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CALL FOR TECHNICAL ADVICE ON THE EFFECTIVENESS OF A MINIMUM RETENTION REQUIREMENT FOR SECURITISATIONS

Introduction

1. The EU Commission has called on CEBS to provide technical advice on the effectiveness of the minimum retention requirement for securitisations in Article 122a¹ of the amendments to the Capital Requirements Directive (CRD). The EU Commission submitted two Calls for Advice. The first part questions whether the circumstances under which the retention requirement is met are conducive to meeting the intended objectives, and whether further provisions and safeguards should be added to the wording of Article 122a.² The second part raises additional concerns in relation to specific elements of the Article which may undermine its overall effectiveness.³
2. Article 122a aims to remove the misalignment of incentives between the interests of investors in securitisations on the one hand and those that originate loans for securitisation and structure securitisations on the other. The Article provides that credit institutions should only invest in securitisations if the originator, sponsor or original lender has explicitly disclosed that it will retain,

¹ See Annex A for Article 122a and Recital 26.

² <http://www.c-ebs.org/Publications/Calls-for-Advice/2009/CEBS-today-received-a-call-for-technical-advice-on.aspx>

³ <http://www.c-ebs.org/Publications/Calls-for-Advice/2009/CEBS-today-received-a-call-for-technical-advice-s.aspx>

on an ongoing basis, a material net economic interest of not less than 5% (the 'retention requirement', also referred to as 'skin in the game').

3. The Directive amendments recognise that in the Declaration on Strengthening the Financial System the leaders of the G20 requested the Basel Committee for Banking Supervision and other authorities to consider due diligence and quantitative retention requirements for securitisation by 2010. In response (as set out in recital 26 and Article 156 of CRD), the Commission is to decide before the end of 2009, and after consulting CEBS, whether an increase in the retention requirement should be proposed, and whether the methods of calculating the retention requirement deliver the objective of better aligning the interests of originators or sponsors and investors.
4. European institutions were significant investors in securitisations which were originated by non-EU firms (including non-regulated firms). As the Directive cannot apply directly to non-EU originators, it seeks to provide protection by requiring European credit institutions as investors to ensure that non-EU originators follow European requirements.
5. CEBS has had to work within the parameters already agreed for the introduction of this requirement from 31 December 2010. Accordingly, it has not been able to perform a full analysis of the requirement from first principles, nor consider in detail the impact the requirement will have on market behaviour and the future structure of the securitisation market (e.g. will certain structures become uneconomic?), within the short period of time available. (This is consistent with the specific mandate given to CEBS in the call for advice, which does not envisage a fundamental review of retention as a concept.) However, CEBS has examined the impact

and market failure aspects of the retention policy.⁴ It has also reassessed (below) the extent to which factors other than retention can naturally generate alignment or misalignment of incentives in the absence of any explicit retention provisions.

6. It is important to consider the interaction of different policy objectives when considering any recommendations on this requirement. Banks have to transfer a significant part of the credit risk of a securitisation to investors in order to receive any reduction of the capital requirement for having transferred exposure to investors. A significant increase in the retention requirement could endanger the ability of firms to achieve regulatory capital relief via significant risk transfer.

Executive Summary

7. Retention is only one of a package of measures aimed at better aligning the interests of originators and investors in the securitisation market. However, it is not a panacea for previous issues that arose in securitisation, and many concerns may be better addressed by other measures (for instance, enhancing disclosure requirements). Regulatory measures should also be seen as strengthening the natural incentives that exist, such as client relationships and reputation. The particular business model of an institution is also a relevant factor.
8. European institutions, as originators, have in practice already been retaining some net economic interest in the assets underlying their securitisations, either through a first loss tranche, retaining a vertical slice, or by retaining a given percentage of the loans securitised or other similar loans on their balance sheets.

⁴ See separate Impact Assessment paper issued by CEBS.

9. CEBS is also aware that a significant increase in the level of retention required could create unwanted consequences in terms of the ability of banks to achieve significant risk transfer and regulatory capital relief.
10. In terms of the suitability of the various retention options proposed by the Commission, all four retention options should be maintained as each has advantages and disadvantages relative to the others, and no one option can be described as precisely equivalent to another option.
11. The retention number of 5% should also be retained for all four options because there is no single correct number that is universally applicable for options (a) through (d), and likewise there is typically no single number that is universally applicable for any one of the discrete options. Furthermore, it is also important to highlight that a higher retention requirement can be factored into the economics of a transaction by originators by increasing the pricing of such assets to compensate for it. On this basis, resetting the 5% number to a higher level does not automatically increase the alignment of interests.
12. CEBS has also identified a possible additional method of retention ("L-shaped"). This method combines first loss retention with vertical slice retention. However, before the Commission could consider such an alternative⁵, the effectiveness of the current provisions on retention should be assessed in conjunction with other European legislation being enacted on securitisation. If such an L-shaped retention method was to be introduced in the future, then the absolute and relative numbers of the first loss and vertical slice

⁵ The extent to which this alternative would require additional consideration (in terms of its effectiveness) and quantification (in terms of the retention percentages under this method) would depend on the extent to which it is determined that this alternative is best treated as supplementary to, or a potential supplanting of, certain existing options.

would have to be quantified more precisely, and it should also be possible to accommodate the on-balance sheet elements of the existing option (c). Two further, more complex alternative methods for requiring retention are studied briefly but are not recommended and so are not explored further beyond the relevant Annexes.

13. New wording for options (a) and (b) is proposed in order to extend their applicability to other forms of securitisation.
14. To the extent that an originator is not allowed to hedge its exposure, CEBS believes that it should be clarified, what such a hedge should consist of, e.g., a direct hedge on a specific transaction, an indirect one on the asset class, etc.
15. In addition, several other concepts should be clarified, such as how the penalty clause is applied, how interruptions to retention are treated, the method of disclosure of the retained amount, and miscellaneous other points outlined in more detail below.
16. CEBS has also noted that there are potential problems with the exemption of institutions with an assigned risk-weight of 50% or less included in Article 122a.
17. Further safeguards could be provided by enhancing disclosure on such topics as the characteristics of the retained tranches or retained assets, fees, remuneration structures, and the average holding period of the securitised assets.
18. The retention requirements seem appropriate for groups, but CEBS recommends the monitoring of the potential for regulatory arbitrage in cross-border groups.

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Methodology

19. For this Call for Advice CEBS organised the work of its members through its Sub Group on Market Risk, which reports to the Expert Group on Prudential Regulation. CEBS also requested its Consultative Panel to identify members of a new Industry Expert Group (IEG) in order to provide specific technical support. The working group met four times (including via conference call); during its second meeting held on 20 July at CEBS's London premises the IEG and ratings agencies were invited to morning and afternoon sessions respectively. Due to time constraints (which included the main holiday season) it was not possible to incorporate a formal public consultation.
20. In order to help inform the development of the Advice a questionnaire seeking information regarding existing levels of retention in European banks was sent to members of the working group. This proved problematic due to the varying levels and types of data captured and their application across Member countries.

21. In order to answer effectively the questions raised by the Commission, the questions have been grouped into six principal areas:
- a) an examination of qualitative issues pertaining to the alignment of interests and benefits of retention;
 - b) an exploration of the equivalence of the different methods of retention currently envisaged;
 - c) an examination of the appropriateness of 5% as the number for the retention requirement;
 - d) group structures, which covers point (d) of the first letter and point 2 of the second letter;
 - e) exemptions, which covers point (b) (iii) of the first Call for Advice and the point 3 of the second Call for Advice; and
 - f) further provisions and safeguards, which covers point (c) of the first letter.

Background

22. The current turmoil in credit markets has called into question the desirability of certain aspects of securitisation activity, as well as the desirability of many elements of the 'originate to distribute' business model, because of their possible influence on incentives and their potential misalignment thereof.
23. When an originator traditionally extends credit it has a natural, strong incentive to screen borrowers based on sound criteria and on an on-going basis to monitor and service the loans effectively, because it retains the risk and reward from the decision to extend credit.

24. Putting distance between originators and investors can weaken this link, with the potential concern that lending standards may be lowered, resulting in a gradual deterioration in the credit quality of the assets included in the collateral pools of securitised instruments.
25. Accordingly, when an originator undertakes a securitisation and transfers all the risks and rewards to investors it will not have strong risk/return incentives to screen borrowers, as it will not directly benefit from good credit decisions or directly suffer the consequences of bad credit decisions.⁶ Furthermore, once it has transferred the credit risk to investors it no longer has such a clear incentive to incur the on-going costs of monitoring the performance on the investors' behalf.
26. In many cases the situation may be somewhere between these two extremes. Securitisation allows originators to transfer credit risk to investors and so results in disaggregation of the risk/return profile of the underlying assets, which are then redistributed among many different parties, each of which has a different form of exposure to the assets due to their different levels of seniority. The extent of credit risk transfer will depend on which tranches of the capital structure are sold to third parties versus those that are retained by the originator. For example, where an originator retains a sufficiently large first loss tranche it will bear a large part, if not all, of the reasonably probable credit risk of the underlying exposures, and as such has only transferred the risk of unexpected losses. However, even if the originator does not retain such a large first loss tranche, as the originator may share in the rewards through other means (for instance, the fee structure or premiums received),

⁶ This assumes that poor asset quality does not indirectly effect the originator (in terms of funding efficiency) where information symmetry exists; for instance, should rating agencies demand more subordination below the notes issued, or should investors demand a higher rate/spread on the notes issued.

incentives can be driven by wider considerations than simply credit risk.

