STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C010605A

On June 5, 2001, a Petition for Advisory Opinion was received from Commonwealth Bank of Australia, 599 Lexington Avenue, 17th Floor, New York, New York 10022.

The issue raised by Petitioner, Commonwealth Bank of Australia, is whether convertible bonds and credit linked notes are loans of an international banking facility ("IBF") for purposes of section 1453(f)(2)(A) of Article 32 of the Tax Law.

Petitioner submits the following facts as the basis for this Advisory Opinion.

An IBF invests in convertible bonds. It also invests in credit linked notes (CLNs) that are issued by a special-purpose vehicle (SPV).

Petitioner states that a convertible bond gives its owner the option to exchange the bond for a predetermined number of common shares. The convertible bondholder hopes that the issuing company's share price will go up so that the bond can be converted for a profit. But if the shares go down, there is no obligation to convert; the bondholder remains just that. A convertible bond is a bond with an equity call option embedded in it and is therefore like a package of a corporate bond and a warrant. Because of the embedded call option, the coupon rate is below market. When the owner of a convertible bond wishes to exercise its option to buy shares, the owner does not pay cash, it just gives up the bond.

Petitioner describes a CLN as follows. The credit risk of loans on the originating bank's balance sheet is transferred to the securitization SPV via the sale of individual single name CLNs rather than the assignment or participation of the loans themselves. The SPV purchases the CLNs from the originating bank, and the credit premium from this portfolio of notes is used to pay the required risk premium to investors on the risk tranches of the synthetic securitization. The investor receives the coupon and par redemption provided there has been no credit event. The value of a CLN as opposed to a traditional sale or participation of assets is that: (a) the structure is confidential with respect to the bank's customers; (b) the CLN or credit swaps terms generally allow the bank the flexibility to use the contract as a hedge for any senior obligation of the reference obligors (including loans, bonds, derivatives, receivables and so on), and (c) specific asset due diligence regarding transfer to the SPV can be avoided.

For example, a foreign bank buys European corporate bonds. The bank sets up a SPV and transfers the credit risk with respect to the bonds to such SPV. The SPV then issues the CLNs which the IBF invests in.

Applicable Law and Regulations

Section 1453(f) of the Tax Law provides for a deduction in determining entire net income for the adjusted eligible net income of an IBF. Section 1453(f)(1) of the Tax Law provides that the eligible net income of an IBF "shall be the amount remaining after subtracting from the eligible gross income the applicable expenses."

Section 1453(f)(2) of the Tax Law provides:

> Eligible gross income shall be the gross income derived by an international banking facility from:
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> (A) making, arranging for, placing or servicing loans to foreign persons, provided, however, that in the case of a foreign person which is an individual, or which is a foreign branch of a domestic corporation (other than a bank), or which is a foreign corporation or foreign partnership which is eighty per centum or more owned or controlled, either directly or indirectly, by one or more domestic corporations (other than banks), domestic partnerships or resident individuals, substantially all the proceeds of the loan are for use outside of the United States;
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> (B) making or placing deposits with foreign persons which are banks or foreign branches of banks (including foreign subsidiaries or foreign branches of the taxpayer) or with other international banking facilities; or
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> (C) entering into foreign exchange trading or hedging transactions related to any of the transactions described in this paragraph.

Section 18-3.2 of the Franchise Tax on Banking Corporations Regulations (Regulations) provides the meaning of certain terms for purposes of Subpart 18-3 of the Regulations dealing with IBFs. Section 18-3.2(k) of the Regulations provides that "The term *loan* means any loan, whether the transaction is represented by a promissory note, security, acknowledgment of advance, due bill, repurchase agreement or any other form of credit transaction, if the related asset is recorded in the financial accounts of the IBF."

Opinion

Where an IBF invests in a convertible bond, as described above, such convertible bond would be treated as a loan under section 1453(f)(2)(A) of the Tax Law and section 18.3-2(k) of the Regulations for the period of time that the bond is held by the IBF and the related asset is recorded in the financial accounts of the IBF.

Before a determination can be made regarding the CLNs, a discussion about their purpose and use is necessary. Joint Office of the Comptroller of the Currency (OCC) and Federal Reserve

Board Issuance on Credit Derivatives, "Capital Interpretations – Synthetic Collateralized Loan Obligations," dated November 15, 1999 (OCC Banking Bulletin 99-43, December 1999) describes synthetic securitizations including CLNs that are issued as part of such securitizations. This document notes that credit derivatives are being used to synthetically replicate collateralized loan obligations (CLOs), and that credit derivatives are on- and off-balance sheet financial instruments that permit banking organizations to assume or transfer credit risk on a specified or "referenced" asset or pool of assets. The document provides, in part:

