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Committee of European Banking Supervisors
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(by email: cp40@c-ebs.org)

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Dear Sirs

Response to CEBS CP40 consultation paper on guidelines to Article 122a of the Capital Requirements Directive (CP40)

We are grateful for the opportunity to respond to the consultation paper published by the Committee of European Banking Supervisors which seeks views on proposed guidelines for the convergence of supervisory practices with regard to Article 122a of the Capital Requirements Directive (**CP40**).

We would be delighted to meet with the Committee to discuss our response, whether alone or with other law firms or market participants. Please refer any questions or comments to Bob Penn (bob.penn@allenovery.com) and Nicole Rhodes (nicole.rhodes@allenovery.com) in the first instance.

About Allen & Overy LLP

Allen & Overy is one of the world's leading international law firms, with around 5,000 staff and 450 partners worldwide. Since opening its first office in London in 1930, the firm has grown into a global organisation with 36 offices in 26 countries across Europe, Asia, the US, South America and the Middle East. Allen & Overy LLP acts for many, if not all, of the systemic financial institutions in Europe, and has one of the most experienced securitisation teams in the market. We have extensive experience in acting for a variety of market participants on a range of structured finance transactions in Europe and elsewhere.

We welcome this opportunity to comment on the proposed guidelines set out in CP40 and, given the significance of certain matters under consultation, support the need for full consultation. While we have actively participated in the preparation of the response submitted by the joint associations AFME, BBA, ISDA and EBF, we wish in addition to provide this separate response on several points which we consider to be particularly significant with respect to the operation of Article 122a. As a law firm, our principal concerns about the regime cover issues relating to legal and regulatory certainty. Accordingly, this response primarily focuses on certain key legal and regulatory issues raised by the proposals. Other market participants are better placed to address the commercial and economic implications.

Consolidated application

The Executive Summary to CP40 includes a statement that "a credit institution will become exposed to credit risk by virtue of the activities of any related entity which falls within the same scope where consolidated supervision is applied". While the Committee has not requested feedback on this statement, we would like to address this point. In our view, the purported application of Article 122a on a consolidated basis is incorrect and without basis from a technical perspective and raises potentially significant issues for market participants seeking to comply with Article 122a.

No legal grounds for consolidated application

Article 71 of the recast Banking Consolidation Directive (Directive 2006/48/EC) clearly specifies the provisions of the Directive to be applied on a consolidated basis, and there is no authority for the extension of such provisions in the absence of a formal amendment. Article 122a is not among the provisions referred to in Article 71, and there is no reference to application on a consolidated basis in Article 122a itself. Moreover, the Directive does not mandate the Committee to extend the scope of Article 122a.

We therefore see no powers or grounds, under the Directive or otherwise, for the Committee to seek to extend the scope of the legislation in the way proposed: to do so seems to be inconsistent with the intentions of the legislature, and exceeds the Committee's mandate.

We also believe that as the current European regulatory framework evolves towards the new European System of Financial Supervision, it is extremely important, as a matter of principle, that the boundaries of the powers of the new European bodies are both clear and observed in practice. We therefore request that the Committee withdraws the statement and any policy recommendations relating to consolidated application of the article pending legislation which empowers it to do so.

Risk of duplicative and overlapping regulation

Further, if Article 122a is applied on a consolidated basis (notwithstanding the lack of any legal grounds for such an approach), then relevant entities supervised by non-EU authorities would be required to comply in the context of a deal which was otherwise unconnected to the EU credit institution with which they are consolidated. Given that such entities will already be subject to the requirements considered appropriate by their home supervisor and that there is no basis for applying Article 122a more widely, this outcome is not justified. In addition, such an outcome raises significant issues where other (potentially inconsistent or conflicting) retention requirements implemented by the relevant authorities apply in respect of the relevant transaction as well as Article 122a – as this may result in an effective restriction on the ability of relevant group entities to remain active in the local securitisation market.