27. European institutions as originators have in practice already been retaining some net economic interest in the assets that underlie their securitisations, either through a first loss tranche, retaining a vertical slice, or by retaining a given percentage of the loans securitised or other similar loans. For example, in master trusts originators have retained a “seller share” to meet investors’ requirements to ensure that the originator has sufficient incentives to carry out appropriate monitoring and servicing of the underlying assets. So in certain respects the market has already embraced the concept of retention.

An examination of qualitative issues pertaining to the alignment of interests and the benefits of retention

Natural incentives for originators to effectively screen, monitor and service borrowers

28. To examine the alignment of incentives further, it is appropriate to start by looking at what natural incentives (or disincentives) may be at work to support proper screening, monitoring and servicing, *before* then considering the additional role of any regulatory requirements aimed at helping to restore the alignment of interests and the modification of institutions’ behaviour. Any natural incentives may allow regulators to be flexible in applying a retention requirement because retention will not be expected to carry the full burden of encouraging correct behaviour amongst institutions.
29. The factors other than the retention of risks/rewards which will affect this conclusion, include the following:

- i. client relationships;

- ii. remuneration;
- iii. reputation;
- iv. funding; and
- v. information asymmetry.

Client relationships

30. It is reasonable to expect that originators that rely on their client relationships for future income and funding should have better aligned incentives irrespective of their ongoing retention:
- a) they may rely on building or maintaining their longer-term relationships with those they extend credit to for future income (through cross-selling or repeat business); and
 - b) they may rely on their relationships with investors for future funding needs.
31. An originator's business model will determine the importance of these factors. For example, where an originator's main function is to originate assets to sell through securitisation, they will not be so driven by the long-term maintenance of business relationships with the underlying borrowers or investors, assuming that profit generation is in the shorter term. Consequently, there is less incentive to monitor or incur any non-essential costs related to the performance of the underlying assets. On the other hand, a different situation may be expected when an originating institution securitises the assets of a client with whom it has been having a stable business relationship over a period of time; if it wants to sustain this good relationship, it should be motivated to properly monitor and service the assets/receivables.
32. Where originators do not rely on these natural relationships, then retention may have more of a role to play in creating an alternative

form of long-term 'relationship' with borrowers and investors. Relationships are, however, open to imbalances between the size and market importance of the originator and those of the investor (e.g. a very large bank selling securitisations to a very small regional credit institution).

Remuneration

33. Long-term sustainable profitability should be in the interests of the owners/shareholders of most businesses, thereby avoiding the situation where the motivations have an undue focus on high short-term gains, which could damage the business in the long run. Disincentives may, however, arise if individuals are remunerated by short-term profits which could distort the long-term view of the business⁷. Where the originator is remunerated up-front for the extension of credit, they may not be as incentivised to effectively screen the borrower thereafter. Originators may also be remunerated by quantity, rather than quality, of underwriting.
34. A misalignment of incentives may also exist for servicers when their remuneration schemes do not adequately reflect the different costs that they incur when they perform certain tasks, such as modifying loan terms or liquidating assets. Unless servicers receive adequate compensation for all the different actions that they may be required to perform, they may not be inclined to adopt the most appropriate measures with respect to troubled loans. For example, unless adequately covered for such additional expenses, servicers may postpone foreclosure to avoid the costs associated with asset liquidations. Inefficient servicer decisions may reduce the value of a pool of assets and, in particular, the recovery rates of assets that

⁷ The Commission's proposals on Remuneration as part of the CRD 3 changes should be noted, as these may have a beneficial effect in reducing misalignment of incentives here.

ultimately default. This in turn has an impact upon misalignment of incentives.

Reputation

35. Reputation should play a significant role in instilling discipline in the market, spurring institutions to act prudently and generate longer-term returns for shareholders. Poor underwriting standards would eventually damage an institution's reputation and impact the market view of the risk of their business model, for example through the cost of funds or willingness of stakeholders to continue to transact business with it.
36. Institutions that are typically involved in repeat relationships with investors should pay particular attention to reputational issues and behave accordingly. When originators wish to position themselves in a market over the longer term, it is in their interest to act prudently in order to gain a reputation as counterparties that effectively monitor and service borrowers. However, it may be difficult to assess the extent to which originators will actually consider reputational concerns in practice when tempted by strategies that may promise high short-term profits.

Funding

37. Institutions which need to receive on-going funding for future sustainability should have a natural incentive to effectively screen, monitor and service borrowers as future loans will form collateral for further funding. The banking crisis has shown that investors do not expect losses to materialise on these portfolios and will withdraw funding when performance starts to deteriorate. The strength of this incentive may, therefore, depend on how reliant the originator is on this source of funding.

Information asymmetry

38. Originators should have the ability and incentive to screen borrowers effectively using qualitative factors, as well as more quantitative factors. For example, the traditional banker/borrower relationship would imply more personal, judgemental and forward-looking considerations are put into the decision to lend. But possessing more information than investors about the expected loss on a portfolio of assets may also tempt originators to use this to their advantage and transfer bad quality assets ('lemons') to investors, which would be an incentive to reduce the qualitative analysis and simply rely on backward-looking, low-cost quantitative analysis – perhaps previously reinforced by rating agency models.
39. When a loan has been sold as part of a securitised pool to investors, occasionally only quantitative information about the underlying borrower(s) (e.g. credit score, geography, etc) and the contractual terms of the loans (e.g. interest rate, term, repayment profile, etc) have been used by investors when investing in such loans as part of a securitised pool. While investors typically received more detailed information at the issuance stage (e.g. in the prospectus), subsequent information on asset composition and performance was frequently neither standardised nor digitised.
40. Whereas originators are compensated for the quantitative information they provide about the borrower, the incentive for them to process soft qualitative information may depend on whether they have to bear some of the risk of the loans they originate. The improved requirements for disclosure that will be introduced as part of the amendments agreed to the CRD, coupled with industry initiatives to improve market standards in this area, are expected to prove a major factor in helping to address any incentives that work against the alignment of interests.

Holding period

41. When an originator makes a decision to extend credit and knows that it will instantly be transferred to an SPV via securitisation, there is the risk that it screens credits less effectively⁸. Whereas the longer the period during which the underlying assets have to be held on the books of the originator/lender (before being securitised), the less this risk should be. Such a holding period may potentially need to be adjusted for such features as teaser rates and negative amortisation profiles. However, even with a relatively short holding period, the existence of credit and non-credit risk support to investors may help to mitigate the risk.
42. The holding period before assets can be securitised, and consequently the materiality of the issues raised above, is clearly connected with the business model of the originator.

How originators' natural incentives may be affected by their business model⁹

43. It is possible to make a distinction between institutions according to their business model, for instance between investment banks that procure large portfolios with the sole purpose of securitisation, compared to more traditional institutions that know the end-borrowers to a greater extent, have a closer relationship with them, and wish to use securitisation as a way of securing additional funding or freeing up capital to continue to service their core business in the same underlying assets. In reality, of course, there will be multiple institutions whose business models are a hybrid between these two extremes.
44. When originating for the purpose of securitisation becomes a business model in and of itself with the sole goal of achieving profits

⁸ This decision could also be mitigated by other natural incentives, such as reputation, identified above.

⁹ This refers to the originators' business models, and how material securitization is to their business, and therefore which factor dominates (i.e. traditional bank model versus originate-to-distribute model).

upon securitisation and sale of the assets, then incentives may tend to be focused upon the shorter term. For example, it is possible to procure significant volumes of mortgage loans (that can then be securitised) through intermediaries or independent brokers with commissions that incentivise quantity based upon a transaction-driven business model (as opposed to one based on on-going banker/customer relationships), and hence perhaps create less incentive effectively to screen, monitor and service borrowers.

The roles of multiple parties in the securitization value chain

45. The misalignment of incentives in securitization transactions arises from agency problems that are based on the assumption that an agent will first act in order to maximize its own benefit.
46. The BSC report of December 2008 on “The incentive structure of the ‘originate to distribute’ model” looks at the securitization value chain and identifies the possible agency problems occurring between the different actors involved. The report identifies four main groups of actors¹⁰ in the value chain: originators, intermediaries¹¹, investors and third parties¹². Even if conflicts between originators and investors are deemed to be the most material, incentives may be misaligned between investors and any of the other parties interested in the transaction.
47. For instance, the potential misalignment of incentives between intermediaries and investors can be attributed to a large extent, to the remuneration schemes for intermediaries and a possible bias

¹⁰ It should, however, be noted that actors in the value chain may serve multiple roles, for instance the originator also being the servicer. This may further influence the behaviour of the actors and raise the complexity of the retention issue.

¹¹ Intermediaries are generally arrangers and transaction managers. Arrangers purchase assets and bundle them into pools. They design the transaction, frequently to meet the demands of investors. Transaction managers manage the SPVs set up for the purposes of the securitization transaction, or manage the pool of assets on behalf of investors.

