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1st October 2010
(Sent via email)

Carlos Corcostegui
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Cc Paul Rich - CEBS
Cc Gerard Breen - CEBS

Dear Mr Corcostegui

Response to CEBS CP40 Consultation Paper on Guidelines to Article 122a of the Capital Requirements Directive[1].

The joint associations AFME, BBA and ISDA welcome the opportunity to respond to CP40 - Guidelines to Article 122a of the Capital Requirements Directive. For a brief description of the associations and their respective roles, please see the end of this letter.

General Comments

We very much welcome the publication of the draft guidance and we thank the Committee for its work and its engagement with the industry in putting it together. We appreciate in particular the Committee's invitations for dialogue

[1] References to "CRD" and the "Directive" throughout this paper refer to Directive 2006/48/EC.

in areas of flexibility and we are willing to assist in any way we can with achieving a workable introduction of the article 122a provisions.

We also appreciate the flexible and practical approach that CEBS has tried to take in many areas of the guidance.

However, there is a high degree of concern among our members - as there has been throughout the article 122a development process - that investors would be dissuaded from returning to the asset-backed securities markets as a result of the regulation's potentially wide-ranging effect. This would affect materially the financing of the real economy from households to corporates, including SMEs, as securitisation facilitates bank lending activity. We would therefore urge CEBS to make as much use as possible of the discretions inherent in the provision to address this, and we aim to highlight areas of flexibility in this letter.

EU funding needs and the securitisation market

As the Committee will be aware, the wholesale funding needs of European Banks are estimated by the European Central Bank at a figure of EUR1.3 trillion over the next 14 quarters up to the end of 2013. Given this, the ECB says that banks may be expected to increase their issuance at some time in the coming months in order to ensure their long-term financing[2].

For convenience, we set out at Annex 1 some statistical information on the asset-backed securities market in Europe. In 2006 and 2007, securitisation issuance in Europe was approximately EUR 450 billion per year. Over 90% of this issuance was "real economy" securitisation, the proceeds from which funded consumer and corporate assets. Since 2007, the amount of issuance in the public markets has dropped significantly and almost all has been used in repo transactions with central banks. In 2009, of the EUR 414 billion of securitisations "issued" only 6% (i.e. EUR 24 billion) were public or private placements. In Q1 2010, there was EUR 76 billion of "issuance" and public and private placements increased to 19% of the total (i.e. EUR 15 billion).

By way of comparison, the total covered bond issuance in Europe 2009 was Euro 179 billion and in 2008 183 billion.[3] Investment in covered bonds has performed relatively well during the crisis since they have been supported by a variety of legislative and investment incentives, including the 2009 ECB covered bond purchase programme.

The securitisation market has a pivotal role in restoring capacity to the European banking system, providing not only prudential balance sheet

[2] ECB Monthly Bulletin, August 2010.
[3] sources: J.P. Morgan European ABS & CB Research, Dealogic

management but also refinancing of both corporate and household borrowings. Institutional investors should be encouraged to continue to contribute to the financing of the real economy with asset-backed securities, albeit on a more informed basis. Whilst the guidance is in many respects helpful, some aspects such as the additional risk weights go much too far toward deterring investors and would have a detrimental rather than a beneficial effect on the systemic stability of the wholesale lending market in Europe.

Article 122a of CRD

We appreciate that Article 122a was added into the CRD2 text at a late stage. We understand fully that in producing its guidance, CEBS is bound by the wording of the Directive: we note that the Committee has in some cases chosen a sensibly flexible interpretation of the requirements (e.g. due diligence intensity and permitted hedging). However, we believe that in some cases, the guidance goes beyond what is required by the Directive and that the regulators are restricting discretions which they could opt to use more appropriately (e.g. choosing a fixed and overlapping scale for application of additional risk weights which would often lead to full deduction even on first breach).

We agree that harmonisation of the application of the rules across Member States promotes a fair and transparent market. However, there are significant differences between article 122a and other similar international regulations, which is unfortunate. Further points in respect of the interaction between article 122a and the retention requirements contemplated by the Dodd-Frank Act in the U.S. (as well as concerns about inconsistent application within the EU (specifically in Germany))are discussed in the section below headed "Comments not in response to specific questions".

CP40 and the industry response

Before highlighting our key points arising from CP40, we would like to stress to the Committee that we share its desire to allow the market in "real economy" securitisations to be restored and that should be the overriding message that comes from this letter. The nature of 122a however, (and CRD as a whole) is that there are definitional issues with securitisation which can appear on the one hand potentially to widen the scope of 122a, and on the other to make it hugely challenging to comply (for instance in the correlation trading and managed CLO arenas). The desire to restore real economy securitisation should not inadvertently threaten these other areas of bank business and for this letter also reflects the concerns of our members in those areas.

Turning to our key points:

1. *Additional Risk Weights:* A fundamental concern among industry participants is the level of additional risk weights proposed, which are well in excess of what is expressly required by article 122a, and the likely impact of these on the full recovery of the securitisation market.

2. *Hedging and trading book activity:* We welcome the Committee's flexibility on permitted hedging activity. We also welcome the distinction between the intensity of the due diligence required for the trading book and that required for the non-trading book which we view as essential to a secondary market in asset-backed securities. There are still difficulties with trading book due diligence, but we suggest what we believe to be a viable solution below.

3. *Asset-backed commercial paper programmes:* Article 122a has no specific provision for ABCP conduit programmes, though these programmes have characteristics very different from those of typical term ABS transactions for which 122a's requirements were apparently designed. To the extent that article 122a applies to any ABCP or to other investments in or exposures to ABCP conduits, it raises a number of questions and difficulties which the proposed guidance does not address. The industry needs its regulators to apply a practical and flexible interpretation of the text of 122a in order to make it work for ABCP conduit programmes insofar as it applies to them. We set out our thoughts in Annex 2.

4. *Correlation trading*: We seek confirmation that bespoke credit correlation activity is exempt from the retention requirements. Correlation trading desks do not transfer or package existing credit risk, they operate strictly on the basis of public information, and there is no misalignment of interests between the trading parties. Annex 4 sets out the reasoning behind our suggested treatment of correlation trading activity.

5. *Consolidated Application:* We believe the guidance incorrectly incorporates non-credit institution entities within the scope of 122a through the consolidated reporting requirements (see below).

6. *Structures without an originator/sponsor*: With some transactions which potentially come under the definition of securitisation, there may be no entity that can fulfil the role of originator or sponsor as defined in the original CRD. This is the case for managed CLOs, in which the sponsor (i.e. the investment manager or arranger) may not be a credit institution as required by the definition, and the original lenders will not be involved. Annex 3 sets out our suggested treatment of managed CLO transactions.

7. *Transition*: The grandfathering provisions of 122a are particularly unclear, and the guidance does not currently address all the issues presented by the CRD text. Further, we think that paragraph 109 of the guidance goes beyond the text of article 122a and we seek clarification of its meaning.

We address below the issues and questions in the order they are set out in the consultation paper.

Comments on the Executive Summary

Consolidated Application

One point on which the Committee does not specifically ask for feedback is the statement in the Executive Summary that "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." We also note that this was mentioned in the CEBS presentation on 22nd July, and the presentation materials state "Requirements are covered by consolidated supervision." We believe this is incorrect. Article 71 of the CRD clearly sets out which provisions of the CRD apply on a consolidated basis: article 122a is not brought within the scope of article 71 either by an amendment to article 71 or within article 122a itself. We would therefore stress that it is an incorrect reading of the CRD to suggest that article 122a should be applied on a consolidated basis.

Paragraph 2 of article 122a allows the retention requirement to be met on a consolidated basis, but this is a permissive provision and applies to the meeting of the retention requirement only. It does not in any way mandate credit institutions to account for exposures to securitisations within any entities falling within the scope of its consolidated supervision (e.g. investment firm subsidiaries) on a consolidated basis when applying article 122a.

If article 122a is applied on a consolidated basis, then entities supervised by non-EU authorities would be required to comply in the context of deals which are otherwise unconnected to the EU credit institution with which they are consolidated. This raises significant operational issues where different retention requirements are required by the home supervisor. This will restrict the ability of relevant group entities to remain active in their local securitisation markets outside the EU.

By way of illustration, several EU banks have US broker-dealer subsidiaries who will have to consider retention provisions. These brokers may invest in US deals which may trigger the application of article 122a if 122a is applied on a consolidated basis. By virtue of provisions to be implemented under the Dodd-Frank Act, differing retention requirements may apply in respect of the same US deals (for details of which see below under "Comments not in response to specific questions"). These differences may become more pronounced to the extent that member states opt to gold-plate the article 122a requirements (e.g. as in Germany). Compliance with article 122a will therefore be extremely difficult in practice (particularly where the local retention regime includes exemptions for certain deals, which are not present in article 122a).

We would therefore strongly urge CEBS against the adoption of an approach based on consolidated supervision.

The Consultation Questions

Question 1: Do you agree with this differentiation between the requirements of credit institutions when "investing" (leading to the applicability of Paragraphs 1, 4, and both sub-paragraphs of 5) as opposed to the lesser requirements when assuming "exposure" but not "investing" (leading to applicability of Paragraph 1 and sub-paragraph 2 of Paragraph 5)?

Investing and assuming exposure

We agree that there seem to be different obligations set out in article 122a depending upon whether the bank is "investing" or "assuming exposure" and agree that the table sets out the distinction accurately. However there is no discussion as to what is meant by "investing" and we do not think it is clear whether, for instance, the provision of credit enhancement by e.g. a subordinated note, would be seen as "investing" or "assuming exposure". We would assume that "investing" implies the provision of third-party arms-length up-front funding, such as via issued/tranched securities, for a return based on price or yield, so that the provision of swaps, unfunded CDS protection, liquidity facilities, etc. are not "investing" (see below in relation to Questions 2 and 3 as to what is meant by assuming exposure to the credit risk of a securitisation).

We note that the last (bottom right) cell in the table on page 10 of CP40 states that the penalties for breach of paragraph 7 are applied to the exposures retained by the originator. However, the discussions in CP40 around the additional risk weights (paragraphs 77 to 90) do not give any further guidance on how these risk weights will be measured, as the scales set out in those paragraphs seem to apply only to breaches by the investor. We ask the Committee to clarify how it envisages the penalties applying to Originators/Sponsors, and how they can be applied if the Originator or Sponsor fails to retain an amount in the securitisation to which the additional risk weights can be applied. The only penalty we see as clearly applying to the originator is that specified under paragraph 6, where failure to apply the same criteria for credit granting to securitised and non-securitised exposures, and to positions to be held in the trading book or the non-trading book, will mean the originator cannot avail itself of the risk transfer treatment in Annex IX. However, this penalty provision does not apply to paragraph 7 breaches.

We would point out to the Committee many of our members' reading of the additional risk-weight provision. Paragraph 5 of 122a is ambiguous as to who bears the additional risk weights for breach of paragraph 7. The inclusion of the phrase "other than when acting as originators or sponsors or original lenders" indicates that the whole of paragraph 5 and its additional risk weights apply only to credit institutions in the role of investor or assuming exposure to a securitisation. The third sub-paragraph of paragraph 5 also applies the risk weight to the "relevant securitisation positions", which means the securitisation positions referred to in the first sub-paragraph of paragraph 5 – i.e. those held by the investor or entity assuming exposure. On this interpretation, if the originator does not supply the investor with the paragraph 7 information as a result of the investor's own negligence or omission (e.g. by the investor failing to ask for it or choosing to invest without seeing it), then it is the investor who will suffer the additional charges (equally, of course, if the failure is purely the fault of the originator, the investor is not subject to additional risk weights). This is certainly how many of our members understood that the additional capital charges would apply, i.e. to the investor and not to the originator. To conclude otherwise would remove the level playing field between EU credit institution and non-credit institution originators, a point accepted by the EC when article 122a was drafted.

