EGPR

PUBLIC HEARING ON ART. 122a of EU Directive 2006/48/EC

Paul Rich, Chair, CEBS Securitisation Task Force
Carlos Corcostegui, CEBS Secretariat
Gerard Breen, National expert and technical adviser to Chair

CEBS

Committee *of* European Banking Supervisors

Art 122a: Today's Agenda

- Welcome and introductory remarks;
- Background and context – how we got to where we are, what the Guidelines are intended to do, and what they do not do;
- Our overall approach to the Guidelines;
- A quick recap on the requirements of the Article 122a text;
- The CEBS Guidelines – key areas of consultation explained;
- Question time;
- Wrap-up and next steps.

Art 122a: Background and Context

- CRD2 negotiations, Article 122a, and were part of the Commission's response to market turmoil.
- Two Commission calls for advice (May and June 2009) to CEBS on the effectiveness of the retention requirement – advice delivered by CEBS 30 October 2009.
- Commission report to European Parliament and Council on impact of Article 122a – issued 28 May 2010.
- CRD2 text requires CEBS to produce Guidelines on Art 122a - issued for consultation on 1 July 2010.
- Other developments – domestic transposition of CRD2.

Art 122a: Approach to the Guidelines

The Guidelines:

- Seek to clarify or elaborate the directive text;
- Achieve convergence of supervisory practices;
- Reinforce the risk management disciplines which institutions should maintain generally;
- Encourage market participants to find solutions;
- Are generic enough to fit transaction structures across member jurisdictions.

but

- Do <u>not</u> mention every specific structure, asset class or exposure type;
- Only deal with Art 122a itself;

and

- Must respect the directive text itself (cannot 're-write' it).

Art 122a: A Quick Recap of Article 122a

Retention:

- A credit institution shall only be exposed to the credit risk of a securitisation if the originator, sponsor or original lender retains a material net economic interest of not less than 5%.

Due diligence:

- By investors: before investing and on an ongoing basis thereafter.

- By sponsors and originators: must apply sound and well-defined criteria for credit-granting of the underlying exposures/loans.

Transparency:

- Originators to ensure sufficient information available to investors.

Additional risk weights:

- For non-compliance with the requirements.

