POSITION PAPER

ESBG position on CEBS' consultation paper on "CEBS Guidelines to Article 122a of the Capital Requirements Directive" (CP40)

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ESBG

The European Savings Banks Group (ESBG) appreciates the opportunity to contribute to CEBS' consultation on "CEBS Guidelines to Article 122a of the Capital Requirements Directive" (CP40).

General Remarks

ESBG welcomes CEBS' intention to develop guidelines for the interpretation of the new Article 122a of the Capital Requirements Directive (CRD II), to be applied to all securitisation transactions and all asset classes. In our view, there is also adequate scope for national supervisors to take into account national securitisation practices and structures.

Yet, we consider that there may be difficulties in applying the draft CEBS guidelines to asset-backed commercial paper (ABCP) programmes, given their many specific features compared to typical securitisations.

In this context we would also like to refer to Recital 25 of the CRD, which states that "purchased receivables should not be subject to the retention requirement if they arise from corporate activity where they are transferred or sold at a discount in order to finance such activity". We have noticed that some supervisory authorities in the EU take the position that Recital 25 only exempts factoring activities from the retention requirement. However, we do not agree with this interpretation as Article 122a does not concern factoring activities, but specifically addresses securitisations. Here we also point out that creating an exemption for a business which originally is not even included within the scope of Article 122a would be illogical. On the other hand, we find that ABCP-conduits falling under Recital 25 should be exempted from the retention requirement. We do not see a conflict of interest between originators and investors in this case.

As a general message we would like to emphasise that the guidelines should not lead to a situation where their qualitative and quantitative requirements prevent or discourage credit institutions from investing in securitised claims on medium sized enterprises. This could have a significant negative effect on the availability of financing for such companies. Similar concerns arise also from the need to balance the costs of disclosure and the administrative burden associated with the reporting requirements.

In addition we also would like to point out that CEBS does not distinguish between securitised portfolios of different granularity. Indeed many of the qualitative requirements (namely in Paragraphs 4 and 7 of Article 122a) presume that the underlying portfolio has to be analysed/disclosed at the level of the individual loan. Since granular portfolios sometimes comprise more than 100,000 individual positions, we question whether it is possible to analyse each position or to disclose information on each individual loan. In any case, however, analysis or disclosure at this level would entail enormous costs disproportionate in comparison with the usefulness of the exercise from a supervisory point of view. Consequently we suggest that for highly granular portfolios, the interpretation of Paragraphs 4, 5, 6 and 7 should give range for a treatment at portfolio level.

A general and conceptual point of criticism is that it is the investor who is penalised for failings of the sponsors to maintain economic interest in the deals or to provide adequate reporting. Here we find that this should be also the responsibility of the sponsor.

Concrete comments on CEBS' 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)?

In general we agree with the proposed differentiation between institutions' roles and requirements. However, we would request the clarification that in each securitisation transaction a credit institution can only play *one* role, in the sense that it can be either originator or investor or sponsor – therefore it should be underlined that only one set of requirements needs to be met.

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)?

CEBS states that a key determinant for the requirements arising for a liquidity provider is whether he is exposed to the credit risk of the securitisation position(s). Here CEBS uses as a critical benchmark whether a liquidity facility ranks 'super senior' according to the requirements set out in CRD Annex IX, part 4, paragraph 2.4.1, point 13. We understand that CEBS considers that such 'super senior' facilities have no exposure to the risk of default of the underlying exposures, but that all other liquidity facilities provided by credit institutions should be subjected to the specific requirements set out for credit institutions assuming exposure to credit risk. However, we do not agree with this approach as the criteria set out in CRD Annex IX, part 4, paragraph 2.4.1, point 13 are too stringent to be used in this context. It also should be taken into consideration whether a liquidity provider is exposed to risks of only one or of multiple securitisation positions.

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?

We agree with the differentiation in the role of a credit institution as hedge counterparty. However, we remain uncertain on the assessment basis in the case where a credit institution would like to retain a provided swap. In this case, we find that it would be inappropriate to assign the notional value of the swap.

We also invite a clarification that underwritten interest and currency swaps do not constitute an 'exposure to 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?

In paragraph 14, CEBS recognises that for the definition of a securitisation it is crucial that the credit risk of a portfolio is transferred between parties. This is indisputable; however we do not think that the additional extrapolations are justified. In particular, we believe that the definition of securitisations is sufficient and that it should not be extended to transactions that do not entail a transfer of risks to third parties. In particular, it would be inappropriate if the requirements of Article 122a were applied to merely group-internal transactions in cases where risk tranching has created a securitisation transaction, without, however the institution (neither at group nor at entity level) profiting from lower risk weights and without foreseeing the involvement of an external investor or the use in refinancing operations.