¹² Third parties include credit rating agencies and servicers. Credit rating agencies provide assessments of both the credit risk and payoff profile of securitization transactions, both initially and during the lifetime of a transaction. Servicers are responsible for the collection of interest and principal payments from the borrowers.

towards certain tranche holders. Intermediaries could be tempted to maximize revenues from providing services that could conflict with investors' objectives of balancing risk and return. This is further complicated by the waterfall structure implying that investors in different tranches have differing, or even conflicting, objectives. To the extent that intermediaries participate in the residual profits that accrue to equity tranche holders, a concern would be that intermediaries favour equity tranche holders over senior tranche holders.

48. Another example is the potential misalignment of incentives between third party providers and investors. In the case of credit rating agencies, this is typically illustrated by the "issuer pays" model or the issuance of ratings for highly complex structures. These shortcomings have been at the origin of recent EU regulation of credit rating agencies. This illustrates that the retention provisions should not be seen in isolation but as a part of a broader package that may involve several pieces of European legislation.
49. In the case of servicers, because of their remuneration structure, they may not adopt the most appropriate measures with respect to problem loans. A purely fee-based remuneration scheme for servicers may not be sufficient as incentives may be better aligned via the retention of ownership in the asset pool.
50. Interestingly, the BSC report identifies that investors' behaviour may influence the conflicts of interest between the different actors in the securitization value chain and that appropriate due diligence and information requests may exert discipline on the various actors in the value chain.

Exploration of the equivalence of the different methods of retention currently envisaged

The requirement for retention to help align incentives

51. Article 122a¹³ of the CRD amendments places a prohibition on credit institutions from investing in securitisation positions unless the issuer has retained not less than a 5% interest in the securitisation (the 'skin in the game' or retention requirement). The requirement aims to help remove any misalignment of incentives between the interests of investors in securitisations on the one hand and those that originate loans for securitisation and structure securitisations on the other.
52. The Directive amendments provide four methods of meeting the 5% retention requirement¹⁴:
- a. retention of each tranche sold or transferred to investors;
 - b. retention of an originator's interest in securitisations of revolving exposures;
 - c. retention of equivalent exposures on balance sheet; or
 - d. retention of a first loss tranche.

It should be noted in advance that to the extent that there are multiple options available to an originator, the originator will generally choose the option that is most advantageous to it (given the asset class, structure, and assumed economic environment), unless investors or other market participants exert sufficient market control or pressure for it to be otherwise.

53. There is growing international interest in imposing a retention requirement. IOSCO has issued the recommendation that regulators should 'consider requiring originators and/or sponsors to retain a

¹³ See Annex A for Directive text

¹⁴ See Annex B for illustrative diagrams

long-term economic exposure to the securitisation.’ The US Treasury has also put forward a 5% retention requirement to encourage originators to make loans of better quality¹⁵.

54. The proposal to retain an economic interest is based on the assumption that where an originator retains 100% of the risk and reward from a decision to extend credit, it will have strong natural incentives to effectively screen, monitor and service borrowers, as opposed to when it transfers the risk to third parties via securitisation. The extent of credit risk transfer, and the degree of any misalignment of interests, will depend on (among other things) which tranches of the capital structure are sold to third parties versus those that are retained by the originator.
55. Before examining the various methods of retention available, as well as their respective advantages and disadvantages, it should be pointed out all forms of retention share the one key trait of preventing an originator from undertaking an originate-to-distribute business model in which 100% of the risk is transferred to third parties on a constant basis. This constraint on the originate-to-distribute business model is a key outcome (and potential benefit) of any retention requirement, regardless of the precise form in which the requirement is implemented.
56. On the other hand, the retention requirement also neglects to take into account the rewards in any given transaction that will impact the originator’s overall incentives. For example, originators may still originate and securitise assets where the rewards (for instance, excess spread) are sufficiently high to offset the cost of retaining an

¹⁵ In contrast to the EC, the US may be considering targeting capital charges for non-compliance at originators rather than investors.

ongoing interest in the transaction.¹⁶ Furthermore, originators can effectively reduce their level of risk by providing ancillary or counterparty services to the transaction, for example servicing fees or swap arrangements. The impact of these rewards can ultimately render the nominal risk retention of any number (5% or otherwise) much less meaningful.

Pari passu methods of retention and the alignment of interests (options (a)-(b))

57. Two of the four methods above (options (a) and (b)) for calculating retention create a shared (or 'pari passu') interest in the performance of the underlying assets, either through a vertical slice or an originator's interest. In simplistic terms, these options do create an alignment of interests between originators and all investors in a securitisation, i.e. originators will share in 5% of all losses suffered by investors. Furthermore, because it is a vertical slice that is retained (not a specific tranche or position), there is alignment with investors at all points in the capital structure. For the same reason, a vertical slice also provides longer-term incentives, as it creates "cradle-to-grave" exposure to the assets (it cannot be eroded over time, like a first-loss piece).
58. However, retaining a 5% pari passu interest may not always be sufficient to impact the behaviour of originators and align their interest with those of investors in absolute terms for two reasons. First, a 5% pari passu interest does not provide a strong amount of economic exposure to the assets; for instance, if the underlying assets suffer a 5% loss, the seller would only suffer a 5% loss on its 5% vertical slice (compared to a 100% loss under option (d), i.e. first loss retention). Second, to the extent that the assets in a vehicle are of sufficiently low quality (and hence, typically high

¹⁶ However, should the underlying assets perform poorly, then such excess spread would not necessarily be available, and so could not be received by the originator. As such, there could be an indirect alignment of interest in this respect.

yielding), and to the extent that the excess spread from such high-yielding assets can still flow to the originator after making payments to both the bondholders and the originator's vertical slice (for instance, in the form of deferred purchase price or an excess spread note), there may still be an incentive for an originator to originate poor quality assets and place them in the vehicle, in the knowledge that its risk is limited to the 5% vertical slice, but the potential rewards (in terms of deferred purchase price or excess spread) more than compensate for this. However, this potential issue also arises also with other options, including option (d), where it is typically a greater risk.

59. Consequently, a vertical slice may not necessarily single-handedly guard against the potential origination of lower quality assets. However, when targeting the alignment of interests within a securitisation structure (irrespective of whether the assets within such a structure are of higher or low quality), the vertical slice option (when compared to other options outlined below (in particular option (d)) is more long-term (and hence should foster longer-term business models), may be less subject to abuse (such potential abuses are examined below), and may be less subject to distortions by asset class. These issues are discussed further below.

Retention of equivalent on-balance-sheet exposures and the alignment of interests (option (c))

60. The third option (option c)) requires the originator to retain 5% of equivalent exposures on its balance sheet. In terms of the risk/reward profile of an originator versus investors, this option (c) is substantially similar to options (a) and (b) above, as the originator would retain a similar amount of economic exposure to the assets. However, the retention of exposures outside of the securitisation structure (rather than inside the structure) raises two

types of issue.¹⁷ Firstly, the somewhat subjective judgement of what is an “equivalent” exposure. Secondly, the determination of whether the originator’s non-involvement in the structure could be detrimental to investors even though the originator still has exposure to similar underlying assets. It is these issues that differentiate option (c) from options (a) and (b), and they are explored in more detail below.

61. In terms of determining what constitutes an “equivalent” exposure, it is currently envisaged that a random selection process of assets to be securitised will ensure that there is no abuse of the concept of equivalence. If a truly random process is used within a sufficiently large and granular pool (so that one can assume a pool of homogeneous assets in terms of quality), this should ensure equivalence. The question arises of who should confirm that the selection process has been truly random – the firm itself, the auditor of the loan file, the competent authority, or another party. Furthermore, it needs to be ensured that the randomness captures all potential parameters that can impact credit quality; for instance, if vintage was not such a parameter an originator could originate and distribute 100% of poorly underwritten new loans from recent vintages while retaining its 5% in better underwritten seasoned loans from earlier vintages.
62. The second issue to consider is whether holding assets outside the structure means the alignment of incentives is sufficient. For instance, if an originating institution can determine how “equivalent” assets are defined, it could use this option to circumvent the requirement to retain truly “equivalent” exposures. On the other hand, there are offsetting benefits to this option in

¹⁷ One member indicated that option (c) requires a direct involvement of the originator in the securitisation in order to be comparable to options (a), (b) and (d). This member suggested that this could be achieved if the assets are randomly selected from the securitised portfolio, as further outlined above.

terms of alignment of interest. For instance, to the extent an originating institution is holding an equivalent retained exposure outside of the structure it will have fewer incentives to influence or tamper with certain events (for instance, breaches or avoidance of triggers) within the structure in order to optimise cash flows to the positions or tranches it has retained itself.

