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22 August 2013

Dear Sirs

Response to Consultation Paper EBA/CP/2013/14

We refer to the “*Consultation Paper on Draft Regulatory Technical Standards On the retention of net economic interest and other requirements relating to exposures to transferred credit risk (Articles 394, 395, 397 and 398) of Regulation (EU) No [xx/2013] and Draft Implementing Technical Standards Relating to the convergence of supervisory practices with regard to the implementation of additional risk weights (Article 396) of Regulation (EU) No [xx] of [xx/2013] (EBA/CP/2013/14)*” (the **Consultation Paper**) published by the European Banking Authority (the **EBA**) containing draft regulatory technical standards (the **RTS**) and implementing technical standards (the **ITS**) in relation to the risk retention requirements of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (the **CRR**).

We welcome the opportunity to comment on the proposals put forward in the Consultation Paper. We have set out below our responses to these proposals.

In addition to the responses set out in this letter, we would also like to note that we fully endorse the responses that you will have received separately from the Association for Financial Markets in Europe (**AFME**), and the Financial Markets Law Committee (**FMLC**).

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Response 1: Application of the RTS – definition of “securitisation”

We note that the purpose of the RTS as set out in Article 410 of the CRR is to “specify in greater detail” the requirements of Articles 405 to 409 of the CRR. However, we consider that in order to be able to establish when the requirements of Articles 405 to 409 apply to a transaction, further clarification is needed as to how the definition of “securitisation” will be applied.

The purpose of the risk retention provisions currently set out in Article 122a of Directive 2006/48/EC, which will be replaced by Articles 405 to 409 of the CRR on 1 January 2014, is to achieve “an alignment of interests between the parties respectively transferring and assuming the credit risk of the securitised exposures” (as per recital 7 of the RTS). The definition of securitisation is accordingly clearly intended to apply to situations where, firstly, credit risk is “transferred” away from the originator and, secondly, absent the risk retention requirements of Article 122a / Articles 405-409, the interests of the transferee and transferor of such exposure(s) would not be aligned.

However, without further clarification, the definition of “securitisation” *prima facie* catches transactions where there is no transfer of credit risk away from the originator and no misalignment of interests, and which the financial markets would not typically consider to be securitisation transactions.

By way of example, in a typical secured corporate or project financing, a special purpose entity issuer will issue several tranching classes of bonds. The proceeds of the issuance of these bonds are then lent to one or more borrower companies, which are typically operating companies, or companies holding project assets, in a corporate group. The proceeds may be used by the borrowers to repay existing debt, for general corporate purposes and/or for financing a specific project. The borrowers will repay the loans from the issuer from the revenues and profits generated from the day-to-day operations of the corporate group or from the operation of project assets. Each borrower will grant security for its obligations under the loans.

The market view of such transactions is that an investment in the bonds issued by the issuer does not constitute an exposure to a “securitisation position” under Articles 122a or 405.

Recital (50)¹ of the CRR and recital 7² of the RTS are helpful in indicating the concept or type of transactions which are not intended to fall within the risk retention provisions because there has been no transfer of credit risk away from the originator and no misalignment of interests.

We consider that more explicit guidance is required in order to provide certainty to market participants and in order to ensure that the CRR is interpreted uniformly by Member States.

In the case of recital 7 of the RTS, it would be helpful to note in the text that even if the “first recourse” is to an SPV rather than the “originator”, the use of an SPV issuer as a mere structural tool in a transaction does not prevent a transaction qualifying as a transaction “Where an entity securitises its own liabilities, and the originator is the final debtor in first recourse to the investor”; and, secondly, in addition to covered bonds, the examples of transactions where alignment of interests is established automatically, regardless of whether the final debtor collateralises its debt, should be expanded to include project bonds and structures for general lending to businesses, where the credit risk is considered to remain with the originator or the originator group.

In addition, whereas recital 7 of the RTS states that the risk retention requirement is not applicable to certain transactions where no misalignment of interests arises, Recital (50) of the CRR states categorically that a direct payment obligation for a transaction or scheme used to finance or operate physical assets should not be considered an exposure to a

¹ Recital (50) of the CRR states that:

“...An exposure that creates a direct payment obligation for a transaction or scheme used to finance or operate physical assets should not be considered an exposure to a securitisation, even if the transaction or scheme has payment obligations of different seniority.”

² Recital 7 of the RTS states that:

“... Where an entity securitises its own liabilities, and the originator is the final debtor in first recourse to the investor, such alignment of interests is established automatically, regardless of whether the final debtor collateralises its debt (for example when the liabilities take the form of covered bonds). In such cases it is clear that the credit risk remains with the originator throughout, so the retention of interest by the originator is unnecessary and would not improve on the pre-existing position.”

securitisation. Transactions falling under the exception in Recital (50) are intended, we assume, to fall outside the scope of all the provisions of the CRR relating to securitisations and not just Article 405, to which recital 7 of the RTS is restricted. There is no apparent reason for this distinction. It would be more accurate, and more in line with market practice, for recital 7 of the CRR to specifically state that where there is no misalignment of interests because the credit risk remains with the originator or the originator group, there is no “securitisation” for the purposes of the CRR.