General comments on retention

Generally, please confirm that the statement in the Executive Summary that "measurement of the level of commitment will not be affected by either the amortisation of such interest … or through the allocation of losses which in effect reduce the level of retention over time" applies to <u>all</u> of options (a) to (d) and not just option (d) (as paragraph (ii) on page 19 references only option d), and clarify that in respect of options (b) and (c) that "losses" for this purpose includes defaults in the retained exposures as well as losses on the securitisation tranches.

Also, please confirm whether in paragraph 34 (iii) on page 20, the two references to "balance" in the final two lines should read "notional".

Question 2:
Do you agree with this differentiation in the role of a credit institution as liquidity facility provider (based on the provisions of CRD Annex IX, part 4, paragraph 2.4.1, point 13)?

We agree with CEBS statement in paragraph 7 of the CP that "With respect to liquidity facilities provided by credit institutions to securitisations, a key element of deciding whether the credit institution should be subject to Article 122a is whether the credit institution as liquidity facility provider is exposed to the credit risk of the securitisation position(s)." This principle is consistent with the wording of Article 122a (1) which is expressed to apply to credit institutions that are "exposed to the credit risk of a securitisation position".

However, we strongly disagree with the Committee's proposed guidance that only liquidity facilities that fall within the definition of an "eligible liquidity facility" set out in Annex IX, part 4, paragraph 2.4.1 point 13 BCD should be treated as not being exposed to the credit risk of a securitisation position. We agree that an "eligible liquidity facility" provided to a securitisation structure should not be within the scope of Article 122a (1) because it does not expose the liquidity facility provider to the credit risk of the securitisation. However, we believe that an "eligible liquidity facility" is not the only type of liquidity facility in which the provider is not exposed to the credit risk of the securitisation. In the case of liquidity facilities provided in term ABS transactions (as opposed to in ABCP conduits), these usually contain provisions which prevent further drawdown if there is an event of default or potential event of default. Liquidity amounts already drawn will generally be payable in the next interest period at the top of the priority of payments. We note that the definition of an "eligible liquidity facility" is very restrictive and that it is only relevant in the context of specific structures (e.g. it is not relevant in general in the context of term securitisations).

We understand that the Committee wishes to assist credit institutions to determine in what instances Article 122a(1) will apply to them, but the proposed reference to an "eligible liquidity facility" is too restrictive and is inconsistent with the express wording of Article 122a(1). Such guidance would therefore be an effective amendment of Article 122a (1) and, as such, it is outside CEBS's mandate under Article 122a (10) to ensure convergence of supervisory practices.

On this basis, we ask CEBS to remove the references to an "eligible liquidity facility" in paragraph 7 of the CP and instead to allow a credit institution itself to determine whether it, in a capacity as a liquidity facility provider to a securitisation, is exposed to the credit risk (in which case it will be subject to Article 122a (1)).

Question 3
Do you agree with this differentiation in the role of a credit institution as hedge counterparty, and what issues might arise when credit institutions seek to determine whether their role as hedge counterparty results in the assumption of credit risk or not?

With respect to the provision of liquidity facilities/hedge instruments, CP40 paras 7and 8 describe a distinction between instruments which assume principal losses and instruments which do not. We welcome this distinction, and we take the view that all currency and interest rate swaps which are used to hedge against movements in FX and interest rates (including those with balance guaranteed notionals), should not be deemed to "assume exposure" to the securitisation exposures. These hedges are not structured to provide credit enhancement to the securitisation, and hence it should be clarified that all such structures are exempt. The present value of these hedges may vary in line with movements in FX, interest rates, or writedowns in the underlying collateral pool, but these variations do not amount to assumption of credit risk.

Question 4: Does this guidance adequately address means of fulfilling the retention requirement in the case of securitisations of exposures from multiple originators, sponsors, or original lenders? And if not, what suggestions do you have for additional clarity?

More clarity is required as to how the guidance on multiple retention requirements set out in paragraph 20 of CP40 would apply (to the extent article 122a applies) to exposures to ABCP conduits. Our comments on this topic are set out in Annex 2.

In respect of the first sentence of paragraph 20, please clarify that where different original lenders sell their exposures to a single intermediate originator which sells them on to the issuer, then that single intermediate originator ought not to have to retain in respect of any proportion of the pool for which an original lender has made the required retention. However, the retention requirement is permitted to be met by the intermediate originator in respect only of exposures from original lenders who have not retained in respect of their portions of the pool.

The multiple retention requirements for multiple sellers should equally not apply to originators in the same corporate group. One originator should be able to fulfil the requirement across the group. Whilst there is no explicit provision in 122a for non-banking groups which report on a consolidated basis for accounting purposes to retain the 5% risk on a consolidated basis, we believe this must be implied and would welcome guidance allowing retention on this basis to satisfy the requirements. Whilst we understand that accounting treatment does not necessarily equate with capital treatment, as these entities are not subject to their own capital requirements they ought to be able to account for the retained exposure in the most tax/accounting efficient manner without the investor being penalised.

Question 5: Do you agree that the form of retention should not be able to be change during the life of the transaction, except under exceptional circumstances only, or alternatively should some additional flexibility be granted? Please provide evidence of exceptional circumstances which would justify a change in the form of retention.

As long as the form of retention complies with article122 (a) and is disclosed to investors, we do not think this restriction is necessary nor required by the wording of article122a. A change in the form of retention would be justified for example where there is a reorganisation of the Originator, for legal or accounting reasons, or for regulatory reasons if there is no uniform solution to the conflicts between different sets of rules in different jurisdictions. Another example might be a conduit that initially relied on sponsor-provided credit facilities and, after some turnover and restructuring of underlying transactions, needs to switch to relying on originator retained interests.

Question 6: Should the definition of "net economic interest" in terms of "nominal" exposure be interpreted to mean that both excess spread tranches (i.e. where only residual interest cash flows are sold) and interest-only tranches (i.e. where all interest cashflows are sold) be excluded from the various means of fulfilling the retention requirement (as both have notional rather than nominal values), or should either be a valid means of fulfilling the retention requirement? If the retention requirement were allowed to be fulfilled by retention of a tranche with no principal component (for instance, an excess spread tranche or an interest-only tranche), how would the retention percentage be computed – with reference to the notional value, market value, or otherwise?

The calculation of the net economic interest on the "nominal" exposure requires clarification. In particular, is this the book value of the securitisation assets prior to securitisation, or the discounted value of these assets?

Generally, investors like to see excess spread in deals, and they do not normally object to excess spread tranches or interest-only tranches as long as these are subordinated and rank below any reserve fund. If a positive market value can be assigned to an excess spread or interest-only tranche at the inception of the transaction, this represents a genuine economic exposure to the underlying assets and therefore should be eligible for inclusion in the assessment of net economic interest. If there is a genuine economic interest in the transaction, this should be treated as satisfying one of options a) or d) regardless of the lack of a principal component. Although calculating the value of such a tranche for the purpose of the retained interest is complex, (valuation will be made on the basis of certain assumptions around default rates, loss rates, delinquencies and prepayments, which have a greater effect on excess spread tranches than other tranches of the deal), there is no reason in principle why an excess spread tranche, to which a value can be given, should not satisfy the retention requirement as long as a valuation methodology can be agreed and both this and the underlying assumptions are transparent to the investor.

A related point is that paragraphs 46 of the guidance states that a refundable purchase discount can count as a first loss tranche. We would suggest that the refund can be made when the underlying exposure discounted has fully performed. This seems consistent with the Committee's view that once a first loss tranche has been used it does not need to be replenished.

Question 7: Where Paragraph 1 indicates that a credit institution must ensure that retention has been "explicitly disclosed", is the guidance above sufficient? In particular, will the market evolve such that credit institutions would expect such disclosure by market participants to be of a binding nature, and therefore provide some means of enforcement or redress to them, or should such a requirement be part of the CEBS guidance? Feedback is welcome on the most effective means to assure that the commitment of the originator, sponsor or original lender is enforceable by credit institutions that invest. This is an area which CEBS is likely to pay particular attention to in as part of keeping these guidelines up to date and in annual reviews of compliance.

It is clear from the guidance that an investor should not be penalised or be subject to an additional risk weight if the originator, sponsor or original lender fails to act in the manner it disclosed. Hence, investors will not be required to enforce to seek compensation for additional capital charges. However, we expect that the market will evolve so that the transaction documents protect investors from loss of liquidity in their instruments if the originator fails to disclose since, as intended, investors are expected to take a keen interest in ensuring that originators and sponsors fulfil the obligations imposed on the latter.

Our members are, however, concerned that incorporating enforcement provisions into existing transactions that are not grandfathered under paragraph 8 will be extremely difficult, and that in these instances investors would have to rely instead on the deterrent effect of the reputational damage to the originator which would result from failing to retain.

We should note that there will be local law differences in the viability of contractual claims and types of remedy for such loss of liquidity, depending on the law of the contract and where it is enforced. As a result, it is not possible to give a comprehensive summary of how the retention requirements could be made an enforceable obligation against the originator, sponsor or original lender. The market will develop these mechanics over time, with the assistance of legal advisers to the transaction, depending on the transaction structure and the jurisdictions involved.

That said, we expect that a covenant for the benefit of the investors from the relevant entity holding the retained interest would be granted in an appropriate contractual agreement. The prospectus is not a contractual agreement between the originator and the investor. In the absence of the investors entering into separate agreement with the originator or sponsor, it may be appropriate to have a chain of covenants from the originator to the issuer of the securities, to the trustee where applicable, and to the investors.

Alternatively, depending on the jurisdiction and whether third party claims under contractual agreements are recognised, the investors could be permitted by the terms of the relevant agreement between originator/sponsor and issuer to sue the sponsor/originator directly rather than being required to enforce their rights only through the trustee or fiscal agent

Question 8: Does this guidance address properly the subject of hedging of retained exposures? What specific types of hedge should be permitted? CEBS would welcome evidence and examples from respondents.

We appreciate that the Committee has shown a willingness to permit hedges which do not exactly replicate the exposures retained in the securitisation transaction, and we welcome the opportunity to give feedback on this point. The guidance allowing such hedges seems to recognise the need for firms to engage in prudent risk management.

Our view is that the rationale for the restriction on hedging is that the originator should not be able to divest itself of the particular risks associated with the portfolio of securitised assets (i.e. the idiosyncratic risks of that portfolio) underlying the retained position. The restriction should therefore be limited to direct hedges of the retained position (e.g. through a specific credit default swap or total return swap) and should not extend to activities which are part of prudent risk management undertaken for systemic purposes or for concentration risk management purposes.

Without such limits on the hedging prohibition, there are potential serious unintended consequences for banks' risk-management activity. For example, where there is an active market in the underlying assets, (e.g. corporate loan portfolios) trading desks will need the ability to trade these instruments (e.g. through their correlation trading desks). This is a sensible part of risk management, but if seen in the wrong context might appear to reduce retention exposure. The interests of originator and investor remain aligned whether or not the originator carries out its normal risk-management activity, as we would expect investor credit institutions equally to manage the risks in their investment portfolio. We do not believe 122a was intended to prevent this type of activity, but simply to stop the retaining party from avoiding the principle underlying the retention requirement (i.e. ensuring an alignment of interests in the specific risks of the securitised exposures).