63. A separate consideration is the fact that retention on balance sheet can meet the requirements of the CRD amendments while somehow addressing concerns of asset encumbrance and related ramifications. To be more specific, to the extent that an originator has chosen to retain its 5% on balance sheet, and under the assumption that the current legislation prevents its use for other collateral purposes (e.g. a covered bond transaction), there are fewer assets encumbered within special purpose vehicles (SPVs) for the benefit of secured creditors (as opposed to depositors and unsecured creditors), and there is also less likelihood of such assets being indirectly placed beyond the reach of depositors and unsecured creditors (for instance, through time-subordination of the seller interest in a master trust). This consideration, however, raises the issue of the availability of the 5% retained on balance sheet for other business purposes, like the reimbursement of depositors and unsecured creditors. This should probably be clarified in the Directive text.
64. It was already indicated above that option (c) is equivalent to options (a) and (b) in terms of economic risk but that the differentiating factor (i.e. the originator's interest is being held outside the SPE) raises a number of issues. However, it would be possible to mitigate many of the risks that arise from this differentiation. Such mitigants include:

- a) ensuring that the selection process of assets from among the eligible pool is truly random;
 - b) having a third-party examine and attest to the equivalence of the securitised pool and the assets remaining on balance sheet both in quantitative terms (for instance, weighted averages and stratification tables of collateral) and in qualitative terms (for instance, that both pools of assets arose from an origination process that is demonstrably similar);
 - c) ensuring simultaneous disclosure of the collateral attributes of the securitised pool and the assets remaining on balance sheet at the time of securitisation;
 - d) ensuring on-going disclosure of the collateral performance of the securitised pool and the assets remaining on balance sheet post securitisation; and
 - e) ensuring that the management and servicing process of the securitised pool is the same as that of the assets remaining on balance sheet post securitisation.
65. This option is effectively already prevalent in the business and funding models of many European lenders, in particular those in which the originator is not originating assets purely for onward distribution of risk to investors, but instead is undertaking securitisation as one element of a broader funding strategy. Option (c) supports such business and funding models, and provides an effective avenue to grandfather existing transactions of this kind into the retention framework.
66. Within such parameters, the on balance sheet retention method of option (c) may consequently also be consistent with behaviour that supports longer-term, more stable business models and can create

an alignment of incentives between originators and investors that is equivalent with those of options (a) and (b).

Retention of a first loss piece and the alignment of interests (option (d))

67. CEBS was also asked to opine on the equivalence of the different methods of retention. To determine equivalence, if the subordination of the originator's retained position in the capital structure is considered, then option (d) is a clear outlier as the interest is subordinated to investors, whereas the other options (options (a) to (c)) create a real or virtual pari passu interest with investors (i.e. either inside or outside of the structure), and arguably are equivalent among themselves. Consequently, the question to consider is whether this subordinated interest can achieve the objective of aligning interests, may create potential misalignment, or perhaps work either way according to the precise circumstances of the transaction.
68. In the analysis that follows it is always assumed that when option (d) takes the form of a reserve fund to meet the retention requirement, such reserve fund is funded upon the closing of the transaction rather than building up over time via excess spread.
69. Where the originating institution retains a share (e.g. vertical slice) in the transaction, it should always have an incentive to ensure a more optimal performance of the assets until the very last loan has either defaulted or paid off. This is clearly not the case with retention of the first loss piece, which has the potential to be eroded due to realised losses on the assets. Furthermore, the alignment (or misalignment) created by the first loss option will depend greatly on the firm's loss expectation, the regulatory capital treatment of the underlying assets, how control is aligned with seniority in the structure and the servicing approach to the underlying assets. On

the other hand, retention of a first loss piece creates greatest alignment of interest in economic terms. Therefore a uniform approach across all assets that does not consider the different degrees of risk within each securitisation and the impact on the alignment may not always be appropriate when applying option (d). (These issues are explored in more detail in the paragraphs that follow.)

70. In terms of servicing, retaining a first loss piece can specifically create situations where there is clear potential for misalignment of interests. For example, when the performance of the assets deteriorates it is the first loss piece that is first to be cut off from the cash flows of those assets, and the first to take write-downs on the assets. To the extent that the originating institution is also the servicer (as is typically the case), then it has an incentive to influence both trigger levels and arrears management practices to its advantage which could potentially be to the detriment of more senior note holders.
71. The two preceding paragraphs seem to suggest that a vertical slice is more desirable than retention of a first-loss piece, because the vertical slice aligns incentives from "cradle to grave" whereas the first-loss piece may have an impact only at the point of asset origination. However, the extent to which incentive alignment during the lifetime of the transaction is important relative to incentive alignment at the point of origination really depends upon the type of transaction. For most transactions the originator's influence on the quality of the portfolio at origination is probably a much more important factor for the transaction's performance than the influence that the originator can exert via monitoring or some other activity post origination. For example, for RMBS third-party servicers may be designated, in which case the originator will play no role following origination. Even if the originator remains the

72. Therefore, there is probably a trade-off to be made between the vertical slice and the first-loss piece: whereas the vertical slice may align the incentives with respect to servicing and arrears management decisions during the lifetime of the transaction, it may be less effective than the first-loss piece in guaranteeing asset quality at the point of origination.
73. In terms of control being aligned with seniority within the structure, the assumption that the first loss piece is more exposed to the assets does not take into account differences in exposure versus differences in control. For instance, in a CMBS transaction the holder of the first loss piece of the underlying loan is typically the controlling party in the transaction when asset performance deteriorates (and could potentially act in this capacity to the detriment of the senior investors), thus potentially further exacerbating the misalignment of interests that was referred to above.
74. In terms of economic alignment of interest, whilst holding a vertical slice may create better alignment from a timing perspective, a first loss piece can create better alignment from the perspective of absolute exposure to losses. This is because there is a basic disconnect in the degree of alignment that the retention of a 5% first loss piece creates and that retention of the same percentage as a vertical slice creates. For instance, assuming that a certain portfolio of assets of say €1,000 has a base case loss expectation of 5% (or €50), if the originator chose to retain its 5% interest in the

75. To offset the greater degree of risk that is assumed by the first-loss piece, it frequently benefits from any excess spread (i.e. residual cash flows in a transaction after all other payments have been made). It may consequently be argued that the greater degree of risk assumed by the first-loss piece is offset to some extent by the greater potential rewards it can accrue, thus negating any potential benefits in terms of incentive alignment versus options (a) and (b). However, this stance does not necessarily always hold, as excess spread need not always flow to the holder of the first-loss tranche, and transactions could be structured for such excess spread to flow to any tranche or to a vertical slice holder.
76. To conclude, while recognising its limitations, this option still has a role to play as it can create alignment of interests, and furthermore it is also a market-standard mechanism which institutions currently use, and which may be actively sought by some investors.

Realised Losses on Assets:	5.00%
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Rating	Capital Structure	Option (a)	Option (b)	Option (c)*	Option (d)
AAA	90.00%	4.50%	4.50%	4.50%	0.00%
AA+					
AA	2.00%	0.10%	0.10%	0.10%	0.00%
AA-					
A+					
A	2.00%	0.10%	0.10%	0.10%	0.00%
A-					
BBB+					
BBB	2.00%	0.10%	0.10%	0.10%	1.00%
BBB-					
BB+					
BB	2.00%	0.10%	0.10%	0.10%	2.00%
BB-					
NR	2.00%	0.10%	0.10%	0.10%	2.00%
Total	100.00%				
Retained		5.00%	5.00%	5.00%	5.00%

Loss as % of Originator Retained Interest	5.00%	5.00%	5.00%	100.00%
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** For analytical purposes, option (c) can be treated as equivalent to options (a) and (b), assuming that the on-balance-sheet selection process truly creates an equivalent retained exposure to what was securitised.*

Another possible method of meeting the retention requirement: "L-shaped" retention

77. As an alternative, it would be possible to require the retention of two types of exposure from among those listed above, and more specifically to require the retention of both a first loss piece and a vertical slice (hereafter referred to as "L-shaped" retention).

a) This has the advantage of ensuring the optimal form of retention, as the specific distortions and abuses that both the first loss option and the vertical slice option generate disappear when the combination of both is employed.

b) The disadvantage is that it effectively dictates an L-shaped retention structure (first loss plus vertical slice) across the market regardless of capital structure and asset class, as opposed to allowing the market to decide which of the options is

most suitable according to the capital structure and asset class of individual transactions.

78. If the L-shaped retention method is mandated, then:

- a) The absolute and relative numbers for each of the first loss and vertical slice (for instance, by way of illustration, 2% first loss and 4% vertical slice) would have to be more precisely quantified to ensure that there are extra benefits to be gained from mandating L-shaped retention.
- b) It must also be borne in mind that the retention provision has been defined as the starting point for transferring risk; the calibration of an L-shaped retention method should therefore ensure this alternative would not effectively impair risk transfer.
- c) In addition, before considering this as a possible alternative, the effectiveness of the current provisions on retention should be assessed in conjunction with other existing pieces of European legislation on securitisation and credit rating agencies. While retention is a way of reducing the misalignment of incentives between originators and investors, disclosure has also been identified as an important element in providing investors with a tool to help bring about market discipline.
- d) Finally, should this option be pursued, its final form should be able to accommodate the on balance sheet elements of option (c), the benefits of which have previously been explained.

79. In summary, whilst there is no current evidence to suggest that such a change is required at this point in time, it is the conclusion of CEBS that an L-shaped retention could have potential to provide a more optimal alternative to the existing options that strengthens the alignment of interests between originators and investors. The

Commission may wish to consider such an alternative¹⁸ on a longer-term basis, but only after having first assessed the effectiveness of the current provisions on retention and other legislation. However, given the nature of the securitisation market and retention as a regulatory tool, even an L-shape method would not necessarily always provide a more optimal solution.

80. Aside from the “L-shaped” retention framework outlined above, two other methods of framing the retention requirement were also considered. These relatively more complex alternatives consist of percentile-weighted and ratings-weighted retention curves, the details of which are outlined in Annexes C and D, respectively. However, as neither method is recommended by CEBS, they are not examined any further here.

