection process. The initial servicer is typically the Seller or Originator of the assets, or a related firm.

Servicer Risk: the possibility of loss due to inefficient, careless or improper collection procedures by the Servicer.

Single Seller Program: an ABCP conduit established to fund the assets originated by one Seller, or one Seller and its subsidiaries and related entities.

SIV: Structured Investment Vehicle.

SLNs: Secured Liquidity Notes. See Extendible Commercial Paper.

Special Purpose Corporation: or SPC. See Special Purpose Entity.

Special Purpose Entity: a limited purpose corporate or trust entity typically used for securitization. The exact legal form will depend on the jurisdiction in which the entity is created and the business purpose. Also called an SPE, Special Purpose Corporation or SPC, or Special Purpose Vehicle or SPV. The terms are used interchangeably.

Special Purpose Vehicle: or SPV. See Special Purpose Entity.

Sponsor: Entity that has set up the ABCP program. The sponsor approves the sellers and receivable pools to be included in the program. The sponsor often serves as administrator.

SPC: or Special Purpose Corporation. See Special Purpose Entity.

SPE: see Special Purpose Entity.

SPV: or Special Purpose Vehicle. See Special Purpose Entity.

Structured Investment Vehicle: or SIV, a market value, securities arbitrage program that typically purchases highly-rated securities funded by ABCP and MTNs, under strict investment and operational guidelines. Also called a Limited Purpose Investment Corporation or LIPIC.

Support Provider: see Service Provider.

Surety Bond: a guaranty issued by a monoline financial insurer. See Monoline Insurance Company.

Swap: a financial agreement under which two parties agree to exchange defined payment streams. Typically a swap is used to hedge interest rate, exchange rate, market value or some other form of risk, and is based on a Master ISDA Agreement. See ISDA, Hedging.

Syndicated Liquidity: in ABCP transactions, a liquidity facility provided by a group of Liquidity Banks on a pro rata basis relative to their commitment amounts.

Syndicated Transaction: an asset-backed transaction financed by a group of ABCP conduits on a pro rata basis relative to their commitment amounts. Also called a Club Deal.

Ten Bank Rule: A structural mechanism in an ABCP program that mitigates against the possibility that delays in payments of ABCP will occur due to operational or administrative problems. Pursuant to the 10 Bank Rule, once the number of banks equals or exceeds 10, the liquidity documentation in an ABCP program should provide for non-pro rata draw. This means that funds may be requested from any liquidity bank (up to the amount of the particular bank's commitment) to cover the failure of another bank to advance funds in a timely manner.

Term ABS Transaction: an asset-backed securitization funded by issuing long-term debt, typically with a long-term rating.

Term Receivables: receivables that have a term longer than one year. Term receivables may have consumer or corporate obligors.

Termination Event: a transaction feature that provides for the orderly wind down of a transaction. Termination Events are typically triggered by events that signal credit deterioration and increased risk to investors, and cause the transaction to end prior to its Scheduled Maturity. See also Trigger Event.

Third party: in an ABCP program, all parties other than the conduit and the ABCP investors. Typically Support or Service providers.

Trade Receivables: Receivables that arise between business entities and that are due and payable in less than one year. Trade receivables often have a turnover period of 30-60 days.

Trapping Mechanism: a transaction structural feature that retains cash within the transaction accounts rather than passing it on to a third party. Many transactions require cash be retained if credit deterioration occurs.

Trigger Event: a defined event, usually credit related, in a transaction that signals a material change in operation, for example early wind down, replacement of the Servicer, cease issuance of ABCP or immediate funding by the Liquidity Facility. See also Termination Event.

True Sale: a legal term indicating that an asset has been sold for adequate compensation in accordance with the pertinent laws and regulation so that it will not be overturned or reversed by a court judgement, in particular as a result of bankruptcy of the seller.

Turnover: Describes how often receivables "turn over" during the year. For example, if receivables are usually paid in 30 days, they turn over 12 times a year, or it takes 30 days for receivables to turn over.

Two-Step Sale: the most common form of asset securitization structure, in which a Seller sells assets to a Special Purpose Entity in a True Sale and that entity is then funded by a loan from another Special Purpose Entity that issues debt to investors.

Unsecured ABCP Program: an ABCP program in which the ABCP investors do not have a direct security interest in the assets.

Warehouse Transaction: a particular type of ABCP conduit transaction that finances assets for a period of time until the amount of assets accumulated and market conditions permit the assets to be efficiently securitized in the term ABS market.

Waterfall: see Priority of Payments.

Wind Down Events: Trigger Events that cause an issuer to cease purchasing receivables or to cease issuing ABCP. For example, if a seller reaches a wind-down event, the issuer ceases to purchase receivables from that seller. If there is a program wind-down event, the issuer ceases to issue ABCP.

Wrap: a full guarantee of repayment, usually by a highly rated party. See Surety Bond.

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