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Changes to the Capital Requirements Directive – impact for securitisation

Last week, the European Council approved a directive amending the Capital Requirements Directive. This briefing looks at the provisions of new Article 122a of the amended Capital Requirements Directive, which imposes various requirements on securitisations, including a requirement for the originator, sponsor or original lender to retain a net economic interest in the securitisation or the underlying assets and enhanced due diligence requirements.

Much of Article 122a stems from the belief of some regulators that losses sustained by credit institutions on securitisation positions might have been avoided if originators had kept some "skin in the game" and investors had conducted more thorough due diligence. It is interesting to note, however, that many securitisation transactions are likely to comply already with the new minimum retention requirements and prudent investors would already be complying with many of the new due diligence requirements.

Minimum retention requirement

Once the amendments are brought into force, a credit institution (other than when acting as an originator, sponsor or original lender) will only be able to hold a securitisation position if the originator, sponsor or original lender has explicitly disclosed to such credit institution that it will retain, on an ongoing basis, a material net economic interest which, in any event, shall not be less than 5%. This applies to securitisation positions both in the trading book and the non-trading book.

The rationale for this new rule is to better align the interests of originators and investors by restricting the "originate to distribute" business model. Because the retention rule is focussed on EU credit institutions that hold securitisation positions, it will apply to any originator globally that wants to sell securitisation tranches to an EU credit institution.

There are four specified ways of retaining a net economic interest:

- retention of no less than 5% of the nominal value of each of the tranches of notes sold or transferred to the investors (in other words, a vertical slice of 5%);
- in the case of securitisations of revolving exposures (which would include credit card securitisations but may also include other structures, including master trusts, that allow for asset replenishment), retention of no less than 5% of the nominal value of the securitised exposures (in other words, a *pari passu* share of the pool);
- retention of randomly selected exposures equivalent to no less than 5% of the nominal amount of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is no less than 100 at origination; and
- retention of the first-loss tranche and, if necessary, other tranches having the same or more severe risk profile than those transferred or sold to investors, and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total no less than 5% of the nominal value of the securitised exposures.

Key Issues

Minimum retention requirement

Credit quality requirement

Due diligence requirement

Further changes expected

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The retention must take place at origination and be maintained on an ongoing basis. It cannot be subject to any credit risk mitigation or any short positions or any other hedge.

The retention requirement does not apply to:

- transactions where the securitised exposures are claims or contingent claims on or fully, unconditionally and irrevocably guaranteed by: (a) central governments or central banks, (b) regional governments, local authorities and public sector entities of Member States, (c) institutions to which a 50% or less risk weight is applied under the standardised approach or (d) multilateral development banks;
- transactions based on a clear, transparent and accessible index, where the underlying reference entities are identical to those that make up an index of entities that is widely traded, or are other tradable securities other than securitisation positions; or
- syndicated loans, purchased receivables or credit default swaps where these instruments are not used to package and/or hedge a securitisation covered by the retention requirements described above.

Credit quality requirement

Sponsor and originator credit institutions are required to apply the same sound and well-defined criteria for granting credit to exposures to be securitised as they apply to exposures to be held on their book. To this end, the same processes for approving and, where relevant, amending, renewing and re-financing credits shall be applied by the originator and sponsor credit institutions. Credit institutions shall also apply the same standards of analysis to participations or underwritings in securitisation issues purchased from third parties whether such participations or underwritings are to be held on their trading on non-trading book. Where these requirements are not met, the originator credit institution will not be allowed to exclude the securitised exposures from its calculation of capital requirements.

Due diligence requirement

Before investing, and as appropriate thereafter, credit institutions are required to be able to demonstrate to the competent authorities, for each of their individual securitisation positions, that they have a comprehensive and thorough understanding of, and have implemented formal policies and procedures (appropriate to their trading book and non-trading book and commensurate with the risk profile of their investments in securitised positions) for analysing and recording, among other things:

- the risk characteristics of the individual securitisation position and of the exposures underlying the securitisation position;
- the reputation and loss experience in earlier securitisations of the originators or sponsors in the relevant exposure classes underlying the securitisation position;
- the statements and disclosures made by the originators or sponsors, or their agents or advisors, about their due diligence on the securitised exposures and, where applicable, on the quality of the collateral supporting the securitised exposures;
- where applicable, the methodologies and concepts on which the valuation of collateral supporting the securitised exposures is based and the policies adopted by the originator or sponsor to ensure the independence of the valuer; and
- all the structural features of the securitisation that can materially impact the performance of the credit institution's securitisation position.

Credit institutions must regularly perform their own stress tests appropriate to their securitisation positions. To this end, credit institutions may rely on financial models developed by a credit rating agency provided that credit institutions can demonstrate that they took due care prior to investing to validate the relevant assumptions in, and structuring of, the models and to understand methodology, assumptions and results. Other than when acting as originators, sponsors or original lenders, they must also establish formal procedures, appropriate to their trading book and non-trading book and commensurate with the risk profile of their investments in securitised positions, to monitor, on an ongoing basis and in a timely manner, performance information on the exposures underlying their securitisation positions. Where the underlying exposures are themselves securitisation positions, credit institutions shall have the information not only on the underlying securitisation tranches, but also on the characteristics and performance of the pools underlying those securitisation tranches.

If these due diligence requirements are not met in any material respect by reason of the negligence or omission of the credit institution, they shall be subject to a proportionate additional risk weight of no less than 250% of the risk weight which would apply to the relevant securitisation positions (capped at 1,250%), which shall increase progressively with each subsequent infringement.

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Sponsor and originator credit institutions shall ensure that prospective investors have readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation exposure as well as such information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures.

Timetable

The amending directive will be published in the Official Journal of the European Union shortly and will enter into force 20 days later. Member States are required to adopt national laws to implement its requirements by 31 October 2010 and to apply those laws from 31 December 2010.

The requirements relating to securitisation will apply to new securitisations issued on or after 1 January 2011 and to existing securitisations after 31 December 2014 where new underlying exposures are added or substituted after that date.

Review

By 31 December 2009, the European Commission shall report on the expected impact of Article 122a, and shall submit that report to the European Parliament and the European Council, together with any appropriate proposal. The European Commission shall draw up its report after consulting the Committee of European Banking Supervisors. The report shall consider, in particular, whether the minimum retention requirement described above delivers the objective of better alignment between the interests of originators or sponsors and investors and strengthens financial stability, and whether an increase of the minimum level of retention would be appropriate taking into account international developments.

By 1 January 2012, the European Commission shall report to the European Parliament and the European Council on the application and effectiveness of Article 122a in the light of international market developments.

Other regulatory changes

These changes to the Capital Requirements Directive cannot be viewed in isolation since other changes to securitisation rules have recently been made or proposed. Last month, the Basel Committee on Banking Supervision approved amendments to the Basel II Framework, which, among other things, included provisions relating to: due diligence requirements and the risk-weighting of re-securitisations. Also last month, the European Commission both adopted a proposal for further amendments to the Capital Requirements Directive, covering many of the same points as the Basel II amendments, and launched a consultation about even further changes to the Capital Requirements Directive.

We continue to monitor the impact of these changes and the inter-relationship between them.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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