Is the minimum level for the retention requirement of 5% adequate to avoid misaligned incentives and to mitigate systemic risks within the securitisation markets, or should the number be raised?

81. The Commission has asked CEBS whether an increase in the retention requirement is necessary to achieve the policy objective of aligning incentives between originators and investors and to mitigate systemic risks within the securitisation markets. In considering this question it is important to remember both the other policy responses which will facilitate the alignment of incentives between originators and investors, namely increased disclosure and due diligence requirements, and the natural incentives identified earlier in this paper. However, as discussed above, retention may

¹⁸ The extent to which this alternative would require additional consideration (in terms of its effectiveness) and quantification (in terms of the retention percentages under this method) would depend on the extent to which it is determined that this alternative is best treated as supplementary to, or a potential supplanting of, certain existing options.

have a role to play in certain business models to facilitate the alignment of incentives (economic or otherwise).

82. Any assessment of whether an increase in the retention requirement is necessary begins with the suitability of the current requirement of 5%. It is difficult to provide conclusive evidence on the adequacy of 5% as the effectiveness of the alignment it creates will vary across asset classes, structures and geographies. It will also vary according to expected losses and expected returns on various underlying assets and according to the option ((a) to (d)) which an institution chooses to meet the requirement. For instance, 5% may be sufficient for lower-yielding prime residential mortgage assets from one country structured into a simple pass-through, but may not be sufficient for higher-yielding leveraged loans from another country packaged into a more complex CLO structure. Consequently, CEBS concludes that there is no strong evidence that a change in the retention percentage (from 5% to another single number) would result in better alignment of (economic) interest between originators and investors.
83. It is also important to highlight that a higher retention requirement can always be factored into the economics of a transaction by originators by increasing the pricing of such assets to compensate for it – essentially ensuring that the return on the assets is sufficiently high to monetise and pay back as quickly as possible the risk of the higher retained tranche. On this basis, resetting the 5% number to a higher level (for instance, 10%) does not automatically increase the alignment of interests – it just resets the boundaries within which originators must operate to make such a retention requirement economically feasible, where such boundaries include considerations of asset class, asset yield, and form of retention.

84. It can also be argued that moving the required retention percentage from 5% to (for instance) 10% would only either increase lending costs to borrowers, or reduce lending volumes, and would not necessarily ensure increased originator controls (e.g. screening) over asset quality or the more accurate pricing of credit risk in the underlying loans. This is because as the retention requirement rises to certain levels (for instance, from 5% to 10% or 15%), the originator would simply factor this into the economics of the transaction – essentially raising the margin on the loans to compensate for (and ultimately pay off) the retained portion. As the retention requirement increases further to an extremely high level (for instance, 50%) there would simply be a drop in volume as many originators would be unable or unwilling to retain such a large exposure in absolute terms. (In other words, as the retention requirement increases, initially the margin on the loans goes up and finally the volume of the loans goes down.)
85. Assuming that the retention requirement does not rise to volume-reducing levels (for instance, 50%) but instead is raised to margin-raising levels (for instance, 10%), there is no obvious direct incentive for originators to price credit risk any more accurately in all cases (though there may be in some). This is because in most transactions (whether the originator holds its share as a vertical slice, first loss or otherwise), any increase or reduction in excess spread is not shared symmetrically between the originator and the investor (it is the originator that asymmetrically benefits or suffers). Consequently, it cannot necessarily be assumed that the originator will price credit risk more accurately if it has a higher retention percentage as any re-pricing of the underlying loans to offset this increased retention requirement asymmetrically benefits the originator (as opposed to the investors).

86. The counter-factual to the above is that for many originators securitisation is just one of a number funding and risk transfer mechanisms, and therefore increasing the retention percentage may simply motivate them to undertake less securitisation and seek more funding from other sources. Furthermore, competitive forces (especially among competitors that are not reliant on similar funding mixes) may prevent originators from pricing the increased retention into margins on the loans that they extend. This counter-factual could, however, have an adverse impact on originators that fund themselves predominantly via the securitisation market, and thus lead to competitive distortions (with particularly adverse impact on non-bank lenders).
87. In conclusion, if the aim of the retention percentage chosen is to discourage originate-to-distribute models that potentially misalign interests and threaten underwriting prudence, as opposed to ensuring the uniform retention of true economic loss exposure by originators (regardless of asset class, geography and structure), then CEBS cannot find evidence that a change in the retention percentage from 5% to any other single alternative number would consistently result in an improved degree of alignment of interest.

Exemptions

88. A number of exemptions to the application of paragraph 1 of Article 122a of the CRD amendments are listed in paragraph 2 of the same Article; in particular, when the securitised exposures are claims or contingent claims on (or are wholly, unconditionally and irrevocably guaranteed by) i) central governments or central banks, regional governments, local authorities and public sector entities of Member States; ii) institutions to which a 50% risk weight or less is assigned

under Articles 78 to 83; or iii) multilateral banks being of comparable credit risk to central banks.

89. Likewise, the Directive provides that paragraph 1 shall not apply to:
- i) 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; and
 - ii) syndicated loans, purchased receivables or credit defaults swaps where the instruments are not used to package and/or hedge a securitisation that is covered by paragraph 1.
90. CEBS can find no obvious reason why the exclusions stipulated in the above points should lead institutions to structure securitisation transactions in such a way as to avoid the retention requirement when it is otherwise justified and hence to impede the further alignment of incentives.
91. However, the exemptions which refer to institutions with an assigned risk-weight of 50% or less can be seen as problematic, considering that under Articles 78 to 83 of CRD the risk weights (especially 50%) are assigned to credit risk exposures of highly ECAI rated entities¹⁹. As the current crisis has made clear, this is not at all a guarantee of the entity's ability to repay its credit obligations. This could therefore be an area where extending a retention requirement could provide added comfort.
92. Besides, if the exceptions are meant to be equivalent, those related to regional governments and multilateral development banks should be confined to those exposures that are treated as exposures to central governments and central banks according to what is

¹⁹ See link to Supervisory disclosure, recognition of ECAIs.
http://www.c-eps.org/documents/Supervisory-Disclosure/spreadsheets/rules/ecai_recognition.aspx
According to the table the exemptions would be applied to all institutions rated over BBB- by S&P.

established in Art. 86(2) of the CRD. Thereby, the wording proposed is:

“Paragraph 1 shall not apply when [...]:

(aa) regional governments, local authorities and public sector entities of Member States whose exposures are treated as exposures to central governments under Subsection 1;

(c) multilateral development banks whose exposures are treated as exposures to central governments under Subsection 1”.

Other than that, depending upon their economic substance, a new exemption should be incorporated into the CRD (specifically, into Art. 122a, para. 2) in order to prevent securitisations based on an institution’s own liabilities (including covered bonds whose underlying collateral is on the balance sheet of the issuer institution) from falling under the scope of Article 122a.

Suggested CRD Text: Paragraph 1 shall not apply to:

“(c) Securitisations whose underlying exposures are liabilities (including covered bonds) issued by the originator, or originators in the case of multi-seller structures, with the intention of raising funds and not transferring credit risk. This exemption also applies to the cases in which an instrumental institution intermediates between the originator (issuer of the securitised liabilities) and the SPE.”

Further provisions and safeguards

93. CEBS has been asked whether additional provisions and safeguards should be added to the wording of Article 122a in order to address the potential problems identified. We do not consider retention in itself to be a panacea, nor will it be possible to consider all the factors which could undermine its effectiveness. However, that does not mean these factors are not important to investors' decisions, and therefore we propose that these should be dealt with through enhanced disclosure.
94. The primary issue which the Commission has highlighted is the ability to structure transactions in ways that avoid the application of the retention requirement, in particular through any fee or premium structure. We consider that this information (i.e. fees and remuneration structures) should be disclosed to enable investors to take a view on its impact on the interests of the originator. Other areas where we have identified issues which could be addressed through disclosure include: average holding period of the securitised assets; performance of assets held outside the securitisation when using option (c); and an originator's hedging policies.
95. We note that the Commission has not specified the mechanism for the disclosure requirements, and in particular that the current language only requires originators to 'explicitly disclose' that they meet the retention requirement. This could be open to wide interpretation, and at the extreme could simply be met by a clear verbal commitment in a "sales pitch". The Commission should consider whether the language is strong enough to achieve its objectives, especially taking into account that this requirement is meant to be met on an on-going basis.

96. These disclosure requirements could be dealt with by Pillar 3. However we note that those disclosures are made annually, and so may not be the most appropriate mechanism if, for example, securitisation reporting templates were to be required on a quarterly or semi-annual basis. Additionally, if a framework is to be developed for disclosure of the relevant information to comply with the due diligence requirements for European investors, it should be borne in mind that non-European originators should somehow be persuaded to follow suit.
97. Disclosure of those transactions retained by originators for refinancing purposes, which are not under the capital requirements of Arts 94 and 101, would also be advisable. It would be necessary to identify those securitisations that are off balance sheet, not subject to accounting consolidation, and those not subject to capital requirements. Such measures would allow stakeholders to be informed of all the securitisation-related transactions carried out by the institution, and assess properly the reason and risks of the institutions.