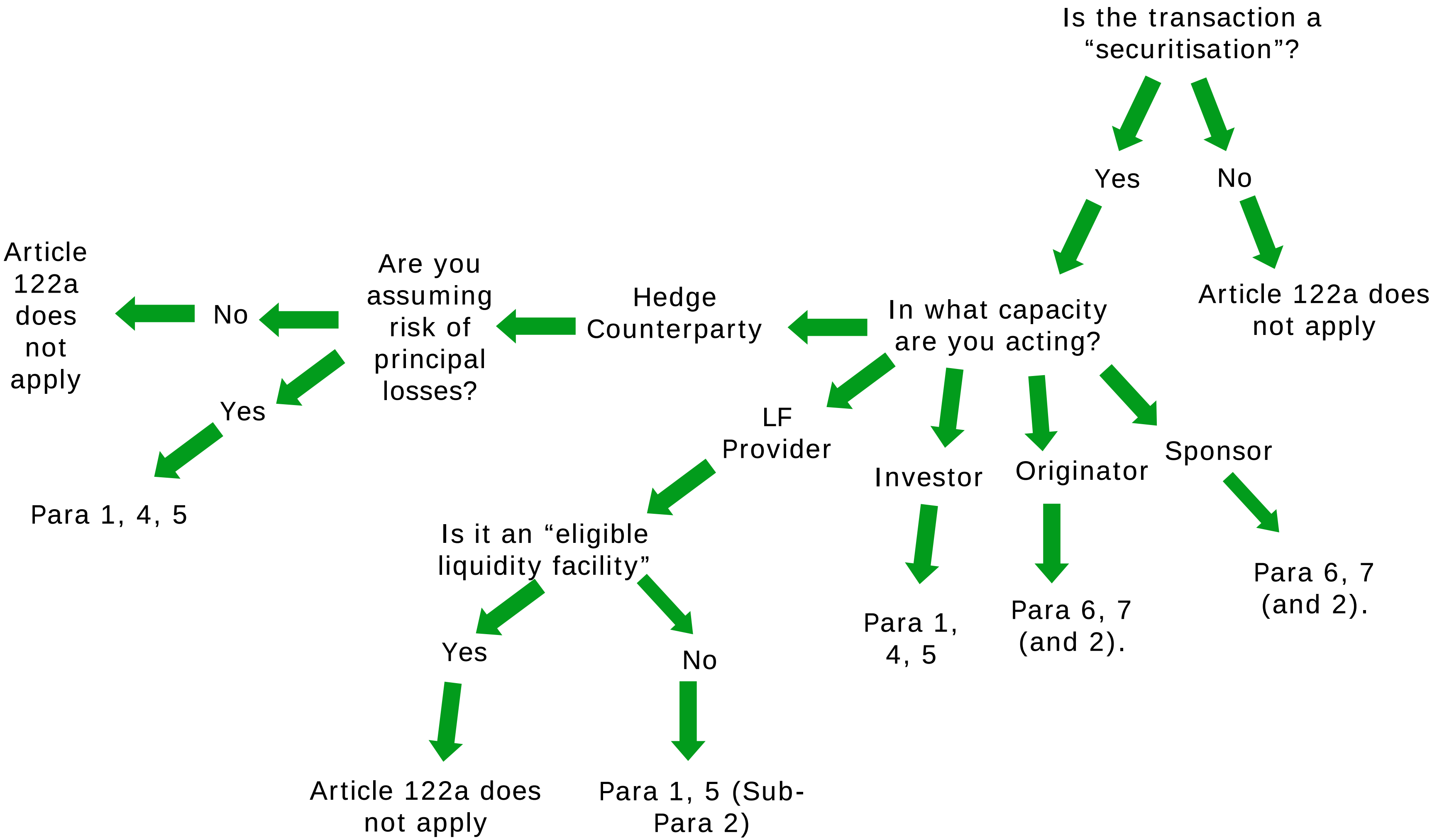
Art 122a: An Overview of Scope

- What?
  - Applies to all securitisations under CRD definition.
  - Certain exclusions listed in Paragraph 3 of article.
  - Other clarifications provided in guidance (certain types of covered bond, e.g. Spanish multi-cedulas, where retention requirements are “automatically met”).
- Who?
  - The positioning of Art 122a within 2006/48/EC; it applies to credit institutions but not to investment firms per se.
  - Potential roles defined/captured by Article 122a include: originator, sponsor, original lender, investor, and others with exposure to credit risk (liquidity facility provider, derivative/hedge counterparty, etc).
- When?
  - Applies to new securitisations on or after 1 January 2011.
  - Applies to existing securitisations after 31 December 2014 where new underlying exposures are added or substituted.
- Where?
  - Domestic transposition of the requirements for local implementation.
- How?
  - Requirements are covered by consolidated supervision.

Art 122a: An Overview of Scope

	Para 1 (All)	Para 4 (All)	Para 5 (Sub-Para 1)	Para 5 (Sub-Para 2)	Para 6 (All)	Para 7 (All)
Summary requirement:	Confirm retention	Analyze, understand, stress-test	Monitor	Understand structural features	Same criteria for securitised and retained exposures	Provide sufficient disclosure and information
Applies to:	Credit institution assuming "exposure" to credit risk (including when "investing")	Credit institution when "investing" only	Credit institution when "investing" only	Credit institution assuming "exposure" to credit risk (including when "investing")	Credit institution as "sponsor" or "originator"	Credit Institution as "sponsor" or "originator"
Would typically apply to credit institutions in role as:	Investor; liquidity facility provider; derivative/hedge counterparty assuming risk arising from principal losses	Investor; derivative/hedge counterparty assuming risk arising from principal losses	Investor; derivative/hedge counterparty assuming risk arising from principal losses	Investor; liquidity facility provider; derivative/hedge counterparty assuming risk arising from principal losses	Sponsor, originator	Sponsor, originator
Would typically not apply to credit institutions in role as:	Derivative/hedge counterparty not assuming risk arising from principal losses	Eligible liquidity facility provider; derivative/hedge counterparty not assuming risk arising from principal losses	Eligible liquidity facility provider; derivative/hedge counterparty not assuming risk arising from principal losses	Derivative/hedge counterparty not assuming risk arising from principal losses	All other roles	All other roles

Art 122a: Is A Transaction Captured: Sample Decision Trees



Art 122a: Types of Retention: Underlying Text

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;

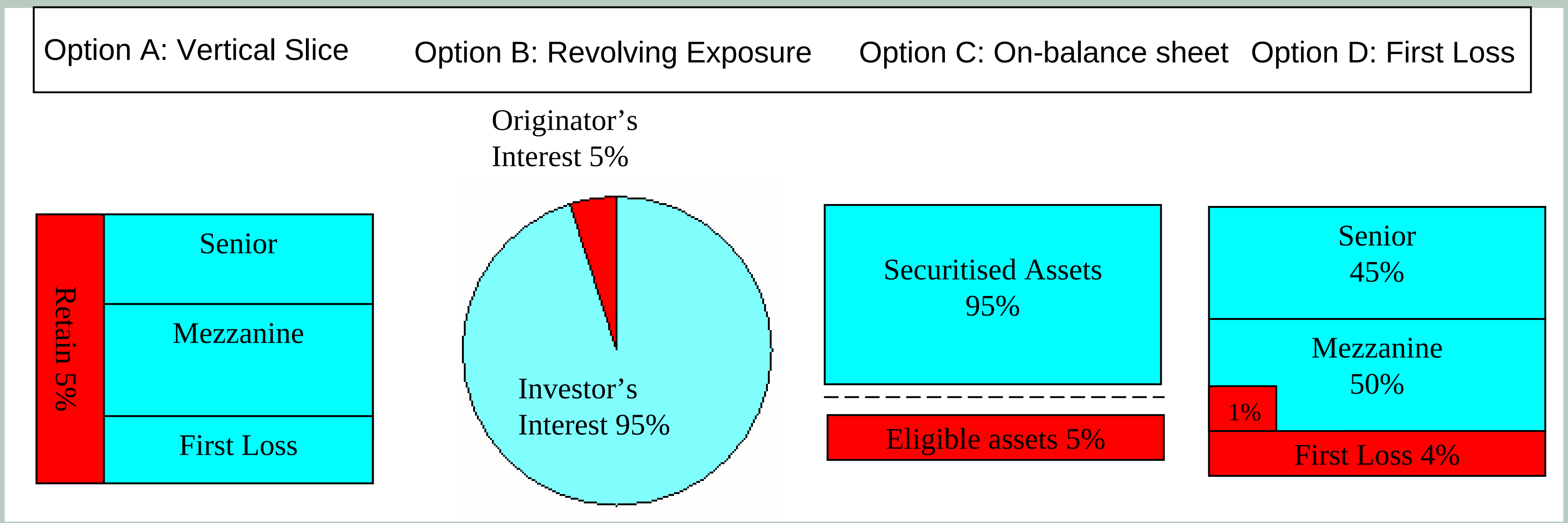
c) Retention of randomly selected exposures, equivalent to no less than 5% of the nominal amount of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is no less than 100 at origination; 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.