From a practical perspective, the prohibition on hedging does not require a wider interpretation due to the clear separation of responsibilities between trading desks and securitisation origination staff within banks. Traders have their own P&L and will generally be unaware of the existence or composition of retained positions held by the loan origination or loan management teams. Hence the traders will have neither the incentive nor the intent to hedge such positions. However, even restricting the hedge prohibition to the specific idiosyncratic risks of the exposures themselves may present challenges in certain circumstances, which we would welcome the opportunity to discuss with you further.

Also, in securitisations of trade receivables, originators (or the SPVs) commonly take out external credit insurance against potential losses on their trade receivable books. We do not believe that this practice is contrary to the intention of article 122a, as it is part of the normal operating business insurance that a non-bank / non-finance company originator would take out. Confirmation is sought in the guidance that such insurance is not treated as a "hedge" of the underlying exposures contrary to 122a, but is instead a legitimate and prudent part of insuring an operating business. Another example is mortgage guarantee insurance which may be taken out in respect of a mortgage pool; this is normal course insurance taken out mortgage lenders and should likewise not fall foul of the restriction in 122a.

With regard to paragraph 33 (synthetically recreating sold exposures), please see our response to Question 13 below.

Question 9: Should retention of 5% of each securitised exposure fulfill the requirements of Paragraph 1 under option (a)?

We welcome the explanation of option (a) set out in CP40, whereby an originator may hold 5% of each of the exposures rather than the ABS securities issued.

Question 10: Should option (b) be applicable equally to both securitisations of revolving exposures and revolving securitisations of non-revolving exposures (or revolving securitisations with a combination of revolving and non-revolving exposures) in fulfilling the requirements of Paragraph 1?

We agree that option (b) should apply equally to revolving exposures and revolving securitisations of non-revolving exposures. This is a point which has been made in previous industry feedback on article 122a and we are grateful that the Committee has clarified this issue.

In the various retention options, there references to "nominal value" (in (a), (b) and (d)), and "nominal amount" in (c). It is clear that the net economic interest is to be measured at origination, but it is unclear whether this means origination of the securitisation or origination of the relevant assets.

Additional clarification is required on this, as it is particularly problematic in the context of CLOs due to their revolving nature. We refer further to this in Annex 3.

We therefore believe that the retention amount should be set at closing based on the acquisition price of the assets or, in the case where the assets have not been acquired at closing, the proceeds of the issuance which will subsequently be applied to acquire assets.

Question 11: Do you agree with this interpretation of the phrase "there shall be no multiple applications of the retention requirement" to mean that there shall be no requirement for multiple application either by individual parties or at the level of individual SPVs, but that there may be multiple application at the overall transaction level (for instance, where a transaction is the resecuritisation of existing securitisations), and does the above lead to an effective and proportionate alignment of interest for resecuritisations?

Paragraph 48 of the guidance states that the sponsor or originator of such a resecuritisation has a duty to ensure that the securitisations from which it is constructed also fulfil the retention requirement "at that point in time" and to disclose this to investors in the resecuritisation. We believe this is incorrect, and not required by the text.

Recital 25 to Directive 2009/111/EC states specifically "where securitisation transactions contain other securitisations as an underlying, the retention requirement should be applied only to the securitisation which is subject to the investment".

We agree that at the point in time the original securitisation is entered into, the investor in that securitisation would have to check the retention, but there is no requirement that such investor, who may then become the originator in the resecuritisation, must check compliance with the retention on an ongoing basis under paragraph 5. Its duty is to disclose only its own level of retention to the investors in the resecuritisation. The investor (i.e. the originator in the resecuritisation) should not be penalised for actions beyond its control – and should therefore still be able to resecuritise ABS it holds even when the originator (i.e. in the underlying securitisation) fails in its obligation to continue to retain (e.g. due to asset-disposals during administration etc.) as long as that originator had formally committed to retain at the outset and as long as the securitised assets are performing.

Question 12: Does this interpretation of the phrase "net economic interest shall be determined by the notional value for off-balance sheet items"

raise any potential issues with respect to application of the retention requirement?

For credit card transactions, the notional value of the transaction is based on receivables generated, not available balance. This is the way the credit card securitisation market has evolved; notional value of the agreement is never considered as the agreement can be cancelled at any time. For credit card transactions using option (b), the seller interest should be calculated as a portion of the actual receivables generated under the relevant credit card agreements. See also our comments on Question 10 above.

Question 13: Given that Paragraph 1 specifies that "retained positions, interest or exposures are not hedged or sold", to what extent will it be possible for an originator, sponsor or original lender to use such retained interest for secured funding purposes without having "sold" such retained interest, for instance in cases where such funding is sought under a TBMA/ISMA Global Master Repurchase Agreement (GMRA) or alternatively under a bespoke repo agreement?

We agree with paragraph 51 of the guidance that the retained positions should be available to be used as collateral for secured funding purposes. We would urge that this is replicated in national regulations to ensure that there is not considered to be a breach of the retention requirement should originators do this.

With respect to repo agreements in which the repo takes the legal form of a title transfer, these agreements are legally structured with an outright spot sale of the securities and an unconditional forward buy back of such securities concluded simultaneously. Hence, the transferor of the securities -lending out the securities and borrowing the repo cash amount - retains throughout the repo transaction the economic risk associated with the securities. Effectively, if any such security defaults, the transferor has to replace it with a performing security at no cost to the counterparty. This confirms that the retention requirement is effectively satisfied where the exposures are repoed out to a third party under a TBMA/ISMA Global Master repurchase agreement or similar bespoke repo agreement. Whilst the third party -borrowing the securities and lending the repo cash amount - may indeed default and fail to transfer back equivalent securities at the end of the term of the repo, the assumption of this counterparty risk by the transferor is mitigated by regular collateral calls, and is not inconsistent with retaining the originator's interest in the securitised exposures, as in the normal course of events the counterparty will transfer back the securities. Any exposure retained without being repoed would also be subject to counterparty credit risk yet this does not impair the nature of the retention.

Furthermore the prudential treatment of a repo transaction fully supports our view above. In a repo transaction, the transferor has to calculate RWA on the transferred security (to account for the unconditional forward buy back agreement) and in addition will have to calculate a counterparty risk charge which will be a function of the repo haircut, and will cover only the marginal risk of the difference between the market value of the securities transferred and the value of the cash and any collateral posted in return. The Financial Collateral Directive also treats repo agreements the same way – i.e. as secured lending transactions and not outright transfers.

In the same way, full economic risk to the retained exposures is maintained where the originator or sponsor sells outright the exposures and simultaneously takes the economic risk back via a credit derivative transaction (CDS or total return swap as the case may be). Interests are aligned when the economic risk is retained – just as it would not be permissible to buy protection on the retained exposures using an exactly matching CDS, so it should be possible to sell them and re-purchase the economic risk with a matching CDS. Furthermore, we are of the view that originators should have the flexibility to retain synthetically. It should be possible for the Originator or Sponsor to retain risk of the vertical slice or first loss portions of the assets or tranches sold on an unfunded basis, as the economic risk held will be the same. We believe that paragraph 33 of the guidance should be deleted and that holding the retained exposures on an unfunded basis should be allowed.

Hence we believe that the extent a party is retaining a net economic interest (whether it be sponsor, originator, original lender, asset manager), that party should have the discretion to secure the most efficient funding that is possible so as not to constrain the availability of credit to the market. This should include pledging positions under secured loans, as well as repo / GMSLA type lending arrangements.

Question 14: Is further clarification needed on the ability to differentiate between the trading book and the non-trading book?

Firstly, we agree with the high-level approach to guidelines in relation to due diligence in preference to a more prescriptive approach overall. However, our members do need further guidance on how to differentiate between what is appropriate for the trading book and the non trading book.

CP40 states that the "intensity of the due diligence process may vary (if justified) according to the specificities of the trading book versus the non-trading book". The meaning of this is unclear. The intensity of review that is possible in respect of a non-trading book investment is often not possible in a fast paced trading environment. Securitisations which are structured to be financed on the banking book by either conduit or balance sheet generally take months to structure. By comparison, a trading desk may trade large numbers of bonds each day. Therefore, the level of diligence that is possible differs due to time constraints and the nature of the holding. The imposition of due diligence requirements in the trading environment needs to be carefully calibrated to ensure that market liquidity is not compromised - investors' key concern for European ABS is mainly the limited liquidity in this product and it is important not to further undermine that liquidity.

Whilst the wording of article 122a includes the need for firms before investing to implement policies and procedures "*appropriate to their trading book and non-trading book*" for recording and analysing points (a) through (g) of paragraph 4, the guidance seems to go beyond this by requiring (at paragraph 59) that a credit institution must meet the "*minimum threshold due diligence requirements*" in clause (a) through (g) of paragraph 4 irrespective of whether it in the trading or non-trading book. We would argue that paragraph 4 only requires the institution to have appropriate due diligence policies for recording and analysing these matters and not to have to meet a *minimum threshold* for the trading book to apply due the same points of due diligence in every case regardless of the circumstances behind the trade. We would foresee, for example, trading desks implementing policies and procedures whereby they might "pre-vet" a universe of existing transactions in the market and continue to monitor those transactions on an ongoing basis. If a particular transaction is so "pre-vetted" and has been monitored, then the desks would bid on or make markets in the bonds from that transaction on any particular day based on pre-vetting monitoring. This practical application of the Committee's approach to the differing "intensity" of diligence in a trading environment would preserve the viability of a secondary market. It would be helpful to receive the Committee's feedback on this.

As a further point in relation to paragraph 4, we would ask the Committee to confirm that, where assets are not yet in a pool at funding (e.g. during a ramp-up period or where assets may be substituted into a revolving pool), investor due diligence may be performed on the eligible assets in the absence of actual assets. Paragraph 4 would be unworkable if that were not the case.

Question 15: Is the general guidance on securitisation stress testing in the document linked above sufficient, or is further guidance needed on how stress testing should be undertaken for the specific requirements of Article 122a, and if so what topics should such further guidance cover?

We note the guidance allows investors to rely on rating agency models for performing stress tests. These are typically developed by the rating agency, and are not always published. It could be difficult, and in certain cases (e.g. WAFF and WALS models) impossible, to specifically validate the assumptions used in the structuring of those models by the relevant rating agency without the full underlying data supporting the design and metrics of those models.

Question 16: Do you agree with this method of calculating the additional risk weight?

The Directive says that for the various breaches, the competent authority must impose “a proportionate additional risk weight” in the case of breach. The additional risk weight should be “no less than 250% of the risk weight (capped at 1250%) which would, but for this paragraph, apply to the relevant securitisation positions under Annex IX…”.

This wording is not especially clear. In our view, the latter of the quoted phrases above means that the cumulative result of application of the rules should not result in the capital held against a securitisation position exceeding the exposure value of the position, so that “capped at 1250%” should refer to the aggregate risk weight inclusive of any and all additional risk weights, rather than only to a specific additional risk weight in isolation. We believe this reference is to clarify that the overall risk weight applied should be consistent with the whole of the Basel credit risk and securitisation frameworks in which the maximum risk weight applied to any exposure equates to a deduction from capital. If “capped at 1250%” were to refer only to the additional risk weight, then extremely punitive capital charges (as set out in the Committee’s table on page 34 of the guidance) could result.

Recent Barclays Capital research finds that the Committee’s interpretation at paragraph 80 produced in their words, the most “well-behaved” additional risk-weight function across the range of rated bonds[4] and we agree with that conclusion.