Group structures

98. In absolute terms, the principle of application of the retention requirement at both solo and consolidated levels still remains the general case in the revised CRD, which allows for achieving the alignment of interests at each level.
99. However, the retention requirement can be satisfied on a consolidated basis when the originators or sponsors belong to the same group.²⁰ Nevertheless, the possibility offered in the revised

²⁰ “Where an EU parent credit institution or an EU financial holding company, or one of its subsidiaries, as an originator or a sponsor, securitises exposures from several credit institutions, investment firms or financial

CRD to apply the retention requirement on a consolidated basis is limited. According to Article 122a 1a, specific preconditions surround its use:

- a) the credit institution has to securitise exposures for several credit institutions, investment firms or financial institutions;
- b) these latter credit institutions have to be included in the scope of supervision of a group that meets the retention requirement on a consolidated basis;
- c) they also have to commit themselves to apply the same sound and well-defined criteria for credit granting for the securitised exposures as those applied to the exposures to be held on their books; and
- d) they should deliver to their EU parent credit institution or EU financial holding company all the relevant information needed to ensure that prospective investors have readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures.

100. Thus the retention requirement is not compulsory on a solo basis in the case of a specialised entity that does not directly originate the securitised exposures but belongs to the same group as the originator entities. In such a case, imposing compliance with the retention requirement on a solo basis could artificially generate a fragmented view of the risks attached to the securitised portfolios of the group, thereby missing key information.

institutions which are included in the scope of supervision on a consolidated basis, the requirement referred to in the first subparagraph may be satisfied on the basis of the consolidated situation of the related EU parent credit institution or EU financial holding company. This paragraph shall only apply where credit institutions, investment firms or financial institutions which created the securitised exposures have committed themselves to adhere to the requirements set out in paragraph 5 and deliver, in a timely manner, to the originator or sponsor and to the EU parent credit institution or an EU financial holding company the information needed to satisfy the requirements referred to in paragraph 6”.

101. Management of the retention requirement at group level is expected to provide a better understanding of the risk attached to the securitised portfolios of the group. This is particularly relevant when risks are assessed and capital is allocated at group level. Moreover the requirement for the institutions in a group to deliver all relevant information to the EU parent credit institution or EU financial holding company ensures good information sharing within the group which might not be so complete if the retention requirement was to be complied with solely on a solo basis.
102. However, regulatory arbitrage could potentially arise in cross-border groups where different entities are based in different jurisdictions. Future CEBS implementation guidelines for supervisory convergence should help to address this issue.
103. Another problem that could arise is that the originator or sponsor or even the entity that retains the interest in the securitisation could be stripped out of the group (for instance, via a sale). The group would have to address this issue so as to be able to carry on complying with the retention requirement.
104. In cases of changes in the group structure, there should be clear disclosure by the group specifying the different roles played by the entities (originator, sponsor, servicer, retainer), which supervisors should monitor appropriately.
105. Overall, the conditions set out in Article 122a(1) appear to be appropriate to achieve the desired alignment of interests.

Conclusions and recommendations

106. The analysis above leads to the following recommendations and conclusions.
107. A significant increase in the retention requirement, or changes in the options available, could have the unwanted consequence of undermining the ability of firms to achieve regulatory capital relief via significant risk transfer.
108. To aim for simplicity and transparency in the retention options available, the Commission should continue with the current options (a) to (d).
- a) None of options (a) through (d) should be eliminated, as when viewed from different perspectives (ranging from alignment of interest through economic risk sharing, from potential for unwanted distortions to potential for arbitrage and abuse) each has advantages and disadvantages relative to the others.
 - b) Likewise, the 5% number should not be changed for any or all of options (a) through (d), because CEBS cannot produce evidence that any other single number would result in better alignment of (economic) interest between originators and investors.
109. There is no evidence so far that the following approach would provide greater assurance that the retention options fully align the interests of investors with those of originators; however, the Commission could consider whether the alternative²¹ of an L-shaped retention (first loss plus vertical slice) has potential as a further development of the CRD framework in the future. If such an L-

²¹ The extent to which this alternative would require additional consideration (in terms of its effectiveness) and quantification (in terms of the retention percentages under this method) would depend on the extent to which it is determined that this alternative is best treated as supplementary to, or a potential supplanting of, certain existing options.

shaped retention method was introduced, the absolute and relative numbers for each of the first loss and vertical slice would have to be more precisely quantified to ensure that there are indeed extra benefits gained from mandating L-shaped retention. Also, as stated above, the calibration of the L-shaped retention method should provide an alternative that would not impair risk transfer, should be able to accommodate the on-balance sheet elements of the option (c), and the effectiveness of current provisions on retention should be assessed in conjunction with other existing pieces of European legislation on securitisation and credit rating agencies before considering it as an alternative.

110. The wording of option (a) needs to be amended, because as currently worded it does not recognise certain types of schemes that are equivalent to the retention of a vertical slice. For instance, a current practice in the securitisation market, actually demanded by certain investors, is that the originator retains a given percentage of each of the assets (loans) synthetically securitised. By retaining a share of all the cash flows of the loans synthetically securitised (by means of a CDS), the originator's position actually ranks *pari passu* with the investors' positions, as is the case in the vertical slice option. Therefore, to include such other types of schemes that have the same economic substance as option (a) the clause "retention of not less than 5% of the nominal value of each of the tranches sold or transferred to the investors" should become "retention of not less than 5% of the nominal value of each of assets securitised or each of the tranches sold or transferred to the investors".
111. The wording of option (b) needs to be amended, because as currently worded it only allows for the vertical slice in "securitisations of revolving exposures" (note these are "revolving exposures", not "revolving securitisations"). Technically, this means

that credit card master trusts are allowed to use the vertical slice option, but mortgage master trusts (as commonly used in some Member States) are not. For consistency purposes, CEBS recommends that the wording here should be amended to capture both. So the clause “in the case of securitisations of revolving exposures, retention of the originator's interest of no less than 5% of the nominal value of the securitised exposures” should become “in the case of securitisations with either revolving structures or revolving exposures, retention of the originator's interest of no less than 5% of the nominal value of the securitised exposures”.

Supplementary Issues to be Resolved

112. The requirements as currently drafted raise a number of technical, textual, practical and conceptual difficulties that need to be clarified (for instance, in guidance notes) prior to their implementation. We expect these issues to be examined within an appropriate (but potentially separate) timeframe. These are outlined below.
113. To the extent that an originator is not allowed to hedge its exposure, it must be clarified what such a hedge consists of. For instance, which of the following would be captured?
 - a) A direct hedge on the specific transaction (for instance, buying protection via a credit default swap).
 - b) An indirect hedge on the asset class in general (for instance, buying protection via CMBX, ABX, LCDX, etc).
 - c) An indirect hedge on the underlying collateral or security (for instance, taking a short position in house price futures).
 - d) An indirect hedge on the macro variables that are most likely to cause credit stress in the underlying obligors (for instance, purchasing an interest rate cap).

- e) It is also not clear if the hedging of exposures other than credit risk is allowed. For instance, if the originator provided an interest rate swap for the transaction and then hedged this swap on a back-to-back basis with a third party, would this not be allowable (the originator is essentially just hedging its provision of a non-credit-related swap for the transaction)?
- f) It is also not clear to what extent an originator could synthetically recreate retained exposure after its sale of such an exposure. For instance, an originator could sell its vertical slice combined with writing a CDS on the transaction in order to get 5% more funding but have the same exposure and regulatory capital treatment.

Such details will need to be clarified for implementation of the retention clause. Alternatively, disclosure requirements could be put in place for originators to make information on any hedges available on an ongoing basis.

- 114. The duration of the retention requirement, and the treatment of inadvertent interruptions to this duration that are not the fault of the originator and/or investor, will have to be clarified. ("The current wording of the text is "Net economic interest is measured at the origination and shall be maintained on an ongoing basis.") If the 5% retention is only at point of issuance, and does not have to be maintained (or "topped up") thereafter, none of the following issues arise. However, to the extent that it has to be retained at the level of 5% each of the following issues crystallises.

- a) If the originator holds its retained interest in the form of a first loss piece (i.e. option (d)), as losses flow through the transaction and erode this first loss piece, then the originator will ultimately end up with less than a 5% interest. Should the originator be required to constantly replenish its interest back up to the 5%

level, its credit exposure to the asset pool would be unlimited, and consequently regulatory capital relief would be impossible.

- b) If the 5% can no longer be retained or maintained because the originator has become insolvent, would this also trigger increased capital requirements for investors? While in most transactions originator insolvency would cause the originator interest to remain the same or actually grow in percentage terms (as cashflows get reallocated from the originator interest to the investor interest), there could be cases where the administrator of the insolvent originator chooses to sell the interest to a third party.
- c) If an originator choose the on balance sheet option (i.e. option (c)), and the assets on its balance sheet prepay faster than those within the structure, would this count as breach of the 5% requirement?
- d) There can be cashflow triggers in transactions that accelerate or decelerate repayment of the originator's interest (repaying it faster via a "turbo" mechanism; repaying it slower via early amortisation). These may cause difficulties in constantly maintaining 5%, although it should be noted that most of these triggers increase rather than decrease the seller interest (though this is not always the case).
- e) If an originator hits certain sale triggers that prevent it from selling new loans to the trust, and if (for some reason) cashflows from the assets are being directed to the originator's interest (as opposed to the investor's interest), the originator's interest could fall below 5%. While this is an unlikely combination of circumstances, it does place the originator in an uncomfortable scenario of being contractually unable to meet investor requirements to maintain a 5% share.

