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Client Alert
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Amendments to the Capital Requirements Directive Adopted by European Parliament

Details on the 5% retention

BACKGROUND

The 5% retention represents an attempt by the EU to align the interests of originators, arrangers and bank investors in securitisations. Some have questioned this concept on the basis that markets rely on sellers and buyers having opposed interests which are resolved through the price mechanism and asymmetries of information between seller and buyer may be better dealt with through transparency, disclosure and due diligence. Nevertheless, the idea of some form of retention in some form as a device to combat perceived weaknesses in the 'originate-to-distribute' model gained widespread currency during 2008. Earlier drafts of the CRD amendments proposed by the EC last year proposed a 10% retention. This was reduced to 5% following industry consultation.

As mentioned above, the EC is required to consult with the CEBS during the remainder of this year and, if it deems it appropriate, publish a proposal for an increased retention level.

NEW ARTICLE 122A

Under the Amended CRD, a bank or other credit institution - other than an originator, sponsor or original lender - may only take on exposures to the credit risk of a securitisation position "*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%.*"

New Article 122a then sets out that retention of the "net economic interest" means any of the following:

(a) "*5% of the nominal value of each of the tranches sold or transferred to the investors; or*

(b) "*in the case of securitisations of revolving exposures, retention of originator's interest, of not less than 5% of the nominal value of the securitised exposures; or*

(c) "*retention of randomly selected exposures, equivalent to no less than 5% of the nominal amount of the securitised exposures, where these would otherwise have been securitised in the securitisation provided that the number of potentially securitised exposures is not less than 100 at origination; or*

(d) "*retention of the first loss tranche and, if necessary, other tranches having the same or more severe risk profile and not maturing any earlier then those transferred or sold to investors, so that the retention equals in total not less than 5% of the nominal value of the securitised exposures.*"

By setting out various ways that originators or sponsors can satisfy the 5% retention, Article 122a provides some welcome flexibility (compared with the initial proposals which suggested that the only way for originators to satisfy the retention would be for them to retain a vertical slice of the full structure of securitised positions).

Having said that, why the EU chose these particular ways to satisfy the retention is harder to fathom. It is not clear why point (b) (originator's interest) is limited only to revolving securitisation - it might be more effective in improving underwriting and origination practices if this option were also available to non-revolving securitisations. Point (c) (retention of randomly selected exposures) although arguably a retention based on the risk-weighting of the securitised exposures rather than nominal value would be more appropriate.

On point (d), in practice, originators often retain the first loss or similar tranches; but for Article 122a purposes, arguably, the required retention of the first loss tranche should be based on 5% of the pre-securitisation risk-weighted exposure amount of the securitised exposures, not 5% of their nominal value. The first loss piece will always be riskier - typically, far riskier - than the securitised exposures in the pool taken as a whole, so to compare the nominal value of the first loss retention to the nominal value of the pool is not appropriate.

Exemptions to the 5% retention

The Amended CRD contains certain exemptions from the 5% retention requirement.

The first exemption relates to securitisation exposures benefiting from guarantees given by central governments, certain public sector entities within the EU, central and multilateral development banks and institutions attracting a 50% risk-weight. The list of guarantors has been expanded from what was contained in the EC Proposal.

Other exemptions include:

- Syndicated loans, purchased receivables and credit default swaps (CDS) which are not being used to package or hedge securitisations.
- Transactions based on a "clear, transparent and accessible" index, which is itself widely traded or is composed of securities which do not represent securitisation positions.

The finance industry and corporate entities are, however, likely to be disappointed that there is no carve-out for non-bank corporations which fund themselves through the securitisation markets - unless they benefit from one of the other exemptions, such structures would appear to be caught by the 5% retention requirement – even though such securitisations would not be based on the originate-to-distribute model that these new rules are intended to regulate.

If the originator or arranger is a credit institution, then the usual capital charges would be applied to the retained portion.

Additional requirements for investing credit institutions

Whilst the 5% retention is partly aimed at raising loan origination standards, the Amended CRD also imposes ongoing requirements on the investing credit institution.

These requirements have not changed significantly from the EC Proposal. The investing credit institution must demonstrate to its national regulator that it has a "*comprehensive and thorough understanding of and [has] implemented formal procedures appropriate to [its] trading book and non trading book and commensurate with the risk profile of [its] investments in securitisation positions for analysing and recording*" the risk characteristics, the originator's/sponsor's due diligence, collateral valuation methodologies, structural features and the originator's/sponsor's "reputation and loss experience" in respect of any securitisation positions it holds.

This last criterion - analysing and recording reputation – will pose a methodological challenge to investors, since "reputation" is so subjective.