Art 122a: Types of Retention: Examples

Examples:

- Option A: Not currently common practice;
- Option B: Credit Card master trusts, RMBS master trust;
- Option C: Most lenders with “originate-and-distribute” business models;
- Option D: Certain auto ABS, CDOs/CLOs, stand-alone RMBS.



Art 122a: Types of Retention: Feedback Sought

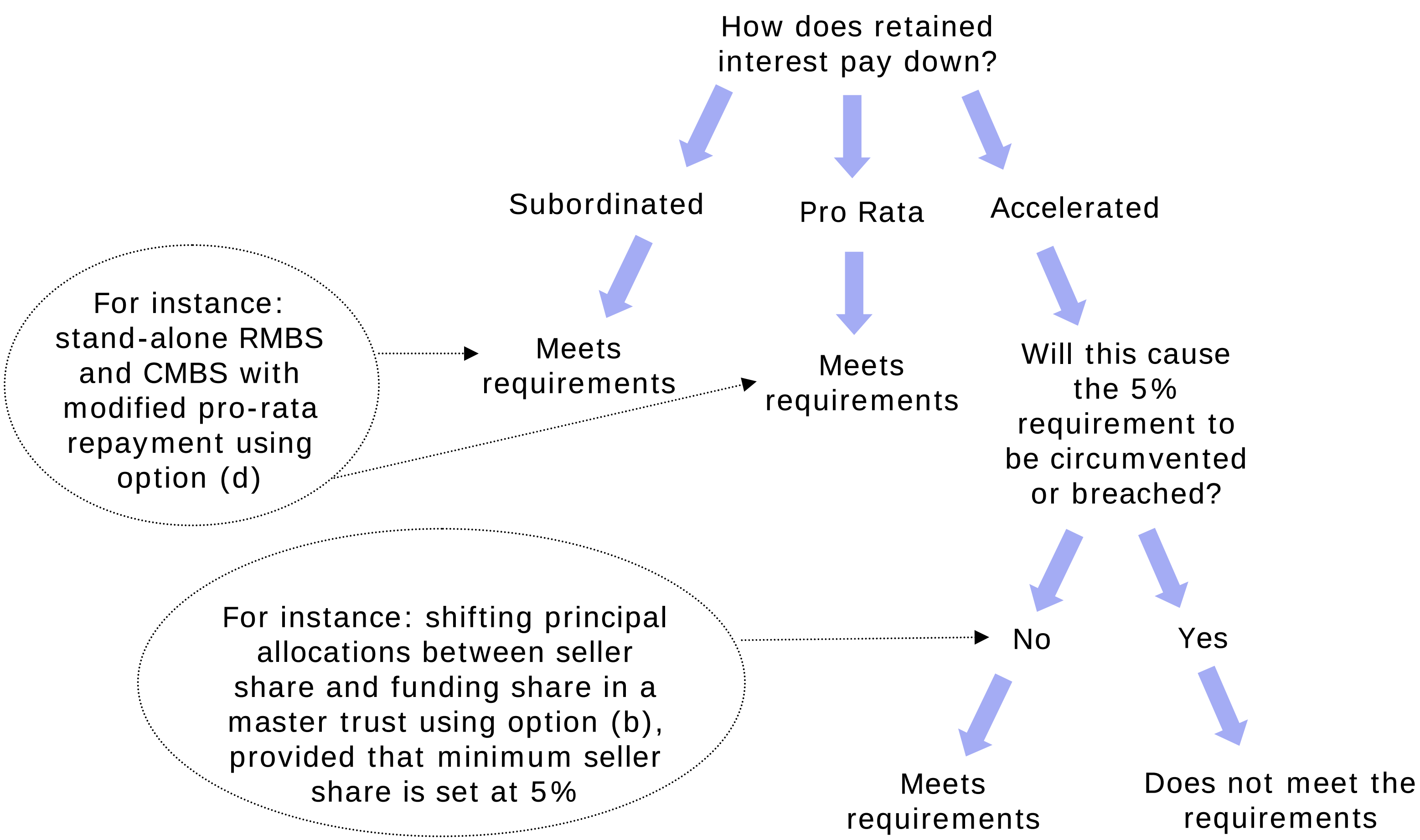
Feedback is sought on:

- Vertical slice retention is interpreted to be fulfilled by retaining 5% of each securitised exposures (e.g. 5% of each individual loan), not just 5% of each tranche.
  - For instance, where a portion of the loan entering a CMBS transaction is retained.
- Originator interest retention is interpreted to be applicable to both securitisations of revolving exposures and revolving securitisations of non-revolving and revolving exposures.
  - For instance, this would capture both credit card master trusts (revolving exposures) and mortgage master trusts (revolving securitisations).
- What is the most effective means to ensure the commitment of the originator, sponsor or original lender is enforceable by credit institutions as investors? Will market solutions prevail or is further regulatory intervention required?

Art 122a: Measuring/Managing the Retained Interest

- Measurement of retention is "at origination" i.e. when exposures were first securitised, not when loans were first extended.
- 5% is a "point in time" number; dynamic re-measurement and re-adjustment is not required.
- Where retention is a first loss tranche, do not need to replenish it as losses are allocated to it.
- There should be no embedded mechanisms by which the retained interest pays down faster than the transferred interest, such that the retention requirement is no longer fulfilled.
  - For instance, retained interest may pay down on a time-subordinated or pro rata basis, but may not on an accelerated basis ahead of investors such that the requirements are circumvented or breached.
- If there are multiple originators/lenders, retention must be fulfilled either by each discretely (as % of total securitised exposures), or by the sponsor of the securitisation. It cannot be fulfilled by one originator/lender on behalf of all others.
  - – Would this have a larger impact on specific asset classes; for instance, CLOs and conduit CMBS?

Art 122a: Measuring/Managing the Retained Interest



Art 122a: Changing the Retained Interest

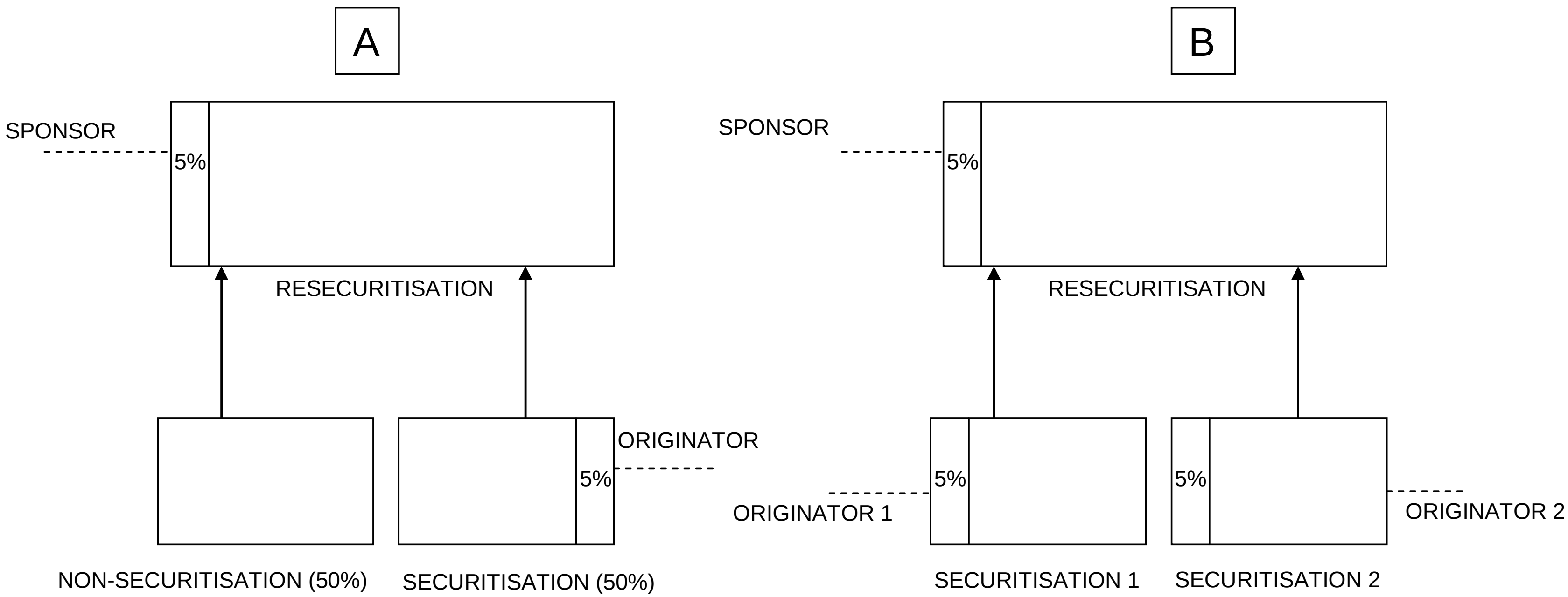
- Form of retention cannot change except under exceptional circumstances (e.g. re-structuring); it must then be disclosed to investors.
  - Investors must have certainty as to alignment of incentives.
  - However, it is undesirable that the retention requirements are sufficiently inflexible that they impede work-out situations.
  - For instance, a sponsor or originator could hypothetically agree to change its form of interest in a securitisation (for instance, from pro-rata to first loss) as part of an overall work-out or restructuring agreement with bondholders of the SPV.
  - If the retention requirements did not allow such changes in the retained interest, would it impede mitigation of credit risk for investors via orderly restructuring?