As stated above, if the 5% retention is only at the point of issuance, and does not have to be maintained (or “topped up”) thereafter, none of the issues raised above are material. The wording of the text could potentially be changed to clarify that the word “maintained on an on-going basis” shall not prevent the interest retained by the originator from falling below 5% when this is not the result of actions undertaken by the originator itself.

115. There are certain elements of the provisions as currently worded that are either textually or logically confusing, or are otherwise open to misinterpretation. These include the following:

a) The on balance sheet option (i.e. option (c)) is technically not equivalent to options (a) and (b), as the 5% is on balance sheet against a pool of 100%, therefore notionally retention is 4.76% (5/105 rather than 5/100). A correction for this would be to replace it with the wording “retention of randomly selected exposures, equivalent to not less than 5% of the notional amount of the total amount of eligible exposures to be securitised in accordance with the contract of the securitisation”.

b) It has been said that the penalty clause may be vague on how the 250% is applied when 5% retention is not met. One interpretation is that the 250% is applied as a multiple to the existing regulatory capital treatment for the tranche. Another is that the 250% is applied as the new regulatory capital treatment in absolute terms. A third interpretation is that the firm would apply an additional risk weight of not less than 250% of the risk weight that would otherwise apply (for instance, 10% + (250% x 10%)). This requires consistent interpretation.

c) In option (d) the wording “same or more severe” is vague in the sentence “retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile

than those transferred or sold to investors". It could potentially be replaced with wording that reads: "retention of the first loss tranche and, if necessary, other contiguous positions that are senior to it, but still junior to any position transferred or sold to investors".

d) The retention types as currently laid out only refer to the retention of nominal exposures, and not notional exposures. If an originator held an interest-only strip from a transaction, it could have a very high notional exposure, but no nominal exposure.

e) One commentator noted that Article 122a envisages that the percentage of retention is referred to as the nominal value of the securitised exposure and it is unclear if that value should or should not refer to the exposure value gross or net of value adjustments (which approximately equates to book value taking into account any impairment losses).

116. It could be argued that the on balance sheet option (i.e. option (c)) should be disallowed for synthetic transactions if the assets that are counted towards on balance sheet retention are the same as those synthetically protected as part of the reference pool in that same synthetic transaction.

117. The retention requirement in Article 122a points to asset securitisations, such as RMBS, CMBS, CDOs, etc. (It is worth noting that, depending upon their economic substance, those securitisations whose underlying exposures are liabilities (including covered bonds) issued by the originator, or originators in the case of multi-seller structures, with the intention of raising funds and not transferring credit risk, are out of the scope of Article 122 a). The clauses as currently drafted are informed primarily by asset securitisations as undertaken by credit institutions (and certain non-

bank originators), and as purchased by investors subject to the regulatory capital requirements of Basel II. This means that the following extra considerations may not be fully captured:

- a) to what extent do the requirements as currently drafted adequately account for certain types of liability securitisation (for instance, when insurance firms transfer certain types of event risk, for instance via catastrophe bonds), as opposed to asset securitisation (for instance, RMBS, CMBS, CDOs, etc)?
 - b) to what extent do the requirements as currently drafted adequately account for corporate securitisations (for instance, securitisations backed by receivables generated by health care receipts or pub sales)?
 - c) to what extent are these requirements transferable from a CRD framework to a Solvency II framework? and
 - d) to what extent do these retention requirements potentially conflict with the derecognition process under IAS 39?
118. Finally, in the absence of a "one size fits all" retention scheme, disclosure requirements should be considered as a powerful complement – if not to a certain extent an alternative – to retention provisions (see notably the conclusion of the paper by Mitchell & Fender, "The future of securitisation: how to align incentives?", BIS Quarterly Review, September 2009) as well as "Good Practice Guidelines On Pillar 3 Disclosure Requirements For Securitisation" drafted by EBF, LIBA, USBG, EAPB, 18 December 2008). While the current CRD text already provides additional requirements in terms of disclosure for securitisation transactions, more guidance should be provided on the specific form in which the 5% retention should be disclosed by the originator to the investor. One possibility would be to require originators (or sponsors) to publicly disclose at

issuance and then, periodically, over the lifetime of the transaction, the level of retention and the characteristics of the retained tranches (including the underlying assets) or retained assets (depending on the selected retention option). An independent third-party mechanism should probably be put in place to guarantee the quality of the information provided.

ANNEX A

Article 122a: Exposures to transferred credit risk

A credit institution, other than when acting as an originator, a sponsor or original lender, shall be exposed to the credit risk of a securitisation position in its trading book or non-trading book only if the originator, sponsor or original lender has explicitly disclosed to the credit institution that it will retain, on an ongoing basis, a material net economic interest which, in any event, shall not be less than 5%.

For the purpose of this Article, "retention of net economic interest" means:

- (a) retention of no less than 5% of the nominal value of each of the tranches sold or transferred to the investors;
- (b) in the case of securitisations of revolving exposures, retention of the originator's interest of no less than 5% of the nominal value of the securitised exposures;
- (c) retention of randomly selected exposures, equivalent to no less than 5% of the nominal amount of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is no less than 100 at origination; or
- (d) retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total no less than 5% of the nominal value of the securitised exposures.

Net economic interest is measured at the origination and shall be maintained on an ongoing basis. It shall not be subject to any credit risk mitigation or any short positions or any other hedge. The net economic interest shall be determined by the notional value for off-balance sheet items.

For the purpose of this Article, "ongoing basis" means that retained positions, interest or exposures are not hedged or sold.

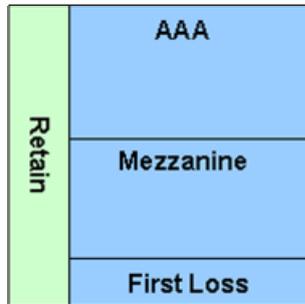
There shall be no multiple applications of the retention requirements for any given securitisation.

Recital 26

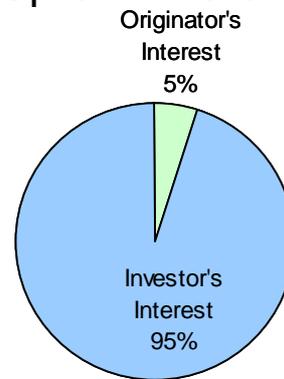
In their Declaration on Strengthening the Financial System of 2 April 2009, the leaders of the G20 requested the Basel Committee for Banking Supervision and authorities to consider due diligence and quantitative retention requirements for securitisation by 2010. In view of those international developments, and in order best to mitigate systemic risks arising from securitisation markets, the Commission should, before the end of 2009 and after consulting the Committee of European Banking Supervisors, decide whether an increase of the retention requirement should be proposed, and whether the methods of calculating the retention requirement deliver the objective of a better alignment of the interests of the originators or sponsors and the investors.

ANNEX B

Option A: Vertical slice



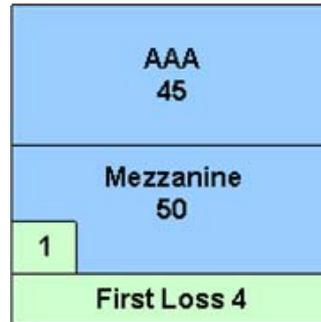
Option B: Revolving exposures



Option C: On-balance sheet



Option D: First Loss



ANNEX C

Percentile-weighted retention

1. The current methods for meeting the retention requirement do not give credit towards meeting the 5% in situations where an originating institution chooses to hold certain interests that could actually create a larger degree of alignment, but fall outside the precise options (options (a) to (d)) currently envisaged. For instance, an originator could hold a large mezzanine²² tranche with only a 0.5% subordinated junior tranche below it and a 50% senior tranche above it (thus holding 49.5% of the capital structure, from 0.5%-50%). In such a case, the originator may have retained the majority of the credit exposure to the assets (in base case, stressed, and potentially even catastrophic circumstances), but is given no credit for this under the current proposals.
2. The current methods also do not always give credit for holding combinations of those retention types for which credit could separately be given. For instance, under the current proposal, there would be no credit given for holding a combination of a 2% first loss tranche and a 10% mezzanine tranche, if there was another 1% tranche placed between these first loss and mezzanine tranches (because the first loss and mezzanine are not contiguous within the capital structure, and so the mezzanine does not have “the same or a more severe risk profile than those transferred or sold to investors”, which is required by Article 122a).
3. One potential solution to this would be not to prescribe where in the capital structure the originator has to hold the 5% of assets, but instead to prescribe that originators always hold at least 5% across the capital structure of the transaction and to “risk-weight” where in the

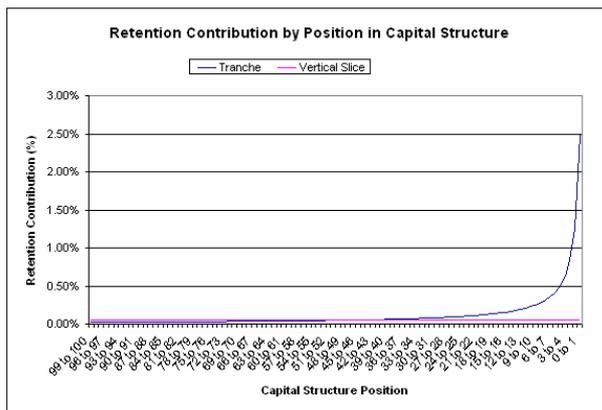
²² A mezzanine position means a securitisation position to which a risk weight lower than 1250% applies and that is more junior than the most senior position in the securitisation and more junior than any position rated AAA – AA-.

capital structure they hold it. To illustrate, if an originator holds a vertical slice of a transaction, the originator is basically holding a 0.05% exposure to each 1% percentile band within the capital structure and the aggregate of these 0.05% increments (100 of them) amount to 5%. A simplified curve could be created, whereby if an originator chose to hold not a vertical slice, but instead specific points in the capital structure, they build up 5% by aggregating the points in the capital structure that they hold (with higher weights being assigned to more junior points in the structure, and lower weights to more senior points in the capital structure). For instance, a 5% vertical slice equivalent could be produced by holding the junior 0%-4%, the mezzanine 2%-19%, the senior 13%-100%, or other combinations from among these tranches. The curve of risk-weights would sit above a vertical slice at the lower points in the capital structure, and below the vertical slice at the higher points of the capital structure (see graph below).