However, when an originating institution retains an interest in the securitisation, if the Committee takes the view that the additional risk weight provisions of paragraph 5 do apply to the originator for breach of paragraph 7(contrary to our comments above), the resulting overall risk weight applied to the retained tranche(s) should also be capped at the risk weight attracted by the securitised pool of exposures prior to the securitisation. The provisions are meant to be reflective of additional risk, not punitive (as CEBS has stressed), and there would be no additional risk in the originator as a result of breach of paragraph 7.

As a related point, the new capital requirements agreed in September by the Basel Committee on Banking Supervision have changed the definition of capital so that it is possible, after the provisions have been implemented, that the capital requirement applicable to risk weighted assets may amount to more than 8% of the exposure. As the 1250% mentioned in article 122a is expressed as a maximum, we believe it is within the Committee’s gift to allow an institution to which this risk weight would apply to deduct the position from capital instead.

[4] Barclays Capital ABS Research – August 11th 2010

We note that the Committee's interpretation in the last 4 lines of paragraph 81 should apply to *any* application of additional risk weights and not just to the effect of cumulative increases.

Question 17: Do you have any comments on this approach to achieving consistent implementation of application of the additional risk weights by competent authorities, including both the level and duration for which additional risk weights are applied? Do you agree that, notwithstanding the textual provisions of Paragraph 5, the cumulative result of applying such additional risk weights should not result in the capital required to be held against a securitisation position exceeding the exposure value of such securitisation position?

Although as stated above we agree with the interpretation in paragraph 80, we have fundamental concerns that the fixed scale of additional risk weights introduced by paragraphs 84 to 90 will deter investors from the ABS market owing to its penal nature. We would argue that the committee is fettering the discretion of national regulators which is inherent in the wording of paragraph 5 of 122a.

The obligation on the authority under paragraph 5 is to impose "a proportionate additional risk weight", which is no less than 250% of the risk weight that would have applied otherwise. There is no reference in the directive to a fixed scale of additional risk weights of between 250% and 1250%, only to a cap on the resulting risk weight of 1250%. Between these two figures, regulators have discretion to decide the level of additional risk weight to apply. The scale set out in the guidance is therefore based on an incorrect assumption and is, in our view, inappropriate and potentially harmful to the nascent recovery of the European securitisation market.

Application of additional risk weights to single breaches

The overall requirement in the Directive wording is that the additional risk weight should be "proportionate". At the public hearing on 22nd July, the Committee stressed that the additional risk weights are not penalties. However, using an example from the table on page 34, if a credit institution were to buy as part of a large bid list a tranche of the transaction for which the Annex IX risk weight is 100%, and inadvertently (as a "first-time offence" under 122a) fail to check the disclosure of the originator's retention, the effect of applying an additional risk weight of 1000% means the capital charge on an exposure of 100 goes from 8 to 88 immediately, although there may be nothing at all wrong with the asset pool in which the credit institution has invested. We do not believe that this is "proportionate" and is instead punitive, especially in a "first-time offence" scenario.

Application of cumulative additional risk weights

We believe that the Committee has misinterpreted the phrase in paragraph 5, that the competent authority "shall progressively increase the risk weight with each subsequent infringement of the due diligence provisions". The Committee has read "subsequent" to mean "individual" whereas "subsequent" should mean "following", so that only one additional risk weight should apply to a failure to meet the due diligence requirements, with later penalties increasing only if the investor later makes the same breach in relation to investing in securitisation positions. In other words, the "subsequent" additional risk weights are intended to capture breaches which are or threaten to be systemic within the bank rather than one-off breaches. The following table shows the effect of the imposition of cumulative "additional" rather than "subsequent" risk weights on the range of rated ABS (assuming the caps on additional risk weight <u>and</u> overall risk weight are confirmed in the final guidance).

Figure 8: Maximum penalties Rating	Initial RW	Max. RW	Min. No. of Penalties	Escalation Factor
AAA (senior, granular)	7%	95%	5	13.5
AA	15%	203%	5	13.5
A+	18%	243%	5	13.5
A	20%	270%	5	13.5
A-	35%	473%	5	13.5
BBB+	50%	675%	5	13.5
BBB	75%	1013%	5	13.5
BBB-	100%	1250%	5	12.5
BB+	250%	1250%	2	5.0
BB	425%	1250%	1	2.9
BB-	650%	1250%	1	1.9
<BB-, NR	1250%	1250%	0	1.0

Source: BIS, CEBS, Barclays Capital ABS Research

The entries in the third column show the minimum number of additional risk weights needed for a bond with that rating to reach its maximum risk weight assuming the paragraph 80 interpretation (i.e. a maximum additional risk weight of 1250% of the original risk weight, and a cap of 1250% overall).

These figures do not appear "proportionate" for breaches on the same exposures. It is likely that if any one of the elements of the due diligence requirements is breached, other elements will also be breached. Bearing in mind that each element of the due diligence requirements attracts an additional 250% of the original risk weight on the basis of the fixed scale. It is highly likely that a bank will reach the cap alarmingly quickly. We would strongly urge the Committee to reconsider the additive nature of the additional risk weight structure so that it is not penal in nature as currently contemplated in CP40.

We further believe that paragraph 84(f) is effectively gold-plating paragraph 5 of 122a. Paragraph 5 deals with repeat breaches already, through the "subsequent breaches" wording, and states that the competent authority must progressively increase the risk weight for such breaches. If an instant 1250% risk weight is imposed, there is no room for progressive increases. Similarly, paragraph 88 seems to be based on the premise that subsequent breaches need a double risk weight, where paragraph 5 simply states that the risk weight applied should be progressively increased (and as we argue above this increase should be applied instead of "additional" risk weights). There is no basis in article 122a for doubling the additional risk weight and applying this for a minimum of twelve months, particularly if the breach is corrected and/or the positions sold.

We are further concerned as to the effect of an originator's failure to retain the 5% economic risk on an investor's ability to sell its securitisation positions in the secondary market. Whilst an investor may comply with all requirements of paragraph 4 and 5 of 122a, and therefore as stated in paragraph 87 of the guidance no additional risk weights will apply to it, it will still be effectively and potentially quite extensively penalised by the market (i.e. by falling valuation) if the originator fails to retain its portion of risk, even though the underlying assets are robust. This effective market penalty may also extend to all other securitisations issued by that same originator (even if it has not specifically breached its obligations in respect of any other transaction) owing to the risk faced by all investors of having exposure to any transaction undertaken by an originator that has, in one instance, breached.

With regard to paragraph 86 – please change "could" to "will", so that it is clear the additional risk weights will cease to apply once the requirements of 122a are met.

Impact on the market

We are firmly of the view that the disproportionate application of penal additional risk weights will deter bank investors from the securitisation market, especially with respect to the senior tranches which contribute most to the funding of securitisations, since the impact on the respective size of the position will produce massive relative capital requirement increases even for inadvertent breaches. Likewise, since we understand provisions similar to article 122a are intended to be introduced into other directives such as the Solvency II and AIFM Directives, such a punitive approach will seriously impact the entire investor base for European securitisations. Even if such similar provisions are not introduced in other directives, the punitive nature of the Committee's approach might also deter non-bank investors from investing in the first place owing to the potentially reduced liquidity in the secondary market.

The Committee's approach on this issue is also particularly harsh when seen in the light of the uncertainty surrounding which transactions are caught by the 122a regime. Furthermore, as the penal structure set out in CP40 appear to apply in the same way to breaches of ongoing monitoring requirements, investors could be potentially required to deduct from capital for positions they bought in full compliance with the rules, where the bonds are performing and there is no rating downgrade. This, in our view, does not appear proportionate with the requirements or intentions of article 122a.

Additional risk weights in the Trading Book

Paragraph 90 of CP40 seems to indicate that additional risk weights could actually be higher in the trading book than in the non-trading book, saying "This guidance interprets the outcomes of such circumstance with reference to the forthcoming trading book proposed amendments to the Directive ("CRD 3"), where a 'floor' is introduced to the effect that the capital requirement for a securitisation position can be no less than that which would apply if the position was held in the non-trading book." Please clarify what the Committee is intending by this statement and how additional risk weights will be accounted for in the trading book under CRD3.

Exempt transactions

Please clarify how CEBS plans to implement the final sentence of paragraph 5 of 122a, which reduces the risk weights for securitisations which are exempt from paragraph 1 under paragraph 3. This is an area of flexibility in the text of CRD which has not been used by the Committee in the current draft guidance.

We would encourage the Committee to make maximum use of this flexibility to apply lower additional risk weights for breaches of due diligence requirements by investors in transactions exempt from paragraph 1, and also transactions which automatically fulfil the retention requirement so are in effect exempt .

General comments

Given the discretion afforded to national regulators in paragraph 5 of 122a in applying additional risk weights, we think it would be of greater benefit to the securitisation market to allow grace periods for compliance and to remove the fixed scale. Thus regulators could impose higher additional risk weights for substantial breaches or negligence by investors and less onerous risk weights for inadvertent or lesser breaches. In this way, there is also the opportunity for investors to correct the breach without the damage to reputation that could result from the imposition of additional risk weights of what appear to be a punitive nature rather than an appropriate measure of risk.

Question 18: If a credit institution is involved as sponsor in the securitisation of exposures on behalf of third parties in an asset class or business line in which such sponsor is not itself active in extending credit, is the guidance provided above a sufficiently high standard to hold such sponsor to?

Paragraph 6 is intended to align origination practices for on-balance sheet credit-granting with practices for credit-granting for securitisation. We believe that there where a sponsor does not grant credit in those asset-types, paragraph 6 should not apply. Investment banks who do not originate the assets concerned, but just trade in them, will still be caught by paragraphs 4 and 7.

There does need to be a sensible distinction applied to the different types of activities within banks with both retail and investment divisions, to ensure that they can continue both types of business following origination practices which are appropriate to those divisions without causing undue restriction on activity, and paragraphs 92-95 appear to do that.

Question 19: Is this interpretation or the requirement with respect to "participations and underwritings in securitisation issues" clear and unambiguous, or are there alternative interpretations possible or clarifications necessary?

With respect to paragraph 96, we think that a similar distinction between the intensity of analysis of positions to be held in the trading book and those to be held in the non-trading book should apply where the credit institution is underwriting the transaction, as apply where the credit institution is investing.

Questions 20 and 21:

Would disclosure templates that currently exist or are in the process of being prepared by trade associations, industry bodies, central banks, market participants or others fulfill these requirements on an adequate basis?

Various initiatives currently aimed at standardising securitisation documentation are being developed. These include the production of standardised investor reports and loan-by-loan disclosure templates, as part of new requirements for eligibility of asset-backed securities for the European Central Bank's open market repo operations and the Bank of England's Discount Window Facility. The Bank of England initiatives are being moderated by AFME under the chairmanship of several leading originating UK banks or law firms. Also in development are projects to standardise (were possible0 and make more transparent definitions and transaction documents and to make basic cash flow models for transaction structures more widely available.

Whilst these projects were conceived for the purpose of the eligibility of asset-backed securities for the ECB's open market repo operations and the Bank of England's Discount Window Facility, we understand that those working on the projects at the Bank of England are taking into account the requirements of paragraph 7 in producing those standardised documents and we expect the ECB to follow suit. The resulting disclosure documentation is expected to become market standard.

However, whilst we expect the initiatives outlined above to be extremely helpful, we note that the requirements imposed on credit institutions in paragraph 7 are set out in paragraph 7 itself and not in standardised documentation. In the event that an originator or sponsor does not require an issuer to use these disclosure tools (which are in development) paragraph 7 may still be satisfied on a bespoke basis on the transaction's own merits. We would stress that paragraph 7 does not require originators to publish loan-level data, and the standardisation projects currently underway should not bring in a requirement for loan-level data "through the back door" for 122a.