By way of illustration, we note that several EU banks have US broker-dealer subsidiaries which are active in the US domestic securitisation market and which commonly undertake dealing and other activities in respect of US deals likely to trigger the application of Article 122a (if such article is construed to apply on a consolidated supervision basis). However, in addition to Article 122a, under legislative provisions approved by US authorities as part of the Dodd-Frank Act, another set of retention requirements may apply in respect of the same US deals (although, technically, application will be driven by different transaction parties, given that the EU requirements are framed as an "investor" restriction and the US requirements are framed as a securitiser requirement). While much of the detail under the Dodd-Frank Act requirements will be set out in corresponding implementing regulations, there are fundamental differences between the requirements contemplated by the Act and those which apply under Article 122a (and these differences may become more pronounced to the extent that member states opt to gold-plate the Article 122a requirements). These differences will make compliance with both regimes extremely difficult in practice (particularly where the deal structure does not fit neatly within Article 122a and the corresponding definitions and/or where the local retention regime reflects the particularities of the domestic market and includes exemptions for certain deals, which exemptions will not track through to Article 122a). In turn, we are concerned that this will effectively restrict the ability of US broker-dealer subsidiaries to continue to undertake dealer and other relevant activities in respect of deals subject to the US regime.

We would therefore strongly urge the Committee against the adoption of an approach based on consolidated supervision.

Materiality threshold for application to existing securitisations

The Committee asks in Question 22 of CP40 whether implementation of Article 122a to existing securitisations without a materiality threshold for asset additions and substitutions would create complications or be overly burdensome. In our view, implementation on this basis would indeed give rise to potential issues for market participants. We consider that the application of a materiality threshold would not be inconsistent with the text of Article 122a itself and/or the principles behind it and that such an approach would work to more properly ensure that the Article is applied to a select range of existing transactions (in keeping with the original intention of the European authorities, as we understand such intentions).

It is our understanding that the application of Article 122a in respect of existing securitisations was intended in principle by the European authorities to capture pre-2011 issuances involving an actively revolving or dynamic pool of underlying assets or asset substitutions or additions resulting in a material increase in the originally agreed risk profile. In this regard, we note that paragraph 8 itself refers to the addition or substitution of "new underlying exposures" (i.e. in plural), and does not refer to, e.g., "one or more new underlying exposures". It is not clear why limited asset substitutions occurring on or after the end of 2014 should trigger the application of Article 122a to existing securitisations from a policy perspective. We note that this point was picked up in the implementing measures advice in respect of Solvency II prepared by the Committee of European Insurance and Occupational Pensions Supervisors (**CEIOPS**) and, in that context, CEIPOS has suggested that the relevant requirements should apply only in respect of transactions involving "material substitutions" after the grandfathering date.

In the absence of a materiality threshold, Article 122a may apply to most existing transactions (unless changes were made to such transactions) as provision is commonly made for substitution in circumstances where it is determined that the relevant assets did not satisfy the representations and warranties provided by the seller on closing. We note that it may not be possible to amend the transaction documents to provide for an alternative method of dealing with asset warranty breaches, as other methods may give rise to separate issues (e.g. if cash was to be put in instead, negative carry considerations may apply) and, moreover, noteholders may not agree to the required amendments (particularly if they are not EU regulated credit institutions).

In addition, it is not entirely clear what will be a relevant substituted or added "exposure" for these purposes. Certain transactions are backed by cashflows generated by a range of assets rather than assets forming part of a defined pool. We assume that, in relation to a commercial mortgage backed security, where restructurings of the underlying property loans are ongoing, an extension of an underlying asset would not be considered to be a "new underlying exposure", nor would a new rental agreement. It is helpful that the Committee has confirmed that product switches should not be regarded as giving rise to a relevant new underlying exposure but it would be useful to receive further guidance from the Committee as to how relevant exposures should be defined.

Based on the foregoing, we would therefore strongly urge the Committee to apply a materiality threshold for asset additions and substitutions. There are various ways in which such a threshold could be structured and we would be happy to discuss this with the Committee.

Thank you once again for the opportunity to comment on the proposals set out in the consultation paper. Should you have any questions or need additional information regarding any of the comments set out above, please do not hesitate to get in touch.

Yours faithfully

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