We would suggest that an appropriate definition of “physical assets” should be included in the RTS. The reference in recital (50) of the CRR to “physical assets” is confusing. Consistent with the points made above, we believe that this reference is intended to, and should, encompass not only real estate and other items traditionally thought of as physical assets (trains, aeroplanes, minerals, plant, infrastructure etc.) but also the business or businesses of the company or group which is putting the transaction or scheme in place and to project bonds.

Response 2: Application of the RTS to existing transactions

The amendments to Directive 2006/48/EC which introduced the risk retention requirements of Article 122a included a “grandfathering” provision which provided that the new requirements would apply only to “new securitisations issued on or after 1 January 2011” and “after 31 December 2014, apply to existing securitisations where new underlying exposures are added or substituted after that date.”

The CRR, however, will apply from 1 January 2014 to “new securitisations issued on or after 1 January 2011” and “after 31 December 2014, apply to existing securitisations where new underlying exposures are added or substituted after that date.” No grandfathering is provided for and existing “securitisations” which have been structured so as to comply with the provisions of Article 122a, the CEBS Guidelines and the Q&A, will become non-compliant from 1 January 2014 where provisions of the CRR and the RTS differ from the existing law.

This will result in additional risk weightings being applied to such securitisation positions which are being held by “institutions” pursuant to Article 407 of the CRR. The securitisation transaction to which the institution is exposed will either need to be

restructured, or the institution will have to bear the additional risk weight or it will be forced to dispose of its investment. Such a forced disposal is unlikely to be on beneficial terms for the investing institution and will potentially create market instability. In this regard, it should be noted that restructuring a securitisation transaction can be a lengthy and costly process, and will not necessarily be an approach which an originator etc. is prepared to take given that the original transaction will already have been structured to take account of the risk retention rules as they then stood.

We note that it would be open to a competent authority to conclude that, in these circumstances, the requirements of Articles 405, 406 or 409 are not being met other than by reason of the negligence or omission of the institution, and therefore to abstain from imposing the additional risk weighting. This creates scope for uncertainty and potential for differences in application between Member States.

If the RTS as enacted result a significant change in the risk retention requirements (which we consider they would do if enacted in their current form), then it is essential that grandfathering provisions be made to protect the investors in existing transactions, who have complied in good faith with the law as it stands and the guidance published in relation to it.

We would also like to note that we specifically endorse the comments on this point which are set out in the AFME response.

Response 3: Responses to specific questions raised in the Consultation Paper

Questions 1 and 2:

In our experience, paragraphs 25 and 26 of the CEBS Guidelines have been extremely widely relied upon.

We consider that the guidance set out in paragraphs 25 and 26 of the CEBS Guidelines should be retained as it is clearly in the spirit of the legislation – allowing an entity whose interests are most optimally aligned with those of the investors but which may not fulfil the originator / sponsor / original lender definition to retain not only in transactions where there is no originator / sponsor / original lender but also where the interests of the actual originator / sponsor / original lender are not most optimally aligned with those of the investors.

Requiring the originator / sponsor / original lender to fulfil the retention requirements in these circumstances would clearly not align interests in the securitisation value chain.

In addition, if the guidance set out in paragraphs 25 and 26 of the CEBS Guidelines is not retained, then, as we note in Response 2 above, all securitisation transactions which have relied on these paragraphs in order to comply with the retention requirements under Article 122a, will (absent a restructuring) immediately cease to be compliant on 1 January 2014. Investors in these transactions will be forced to either bear the additional risk weight or dispose of their exposures.

By way of example, the following structure (or variants thereon) has been used by banks looking to deleverage and/or eventually exit the residential mortgage market:

- an orphan SPV (the *Purchaser*) is incorporated to purchase a portfolio of residential mortgages either directly or indirectly from the seller bank (the *Seller*) which is deleveraging and/or exiting the residential mortgage market;
- the Purchaser finances the purchase of the mortgage portfolio by issuing senior notes and junior notes (the *Phase 1 Notes*);
- the senior notes will be issued to a bank lender (the *Lender*) and the junior notes, which will be sized to equal no less than 5% of the nominal value of the securitised exposures, will be issued to an entity (the *Company A*), whose shares are held by the entities which are arranging the transaction (typically a private equity consortium);
- the Company A will have an independent board of directors, a business plan, and will have other interests in addition to its interest in this specific transaction;
- the Purchaser will refinance the senior and junior notes by way of a public note issuance (the *Phase 2 Notes*) secured on the mortgage portfolio; and
- Company A will purchase and hold the most junior tranche of the Phase 2 Notes, which will be sized to equal no less than 5% of the nominal value of the securitised exposures.

