C L I F F O R D

C H A N C E

Client briefing
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CEBS guidelines on CRD Article 122a - Lifting the regulatory fog part 2

The CEBS consultation paper guidelines on Article 122a (which sets out the requirement for securitisation originators to retain a portion of their securitised exposures) of the Capital Requirements Directive are intended to encourage a uniform approach to supervisory practices and guide market participants' efforts to comply with Article 122a. Whilst the draft guidelines do clarify some aspects of the legislation, they also contain a few surprises and further clarification will be required before a practicable path to compliance becomes clear.

Key Issues

CEBS consultation paper provides guidelines for complying with CRD Article 122a.

Minimum retention level of 5% will be retained.

Market practice rather than further legislation to guide compliance procedures.

CEBS seeks further direction from market participants on interpretation and implementation of Article 122a.

Guidelines remain in public consultation until 1 October 2010.

Consultation period ends 1 October 2010

On 1 July 2010 the Committee of European Banking Supervisors (CEBS) published a consultation paper in response to the Commission's request that CEBS provide market participants with guidelines on the interpretation and implementation of Article 122a. The guidelines will remain in public consultation until 1 October 2010 and CEBS have requested feedback on a number of points from the market as part of such consultation. Clifford Chance will submit responses to CEBS as part of the public consultation and would welcome any feedback readers might wish to share on the issues outlined in this briefing or any other questions or concerns related to Article 122a. Article 122a will apply to new securitisations on or after 1 January 2011 and to existing securitisations where new underlying exposures are added or substituted from 31 December 2014.

The guidelines contain a number of helpful clarifications. There is confirmation that CEBS are minded to recommend that the Commission allow market practice, rather than legislation, to dictate the manner by which this new legislation is implemented. Helpfully CEBS has clarified that investors will not be penalised where originators are negligent in initial or ongoing compliance with the disclosed method of retention of a net economic interest, though it is still not clear how credit institutions intending to sell securities on the secondary market will deal with the fact that securities may be rendered illiquid by the negligence or failure of an originator to comply with the requirement to retain a net economic interest in the securitisation.

In previous publications on some of the issues raised by Article 122a (as to which please see our New Beginnings article *Lifting the regulatory fog – will the amendments to CRD reveal a new landscape?* and our New Horizons article *Investor disclosure*) we have raised concerns over ambiguities and made suggestions for improvement. This briefing revisits some of the key questions under Article 122a and discusses how the CEBS guidelines seek to resolve them. The guidelines also contain a number of questions to industry participants; it is hoped that market responses will result in the final guidelines providing a more workable path to compliance in the final guidelines.

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RETENTION OF NET ECONOMIC INTEREST

Will the net economic interest retention level be increased beyond 5%?
The guidelines point to a report published by the Commission on 28 May 2010 where the Commission concluded that the minimum retention level of 5% (being the minimum amount of a securitised exposure required to be retained by the originator) would be retained, but acknowledges that investors may require a higher level of retention in certain circumstances.

Must the form of retention be static over the life of the transaction?
The requirement to retain a net economic interest of 5% under Paragraph 1 may be fulfilled by compliance with any one of options (a), (b), (c) or (d) separately (see below), but not by a combination of more than one of these options. The form of retention cannot change during the life of the transaction, save under exceptional circumstances (for example where a restructuring is necessary), provided that the exceptional circumstances are disclosed to investors and that such change does not affect the compliance with the requirements of Paragraph 1 of Article 122a. Unfortunately the guidelines do not state whether it would be acceptable for an originator to vary the manner by which it achieves compliance under an option by changing the nature of compliance within the parameters of that option. Options (a), (b), (c) and (d) are set out below:

> *For the purpose of this Article, "retention of net economic interest" means:*
>
> *a) retention of no less than 5% of the nominal value of each of the tranches sold or transferred to the investors;*
>
> *b) in the case of securitisations of revolving exposures, retention of the originator's interest of no less than 5% of the nominal value of the securitised exposures;*
>
> *c) 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; or*
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> *d) retention of the first loss tranche and, if necessary, other tranches having the same or a 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.*

Is retention of 5% of each securitised exposure sufficient to comply with option (a)?
The vertical slice retention of 5% of the nominal value of each of the tranches may also be achieved by retaining 5% of each of the securitised exposures if the portions retained always rank *pari passu* or are junior to the securitised portions.