Art 122a: Multiple Retention: In Theory

- Art 122a text: “There shall be no multiple applications of the retention requirement”
  - Means no multiple retention required by individual parties or individual SPVs, but there may be multiple application at the overall transaction level (e.g. a re-securitisation of existing securitisations, where the underlying securitisations have existing investors).
- For an investor in a re-securitisation, the retention requirement would apply only to the second (“repackaged”) layer of the transaction, in which they are investing.
- Sponsor or originator of a re-securitisation has duty to ensure underlying securitisations fulfil retention and to disclose this to investors in the re-securitisation.
- Credit institutions should be particularly sensitive to the use of SPVs/structures created with intention of avoiding the underlying economic substance of the retention requirement.

Art 122a: Multiple Retention: In Practice

Retention Requirement with Resecuritisation: Transaction Examples



EFFECTIVE RETENTION OF ASSETS THAT ARE SECURITISATIONS:

MIN RETENTION BY SPV : 5%

MIN RETENTION BY PARTY : 5%

MIN RETENTION BY TRANSACTION : 7.375%

EFFECTIVE RETENTION OF ASSETS THAT ARE SECURITISATIONS:

MIN RETENTION BY SPV : 5%

MIN RETENTION BY PARTY : 5%

MIN RETENTION BY TRANSACTION : 9.75%

Art 122a: Hedging: Finding an Equilibrium

- Art 122a text: "The retention requirement should not be subject to any credit risk mitigation or any short positions or any other hedge."

  interpreted to mean

- Disallow hedging that eliminates a sponsor's, originator's or original lender's exposure to the credit quality of the specific exposures that have been securitised;

  but balanced with

- Ensuring that sponsors, originators and original lenders still have sufficient flexibility to risk-manage their exposure to broad-based or systemic changes in the credit quality of the asset classes, collateral, or macroeconomic variables to which they are exposed.

  and

- Need to ensure application at group level does not lead to arbitrage.

Art 122a: Hedging: Permissible and Non-Permissible Types

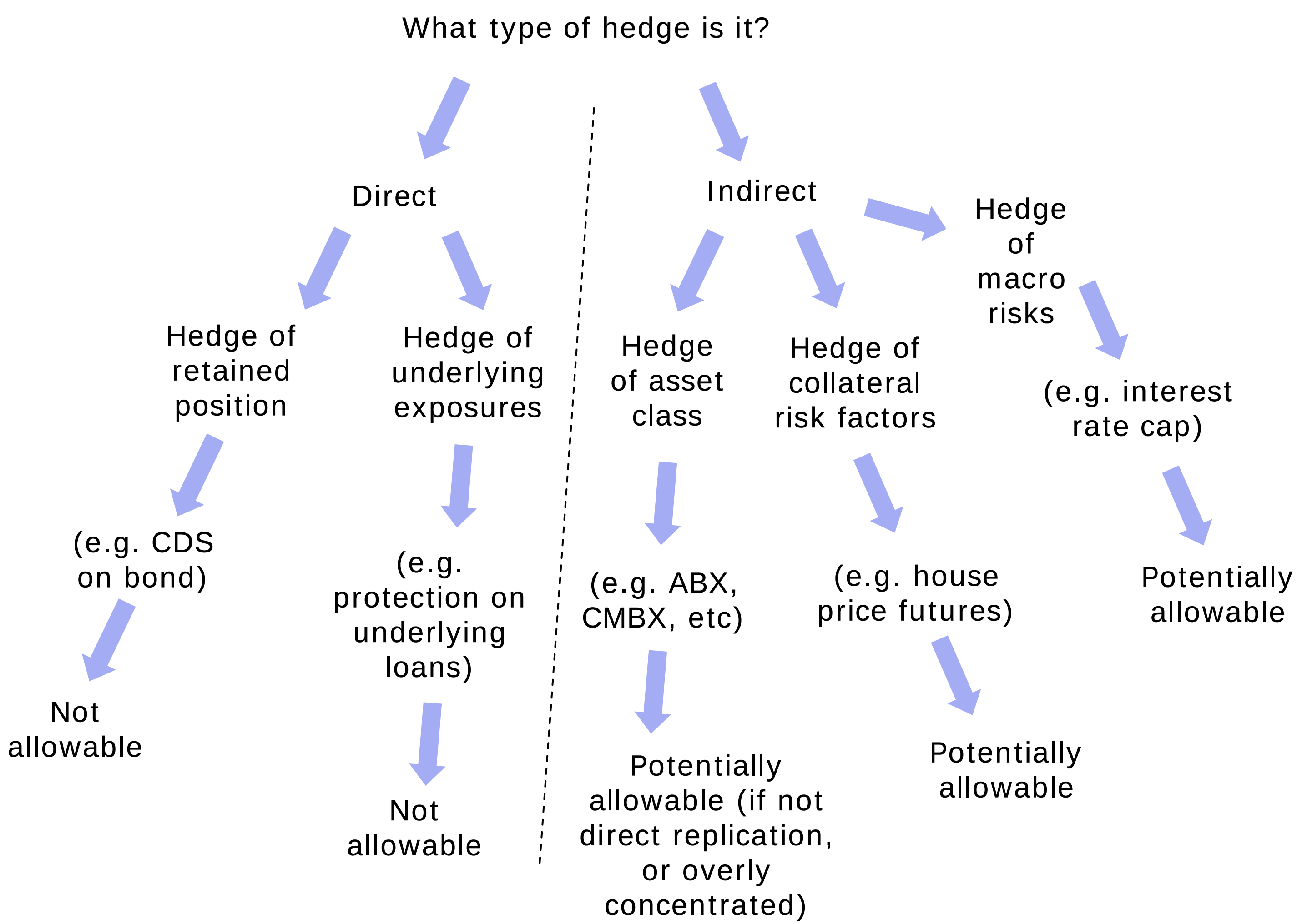
The following types of hedge are **not** permissible:

- Direct hedge on the credit risk of the retained securitisation positions.
  - For instance, cannot buy CDS protection on the retained position.
- Direct hedge on the securitised exposures.
  - For instance, cannot buy protection on the underlying loans.

The following types of hedge **may potentially be** permissible (**subject to consultation**):

- Hedge based on an index which contains the same underlying asset classes.
  - For instance, can buy protection via CMBX, ABX, LCDX, etc.
  - Provided reference exposures in index do not replicate exactly, or are not overly concentrated in, the securitised exposures subject to the retention requirement.
- Hedge on risk factors that could impact default, loss and recovery rates of the underlying collateral.
  - For instance, can have short positions in house price futures.
- Hedge on macroeconomic variables potentially impacting performance the securitised exposures.
  - For instance, can purchase an interest rate cap if interest rate increases would adversely impact payment ability of borrowers.

Art 122a: Hedging: Permissible and Non-Permissible Types



Art 122a: Hedging: Feedback Sought

Feedback is sought on:

- Evidence on types of hedging that could be allowed, and those that should be disallowed, in fulfilling the objectives of Article 122a regarding alignment of interest.

Art 122a: Due Diligence (Investors): Before Investing

Due diligence <u>before</u> investing (7 requirements):

- Information on the retained interest.
  - As outlined above.
- Risk characteristics of the securitisation position.
  - Interpretation: Tranche seniority level, tranche cash flow profile, rating, historical performance of similar tranches, bond covenants, credit enhancement, etc.
- Risk characteristics of the underlying exposures.
  - Interpretation: Guidance links this to ongoing surveillance requirements (paragraph 5), which include delinquency rates, default rates, prepayment rates, loans in foreclosure, occupancy status, credit scores, industry and geographical diversification, LTV ratios, etc.
- Reputation and loss experience of the originator or sponsor in earlier securitisations.
- Statements/disclosures of originators/sponsors (or agents/advisors) about due diligence on the securitised exposures and collateral.
- Methodologies underlying valuation of the collateral; policies that ensure independence of the valuer.
- Material structural features of the securitisation.
  - Interpretation: Waterfalls, triggers, swaps, liquidity facilities, reserve accounts, sponsor support mechanisms, etc.

Art 122a: Due Diligence (Investors): After Investing

Surveillance <u>after</u> investing:

- Performance information on exposures underlying securitisation positions.
  - As outlined above ("before investing"), i.e. delinquency rates, default rates, LTV bands, etc.
- For re-securitisations, must have performance information on underlying tranches and also "look through" to the assets underlying these tranches.
- Must have thorough understanding of all structural features that could materially impact performance: waterfall, triggers, credit enhancement, liquidity enhancement, market value triggers, definition of default, etc.
  - Similar to that outlined above ("before investing").

General principle:

- Should <u>not</u> invest in securitisations where you do <u>not</u> have, and/or will <u>not</u> be able to receive, adequate information to undertake due diligence, and must undertake such due diligence.

Art 122a: Due Diligence (Investors): Information Availability?

- To what extent can these requirements already be met using information sourced from the following?
  - Offering circular, including waterfall, forms of credit enhancement, counterparties, triggers, swaps, liquidity facility, lender's underwriting policies, stratification tables, etc.
  - Investor reports for the transaction, including stratification tables, performance data, trigger breaches, counterparty ratings, etc.
  - Investor report for prior transactions of the same originator, demonstrating their performance.
  - Indicative bond information source from various applications (Bloomberg, ABSNet, ABSXchange, Intex, Trepp, etc).
  - Research sources (sell-side, rating agencies, etc) providing performance information on originator or asset class in general.
- Would the following be possible exceptions or hurdles?
  - Must understand policies to ensure "independence of the valuer" of the collateral?
  - Must be able to look through to the assets of a resecuritisation?
  - Should disclosure of retained interest be embedded in investor reports?