We would also appreciate clarification of paragraph 104 to ensure that banks will not be required to provide information under paragraph 7 which would breach confidentiality between bank and customer, whether such confidentiality arises from legislation, common law or equivalent custom, or the provisions of market documentation.

Further, we refer to our comments on question 15 above as to the availability of the assumptions used in the cashflow models used to stress test securitisation exposures.

In relation to ABCP conduit programmes, our comments are set out in Annex 2.

Question 22: Would such implementation without a materiality threshold create complications or be overly burdensome?

Firstly, the application of the implementation provisions in paragraph 8 of article 122a to certain existing transactions is potentially unclear. We understand paragraph 8 has the following effects:

1) Transactions existing prior to 1st January 2011 which do not allow for any asset addition or substitution do not need to concern themselves with article 122a.
2) Transactions existing prior to 1st January 2011 which do allow for asset substitution or addition will have to comply with 122a only from 31st December 2014 and only if assets are added or substituted after 31st

December 2014 ("Substituting Transactions"). Transactions existing prior to 1st January 2011 will not have to comply with article 122a at any time if assets are only added or substituted before 31st December 2014.

Thus in relation to Substituting Transactions, the article says that the first time assets are substituted or added in 2015 or beyond, the originator must retain 5% of the economic risk, and the investor must perform its due diligence obligations. However, paragraph 109 of the guidance seems to indicate that for Substituting Transactions, the originator has to make the relevant retention disclosure now, prior to the assets being added or substituted after 2014. This is extremely difficult for originators, particularly in the light of the guidance statement (which we challenge above) that the method of retention cannot be changed during the life of the transaction.

As we understood the operation of paragraph 8, the 2014 date was given so as to allow Substituting Transactions either to amortise down, to restructure if desired, or to work out the best way for originators to build up a holding of 5% of the transaction without having to restructure. If assets are added or substituted before 2014, then when the transaction gets to 2014 it can either continue to add assets and comply with article 122a (which it would do if it had found a way to satisfy the 5% retention requirement) or stop adding assets and remain outside article 122a (which it could consider if it could not find a method of satisfying the retention requirement). Paragraph 109 would require the Originator to predict how the 5% retention will be met at the end of a four year period.

If paragraph 109 is correct, it seems to go against the allowances that were made to originators during the industry engagement process behind article 122a. We suggest that paragraph 109 of the guidance is deleted and the guidance makes clear that compliance is required only from 31st December 2014, for existing transactions where assets are added after 31st December 2014.

Furthermore, paragraph 109 as worded does not clearly take account of the provision in paragraph 5 of article 122a that an investor will not be subject to the additional risk weights unless breach is by reason of its negligence or omission. As a result, it could be read as though additional risk weights should be applied automatically from the end of 2014 in respect of existing securitisations involving asset substitutions after 2014 in all cases where the originator or sponsor does not hold the required interest. If read this way, the paragraph could be seen to disregard (a) the fact that the investor invested in the relevant position prior to the application date of the requirements, (b) the lack of any negligence or omission on the part of the investor. This cannot be what is intended, and would be contrary to the statements made in paragraph 87 (that actions beyond the control of the investor should not result in the investor being penalised and that an institution would not be obliged to dispose of a securitisation position in such circumstances) and statements at the public hearings to the same effect. Please clarify that any application of the additional risk weights should be read in a manner which is consistent with the provisions of paragraph 5 of article 122a. We would suggest (if paragraph 109 is kept, contrary to our argument above) that the wording "the additional risk weights" to the end of the paragraph, should be replaced with "the additional risk weights specified by paragraph 5 will only apply to the credit institution after 31st December 2014 in the event of its negligence or omission."

That said, we welcome the ability to comment on the need for a materiality threshold. Whilst some general comments are made below, we would welcome further discussion with the Committee as to how the materiality thresholds should be set, as different asset-classes will require different measurement mechanisms.

Many transactions provide for substitution of assets where current assets fail to satisfy relevant criteria. Substitution for breach of eligibility criteria should be exempt; otherwise, potentially most transactions existing in the market will be caught at 31st December 2014 if they substitute even one asset for this reason. It may not be possible for the transaction documents for an existing deal to be amended to remove provisions for asset substitutions for warranty breaches. Noteholders may not agree to this, particularly if they are not EU credit institutions.

Also, where substitutions are made due to defaulted assets being replaced by the originator, they increase the credit quality of the underlying pool. This is possible in certain transactions where Annex IX treatment is not paramount. We would further point out that the CEIOPS guidance referred to below under the section headed "Solvency II" does include materiality thresholds, which presumably means CEIOPS supports our view. It would be inconsistent for credit institutions to be subject to different requirements from insurance undertakings.

The absence of a materiality threshold may also cause investors in certain asset classes which involve revolving portfolios to be forced to sell their positions prior to 2015 to avoid punitive capital charges. Bank investors would likely face losses on these positions as such institutions would be 'forced sellers' and the market would be aware of this. Furthermore, the attractiveness of new transactions that might otherwise be issued would lessen relative to the secondary market securities that would soon be available at better prices as a result of these forced sales. This will reduce the volume of new issues and further impact the availability of credit in the real economy

With respect to the CLO market, a manager of a CLO has a fiduciary responsibility to the investors in the transaction to manage the portfolio in the best interests of the investors. This will require substituting assets wherever necessary, and this would bring all managed CLOs under the remit of article 122a after 2014.

There are also particular problems for master trusts which issue series of ABS backed by the same underlying pool of credit cards with revolving balances. Each series will either be issued through a separate SPV or via a separate issue of notes, but the asset pool remains the same until the master trust is wound down. As all noteholders should be treated equally for data provision purposes, the entire master trust should either be compliant with 122a or not. We think the better view on the strict interpretation of article 122a is that existing master trusts will not have to comply even if new series of notes are issued. If the master trust is still running as at 2014, it should still not be caught unless it adds or substitutes assets (preferably subject to the materiality threshold advanced above). We would stress here that new assets in a credit card master trust must mean the designation of new accounts, not new receivables generated under the existing accounts. Otherwise all existing credit card deals will be caught in 2014 even if they do not add new accounts. In any event, the lack of any materiality threshold means that master trusts designating any new accounts will lose the benefit of the grandfathering at the end of 2014.

Similar considerations apply to mortgage master trusts in which different series of notes are backed by a revolving pool of assets and it may not be clear in what circumstances a new issue under an existing structure would be construed to be a new securitisation.

It is also not entirely clear what will be an "exposure" for these purposes. We further assume that, in relation to a commercial mortgage backed security, where restructurings of the underlying property loans are ongoing, an extension of an underlying asset would not be considered a "new underlying exposure", nor would a new rental agreement.

In relation to ABCP conduits, see our comments in Annex 2.

Comments not in response to specific questions

US Dodd-Frank Act; interaction with other retention regimes; inconsistent implementation in EU jurisdictions

As discussed above (in the section discussing the Executive Summary), there are significant differences between the provisions contemplated by the Dodd-Frank Act in the US and article 122a in the EU. These could give rise to significant operational challenges for entities finding themselves having somehow to comply with both.

We would strongly favour a mutual recognition and acceptance process with respect to retention, particularly in light of the calls made by the G20 for regulatory coordination between authorities.

Article 122a generally imposes obligations on the investor. In the US, the Dodd-Frank Act imposes the retention requirement on a "securitiser" (broadly meaning an issuer or arranger). However, should article 122a apply on a consolidated basis, both retention regimes would have to be taken into account in the context of US originated securitisations in which EU credit institutions take securitisation positions through a consolidated entity.
Whilst the differences between article 122a and Dodd-Frank cause wider problems than those resulting from proposed consolidated application of 122a, we acknowledge that CP40 itself cannot address those wider questions.

Other key differences between article 122a and the Dodd-Frank Act provisions include the minimum retained interest level, transactions which may be exempted (or in respect of which greater flexibility may be provided) and the manner in which the retained interest may be held. In addition, it is not clear that the two regimes will match in respect of the restrictions imposed on hedging arrangements, the manner in which the retained interest will be measured and the minimum duration of the retention period. Further significant differences are likely to arise to the extent that EU member states opt to gold-plate the article 122a requirements upon implementation (e.g. as Germany has done with respect to setting the minimum retained interest level at 10% and the need to have a credit institution or regulated financial institution retaining the net economic interest).

Of particular relevance, however, is the fact that the Dodd-Frank Act includes provisions for regulations to be made exempting certain types of securitisation and/or providing for greater flexibility for deals backed by certain assets. These provisions envisage an exemption from the retention requirement for transactions backed solely by "qualified residential mortgages", to be defined by regulation and taking into account features including underwriting standards. Certain transactions based on mortgages backed by Government Sponsored Entities may also be exempted. Whilst certain of the latter transactions are not tranched, and may therefore not be caught by the provisions of article 122a, there is still a large market in tranched issues backed by these mortgages. Investment firms who arrange or invest in exempt mortgage transactions in the U.S. should not be caught within 122a by having to apply it on a consolidated basis.

Provision is also made in the Act for implementing regulations which (i) may reduce the retention requirement for other assets if certain (to be specified) underwriting standards are satisfied and/or (ii) in the case of transactions backed by commercial mortgages, may allow for the retention to be satisfied by purchase of the first loss position by a qualified third party based on appropriate due diligence. If such implementing regulations are made, it seems unlikely that US deals which qualify for exemptions will be structured to comply with article 122a. This may result in the effective closure of portions of the US securitisation market to the US broking arms of EU regulated credit institutions if article 122a is applied on a consolidated supervision basis, thus seriously disadvantaging EU firms in the US market.

We use the Dodd-Frank Act as an example due to the size of the US market and the fact that the legislation (although not the implementing provisions) is now in place. However, we would stress that the issues described above are not confined to the US, as regulators in certain other jurisdictions (e.g. Australia) are also considering adopting their own retention requirements, and others may do so in future.

For these reasons we urge against the application of article 122a on a consolidated supervision basis.

We also note the recent developments in Germany in which the upper house of Parliament raised an objection against the proposal that the rational article 122a implementing rules increase the retention requirement to 10 per cent. We would fully support this objection. The Committee, in its Advice on the adequacy of the retention level in November 2009, pointed out that a higher minimum retention level would be likely just to result in increased costs and ultimately lower volumes of loans, and concluded that no increase should be made. We support that view. The draft guidelines in CP40 do not in any way suggest that originators should be considering higher levels of retention, and indeed to impose such higher levels at national level results in differentials between markets which is clearly contrary to the stated text of paragraph 10 of article 122a.

Solvency II

Article 135(2) of the Solvency II Directive provides for the Commission to apply new retention and other requirements to securitisation investors which are insurance and reinsurance undertakings. It is our understanding that the EU authorities wish in principle to apply these requirements consistently with those which apply under article 122a, and the Committee of European Insurance and Occupational Pensions Supervisors (**CEIOPS**) has indicated that it intends to be consistent with the CRD2 provisions in general.

However, the draft Level 2 implementing measures published in January 2010 by CEIOPS include a number of significant differences from article 122a. For example, the draft implementing measures provide that (i) the restriction on multiple applications of the retention requirement for any given securitisation means that "the same minimum 5% retained economic interest cannot support multiple tranches of securitisation", (ii) exemptions from the retention requirement are not as wide as the 122a exemptions and will apply only on a case-by-case basis, (iii) insurance investors must ensure that originator and sponsor credit institutions comply with the underwriting standards similar to those in paragraph 6 of article 122a.

