Wholesale Risk

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VIA EMAIL

Dear Mr Corcostegui,

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

Lloyds Banking Group (LBG) welcomes the opportunity to comment on the proposed implementation of Article 122a, in order to equate these requirements with the business practicalities to which they will be applied.

LBG is the largest retail bank in the UK with a number of leading market positions. We are actively supporting the UK's economic recovery by lending to our business and mortgage customers. During the first half of this year the Group extended £14.9 billion of gross new mortgages to UK homeowners (including £2.5 billion in new lending to first-time buyers), and £23.7 billion of committed gross lending to UK businesses (of which £5.7 billion was for SMEs).

Please treat this feedback as confidential

Our responses to the direct questions of CP40 are below. However, in summary our major concerns are as follows:

1. The high risk weights proposed for the failure to meet disclosure or retention requirements will have a material negative impact on the revival of the securitisation market. Investors are demonstrating a reluctance to invest into a market in which such large and potentially volatile RWA requirements could easily be incurred.

2. Article 122a has clearly been drafted with reference to term securitisations. Hence it is difficult to see how the vocabulary, structures, and processes apply to Asset Backed Commercial Paper (ABCP) conduits which are structured in a very different way. To allow the ABCP business to remain viable, and to allow ABCP to continue to play its current important role in the funding of Banks' balance sheets, we request that CEBS is practical and flexible in its interpretation when applied to ABCP.

Responses to CP40 questions

We have restricted our response to those questions which are most relevant to LBG's operations in the securitisation market.

Question 1: Do you agree with this differentiation between the requirements of credit institutions when "investing" (leading to the applicability of Paragraphs 1, 4, and both sub-paragraphs of 5) as opposed to

the lesser requirements when assuming "exposure" but not "investing" (leading to applicability of Paragraph 1 and sub-paragraph 2 of Paragraph 5)?

Yes this seems sensible.

We would however note that while Article 122a states that Paragraphs 6&7 applies to sponsors, sponsors do not typically undertake the credit approval process in respect of the exposures which they sponsor into conduits.

In ABCP transactions the credit risk of the underlying assets is usually subject to protection, provided by the bank administering the programme. The bank administering the programme is referred to as the "sponsor". This protection may be in the form of a programme-wide or transaction-specific standby letter of credit. The sponsor therefore would be exposed to the credit risk of a securitisation position to the extent of the letter of credit. Alternatively, in some programs credit support is provided by 100% "fully supported" liquidity. It seems to us to be unnecessary that the sponsor in these circumstances should also be required to meet the retention requirements set out in (a) to (d) of paragraph 1, as the sponsor is already supporting the transaction.

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

We agree with the differentiation.

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

We agree with the differentiation.

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

We believe that this should be applied so that the provision of 100% liquidity and/or program wide support being provided to ABCP conduits, are considered adequate retention methods. These represent greater commitments than options a-d. It is virtually impossible to apply options a-d to ABCP vehicles. This should automatically satisfy the Paragraph 1 requirements, as in relation to the ABCP it is similar to a first loss tranche, and so should qualify under option (d).

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

This goes beyond the requirements and our understanding of the intention of the CRD for reasons unknown to us. Usually the costs of restructuring a vehicle would be prohibitive, but so long as sufficient risk is appropriately retained, it is difficult to understand why the means of compliance would be restricted.

Question 6: Should the definition of "net economic interest" in terms of "nominal" exposure be interpreted to mean that both excess spread tranches (i.e. where only residual interest cash flows are sold) and interest-only tranches (i.e. where all interest cashflows are sold) be excluded from the various means of fulfilling the retention requirement (as both have notional rather than nominal values), or should either be a valid means of fulfilling the retention requirement? If the retention requirement were allowed to be

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fulfilled by retention of a tranche with no principal component (for instance, an excess spread tranche or an interest-only tranche), how would the retention percentage be computed – with reference to the notional value, market value, or otherwise?

Excess spread and interest only tranches represent commitment for originators so these would be appropriate means of meeting the retention requirement. Some local regulators require that these are considered 'retained' when assessing significant risk transfer. This is taken as an indication that the risk has been transferred from the balance sheet of the bank.

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

We agree that the retention requirement should not be subject to credit risk mitigation, short positions or any other hedge and we would support the methods of indirect hedging described in the paper.

Also, in securitisations of trade receivables, originators commonly absorb losses by purchasing external credit insurance (mainly to achieve off-balance sheet treatment). We do not believe that this practice is contrary to the intention of Article 122a, as it is part of the normal operating business insurance that a non-bank originator would take out. Confirmation is sought in the guidance that such insurance is not treated as a "hedge" of the underlying exposures, but is instead a legitimate and prudent part of insuring an operating business.

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

It is agreed that this should be considered to meet the requirement under option (a) because this would constitute an overall 5% economic interest in the securitised loans.

For conduits funding receivables transactions, the first loss is taken by the seller/originator through the deferred purchase price they receive when selling the receivables to the conduit. As outlined above, investors get the benefit of both the seller's first loss piece, 100% liquidity support and, in some cases, program-wide Letter Of Credit support.

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

We agree with the interpretation described in paragraph 37 concluding that option (b) should apply equally to revolving exposures and revolving securitisations of non-revolving exposures. Again, this results in the originator having retained risk in the originated loans. There is no reduction in risk held due to the non-revolving nature of the vehicle.

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

We believe that the committee's view that multiple retention restriction is not extended to re-securitisations is incorrect.

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

The intention of the text is to ensure that reckless credit granting does not lead to poor credit quality notes. This is addressed by retention occurring at the credit granting stage as required by Article 122a. To require retention beyond this stage serves no useful purpose to the investors or the economy.