Art 122a: Due Diligence (Investors): Trading vs Non-Trading

- As a general principle, the same policies and procedures should be applied to positions in trading and non-trading books.
- However, can distinguish between the trading and non-trading book as long as it is appropriate and can be justified.
  - Classification that a position is in the trading book is <u>not</u> sufficient justification in itself.
  - Differentiation must be due to an observable distinction in the risk profile.
- For example, a distinction could be made between the following holdings:
  - In trading book - Multiple small positions, high level of turnover, robust size/controls/ageing limits; compared to
  - In non-trading book - Large concentrated position, held-to-maturity.
- If circumstances change (e.g. turnover or price transparency of trading book deteriorate), should trigger commensurate change in due diligence.
- While analysis may be different, it should meet the minimum threshold requirements whether in trading or non-trading book (trading book requirements are <u>not</u> a “subset” of non-trading book requirements).
  - Example: In ensuring “the independence of the valuer” of collateral, fulfilling this requirement could potentially differ for the trading and non-trading books.
  - Counter-example: In analysing “the reputation and loss experience in earlier securitisations of the originators or sponsors”, this is unlikely to differ for trading and non-trading books.

Art 122a: Due Diligence (Investors): Reliance on Third-Parties

- When a credit institution is relying on financial models developed by an ECAI, it must be actively running such a model itself (e.g. ability to change inputs and stresses), and not just relying on the output of the model as provided by the ECAI (e.g. just relying on the rating).
- Credit institutions may use financial models other than those of ECAIs, such as financial models developed by professional services firms or financial technology vendors. Some brought to our attention include (non-exhaustive list):
  - Intex;
  - ABSXchange;
  - Bloomberg;
  - Trepp;
  - Etc.

Art 122a: Due Diligence (Sponsors/Originators): Securitisation

- Art 122a text: "Sponsor and originator credit institutions shall apply the same sound and well-defined criteria for credit-granting [...] to exposures to be securitised as they apply to exposures to be held on their book."
- Objective is interpreted as follows:
  - To ensure that securitised exposures are not substandard in the process of underwriting;
  - But not to homogenise lending standards beyond the point of flexibility.
- Objective is not interpreted as follows:
  - Does not mean borrower types or loan products for all securitised and non-securitised exposures must be the same;
  - Does not mean underwriting criteria must be identical in all respects, but that both should benefit from sound and well-defined criteria;
  - Does not mean underwriting criteria must be identical across all subsidiaries or lending entities, but that each should apply sound and well-defined criteria whether for securitised or non-securitised exposures.
- What if the assets were originated by a lender unconnected to the sponsor or originator of the securitisation?
  - Originator or sponsor should still seek all information necessary to perform sound due diligence on the exposures to be securitised, but information may inevitably be more limited.
- What if the sponsor is not an active lender in the types of exposures being securitised?
  - Sponsor should have sufficient understanding to assess, and undertake an assessment of, whether underwriting criteria of the exposures to be securitised are sound and well-defined.

Art 122a: Due Diligence (Sponsors/Originators): Underwriting

- Art 122a text: “Credit institutions shall also apply the same standards of analysis to participations or underwritings in securitisation issues purchased from third parties whether such participations or underwritings are to be held on their trading or non-trading book.”
- Guidance interprets this as follows:
  - When a credit institution is part of a syndicate or similar group underwriting the issuance of a securitisation (for instance, when such securitisation is backed by receivables purchased from a third party), such credit institution shall apply the same standards of analysis notwithstanding the purchased nature of the securitisations, and regardless of whether such securitisations are held in the trading versus non-trading book (and even if the duration of exposure is brief, e.g. during the underwriting period).
- Question:
  - Is this interpretation clear and unambiguous, or are there alternative interpretations possible or clarifications necessary?

Art 122a: Disclosure

- Art 122a requirement: Originators and sponsors shall provide investors information sufficient to stress-test cashflows and collateral values of the underlying exposures.
  - Guidance: If there are standardized reporting and disclosure templates generally accepted by market participants that fulfil these requirements, they can be used.
- Art 122 requirement: Sponsors and originators shall disclose the level of their retained interest.
  - Should also indicate which of options (a) through (d) was used in retaining such interest.
  - Should also disclose if the form of retention has changed due to exceptional circumstances (e.g. restructuring).
  - Do not have to provide further information on the retained interest, such as market value, impairments, etc.
  - Disclosure should be public unless not appropriate (e.g. private transaction), but oral disclosure is not adequate.
  - Disclosure is at origination, and reconfirmed with same frequency as transaction reporting (minimum annually).
- The term “individual underlying exposures”, typically means data should be provided on an individual loan basis, as opposed to on a collective basis.
- “Readily available” means gaining access to the information should not be overly prohibitive (accessibility, usage, cost, etc).
- Disclosure need not extend to information that would breach other legal or regulatory requirements (e.g. market abuse and confidentiality restrictions).
  - Would this occur more in any specific asset class, e.g. leveraged loans underlying CLOs?