Question 5: Do you agree that the form of retention should not be able to be changed 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.

Paragraph 22 stipulates that investors, as part of their due diligence, should ex ante take into account any (previous?) breaches of the retention requirement by the originator, sponsor or original lender which can lead to additional risk weights. However, we find that this interpretation goes too far. Rather investors should only have to accept a higher risk weight, if there are significant evident shortcomings to their due diligence – on the other hand, any ex post assessment of 'what should have been detected' would be highly subjective.

As regards Paragraph 23, we argue for a higher degree of flexibility in changing the form of the retention. The main condition for changing the form of retention should be detailed disclosure to investors (in this regard we also recall the Banking Industry Guidelines on Pillar III Disclosures for Securitisation which are regularly updated with the new CRD requirements); otherwise, investors should be offered the possibility to terminate their participation in the securitisation before the form of retention is changed.

We also point out that greater flexibility in the form of retention is especially warranted when conduits are adapted or restructured due to changes in the framework conditions arising for instance from changes to the legal or the accounting environment. Also, we believe that changes in the form of retention should be admissible, if enough means have been accumulated in funded reserve accounts. In addition, it should be possible to adapt the form of retention when there is a fusion of conduits and to react if a sponsor's business strategies or market practices have changed.

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 cashflows 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?

We agree that the measurement of the retention requirement in terms of the nominal value of the securitised exposure is adequate in the case of securitisation tranches, claims and credit lines. However, in our view, the proposed nominal value based measurement is less suitable in the case of derivatives and swaps. Similar problems arise for securitisations where the underlying portfolio consists of derivatives. For such cases we would welcome a better suited measurement base.

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.

We agree that the explanations in paragraph 27 are sufficient. It is important that investors can put trust in the disclosed information on retention, unless they know for a fact that the information is incorrect.

Also, we consider that many institutions will regularly publish the amounts retained in their investor reports, which are accessible to investors and other market participants. We also foresee that a market standard will evolve for the publishing of the retention amounts.

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.

As regards the question of admissible hedging (treated in Paragraph 31) we advocate that CEBS should merely provide a conclusive list of those types of hedges which shall not be permitted. Here, CEBS should also take due account of the importance of hedging in context of the bank's overall strategy. On the other hand, if CEBS maintains the list of 'permissible' hedges, then it certainly should include those hedges directed at wider market risks inherent in the retention, as for example currency risks and interest rate risks.

As a general statement, we also need to point out that the prohibition of direct hedges of the credit risks associated with securitisation positions will be difficult to adhere to in practice. For instance, for risk management purposes and in order to avoid conflicts of interest, many institutions have firewalls between banking and trading book activities. In such cases is can be nearly impossible to identify which bank-wide hedges will in fact have repercussions on the effectiveness of the retention requirement for the risk inherent in a given securitised portfolio

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?

We are doubtful whether contingent liabilities should be included in the retention. Also, we would welcome, if for clarification purposes, CEBS could give an example for the calculation of "net economic interests" for off-balance sheet items.

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

In principle we take the view that banks should apply the same rules and formal procedures for securitisation positions in the trading and in the banking book. Differences in the intensity of risk management should only be justified if they are well founded on differences in the respective risk profiles. This being said, the minimum provisions for analysis and recording laid out in clauses (a) through (g) of Article 122 a, Paragraph 4 need to be fulfilled.

However, there is need for greater clarification concerning the rather vague directions on the required depth of analysis for investments in the trading book. In particular, it would be important to recognise that during the trading of securitisations it is virtually impossible to conduct a comprehensive analysis at the level of the individual underlying loans before the actual acquisition of the position. This concern is also related with the point previously made concerning the granularity of portfolios.

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?

As regards the general requirements for stress tests, CEBS announced that the present guidelines would refer to CEBS' specific guidelines on stress tests, once the latter are finalised. In general, we take the view that the presently discussed requirements in context of securitisations should not go beyond what will be required in these 'stress test guidelines'.

Here, we also would like to point out that the rules for institution-wide stress tests are already rather substantial, and that we are concerned that further detailed prescriptions for stress tests of securitisation positions could be unsuitable in the individual cases, depending on the structure of the transaction. Therefore, we would recommend as an alternative that supervisors observe the evolution of markets standards, and intervene at a later point in time, if and when deemed necessary.

In addition we take the view that the information necessary for the stress tests has to be raised at the level of the portfolio only and not at the level of the individual loan. Information requirements should also not exceed what is required for the monitoring duties foreseen in Paragraph 5 of Article 122a.