Is option (b) applicable to both securitisations of revolving exposures and revolving securitisations of non-revolving exposures?
Sensibly, the use of option (b) has been interpreted to be applicable not only to securitisations of revolving exposures, but also to revolving securitisations of non-revolving exposures (or revolving securitisations with a combination of revolving and non-revolving exposures). For example, this means that both a revolving securitisation of credit card loans (where the loans themselves have revolving balances) and a revolving securitisation of mortgage loans (where the loans themselves do not have revolving balances) are captured under option (b).

Where randomly selected exposures are retained, what precisely is meant by the requirement in option (c)?
Where option (c) is used, i.e. the originator chooses to retain randomly selected exposures equivalent to not less that 5% of the nominal amount of the securitised exposures, the requirement that the number of potentially securitised exposures is no less than 100 at origination means that the pool of potentially securitised exposures from which the 5% of randomly selected exposures is drawn contains no less than 100 exposures, not that the randomly selected retained exposure themselves consist of no less than 100 exposures. Notwithstanding this specific number, as a general principle the choice of option (c) as a method of fulfilling the retention requirement is intended primarily for granular pools of securitised exposures, and should option (c) be used the outcome of the random selection process should not result in either the retained or securitised portion being overly concentrated.

Significantly, and somewhat illogically, the randomly selected exposures that are retained on the originator's balance sheet to meet the requirement should be a static pool of exposures, i.e. it is not possible for a sponsor, originator or original lender at different times to designate different exposures as being those that enable it to fulfil the retention requirement, except insofar as this is done to fulfil the requirements with respect to a securitisation in which the revolving balance of securitised exposures fluctuates over time. Although this clarification is helpful, we note that the use of option (c) to comply with Paragraph 1 will require the relevant originator to hold and track the exposures designated as the retained interest at origination.

How is the retention requirement fulfilled where there is more than one originator?
The requirement to retain a net economic interest may not be fulfilled by one originator or original lender on behalf of others where the securitised exposures are those of multiple originators or original lenders. It should instead be fulfilled by each individually or alternatively by the sponsor of the securitisation.

How will the retention requirement apply to resecuritisations?
From the perspective of an investor in a resecuritisation, the retention requirement would apply only to the second "repackaged" layer of the transaction (in which they are investing). However, the sponsor or originator of a resecuritisation has a duty to ensure that the securitisations from which it is constructed also fulfil the retention requirement and to disclose this to investors in the resecuritisations. In the context of resecuritisations, credit institutions should be particularly sensitive to the use of SPVs: the guidelines specify that investors should not invest in structures created with the intention of avoiding the economic substance of the retention requirements.

Tips for managing the retained interest over time?
The level of commitment to retention should not be reduced either through hedging or selling the retained interest. With regard to hedging, the aim has been to exclude hedging that eliminates a sponsor's, originator's or original lender's exposure to the credit quality of the specific exposures that have been securitised; CEBS is open to considering proposals aimed at balancing this with an approach that ensures that there is still sufficient flexibility for credit institutions to risk-manage exposure to broader changes in the credit quality of the asset classes, collateral, or macroeconomic variables to which they are exposed through their lending activities, securitisation activities, or otherwise. CEBS identifies possible types of hedging which might be considered permissible at paragraph 31 of the guidelines.

A credit institution will become exposed to credit risk by virtue of the activities of any related entity which falls within the same scope where consolidated supervision is applied. Furthermore, the economic substance of the requirements (e.g. no hedging) should be respected at consolidated as well as at an individual level.

With regard to the suggestion that an originator would be in breach of Paragraph 1 if it were to sell its retained interest in a securitisation, the guidelines do not state how an equitable sale would be treated where the legal interest would continue to be retained by the originator. Given that the objective of Article 122a is a retention of the economic interest by originators, the ability to fund the retained piece should not be restricted by the legal form of the funding, i.e. a repurchase arrangement is not an economic sale and should not breach the requirements. Unfortunately, CEBS appear to be taking a relatively literal approach to this aspect of the legislation. Furthermore, CEBS have not clarified how the sale of an entire business would be treated. We would suggest the purchaser of the business should inherit the obligation to retain a net economic interest in any assets which form part of a securitisation forming part of the sale however this has not been addressed in the consultation paper guidelines.

Measurement of the level of commitment will not be affected by either (i) the amortisation of such interest via cash flow allocation (within parameters) or (ii) through the allocation of losses which in effect reduce the level of retention over time. Nonetheless, at origination there should not be embedded mechanisms in the securitisation transaction by which the net economic interest retained by originators, sponsors or original lenders could decline over time faster than the interest transferred such that the retention requirement is no longer fulfilled.