We encourage coordination between relevant EU supervisors to avoid uncertainty for originators in attempting to assist investors in meeting the requirements of their regulators. We note that the implementing measures to be made under article 135(2) appear to be intended to apply from 1 January 2011, and hence time is of the essence in coordinating the two sets of guidance. We can highlight further differences if required.

We also note that there appear to be differences between the scope of article 122a and the scope of the Alternative Investment Fund Managers Directive.

Paragraph 3 exemptions to Paragraph 1

Whilst we understand that the definition of "securitisation" for the purpose of CRD is under discussion outside the present consultation, we cannot ignore it for the purpose of implementing article 122a. By the 1st January 2011, and indeed in some cases before then, ABS investors and originators will need to agree in the case of a given transaction whether the provisions of article 122a apply. Whilst it may not be possible to predict the outcome of discussions elsewhere, we believe it necessary at least to state our position in relation to the following:

Correlation Trading

We are of the view that correlation trading activities should be outside the scope of article 122a. These activities are of a very different nature from the "re-packaging of loans into tradable securities" which Recital 24 states 122a was intended to address. During industry engagement with the Brussels institutions on the enactment of 122a, we argued, with some success, that correlation trades should be exempt. The exemption in the second limb of paragraph 3(b) for "transactions based on a clear, transparent and accessible index" was intended to allow correlation trading to continue without application of 122a. However, trades on bespoke baskets of reference obligations were not explicitly exempt. Due to the uncertainty surrounding the definition of securitisation, we argued at the time that there should be a clear exemption from article 122a for trades based on such baskets. The wording "or are other tradable securities other than securitisation positions" was added to the draft at a very late stage with the intention of addressing this, but unfortunately it is not clear from paragraph (b) what the effect of the wording is.

We attach at Annex 4 a short paper explaining why these types of correlation trading activity we believe should be exempt from paragraph 1.

"*CDS which do not hedge a securitisation*"

We are not sure of the meaning of this exemption. A credit default swap should not of itself be caught in the scope of 122a unless it constitutes a securitisation position. This would involve the pool of exposures being tranched, and the tranching determining the distribution of losses on the pool. There is no reason that a single-tranche credit default swap should fall within 122a at all.

The wording “where these instruments are not being used to package and/or hedge a securitisation that is covered by paragraph 1” is confusing. We understand “packaging” of securitisation positions might include a CDO, and therefore would be caught. But if an investor in ABS chooses to hedge its positions to manage its risk, through entering a credit default swap on the underlying entities, we do not understand why this would be an activity which should be penalised with a retention requirement. We believe that the wording is intended to prevent the hedging of the retained amount under paragraph 1, but that the wording is unclear and needs clarification to that effect.

Certain paragraphs which require further explanation

Paragraph 14 of CP40 refers to covered bonds, treasury bonds and similar transactions. We understand that only certain of these transactions fall at all within the context of article 122a and therefore request that the words in the first set of parenthesis are qualified so as to read “(including covered bonds, treasury bonds, or similar transactions in cases in which the definition of securitisation is met)”.

We would appreciate further explanation of paragraph 35 of CP40 as members are unsure of its meaning. We would be grateful for clarification of this paragraph.

With regard to paragraph 89, we would ask what is intended to be achieved by disclosure to the market of a breach of article 122a where the “prior capital treatment amounted to a full deduction”. The prior capital treatment would only be 1250% for the originator, not the investor who does not hold the position before it invests, so does not ascribe it a risk weight. If the originator held exposures for which the prior capital treatment amounts to a full deduction from capital, we are not sure how the breach would be ascribed to those securitised exposures in particular as opposed to others. This paragraph should therefore be deleted.

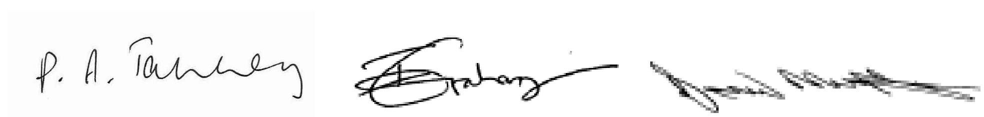
New EU supervisory Architecture:

We also note the changes being implemented to the supervisory architecture of the EU, which will give the European Banking Authority (EBA) the authority to develop legally binding technical standards. If the EBA develops such standards addressing the matters covered by CP40 we ask the Committee to confirm, in so far as it is able to do so, that the EBA will give our members the opportunity for review and comment at that stage.

In Conclusion

We would welcome the opportunity to discuss the above with the Committee at any stage during the implementation process. We look forward to hearing your views to our response.

Yours sincerely



Anne Tanney Managing Director AFME	Director BBA	David Murphy Head of Risk and Reporting ISDA

01 October 2010

The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1st November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association.

The BBA is the leading association for the UK banking and financial services sector, speaking for over 200 banking members from 60 countries on the full range of UK or international banking issues and engaging with 35 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

ISDA represents participants in the privately negotiated derivatives industry, and has over 810 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities

ANNEX 1

HISTORICAL SECURITISATION ISSUANCE IN EUROPE

€ Billions[1]

1.1. European Historical Issuance

	Q1	Q2	Q3	Q4	TOTAL[2]
2000	14.1	16.4	21.4	26.3	78.2
2001	20.5	43.2	22.7	66.2	152.6
2002	24.3	42.6	35.7	55.1	157.7
2003	43.3	51.9	39.7	82.4	217.3
2004	55.8	59.0	53.2	75.5	243.5
2005	47.8	94.4	41.5	143.3	327.0
2006	69.0	114.3	112.8	184.9	481.0
2007	128.47	152.0	99.3	74.7	453.7
2008	40.0	169.6	134.1	367.6	711.3
2009	123.2	81.2	114.7	94.9	414.1
2010	75.5				75.5

1.3 European Issuance by Collateral

	2010 Q1	2010 Q2	2010 Q3	2010 Q4	TOTAL[2]		2009 Q1	2009 Q2	2009 Q3	2009 Q4	TOTAL[2]
ABS[3]	6.5				6.5		17.5	10.4	11.1	13.4	52.5
CDO[4]	15.1				15.1		40.5	16.9	18.6	31.2	107.1
CMBS	1.7				1.7		8.9	0.5	6.0	0.0	15.5
RMBS	51.7				51.7		56.2	53.4	79.0	50.3	239.0
WBS	0.6				0.6						
Total[2]	75.5				75.5		123.2	81.2	114.7	94.9	414.1

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[1] All volumes are denominated in euro2.

[2] Numbers may not add due to independent rounding. Historical or prior period numbers are revised to reflect changes in classification, refined selection methodology, or information submitted to our data source after the prior period cut-off dates.

[3] European ABS issuance includes auto, credit card, leases, loans, receivables and other.

[4] European CDO issuance numbers only include euro-denomical issuance regardless of the country of collateral. A substantial percentage of CDOs are backed by multi-jurisdictional collateral. Historical CDO issuance totals have been revised due to periodic updates of the sector.

ANNEX 2

ARTICLE 122a AND ABCP CONDUITS

Article 122a has no specific provision for ABCP conduit programmes, though these programmes have characteristics very different from those of typical term ABS transactions for which 122a's requirements were apparently designed. To the extent that article 122a applies to any ABCP or to other investments in or exposures to ABCP conduits, it raises a number of questions and difficulties which the proposed guidance does not address. The industry needs its regulators to apply a practical and flexible interpretation of the text of 122a in order to make it work for ABCP conduit programmes insofar as it applies to such programmes.

Our comments in this Annex apply to investments in ABCP and other exposures to ABCP conduits only to the extent that such exposures constitute securitisation positions. If any such exposure is not a securitisation position then article 122a will not apply.

Our members recognise there may be a need to have further discussions with CEBS in due course as to which ABCP exposures may constitute securitisation positions. In the interim, we think it may be helpful to set out our interpretation of article 122a in so far as it applies to any exposure to ABCP structures. Our members ask that the Committee agrees in the final guidance to supplement the guidelines in relation to ABCP as soon as possible to ensure consistent application of article 122a in cases where compliance is required.

ABCP characteristics

Our members consider that the unique characteristics of ABCP and ABCP programmes call for maximum flexibility for market participants to comply with due diligence, information reporting, risk retention and other requirements of Article 122a to the extent they apply to these programmes. The unique characteristics of ABCP programmes are:

(i) investors in ABCP issued by ABCP conduits make a comprehensive evaluation of the ABCP, relying significantly on the structure of the ABCP programme, including the liquidity support (which is always equal to at least 100% of outstanding ABCP) and programme-level credit support (typically 5% to10% of outstanding ABCP) and the creditworthiness of the providers of that liquidity and credit support, the underlying asset transactions and their performance, and the experience and policies of the programme's sponsor when deciding whether to invest (and re-invest) in such ABCP;

(ii) ABCP investors focus less on asset-level information than investors do in other categories of asset-backed securities because an ABCP conduit's assets are not likely to be the primary source of payment of the ABCP—rather, ABCP is expected to be repaid from the proceeds of the issuance of additional ABCP or the proceeds of the credit and liquidity facilities that support the ABCP; and

(iii) ABCP has a short term and is continuously offered, and thus investors are not locked into their investment and have the opportunity to evaluate continuously whether to re-invest in a particular conduit's ABCP.

In addition, ABCP conduits finance a large number of diverse and frequently-changing underlying assets. These include corporate and consumer assets of the types often included in term ABS transactions, but also a large proportion of short-term trade receivables and some less common types such as health care receivables, tax liens, lottery receivables, intellectual property and structured settlements.

In most typical ABCP transactions, the originator retains a subordinated exposure (or sometimes a pari passu exposure or both subordinated and pari passu exposures) to the transferred assets. These retained interests would often exceed 5% of the transferred assets. The originators would provide detailed information (about the exposures) to the conduit sponsors and (if different) to the liquidity providers and programme credit enhancement providers but they would not have any direct communication with the investors in ABCP funding their transactions.

In addition to the economic interests typically retained by originators in ABCP conduit transactions, in relation to the ABCP investors, the conduit sponsor typically retains substantial economic interests. The most typical multi-seller conduit structures include:

(i) liquidity facilities provided by the sponsor or by the sponsor and other banks for each underlying transaction, together equal to at least 100% of the related ABCP, and usually but not always subject to an asset quality test designed to prevent the facility from covering the risk of defaulted receivables exceeding the amount of originator-provided credit enhancement, and

(ii) in many conduits (though not all—it may be omitted, in particular, if all the conduit's liquidity facilities are "full wrap" commitments that include no asset quality tests), a programme-wide credit enhancement facility typically equal to a percentage, usually 5% or more, of outstanding ABCP or the conduit's aggregate maximum investments under the underlying receivables transactions.

ABCP investors focus less on the information relating to underlying assets than do other ABS investors, as the assets in the conduit are not likely to be the primary source of repayment of the ABCP. Instead, the ABCP will be paid from the proceeds of further ABCP issuance or, failing that, from the credit and liquidity facilities which support it. ABCP investors therefore require ongoing information about the sponsor of the programme and the liquidity and credit support providers (if different). However, the ABCP market has evolved so that investor reports covering the characteristics of the current asset pool will typically be provided to ABCP holders on a periodic basis.

As a result of these characteristics, these programmes provide substantial alignment of incentives and interests between investors in the ABCP and the conduit program sponsors. At the same time, it would be impractical, if not impossible, and would not be appropriate for ABCP conduit sponsors or originators to provide, or for ABCP investors to receive and analyse, the same volume and detail of asset-level data as may be appropriate and required for certain kinds of term ABS. By way of example, underlying transactions related to utilities receivables on individuals (e.g. telecoms bills) may include several millions receivables.