> In some recent synthetic CLOs, the sponsoring banking organization uses a combination of credit default swaps[1] and CLNs[2] to essentially transfer to the capital markets the credit risk of a designated portfolio of the organization's credit exposures. Such a transaction allows the sponsoring institution to allocate economic capital more efficiently and to significantly reduce its regulatory capital requirements.
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> In this structure, the sponsoring banking organization purchases default protection from an SPV for a specifically identified portfolio of banking book credit exposures, which may include letters of credit and loan commitments. The credit risk on the identified reference portfolio (which continues to remain in the sponsor's banking book) is transferred to the SPV through the use of credit default swaps. In exchange for the credit protection, the sponsoring institution pays the SPV an annual fee. The default swaps on each of the obligors in the reference portfolio are structured to pay the average default losses on all senior unsecured obligations of defaulted borrowers.
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> In order to support its guarantee, the SPV sells CLNs to investors and uses the cash proceeds to purchase U.S. Government Treasury notes. The SPV then pledges the Treasuries to the sponsoring banking organization to cover any default losses.[3] The CLNs are often issued in multiple tranches of differing seniority and in an aggregate amount that is significantly less than the notional amount of the reference portfolio. The amount of notes issued typically is set at a level sufficient

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[1] A credit default swap is similar to a financial standby letter of credit in that the institution writing the swap provides, for a fee, credit protection against credit losses associated with a default on a specified reference asset or pool of assets.

[2] CLNs are obligations whose principal repayment is conditioned upon the performance of a referenced asset or portfolio. The assets' performance may be based on a variety of measures, such as movements in price or credit spread, or the occurrence of default.

[3] The names of corporate obligors included in the reference portfolio may be disclosed to investors in the CLNs.

to cover some multiple of expected losses, but well below the notional amount of the reference portfolio being hedged.

There may be several levels of loss in this type of synthetic securitization. The first-loss position may be a small cash reserve, sufficient to cover expected losses, that accumulates over a period of years and is funded from the excess of the SPV's income (i.e., the yield on the Treasury securities plus the credit default swap fee) over the interest paid to investors on the notes. The investors in the SPV assume a second-loss position through their investment in the SPV's senior and junior notes, which tend to be rated AAA and BB, respectively. Finally, the sponsoring banking organization retains a high quality senior risk position that would absorb any credit losses in the reference portfolio that exceed the first- and second-loss positions.

Typically, no default payments are made until the overall transaction's maturity, regardless of when a reference obligor defaults. While operationally important to the sponsoring banking organization, this feature has the effect of ignoring the time value of money.

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For risk-based capital purposes, banking organizations investing in the notes must assign them to the risk weight appropriate to the underlying reference assets.[4]

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The sponsoring institution must be able to demonstrate that virtually all of the credit risk of the reference portfolio has been transferred from the banking book to the capital markets.

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A failure on the part of the sponsoring banking organization to require the investors in the CLNs to absorb the credit losses that they contractually agreed to assume may be considered an unsafe and unsound banking practice....

Financial Accounting Standards Board Statement of Financial Accounting Standards No. 125 <u>Accounting for Transfers and Servicing of Financial Assets and Extinguishments of</u>

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[4] Under this type of transaction, if a structure exposes investing banking organizations to the creditworthiness of a substantive issuer, e.g., the sponsoring institution, then the investing institutions should assign the notes to the higher of the risk categories appropriate to the underlying reference assets of the sponsoring institution.

Liabilities paragraph 26, (FAS125, par.26) describes a qualifying special-purpose entity for purposes of paragraph 9 of FAS125, which addresses the accounting treatment for transfers and servicing of financial assets. Such FAS125, paragraph 26 provides that:

> A qualifying special-purpose entity[5] must meet both of the following conditions:
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> a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
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> (1) Holding title to transferred financial assets
> (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
> (3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
> (4) Distributing proceeds to the holders of its beneficial interests.
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> b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it."[6] In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

Based on the Petitioner's description of CLNs and the discussion of their purpose and usage above, where an IBF invests in a CLN, such CLN would be treated as a loan for purposes of section 1453(f)(2)(A) of the Tax Law and section 18-3.2(k) of the Regulations for the period of time that the IBF holds the CLN and the related asset is recorded in the financial accounts of the IBF.

No determination is made in this advisory opinion as to whether the income that an IBF receives that is attributable to its investments in convertible bonds and CLNs, as described above,

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[5] The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.

[6] Scott's Abridgement of the Law on Trusts, 156 (Little, Brown and Company, 1960), 296.

will constitute eligible gross income of the IBF. Such determination must be made pursuant to the requirements of section 1453(f)(2) of the Tax Law and section 18-3.4 of the Regulations.

DATED: April 4, 2003

/s/
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NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.