DUE DILIGENCE AND ONGOING MONITORING

How must the originator disclose its intention to retain net economic interest?
The disclosure by an originator, sponsor or original lender should be made available publicly and should be appropriately documented. Such disclosures may be made privately where appropriate (for example, a bilateral or private transaction), however oral disclosures will not be adequate to demonstrate compliance.

How often should the disclosure be confirmed during the life of the transaction?
The disclosure should be made at origination of the transaction, and should be confirmed thereafter with the same frequency as the reporting frequency of the transaction (but at a minimum annually), and at any point where the requirement is breached. The reporting frequency of the transaction would typically be the frequency with which the servicer report, investor report, trustee report, or any similar document is published. The obligation of a sponsor, originator or original lender credit institution is to disclose that it continues to fulfil the obligation that it initially undertook to maintain net economic interest in the securitisation. The obligation does not extend to providing further information with respect to the current nominal value, current market value, or any impairments or write-downs on such retained interest (although market participants are of course free to supply or demand this as they see fit).

Who is responsible for undertaking due diligence?
Credit institutions should not invest in securitisations where they determine that they do not have, and will not be able to receive, adequate information to undertake thorough due diligence and satisfy the requirements of the CRD.

Actions that are beyond the control of the credit institution as investor will not typically constitute negligence or omission of that credit institution, provided it has already fulfilled, through appropriate due diligence, its requirement to ensure that the originator, sponsor or original lender explicitly disclosed that it would retain such an interest and would make available sufficient information to allow the investing credit institution to fulfil the other relevant requirements of Article 122a.

What if the originator is subsequently negligent in or fails to fulfil its due diligence obligations?
As a general principle, credit institutions are not obliged to dispose of a securitisation position, nor will they typically be subject to additional risk weights, should the originator, sponsor or original lender subsequently fail to act in the manner it disclosed at origination and the credit institution is not deemed to be responsible for negligence or omission in the fulfilment of its due diligence obligations. Whilst helpful, the concern is that the originator's failure to comply with the requirements of Article 122a will still affect investors as this may render securitised investments illiquid on the secondary market (save for those sold to investors not caught by Article122a).

CONSEQUENCES OF NON-COMPLIANCE – ADDITIONAL RISK WEIGHTING
Is there a cap on additional risk weights?
The text of Paragraph 5 of Article 122a provides that the additional risk weight can be no less than 250% of the original risk weight and is capped at 1250%. This could in certain instances result in the overall capital required to be held against a securitisation position exceeding the exposure value of the relevant securitisation position. CEBS indicate that the cumulative result of any application of these rules should not result in the capital held against a securitisation exceeding the exposure value of the securitisation position.

Please see the table below for a summary of material obligations imposed by Article 122a and the additional risk weights applied for non-compliance with each.

	Material obligations imposed by Article 122a	Additional risk weights applied for non-compliance*
1.	Establishing and verifying disclosure of retention by the originator, sponsor or original lender.	1000%
2.	Understanding, analyzing and recording the risk profile of the securitisation positions.	250%**
3.	Stress-testing their securitisation positions.	500%
4.	Monitoring the ongoing performance of their securitisation positions.	750%

*For multiple breaches, the additional risk weights outlined above are additive, albeit subject to a maximum additional risk weight of 1250%.

** The obligation to understand, analyze and record the risk profile of securitisation positions is broken down into six further sub-categories, each of which attracts its own penalty for non-compliance of 250%.

What if repeat breaches occur on the same securitisation?
For repeat breaches on the same securitisation holding, an immediate risk weight of 1250% would be applied for a minimum period of one year. Repeat breaches on the same securitisation holding refers not to the same breach occurring on one holding over a consecutive period of time (for instance, two consecutive days), but to the requirements being breached at different points in time on the same holding.

For how long are the additional risk weights are imposed?
The period of time for which the additional risk weights are imposed would typically match the period of time for which the breach existed or continues to exist.

Are originators obliged to disclose breaches to the market?
In situations where the prior capital treatment resulted in a risk weight that equals (or for any reason exceeds) 1250% and a breach of the obligations under Article 122a occurs, CEBS proposes that the credit institution should disclose to the market that such a breach has occurred.

Although the CEBS consultation paper clarifies some ambiguities in the drafting of CRD Article 122a, a number of key questions remain unanswered and in some instances the present guidance appears impracticable. In light of the severity of the additional risk weights imposed for non-compliance, it is essential that the final CEBS guidelines set out a clear path to compliance for all market participants which is consistent with the objectives of the CRD.