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More Unanticipated Consequences—Application of Article 122a of the EU Capital Requirements Directive to Activities of Certain US Subsidiaries and Affiliates of EU Credit Institutions

In contrast to the frequent criticism made of US financial reform that it is rushed and uncoordinated, the comparable European Union (EU) reforms have generally been seen as deliberate and consultative. Unfortunately, better "process" doesn't mean that EU reforms will not have unanticipated consequences. The recent Guidelines[1] for the implementation of Article 122a of the Capital Requirements Directive[2] (CRD) demonstrate this risk.[3]

Article 122a was added to the CRD on September 16, 2009 and imposed a number of new requirements on EU credit institutions in relation to "securitizations."[4] Article 122a required the Committee of European Banking Supervisors (CEBS) to provide written guidelines to clarify and harmonize its application by different member states.[5] CEBS published the Guidelines on December 31, 2010, on the day before the requirements of Article 122a became effective (for new securitizations issued on and after January 1, 2011).[6] The Guidelines followed Consultation Paper 40[7] (CP40), issued on July 1, 2010 (with a consultation period that closed on October 1, 2010), which had generated significant comments from interested parties, including 18 written submissions,[8] and CEBS also published Feedback[9] on these submissions.

Notwithstanding this relatively consultative and deliberative process, and even though the Guidelines do address many of the concerns raised in the industry comments, substantial questions remain regarding the application of Article 122a. Importantly, these remaining questions include how the requirements apply to securitizations by US subsidiaries and other affiliates that are the subject of "consolidated supervision" of EU credit institutions.

Article 122a specifically imposes risk retention and due diligence requirements on credit institutions that invest in, or otherwise assume credit exposure to, securitizations.[10] The Guidelines state that a credit institution can obtain such exposure by virtue of the relevant activities of any related entity (authorized or unauthorized) which falls within the same scope of a group where consolidated supervision is applied.[11] The Guidelines take this position despite comments on CP40 which argued that consolidated application would be inconsistent with the CRD, including Article 122a, and expressed particular concern about applying these requirements to trading activities of a credit institution's non-EU non-bank subsidiaries (such as a US broker-dealer, asset management firm, financial institution or financial holding company).[12]

Applicability of consolidated supervision to affiliates of an EU credit institution would be determined under the rules set by the credit institution's national banking regulators.[13] Broadly speaking, if a non-EU entity carries out

activities that would be regulated activities in the European Union, and the entity is a subsidiary of an EU-regulated credit institution or a subsidiary of an EU-regulated parent financial holding company of such a credit institution, then it is highly likely that the non-EU entity is subject to consolidated supervision for purposes of Article 122a.

As a result, if a US subsidiary or other affiliate of an EU credit institution that is subject to consolidated supervision with the credit institution invests in or otherwise obtains credit exposure to a securitization (including through certain types of liquidity facilities or as counterparty to currency, interest rate or other swaps that have the risk of principal loss to the securitization), the credit institution will be treated as assuming credit exposure to that securitization and the group may have to comply with Article 122a in relation to that investment or exposure.

Some examples may illustrate the nuances of the application of Article 122a's requirements:

US Subsidiary Underwriting a Securitization. A US broker-dealer that is a subsidiary of an EU credit institution and subject to consolidated supervision arranges and underwrites the securitization by a US consumer finance company of a portfolio of US consumer finance receivables in a public offering and, as part of that role, holds some of the resulting securities for trading. Under Article 122a, as interpreted in the Guidelines, the EU credit institution must comply with Article 122a with respect to those securities (and so must ensure that the originator retains the minimum net economic interest in a manner that satisfies Article 122a, and must meet Article 122a's due diligence requirements for credit institutions investing in or assuming exposure to a securitization position).[14]

US Subsidiary's ABS Trading Activities. Similarly, if the US broker-dealer subsidiary trades asset-backed securities for its own account, even where it did not arrange or have any other role in the securitization transactions, the credit institution may have to comply with those retention and due diligence requirements with respect to each of the securities purchased by the subsidiary.[15]

Warehouse in Anticipation of a Securitization. A US bank subsidiary of an EU credit institution that is subject to consolidated supervision arranges warehouse financing for a portfolio of consumer finance receivables; the subsidiary contributes the portfolio to a special purpose, bankruptcy-remote entity that then obtains financing for the portfolio with a third party that is not an EU credit institution or an affiliate of such an institution. Assuming that the retained residual risk (an equity interest in the entity) is a "tranche," then the warehouse appears to be a securitization. Though the EU credit institution has not taken on additional credit risk of the securitized assets, it may be treated as having invested in or assumed exposure to a securitization position and, thus, will have to comply with the retention and due diligence requirements referred to above. On the other hand, the US subsidiary should not be required to comply with the "same criteria" and disclosure requirements that apply to EU credit institutions that act as originators or sponsors.[16]

While the Guidelines have only recently been issued, already industry participants are raising these questions and others with their regulatory authorities and some further formal or informal clarification may be forthcoming.

Endnotes

[1] Available at http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf.

[2] Available at http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#crd.

[3] The CRD consists of two directives, Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), known as the Banking

Consolidation Directive (the "BCD"), and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast), known as the Capital Adequacy Directive. Article 122a is part of the BCD.

[4] Defined in the BCD as follows: "'securitisation' means a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having the following characteristics: (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme."

[5] Article 122a paragraph 10.

[6] Article 122a paragraph 8.

[7] Available at http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/CP40.pdf.

[8] Available at http://www.eba.europa.eu/Publications/Consultation-Papers/All-consultations/CP31-CP40/CP40/Responses-to-CP40.aspx.

[9] Available at http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Feedback-document.pdf.

[10] For more information, see our January 2011 Legal Update, "European bank regulators issue guidelines on securitisation risk retention, due diligence and disclosure requirements" available at http://www.mayerbrown.com/publications/article.asp?id=10230&nid=6.

[11] Guidelines clause 8.

[12] See Allen & Overy, *Response to CEBS CP40 Consultation Paper on Guidelines to Article 122a of the Capital Requirements Directive (CP40)* (30 Sept. 2010), pages 2-3; Association for Financial Markets in Europe, British Bankers Association and International Swaps and Derivatives Association, *Response to CEBS CP40 Consultation Paper on Guidelines to Article 122a of the Capital Requirements Directive* (1 Oct. 2010), pages 5-6; French Banking Federation, *FBF comments on the CEBS Consultative Paper 40 on guidelines to Article 122a of the Capital Requirements Directive* (1 Oct. 2010), page 4.

[13] For example, in the United Kingdom, the relevant tests are set out in Chapter 8 of the Financial Services Authority's Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU), available at: http://fsahandbook.info/FSA/html/handbook/BIPRU/8.

[14] Article 122a paragraphs 4 and 5. According to the reasoning of Guidelines clause 8 and Guidelines clause 11, it may be argued that Article 122a paragraph 4 and the first paragraph of paragraph 5 should not apply because the credit institution is indirectly assuming credit exposure but is not itself "investing" in the securitization.

[15] Guidelines clauses 8, 9. The Guidelines indicate some flexibility in relation to application of these rules to trading book exposures. *Id.*

[16] Article 122a paragraphs 6 and 7.

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