Credit institutions will also be required to perform regularly their own stress tests (as "appropriate to their own securitisation positions") and to monitor the performance of "the exposures underlying their securitisation position", which, where relevant, shall include monitoring:

> *"the exposure type, the percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, collateral type and occupancy, frequency distribution of credit scores or other measures of credit worthiness across underlying exposures, industry and geographical diversification, frequency distribution of loan to value ratios with band widths that facilitate adequate sensitivity analysis."*

This will represent a significant extra ongoing administrative and analytical burden on investing credit institutions, which may in some cases act to dampen their demand for securitisation positions.

Failure to satisfy these rules will lead to a capital penalty being imposed in the investor. The final terms of the Amended CRD take a more proportionate approach to quantifying this penalty than the EC Proposal. The EC Proposal contained a simple, swingeing 1250% risk weighting to securitisation positions where the investing credit institution did not fulfill the above requirements. The Amended CRD, however, states that the breach of the requirements must be material before the capital penalty applies (although the breach can be caused by "negligence or omission", such that even a non-negligent omission would be caught). The capital penalty is to be an application of not less than 250% of the risk-weight that would otherwise apply to the securitisation position the credit institution holds, to a maximum of 1250%, with the risk-weight multiple increasing in light of any subsequent infringements.. The 250% multiple amount is less than the penalty contained in the EC Proposal (which was for a 1250% risk-weighting) but is less than a lower 150% multiple which was circulating in earlier drafts of the Parliamentary text.

By way of example, if a non-compliant investing credit institution holds a securitisation position to which a pre-penalty risk-weighting of 15% applies, after the application of the penalty it will have to apply a risk-weighting of 37.5% to that same position.

Additional requirements for originating credit institutions

Origination and disclosure requirements

To tighten lending origination standards and increase disclosure, the Amended CRD requires sponsors and originators to:

- apply the same criteria in originating or purchasing loans to be securitised as they would do in originating exposures to be held on their own books;
- disclose to investors the level of their retention commitment; and
- ensure that prospective investors can access all materially relevant underlying data and such other information as is necessary to conduct "well informed" cash flow and collateral stress-tests.

These provisions are broadly unchanged from the EC proposal.

Penalty for non-compliance

Any failure by the originator/sponsor credit institution to apply the same origination criteria for securitisation exposures it holds on its own book will result in its being unable to exclude the securitised exposures from its capital requirements calculations. It would have to hold appropriate capital against them regardless of whether they have been securitised.

If the originator/sponsor fails to disclose its level of commitment or to make available to investors all materially relevant data (as above), the capital penalty will be an application of not less than 250% of the risk-weight that would otherwise apply to the securitisation position the originator/sponsor holds, to a maximum of 1250% (with the multiple increasing in light of any subsequent infringements).

Other points on the text of Article 122a

The text of the Amended CRD differs at a number of other points from the EC Proposal. Many of these are just clarificatory, the main points being:

- Clarification that the Amended CRD Article 122a applies to securitisation exposures in both the banking and the trading books.
- Clarification that the 5% retention only applies in respect of securitisations, not any other pools of obligations. This is really just a tightening up of the wording; it was always generally understood that the 5% retention related to securitisations but the EC Proposal was not as explicit on this point as the Amended CRD.

Effective date

Article 122a will apply to investments in new securitisations completed on or after **1 January 2011**. Where existing securitisations have new exposures added after **1 January 2014**, the new Article 122a will also apply. In each case, the competent authorities may suspend these requirements during periods of general market liquidity stress.

Conclusion

Just as this round of amendments to the CRD has been completed, further amendments are in prospect. The Basel Committee on Banking Supervision has recently closed its initial consultation on changes to its trading book, operational risk and resecuritisation capital requirements, amongst other things, and last month the EC's Internal Market Directorate published a consultation paper addressing similar questions. Those mooted changes, particularly on resecuritisation, could be at least as far-reaching as the 5% retention.

As for the Amended CRD text itself, originators and sponsors can take some comfort from the fact that certain of the more severe provisions in the EC Proposal and earlier initiatives (such as the penalty for non compliance) have been diluted, or, in the case of the retention, a degree of flexibility has been introduced. Generally, there seems to be a recognition amongst policymakers that securitisation is a vital form of funding for originating credit institutions - especially as the Article 122a and the 5% retention changes do not come into effect for new securitisations until 2011.

However, the possibility of the 5% retention level being amended upwards by the EC at the end of 2009, and the wider review of the CRD that has been mandated by the European Parliament addressing pro-cyclicality (which is already on the regulatory radar) and examining whether an overall leverage ratio would be appropriate (which has not, to date, been discussed in detail by the EC) do not aid market participants in assessing the Amended CRD's potential capital impact. Banks can expect many more changes in this area in the coming months and years.

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