Each of the initial purchase of the mortgages and the refinancing may well constitute a “securitisation” within the definition used in the context of Article 122a/the CRR. In order to ensure that additional risk weightings are not applied to an investment in either the Phase 1 Notes or the Phase 2 Notes, the risk retention requirements need to be satisfied at both stages of the transaction.

In the current example, the Seller would be the entity typically thought of as the “originator” or “original lender”. However, the purpose of the transaction is to divest it of its interest in the assets. It would, therefore, clearly not be appropriate for the Seller to retain any of the notes or an interest in the underlying mortgages – not only will it not be prepared to do so, but its interests are in any case clearly not aligned with those of the investors.

In order to come within the definition of “sponsor” an entity must be a “credit institution” or, additionally under the CRR, an “investment firm”. None of the Purchaser, Company A or the private equity houses will, therefore, fall within this definition.

Company A would not fall within the definitions of “originator” or “sponsor”. Nor would it fall within the new definition of “original lender” set out in the RTS. However, as a company of substance with interested shareholders and an independent board of directors that holds the first loss tranche, its interests are clearly aligned with those of the investors. As the law currently stands, the guidance in paragraphs 25 and 26 of the CEBS Guidelines therefore allow it to satisfy the retention requirement.

However, from 1 January 2014, as the CRR and the RTS do not provide for any entity other than an originator / sponsor / original lender to satisfy the retention requirement, this structure will not satisfy the retention requirements (and therefore all transactions which have been structured on this basis will cease to be compliant and will attract the additional risk weighting – as to which please see Response 2 above).

Compliance with the form of the CRR / RTS could, however, be achieved by incorporating an additional orphan SPV (the *Company B*) which would purchase the mortgage portfolio from the Seller and then sell the portfolio on to the Purchaser. Company B would be an “originator” for the purposes of the CRR / RTS (as it would have purchased a third party’s exposures for its own account and then securitised them) and could therefore act as the retainer. Company A would no longer need to hold the first loss tranche and could therefore

exit the transaction upon the issuance of the Phase 2 Notes. There is no requirement in the CRR or the RTS for the retainer to be an entity of substance, nor is there a requirement that “*retention is ultimately met by an entity with which alignment of interest is optimally achieved*” (as there is in paragraph 26 of the CEBS Guidelines). Company B, therefore, could technically fulfil the retention requirements.

We consider that the “substance over form” approach in the CEBS Guidelines and the flexibility provided by paragraphs 25 and 26 contained real advantages for investors and deleveraging institutions seeking to access the securitisation market. Accordingly, the possibility for third party entities to act as the retainer, should be maintained under the RTS.

Questions 4, 6, 7 and 8:

As a general response, we consider that the retention options which were provided for in the CEBS Guidelines should continue to be available under the CRR. If existing transactions are not to have the benefit of grandfathering provisions (as to which, see Response 2 above) then this is crucial to avoid detriment to the investors in those existing transactions.

Even without considering the position of existing transactions, the RTS as currently drafted create a significant amount of uncertainty as to what will satisfy the retention requirements and what will not.

The draft RTS specifically mention certain of the options which are provided for by the CEBS Guidelines (for example, Article 6(1)(a) of the RTS seemingly attempts to incorporate the provisions of paragraph 48 of the CEBS Guidelines, Article 6(1)(b) of the RTS carries across the provisions of paragraph 47 and Article 8(1)(a) provides for the option currently set out in paragraph 57).

However, the CEBS Guidelines also mention various other risk retention options, particularly in the context of the retention of the first loss tranche (option (d)) where subordinated notes, reserve accounts, equity interest, preference share interest and deferred purchase price element are all listed. The CEBS Guidelines also note that the 5% retention requirement can be achieved by retaining more than one type of “first loss tranche”. The implication is that if these options are not specifically mentioned in the RTS where others

are, the intention is that they should no longer be available. This is presumably not intended to be the case, but clarification is required to provide certainty to the market.

We consider that all retention options specifically mentioned in the current CEBS Guidelines should be specifically mentioned in the RTS to avoid uncertainty as to whether these are in fact still permissible options (which surely must be the case for at least certain of the options (e.g. subordinated notes)) and also to ensure that existing transactions structured in this way in reliance on the CEBS Guidelines are not penalised when the CRR comes into force in 2014.

We would be happy to answer any questions you may have on any of the above responses, please contact Marcus Mackenzie (marcus.mackenzie@freshfields.com, +44 (0)20 7832 7423) or James Grand (james.grand@freshfields.com, +44 (0)20 7832 7727).

Yours faithfully

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