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

As such we are not convinced of the practicability of the proposed calculation method. For instance we foresee problems arising in context of ABCP-conduits (unavailability of information on 'scoring' due to short maturities etc).

More importantly, we stress that it should be clearly stated that additional risks weights arising from non-compliance in context of *one* securitisation position should not be applied to *other* securitisation positions where there has been no breach of the requirements.

In any case, we underline that for individual positions, the maximum possible risk weight should be 1250%; risk weights beyond this would have no economic background. Accordingly, Paragraph 81 should introduce the 1250% cap for the 'new risk weight' and not for the 'additional risk weight'. Here, the 'new risk weight' is the sum of the 'original risk weight' and the 'additional risk weight'. We also call CEBS to revise the wording accordingly, wherever this issue arises.

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?

Let us first highlight that in our view the 'additional risk weights' proposed by CEBS appear highly arbitrary. One particular point of criticism is that the current concept does not foresee sanctions that are proportional to the risk arising from a breach or to the degree to which an institution fails to fulfill a requirement. This implies that the same penalty would result from small and from severe failures in compliance. Instead, we invite CEBS to take into account the severity of the breach in the determination of the sanction.

In addition we reject the demand for disclosure of breaches (demanded in Paragraph 89) in the event where the prior capital treatment equals or exceeds 1250%, since this is not covered by the provisions of the CRD. We also point out that such a risk weight already implies a full reduction of an institution's own capital by the exposure value. On this basis, we do not think that in such cases certain requirements in Article 122a, Paragraph 4 and 5, still need to be applied, for instance as regards stress tests, as from a regulatory point of view the bottom has been reached already.

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?

We consider that this interpretation is clear and unambiguous. We also find that the level of care for a trading book asset should be lower than for a non-trading book asset.

Question 20: 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 fulfil these requirements on an adequate basis?

In principle we would welcome standardised disclosure templates, but we take the view that the standard should be determined by the market and not by supervisors. As regards the currently existing disclosure templates, we point out that they do not yet fulfil the requirements. Indeed this is the reason that led the banking industry to draft and update on a regular basis the "Industry Guidelines on Pillar 3 Disclosures for Securitisation".

Question 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 fulfil these requirements on an adequate basis?

As previously indicated, we take the view that the standard should be determined by the market and not by supervisors. Furthermore, given the trend towards greater market transparency, we also think that such an approach would be realistic.

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

Concerning the question of applicability of the Article 122a, Paragraphs 1 through 7, to existing (i.e existing on or after 1st January 2011) securitisation positions which undergo supplementations or substitutions after 31st December 2014, we believe that, contrary to CEBS' proposal, an appropriate materiality threshold should apply. In addition we also advocate an exemption of those cases where a change in claims is due, for instance, to instructions by the trustee, to the conditions of issuance, or to a necessary replacement of claims which ex post are found to be ineligible for the portfolio.

Other remarks

We also have certain concerns on the provisions in paragraph 109, imposing a higher risk weight on securitisation positions dating back before 1st January 2011 where the originator, sponsor or original lender has not disclosed that he will comply with the retention requirement, although supplementations or substitutions to the portfolio are scheduled for the time after 31st December 2014. Here we criticise that this provision is not acceptable for securitizations dating back to before the guidelines are issued. Investors should not be penalised for regulatory developments which could not be foreseen at the time when the transaction was agreed on. In addition we also point out that, absent the disclosure of retention by originator, sponsor or original lender, the investor can only avoid the higher risk weight by selling the position – where, by construction, the range of interested buyers would most likely be limited to unregulated entities.

Last but not least, we would like to direct CEBS' attention to the current discussion regarding the updating process concerning the Banking Industry Guidelines on Pillar 3 Disclosures for Securitisation. One issue that the Industry Working Group has discovered relates to the Pillar 3 requirement. Firms have to provide insight into the roles that they have played in the securitisation process. The main difficulty here is that the text of the Basel II Accord mentions in an illustrative way various roles which a firm can take up in the securitisation process – "originator, investor, servicer, provider of credit enhancement, sponsor of asset backed commercial paper facility, liquidity provider, swap provider" whilst EU legislation transposing the Basel II Accord identifies only two specific roles – i.e. "originator and sponsor"; there is no designated category for holders of securitisation positions.

About ESBG (European Savings Banks Group)

ESBG – The European Voice of Savings and Retail Banking

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of over € 6.000 billion, non-bank deposits of € 3.100 billion and non-bank loans of € 3.300 billion (all figures on 1 January 2009). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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