Art 122a: Additional Risk Weights: RWA Additions

- To ensure harmonisation of additional risk weights for breach of Article 122a, the Guidance has provided a common framework for implementation at the national level.
- Additional risk weights must be not less than 250% of the risk weight that could otherwise apply.
- Additional risk weights are capped at 1250%.
  - This could result in the overall capital required to be held against a securitisation position exceeding the exposure value of the relevant securitisation position, but
  - Guidance interpretation: the cumulative result of such additional risk weights should not have capital required to be held against a securitisation position exceeding the exposure value of that position.

Requirement	
Ensuring disclosure by originator, sponsor, or original lender of retention of net economic interest	1000%
Stress-testing of securitisation positions	500%
Understanding, analyzing, and recording:	
Risk characteristics of individual securitisation positions	250%
Risk characteristics of underlying exposures	250%
Reputation and loss experience in earlier securitisations of originators and sponsors	250%
Statements and disclosures made by originators or sponsors about due diligence on exposures	250%
Methodologies for valuation of collateral supporting the securitisation	250%
Structural features of the securitisation that can impact performance	250%
Monitor the ongoing performance of securitization positions	750%

Art 122a: Additional Risk Weights: Worked Examples

Example 1

Failure to stress-test positions = 500%

Failure to understand, analyze, and record risk of individual positions = 250%

Total additional risk weight = 750%

assuming

Total required capital after additional risk weight <= Exposure value of position

Example 2

Failure to meet all due diligence requirements (6*250%) = 1500%

Failure to monitor performance of positions = 750%

Total additional risk weight = 2250%

but

Additional risk weighted would be capped at = 1250%

and

Total required capital after additional risk weight <= Exposure value of position

Art 122a: Additional Risk Weights: Types of Breach

- Breach of which provisions cause additional risk weights to be applied?

	Para 1 (All)	Para 4 (All)	Para 5 (Sub-Para 1)	Para 5 (Sub-Para 2)	Para 6 (All)	Para 7 (All)
Summary requirement:	Confirm retention	Analyze, understand, stress-test	Monitor	Understand structural features	Same criteria for securitised and retained exposures	Provide sufficient disclosure and information
Applies to:	Credit institution assuming "exposure" to credit risk (including when "investing")	Credit institution when "investing" only	Credit institution when "investing" only	Credit institution assuming "exposure" to credit risk (including when "investing")	Credit institution as "sponsor" or "originator"	Credit Institution as "sponsor" or "originator"
Do additional risk weights apply if breach of requirements?	Yes	Yes	Yes	Yes	No, specific sanctions within Para 6 apply instead (inclusion of securitised exposures in capital calculation)	Yes, additional risk weights are applied to the interest retained by the sponsor or originator

Art 122a: Additional Risk Weights: Approach to Application

- Could be applied to individual positions or multiple positions, depending on whether requirements are not met for an individual position or across a book or business line.
- Need not be permanent; could be lifted if breach is remediated.
- Trivial breaches corrected speedily should not penalized to an incommensurate extent.
- With recurrent infringements specifically of the due diligence requirements, additional risk weights should be doubled and applied for a minimum of 12 months.
- If the prior capital treatment equals (or for any reason exceeds) 1250%, instead disclose to market that breaches have occurred.
- Actions beyond control of the credit institution will not attract additional risk weights, nor will it have to dispose of such positions.
  - For instance, if an originator undertook to retain and then breached this undertaking, this would not necessarily trigger additional risk weights for the investor.

Art 122a: Questions from Attendees

Any questions on the Guidance?

Art 122a: Questions to Attendees

- There are 21 questions in the Guidance; responses are welcome on all of them.
- Selected questions:
  - It is specified that “retained positions, interest or exposures are not [...] sold”. Will it be possible for originators, sponsors or original lenders to use such retained interests for secured funding without having “sold” them, e.g. via repo under GMRA or a bespoke agreement?
  - Will credit institutions expect disclosure of the retained interest to be of a binding nature, providing some means of enforcement or redress should it be breached? What is the most effective means to ensure the commitment of the originator, sponsor or original lender is enforceable by credit institutions as investors? Will market solutions prevail or is further regulatory intervention required?
  - Should the definition of “net economic interest” in terms of “nominal” exposure be interpreted to mean that excess spread tranches (residual interest cashflows) and interest-only tranches (all interest cashflows) are not valid means of fulfilling the retention requirement? If retention were allowed via a tranche with no principal component, how would the retained percent (5%) be computed?

Art 122a: Next steps

Pre implementation

- Consultation period on Guidelines ends 1 October 2010.
- Member states must transpose CRD2 into domestic legislation by end October 2010.
- CEBS members to implement Guidelines domestically by the start of 31 December 2010, when CRD2 rules apply.
- Regulators to disclose methodology for reviewing compliance by 31 December 2010.

Post implementation

- Outcome of supervisory review and description of the measures imposed in cases of non-compliance on an annual basis from 31 December 2011.