ABCP investor's exposure

In some ABCP conduits, the conduit sponsor provides liquidity facilities, equal to 100% of outstanding ABCP, under which the sponsor must provide funds for payment of maturing ABCP without regard to the credit quality, amount or condition of the underlying assets. (Such a support facility may also be in the form of credit enhancement covering the entire programme.) In these programmes, the ABCP investor in effect has no direct exposure to credit risk or other risks of the conduit's underlying assets, as it relies on its exposure to the sponsor for repayment of the ABCP: whatever the performance of the underlying assets, as long as the sponsor is not in default, investors will be fully repaid. It is only in case of default of the sponsor that the performance of the conduit’s assets can help reduce the severity of the losses for the ABCP investor.

Other ABCP programmes also substantially protect the ABCP investors against credit risk and other risks of the underlying assets. Liquidity facilities must equal at least 100% of outstanding ABCP. Most liquidity facilities are provided by the conduit sponsors, but some facilities or parts of facilities for particular transactions may be provided by other institutions. A liquidity facility may limit the amount of funding to the amount of non-defaulted underlying assets, and may have other characteristics of "eligible liquidity" as defined in the CRD securitisation framework's standardised approach. If the conduit's liquidity facilities include such asset quality conditions, normally the conduit sponsor provides a separate programme credit enhancement facility to absorb credit losses on the conduit's assets in the event they exceed the credit protection provided by the originators or otherwise in each transaction. The ABCP investor is thus exposed to credit risk of the underlying assets only to a very limited extent and is protected from dilution and other risks of those assets.

ABCP—retention by originators

Retention by originators is one of at least two approaches that ABCP conduit programmes could take to meeting the article 122a retention requirements. (However, this approach might not work in Germany, where the effect of national implementation of CRD seems to be that, for an originator retained interest to meet the requirement, the originator must be a bank or a regulated financial institution.) For the ABCP investor, the retention requirement (if it applies) should be met if the programme sponsor confirms either that in the case of each of the conduit's underlying transactions the originator (or, as explained below, if an underlying transaction involves multiple affiliated originators, any one or more of them or their affiliates) has retained a 5% net economic interest in the underlying securitised exposures or in the securitisation positions arising from that transaction, or (as discussed below) that the conduit sponsor has effectively retained a 5% economic interest by providing liquidity and/or programme credit support facilities as described below.

ABCP—retention in conduit sponsor facilities

In our view the risk retention requirement could automatically be complied with by the programme sponsor providing either the programme-wide credit enhancement with a value of more than 5% of notional (e.g. in the form of a standby letter of credit issued by the sponsoring bank) or at least 5% of the liquidity facility provided to the ABCP conduit with respect to each underlying transaction. Though these transactions are not typically funded at the outset, economically they represent net economic exposure to the securitisation positions in the conduit or to the underlying securitised exposures. Though in relation to the underlying transactions the standby letter of credit or other programme credit facility is a second-loss and not a first-loss tranche (since it would be used only if transaction credit losses exceeded the credit protection provided by the originator or others at the transaction level), at the programme level and in relation to the ABCP it may be described as a first loss tranche, and such a facility should thus qualify under option (d). The liquidity facilities would be used to replace ABCP funding and would be entitled to repayment from collections on the underlying assets typically pari passu with any remaining outstanding ABCP. These facilities should therefore be treated as falling within retention option (a) or (b).

Other exposures—retention by originators or sponsor

For the credit institution providing liquidity or credit enhancement facilities to an ABCP programme, to the extent it is treated as either investing or assuming exposure to securitisation positions in the programme, the requirement could presumably be met by retention of 5% economic interest by the originator (or, as discussed below, the originator group) in each of the underlying transactions to which the facility provider is exposed. Alternatively, if the facility provider is not the programme sponsor, the retention requirement could be met by the sponsor providing a part of the facility alongside the third-party facility provider or otherwise retaining an exposure described in 122a paragraph 1.

Originator groups

The group originator concept (discussed in the letter under Question 4) is especially important for multi-seller commercial paper conduits, which often provide revolving trade receivables purchase facilities to multiple companies within a single corporate group. Such transactions are very common and typical of ABCP conduits and provide an important alternative source of funding to "real economy" enterprises. In these transactions, the retention requirement should be met if (as is typically the case) one or more of the originators or any of their affiliates retain at least 5% economic exposure to the transferred receivables, whether in the form of a subordinated interest, subordinated deferred purchase price or (as common, for example, in German originator transactions) a subordinated loan provided by an affiliate of the originators.

Due diligence and reporting

In the case of multi-seller ABCP programmes, disclosure to the CP investors of paragraph 7 detailed information on the underlying assets should be unnecessary given the special characteristics of these programmes, including the short term of the investors' exposures, the liquidity and credit support facilities provided by the sponsor and others and the diverse and frequently changing nature of the underlying assets. In both the US and European markets ABCP conduit sponsors, working with ABCP dealers and investor representatives, have developed standard templates for information reporting which investors find satisfactory, and disclosure using these templates should be treated as satisfying paragraph 7. We understand that no concession has been made in the Directive for ABCP transactions, but the text of 122a was clearly written with term transactions in mind, not ABCP. There is also potential for significant divergence from the requirements of the SEC in relation to ABCP transactions which will come into effect in 2012.

Implementation

With reference to paragraph 8 of article 122a and Question 22 of the draft guidance, to the extent that article 122a applies to ABCP conduits, the application of the guidance to multiple originators in the Executive Summary seems to have the effect that where a new seller is added to a conduit after 2014, unless the sponsor is treated as having retained risk, each existing seller into the conduit would suddenly have to purchase 5% of risks it sold prior to 2014. This is not feasible. The original sellers may already hold over 5% of their contributed assets, but the addition of a further seller should not affect them as they are unconnected except by virtue of having sold assets to the conduit. Further, to the extent that a liquidity provider or programme enhancement provider is treated as subject to article 122a requirements as an investor or by assuming exposure to securitisation positions held in the conduit, the retention requirement should be applied only to those transactions to which that facility provider has exposure, and then only to the securitisation positions added after 2014 or revolving transactions to which assets are added after 2014.

In summary

In summary, our members take the view that:

(a) certain investments in ABCP conduits may not be subject to article 122a or its requirements,
(b) investments in ABCP issued by conduits in which the sponsor provides at least 5% programme credit enhancement or the sponsor provides at least 5% of the liquidity facilities for each underlying transaction, and in which the conduit or the sponsor discloses the sponsor's retained economic interests in the ABCP offering documents, would meet the retention requirements of 122a paragraphs 1 and 7 (to the extent they apply),
(c) as an alternative or in addition to (b) above, an ABCP conduit programme in which each of the originators (or, in the case of a transaction with multiple affiliated originators, the originator group) retains an interest in the underlying exposures or resulting securitisation positions complying with any of sub-paragraphs (a) through (d) of 122a paragraph 1 would meet those requirements (even though disclosure and confirmation may be provided by the conduit sponsor rather than the originators),
(d) in relation to information disclosure, reporting and due diligence, in relation to ABCP conduit programmes, credit institutions with exposures subject to article 122a may comply with their respective obligations under 122a by obtaining or providing, as applicable, a level of information which is typical of and appropriate for the ABCP market even though it includes less asset-specific data than may be appropriate and required for certain asset classes in term ABS transactions,
(e) the requirements will be implemented as proposed in the associations' response to Question 22 above in this Annex 2.

ANNEX 3

Impact on the CLO market

There is no particular analysis in CP40 of the difficulties arising in CLO transactions under 122a. To be clear, we are not discussing here “CDO squareds” but single-level CLOs.

CLOs may serve different purposes and be either "balance sheet CLOs" (where the assets are acquired by the CLO from a particular bank's balance sheet for the purposes of obtaining funding or managing risk, or "managed CLOs" (where the assets are acquired at the direction of an investment manager on behalf of the CLO from different entities in the market rather than a particular bank's balance sheet, with the purpose of growth of assets under management, much like in traditional fund management businesses). Although balance sheet CLOs are very similar to traditional securitisations, managed CLOs are fundamentally different, in terms of their purpose and the function they perform in the market.

The loan syndication market – a market that continues to provide financing to businesses in the downturn – is critical to corporate finance. CLOs provide considerable support to the non-investment grade segment of the syndicated loan market. The application of 122a to managed CLOs could inadvertently disrupt the syndicated loan market and, as a consequence, reduce financing available to non-investment grade companies.

The CLO market has been a major source of demand for the European leveraged loan market hence allowing creation of credit in the wider economy. JPMorgan research calculates that the market is approaching a refinancing cliff in years to come - in fact it estimates that $87bn European loans need to be refinanced during the years 2013-2014 alone. Please see below for the loan maturity schedule in Europe.

AFME's members wish to ensure that the CLO market continues to function ahead of this refinancing cliff in leveraged loans. As was evidenced during the recession, when corporates experience difficulty obtaining financing, there is an explicit link with job losses and the general level of economic malaise is exacerbated.

Below we set out some of the major concerns.

Comment on Question 1 – Retention by Originator or Sponsor

There are particular concerns relating to complying with the retention requirement in managed CLO transactions in which an investment manager accumulates loans on behalf of the issuer. The loans are held by an SPV and the investment manager manages the portfolio on behalf of the issuer.

Managed CLOs are fundamentally different from more traditional securitisations in that there is a separation between the origination of the underlying loan assets and the creation of the CLO. Loan assets are originated in the usual way in the syndicated loan market by bank participants, usually with no direct intention to include the assets in a CLO. The CLO is a pooled investment vehicle which acquires its assets (at the direction of an investment manager) from a number of sources, most commonly in the secondary market. In this sense managed CLOs are not an example of an originate-to-distribute model, but are more akin to managed funds where investors are seeking diversification of investment risk and investment management expertise by delegating asset selection to an investment manager through a CLO.

There are key differences between managed CLOs and more traditional securitisations, being:

1. The portfolios are actively managed by the investment manager. As a result, what investors are investing in is not the specific underlying assets (which change), but rather the selection and management skills of the investment manager.
2. CLOs have structures to align the interests of the investment manager and investors. For instance, the investment manager has a significant portion of its fees paid in a manner which is linked to distributions to investors
3. The underlying loans held by the CLO issuer are large and transparent, tend to be liquid and trade in the secondary loan market, and are valued by third party pricing services.
4. Most CLOs own portions of just large corporate loans rather than the whole loans and the investment manager and makes daily decisions as to whether to buy or sell these loans.
5. CLOs investment managers are required by the transaction documents to meet certain asset quality and overcollateralization tests which maintain the quality and diversity of the loan portfolio. Compliance with these tests is checked by an independent collateral administrator.

As a result of these differences, in a managed CLO there is no “originator” as such which is separate from the issuer (as the originators of the assets have no connection with, and commonly no knowledge of, the particular CLO), and the investment manager would not usually be a credit institution but instead would be a fund management or boutique investment firm (and therefore will not technically meet the requirements of the "sponsor" definition). In most cases, the investment manager never holds the underlying assets on its own balance sheet, as the assets are acquired by the CLO directly from market participants. Furthermore, the “original lenders”, being the originators involved in initial origination and syndication of the assets, will in most cases not have any say in whether or not its loans are included in a CLO, as the portfolio investment decisions are made by the investment manager. Additionally, assets may be sourced from the secondary market, over which original lenders have no control. It is therefore difficult to see without further guidance how CLOs can fit within the current framework, given the limited definitions of “originator” and "sponsor”.