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

We agree with paragraph 51 of the guidance that the retained positions should be able to be used as collateral for secured funding purposes.

With respect to repo agreements in which the repo takes the legal form of a title transfer, these agreements are structured so that the transferor of the securities retains the economic risk associated with the securities and as such we believe that the retention requirement should be satisfied, where the exposures are sold to a third party under a TBMA/ISMA Global Master repurchase agreement or similar bespoke repo agreement.

Whilst the third party may indeed default and fail to transfer back equivalent securities at the end of the term of the repo, the assumption of this counterparty risk by the transferor is consistent with retaining the originator's interest in the securitised exposures, as in the normal course of events the counterparty will transfer back the securities. Any exposure is subject to counterparty credit risk and we do not think this impairs the nature of the retention.

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

The proposed Risk Weights seem to go far beyond the requirements of Article 122a. Any mapping of specific risk-weights to this type of breach should have been incorporated into the legislation if this was the intention of the text.

The intention was rather to give an indicative guideline of what level of additional requirement might be suitable. It also specifically recommended that the national supervisor take responsibility for quantification and states that the increase in risk weight should be proportionate.

Article 122a states: "Member States shall ensure that the competent authorities impose a **proportionate** additional risk weight of no less than 250 % of the risk weight … and shall **progressively increase** the risk weight **with each subsequent** infringement." This implies that increases in risk weight from 250% would apply to *further infringements",* not the nature of the infringement itself.

It is a core principle of the Basel Securitisation rules, that the capital required for securitised assets should not exceed the capital required if the assets were not securitised. The CRD proposals do not appear to conform to this principle.

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

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Industry has already observed that a potentially disproportionate application of additional risk weights will deter bank investors from securitisation products, and also deter non-bank investors who may wish to sell positions on to banks in the secondary market. There is concern that breaches could happen unwittingly within well-run institutions who invest in our securitisations. Furthermore, as the penalties apply in the same way to breaches of ongoing monitoring requirements, investors could be potentially required to deduct from capital for positions they bought in full compliance with the rules, where the bonds are performing and there is no rating downgrade. That does not appear proportionate within the requirements of 122a.

In particular we would note that the wording in paragraph 84, that being in breach of "Ensuring disclosure by originator, sponsor or original lender of retention of net economic interest," directly contradicts Article 122a which states that the investor would only be in breach "if the requirements are not met in any material respect by *reason of the negligence or omission* of the credit institution".

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

Paragraph 6 of Article 122a refers to credit granting. In many cases a sponsor does not grant credit, hence there are no criteria to which it should adhere. For example, in ABCP transactions, the sponsor is financing large and diverse pools of assets which are originated by unconnected third parties (and may include trade receivables, autoloans etc.). The sponsor of an ABCP conduit does not actually undertake credit-granting in respect of the assets and does not hold the assets itself.

Paragraphs 94 and paragraph 95 require that sponsors should be aligning with the credit granting rules, whether they are credit granting or not hence asking more than is required. These paragraphs should be deleted.

With regard to due diligence undertaken by an ABCP Conduit sponsor on a seller's origination and collection processes, this will typically comprise of an initial on site visit to meet relevant personnel, review processes and obtain copies of documentation. This information will typically be refreshed on an annual basis. Additionally, in many cases a third party review of the securitisation data provided each day/week/month will be undertaken on an annual or six monthly basis. Clearly, the sponsor does not track or oversee the origination or collection of individual receivables. Rather it monitors performance of the overall portfolio and if there is any deterioration, makes additional specific enquiries as required in respect of the seller's operations.

Questions 20: Would disclosure templates that currently exist or are in the process of being prepared by trade associations, industry bodies, central banks, market participants or others fulfill these requirements on an adequate basis?

We believe that the investor reports proposed by the Central Banks and industry bodies should be considered adequate to meet the requirements of Article 122a, and hence compliance with these should be deemed compliance with Article 122a.

However we request CEBS provide guidance on how we can comply with the unspecified requirements on assets for which investor reporting has not been finalised from these bodies. As the central bank requirements have been undertaken with a comprehensive investigation into the asset types, we recommend that prescriptive details do not form a requirement until these have been finalised.

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

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Paragraph 109 of the guidance seems to indicate that for Substituting Transactions, the originator has to make the relevant retention disclosure now, prior to the assets being added or substituted after 2014. This is clearly beyond the requirements of Article 122a which states "Paragraphs 1 to 7 shall, **after 31 December 2014,** apply to existing securitisations where new underlying exposures are added or substituted after that date."

If paragraph 109 is correct, it seems to go against the allowances that were made to originators during the lobbying process behind 122a. We suggest that paragraph 109 of the guidance is deleted and the guidance makes clear that compliance is required only from 31st December 2014, for existing transactions where assets are added after 31st December 2010.

There are also particular problems for master trusts which issue series of ABS backed by the same underlying pool of credit cards with revolving balances. Each series is issued by a different SPV, and has different noteholders, but the asset pool remains the same until the master trust is wound down. As all noteholders should be treated equally for data provision purposes, the entire master trust should either be compliant with 122a or not.

We think that in the case of ABCP conduits, the guidance should say that where a new seller is added to a conduit, each existing seller into the conduit should not have to purchase 5% of risks it sold prior to 2014, but that only the newly added seller should have to meet the retention requirement.

As noted above, this letter sets out LBG's responses to the consultation, in respect of those questions which we believe to be most relevant to our operations. Separately, we have contributed to the response from AFME, whose conclusions we support.

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Yours sincerely

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