4. The form in which this is prescribed to originators could be a complete curve (where weights are defined for each incremental 1% percentile point in the capital structure), or in summarized form (where weights are assigned by bucket, which essentially summarizes the curve).
5. This approach has the following advantages:
 - a. it takes into account any type of capital structure (it cannot be arbitrated by the thickness or thinness of the junior or mezzanine tranches);
 - b. it ensures that the amount that must be retained is commensurate with the risk of the point in the capital structure at which it is retained; and
 - c. it potentially provides a check on poor quality originate-to-distribute activities, while not necessarily impeding the ability

of originators simultaneously to access secured funding on an efficient basis (without excessive retention) and seek economic risk transfer as appropriate.

6. However, undertaking such an approach is substantially more complex, and equally as subjective, as the simplified approach currently in the agreed amendments to the CRD. It would be almost impossible to choose a single risk-weighting curve that would in all cases prevent originators from abusing their retention requirements by selecting different points of the capital structure depending on the different asset classes being securitised and the different structures within which such assets are securitised.



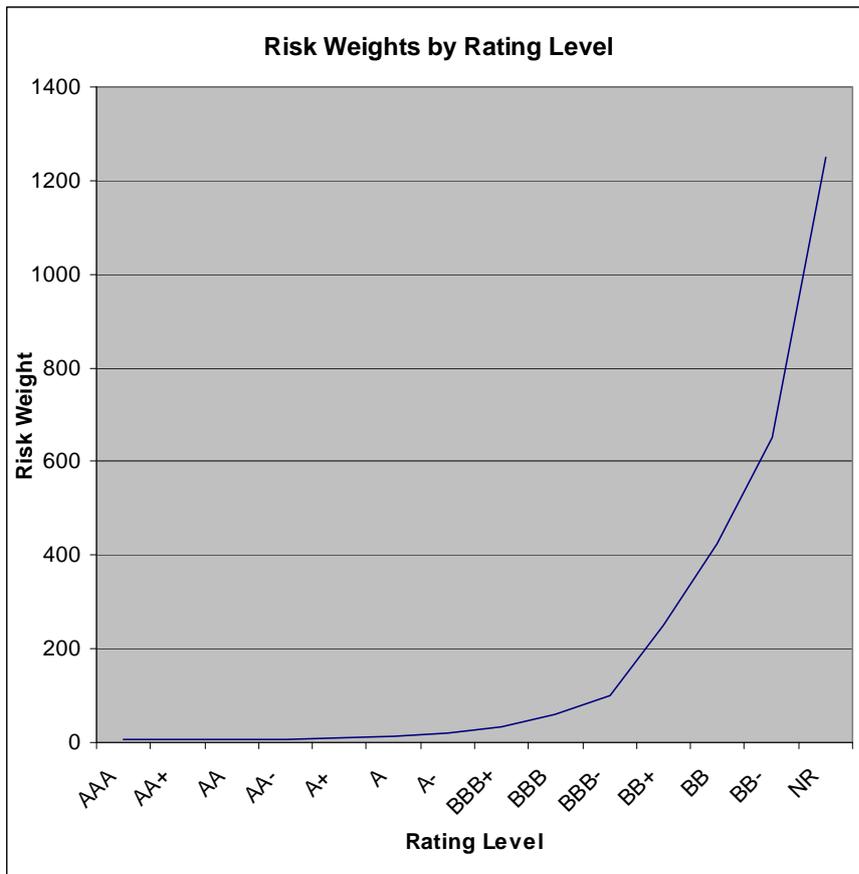
ANNEX D

Ratings-weighted retention

1. There have been proposals by the industry that an approach similar to that outlined in Annex C be used, but with a crucial variation. It is suggested that the 5% retained by the originator could be composed of any tranches within the capital structure, but that the weightings assigned to these different points in the capital structure (when making up the 5%) be related to the regulatory capital requirements of those particular tranches within the capital structure. This is in most respects identical to the proposal outlined in Annex C above, except that:
 - a) the different originator retention points are defined by the tranches of bonds issued and retained, not by the percentiles within the capital structure that are retained; and
 - b) the risk-weights for each tranche retained are driven by the ratings of such tranches, as opposed to being driven by a standardized risk-weighting curve.
2. The advantages of this approach are in most material respects identical to those outlined for the percentile-weighted curve in Annex C. However, one additional advantage is that the percentile-based curve had the weakness of defining retention in absolute terms, while the rating-based curve defines retention in relative terms. This is an advantage because the percentile-based curve would technically need a separate curve for each asset class (or even transaction) to make each form of retention equivalent, whereas the ratings-based curve should generate greater equivalence across asset classes and transactions with a single curve. As the risk weights are being calculated on a relative basis, it is attuned to the risk level of the transaction as a whole, as reflected in the overall ratings applied to different tranches in the transaction.

3. Unfortunately, this approach also leaves itself open to the potential for abuse and idiosyncratic risk. This is because the regulatory capital requirements for each tranche will be ratings-based, and to the extent that the ratings are subsequently found to be an inaccurate reflection of true credit risk (which could be the case not only for individual transactions or individual tranches, but also for entire asset classes), then the ratings-based amount retained by the originator could subsequently prove to be insufficient in providing alignment of interests with investors. However, in most cases in which this happens it is likely that the relative calculation method being used in this approach will mitigate this risk to some extent. In other words, misspecification in ratings will typically (but not always) arise due to poor estimation of credit risk in the underlying assets, an event that should also typically (but will not always) impact almost all tranches issued in the transaction. Hence the calculation of risk on a relative basis will still hold, although the weight of these relative factors may shift somewhat (and may not shift symmetrically across all tranches of the bonds issued).
4. This methodology is also subject to the same weaknesses outlined for the approach under Annex C (originators could decide to hold different points of the capital structure depending on the different asset classes being securitised and the different structures within which such assets are securitised), but to an even greater extent (originators could potentially exploit and arbitrage discrepancies in ratings approaches).
5. If a ratings-based curve methodology is pursued, then the risk-weighted retention percentage required would have to be more precisely quantified, but is likely to be substantially higher than the absolute retention amount (for instance, 30%-40% risk-weighted retention, for illustrative purposes, as opposed to 5% absolute retention).

6. This approach is illustrated in the graph below.



ANNEX E

Relevant questions to CEBS in the Call for Advice.

1. Is the minimum level of the retention requirement of 5% adequate to avoid misaligned incentives and to mitigate systemic risks from securitisation markets going forward or is an increase of the percentage needed?
2. Are the circumstances under which this retention requirement is met (detailed in paragraphs 1 to 3 of Article 122a) conducive to meeting the objectives of the retention requirement? More specifically:
 - a. Can they prevent securitisation transactions being structured in such a way as to avoid the application of the retention requirement, in particular through any fee or premium structure or both?
 - b. Can letters a) to d) in paragraph 1 be considered equivalent in avoiding misaligned incentives, in particular considering the possibility for the issuer to receive payback on his exposure through fees or other means of the securitised assets in an early phase of the life of a securitisation?
3. The extent to which the alternative choices as to what constitutes a 5% retention – and in particular option c)...undermines the alignment of interests between investors and originators/sponsors via the exemption that this option c) provides from exposure of the originator to the securitisation structure itself.

In addition, to the points raised in the second letter, the Commission asked CEBS to focus on the following very specific issues:

- a) The extent to which the alternative choices as to what constitutes a 5 per cent retention and in particular option c)

article 122a, clause 1 of the text adopted on 5th May – undermines the alignment of interests between investors and originators/ sponsors via the exemption that this option c) provides from the exposure of the originator to the securitisation structure itself.

- b) The option included for the retention to be held by any subsidiary of a financial holding company that is securitising assets of a number of originators: This option has not been made conditional on a stipulation by the retaining entity within the holding company confirming that it is and will continue to be held for the ultimate account and risk of the holding company or of the originator, sponsor or original lender. In those circumstances what are the implications for the alignment of incentives with the ultimate investors?
- c) The extent to which the alignment of incentives is weakened and/or capable of being “gamed” by the extent of the other exemptions listed in Article 122a.2 of the amended text adopted on 6th May.