Even if the investment manager did meet the requirements of the "sponsor" definition, many investment managers do not have the capital to be able to hold the retention themselves. This is because they are commonly specialist fund management and boutique investment firms which, although regulated to conduct investment management business, would not have the financial capacity to invest directly.

CLOs are ordinarily arranged and structured by an arranging bank. The arranger acts as agent of the investment manager in assisting to establish the CLO. Thus while the arranger organises and may provide interim finance to the CLO, it does not generally securitise its own assets through the structure. Importantly, it is the investment manager and not the arranger which has discretion to select the portfolio. Furthermore, other than in circumstances where it provides hedges to the CLO, the arranger ordinarily would not have an ongoing relationship with the CLO once it is established. The arranger would not therefore be considered a "sponsor" given it does not "manage" the CLO.

We noted at the 22nd July hearing that the Committee was amenable to consideration of a CLO structure which would utilise an additional company to act as “originator” and retain the 5% (the "Originator SPV"). Several of our members have raised this issue and we will attempt some clarification here. Our membership appreciates that the scope of the rules will extend to managed CLOs, even though that under the managed CLO framework, the underlying assets were not specifically created to be purchased by CLOs. They believe that a structure involving an Originator SPV, where the funding and risk in the Originator SPV is held by an entity which is closely involved in the transaction, will satisfy both the technical requirements ,the policy objectives and spirit of 122a in aligning the interests of investors with the parties to the transaction.

The proposal is as follows:

The Originator SPV would be created to acquire the portfolio of assets from the market and then sell the assets to the CLO issuer. The Originator SPV would therefore meet the requirements of the definition of "originator".

1. The Originator SPV will hold the relevant retention through one of the methods set out in 122a.
2. The Originator SPV will be funded by, and all of the risk in the Originator SPV (and therefore the retention) will be held by an entity (the "Retention Party") that will either be: (a) the investment manager, (b) a fund which is controlled or managed by the investment manager, or (c) another entity which has a role in the structuring of the CLO or the asset selection for the CLO (such as a sub-advisor or portfolio selection advisor).

The reason for the different options (a), (b) and (c) in 3 above in respect of the Retention Party is, as described above, many investment managers do not have the capital capacity to hold the retention themselves. However, given the peculiarities of managed CLOs and their unique function as compared with traditional securitisations, our members are of the view that this approach complies with the spirit of the legislation and which meets the policy objectives of 122a whilst catering for the function of CLOs, as (i) the Retention Party's interests will be aligned with that of other investors in the CLO and (ii) material influence over the structure, terms of the transaction and/or portfolio management will reside with the economic owner of the Retention Party. In many cases the investment manager will be, or will be within a group which includes, an EU credit institution, a MiFID investment firm or some other regulated firm based in a non-EU jurisdiction (e.g. the U.S.). Where this is the case, the Originator SPV may be consolidated into such investment manager or the relevant group. This may not however always be the case, as it will depend on the nature of the investment manager's corporate group and internal arrangements. However, we would suggest that there is no need for this entity to be consolidated as it would meet the definition of "originator" for CRD on its own.

As explained above, to satisfy the risk retention requirement upon closing, the Originator SPV would retain the relevant portion of the assets or exposures. Importantly, there is material capital at risk in the Originator SPV that is contributed by the Retention Party.

Comment on Question 10 – option (b), revolving exposures

As mentioned in the main body of our letter, the asset portfolio in managed CLOs will change over time, as assets are acquired over a period from closing and during a subsequent ramp-up period, and then may change as the investment manager buys and sells assets and reinvests repayments. Furthermore, the price paid by the CLO for assets given they are acquired in the secondary market is likely to be different (and in the current environment lower) than the face amount of the assets. In this context, it is unclear how the 5% retention should be calculated, particularly given at closing it will not be possible to determine the face amount of assets in the portfolio at any future point in time.

We therefore believe that the retention amount should be set at closing for CLOs based on the acquisition price of the assets (or, in the case where the assets have not been acquired at closing, the proceeds of the CLO issuance which will subsequently be applied to acquire assets). This is consistent with the intention of 122a, as the acquisition price and issuance proceeds represent the value of the investment as at closing. The face amount of the assets is irrelevant for this purpose, as that merely goes towards the extent of the discount of premium achieved by the CLO in acquiring assets.

ANNEX 4

We understand that it is not the intention of CRD2 to include credit correlation trading portfolios. Instead the intention behind article 122a is to ensure alignment of interests between those who originate and distribute risk and the investors who buy it and to remedy information asymmetry arising on the transfer of specific risk.

Both index and bespoke correlation trading operate on the sole basis of publicly available information where such asymmetry does not exist. The correlation trading desk's client selects the corporate entities which comprise the reference portfolio on which it wishes to take a single tranche exposure. The CDS market in these reference entities will be two-way and liquid. Corporate CDSs reference public indebtedness where credit events are triggered only by publicly available information and settlement (where relevant) is based on prices based on public auctions.

In addition, it is worth noting that documentation is mostly based on "ISDA bespoke single tranche" standard confirmation whether the exposure is funded or unfunded. Note that the correlation trading desk may not have any exposure to the reference entities through such CDS before it enters the trade with the client, and will actively hedge spread and default exposure. Such hedges are dynamically managed by the correlation traders as they respond to the movements in the risk its client bank has asked it to take, provided such risks are within the risk management scope for the activity. This is radically different from the dynamics of standard securitisations which pass on existing risks to an investor. There is no "originator" in a credit correlation trade as defined in CRD and article 122a therefore should not apply. The correlation trading book focuses on the liquidity of the underlying corporate CDS as well as other risk parameters extensively described in the comprehensive risk measure in CRD3 and the client bank specifies transactions in line with its risk appetite (see below).

In any event, this trading activity will be based on publicly available information which is equally available to all market participants.
Correlation trading desks sit on the trading floor in a public space and may not access private information. The public trading desks are kept entirely separate from the private part of the bank by use of physical segregation and Chinese walls.

The relevant text of CRD

Definition of Originator for retention purposes

In bilateral synthetic corporate credit correlation transactions, the correlation trading desk acquires risk from the client bank and will hedge it dynamically as indicated below. The correlation trading desk does not meet the definition of “Originator” in per CRD2:

1. an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or
2. an entity which purchases a third party's exposures onto its balance sheet and then securitises them.

Correlation trading involves neither of the above. There is therefore no “originator” to hold 5% retention.

The 5% can in the alternative be held by the sponsor in a securitisation. The definition of “sponsor” is

“a credit institution other than an originator credit institution that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities;”

As indicated earlier, corporate correlation trading exposures are purchased/ sold from/to the client bank which has specified the transaction details to the corporate correlation trading desk. This is in contrast to an originator passing on exposure to third party entities to an investor. There is no originator as defined, and no sponsor as defined.

In correlation trading, one party is a protection seller, the other the protection buyer. The corporate correlation trading desk will just hedge dynamically the client bank transaction requirement whether client bank is buying or selling exposure to a bespoke corporate transaction. The aim of 122a is to address poor origination and align the interests of originator and investor, not to prevent trading in CDS baskets which are traded between two counterparties and not held by an “originator” at any stage. The most pragmatic interpretation of 122a derived from paragraph 3 would therefore be that it cannot apply to correlation trading activity due to the lack of an “originator”. However we will also consider the possibility of exemption under paragraph 3.

Exemption from paragraph 1

Paragraph 3 of Article 122a of CRD says that:

“Paragraph 1 shall not apply to:
(a) 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
(b) syndicated loans, purchased receivables or credit default swaps where these instruments are not used to package and/or hedge a securitisation that is covered by paragraph 1."

We understand from the CRD 2 industry discussions which took place with the European Commission and the European Parliament at the time that the paragraph 3 exemptions were intended to cover correlation trading activity, based both on indices and on bespoke baskets. The text explicitly covers index tranches and then goes on to specify that it also applies to "where the underlying reference entities are identical to those that make up an index of entities that is widely traded" (i.e. bespoke baskets). This important distinction would be redundant in paragraph 3(a) if it were not intended to cover trades referencing liquid 2 way entities other than those actually referencing a formal index.

Since a corporate CDS references public indebtedness, the information about the corporate reference obligations and related credit exposure is "clear, transparent and accessible", and there is no misalignment of information between the correlation trading desk and the client bank. The correlation dealer is effectively on the public side of the deal, just as his client bank with no additional access to information. We therefore think the CDS should not have to reference a formal index to fall within the exemption.

It is worth noting that the definition of correlation trading in CRD3 (for the purpose of applying the specific capital charges) requires that all the reference instruments must be "single-name instruments, including single-name credit derivatives, for which a liquid two-way market exists. This shall also include commonly traded indices based on these reference entities." Thus for CRD3 purposes the correlation book is clearly defined to include trades based both on indices and bespoke baskets provided the underlying reference obligations are liquid.

It would therefore be helpful to state in the guidelines that the paragraph 3 exemption extends to trades based on the same criteria as used in CRD3.

There is also a further exemption in limb (b) of paragraph 3 which we believe exempts trades based on bespoke baskets – i.e. that credit default swaps are exempt from paragraph 1 unless they are hedging a securitisation caught by paragraph 1. This would indicate that as long as a correlation trade is not hedging a securitisation, it is not subject to the retention requirement.

Due Diligence

If correlation trading activities are to fall within 122a but only be exempt from the retention requirements by way of paragraph 3, the trading desks would be required to perform the article 122a prescribed due diligence. We would point out that the Comprehensive Risk Measure treatment in CRD3 sets out various diligence requirements which will apply to the correlation book and our view is that traders will use those due diligence requirements as “appropriate” for the correlation trading book on the basis that these requirements are what the EU lawmakers have deemed appropriate in order to use the CRM under CRD3. We believe that the extensive and very stringent requirements of the Comprehensive Risk Measure applicable upon specific supervisory approval for correlation trading exceed the scope of due diligence as required in art 122a.

Currently and prior to the introduction of the CRM in CRD3, correlation trading desk perform extensive due diligence within the context of an actively managed book prior trading a new position. Generally, due diligence is focused on three key areas; (a) the eligibility of the proposed transaction for the correlation trading book ensuring that the reference portfolio comprises only 2 way liquid corporate credit default swaps; (b) extensive review of risk parameters and the impact of including the proposed transaction in the existing credit correlation book; and (c) the review of the related structure and its legal documentation. In any event, this will be based on publicly available information which is equally available to all market participants.

Practicality of applying the rules

If our understanding is incorrect and correlation trading is deemed to fall under the scope of the retention requirements, implementation would be challenging. The correlation desk does not hold the exposures prior to trading, so there would be nothing to “retain”. Effectively the onus of retention would have to be transferred again and again, as where a correlation trading desk sells/assigns onwards the protection it has acquired from client bank 1 to client bank 2, the credit correlation desk has no position left on the initial trade with bank 1.

Furthermore we would also seek clarification as to whether the rules apply equally to both protection sellers and protection buyers. Paragraph 1 states that a “credit institution….shall be exposed to the credit risk of a securitisation position…”. Surely in such instances, both the protection buyer and seller are exposed to mark to market risk on such transactions. In such a case, will both the protection seller and protection buyer be subject to all the rules under 122a? That would seem to defeat the purpose of the article.

In summary

Correlation trading should be exempt from 122a for the following reasons:

- Both correlation trading desks and client banks operate solely on the basis of public information which is widely available. There is no misalignment of information between the two counterparties
- Transaction documentation is based on standardised templates
- There is no party to assume the role of originator, sponsor or original lender

If CEBS can identify the originator and investor;

- The text of paragraph 3(a) can be interpreted to include trading based on bespoke which do not constitute a formal public index, as long as the reference obligations are tradable securities.