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Clients&FriendsMemo

Art. 122a: Risk Retention for Securitisations with European Credit Institution Investors

27 October 2010

What is Art. 122a?

Art. 122a is an article added[1] to the European Union Capital Requirements Directive ("**CRD**").[2] The CRD sets out the framework for bank capital rules that apply to over 6,200 credit institutions established in the 30 member states of the European Economic Area ("**EEA**").[3] Although Art. 122a applies only to EEA credit institutions, it has implications for originators, issuers and arrangers of securitisations worldwide.

Art. 122a requires that an EEA credit institution, unless it is acting as an original lender, originator or sponsor of the relevant securitisation, only invest in, or otherwise assume credit risk in, a securitisation:

(i) if the originator, sponsor or original lender of the securitisation has explicitly disclosed that it will retain a material net economic interest of at least 5% (the "**Requirement for Retention**"); and

(ii) if it has a thorough understanding of all structural features of the transaction that would materially impact the performance of the securitisation exposure and, if acting as an investor, it (a) has undertaken specific due diligence prior to investing, (b) has processes in place to analyse and record information in respect of its securitisation positions and (c) monitors and stress-tests its securitisation positions on an on-going basis (the "**Due Diligence Requirements**").

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1 By Directive 2009/111/EC of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management

2 Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) and Directive 2006/49/EC of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast).

3 The European Economic Area comprises the 27 member states of the European Union together with Norway, Iceland and Lichtenstein.

A failure by an EEA credit institution to comply with the Requirement for Retention or with the Due Diligence Requirements results in a penalty risk weighting being applied to the relevant securitisation exposure in the calculation of the capital of the EEA credit institution. The Committee of European Banking Supervisors ("**CEBS**"), in its proposed guidance on Art. 122a (the "**Proposed Guidance**"), has proposed that in the case of non-compliance with the Requirement for Retention, the credit institution will have to deduct the full amount of the securitisation exposure in calculating its capital.

This memo seeks to provide answers to the following questions of market participants in relation to Art. 122a and the Requirement for Retention:

- who is affected by it;
- when does it start to apply;
- does it apply to all types of securitisations;
- who must retain the material net economic interest;
- how can the material net economic interest be retained; and
- what can be done with a material net economic interest without it ceasing to be treated as retained.

Who is affected by Art. 122a?

EEA credit institution	Art. 122a directly affects EEA credit institutions investing in, or otherwise assuming exposures to credit risk in, securitisations,[4] including: (i) investing in the securitisation by entering into a total return swap or credit default swap; (ii) providing funding in a structure that would not usually be considered a securitisation because of the absence of any issue of securities (e.g. warehouse funding structure); and (iii) assuming exposure to the credit risk in the securitisation in some capacity other than as an investor, e.g. as a swap counterparty or a liquidity facility provider for the securitisation[5].

[4] Art. 122a also imposes a number of requirements on EEA credit institutions acting as originators or sponsors of securitisations, but those requirements are not the subject of this memo.

[5] Under the Proposed Guidance not all swap counterparties or liquidity facility providers are treated as assuming credit risk to the securitisation. The determining factor is whether the swap counterparty or liquidity facility provider is assuming risk arising from principal losses on the securitised exposures.

Subsidiary of an EEA credit institution, including a non-EEA subsidiary (e.g. U.S. broker/dealer subsidiary)	Art. 122a does not directly apply to subsidiaries of EEA credit institutions. However, CEBS, in the Proposed Guidance, indicated that Art. 122a is to be applied on a consolidated basis. In calculating its capital requirements at a consolidated level, an EEA credit institution would have to apply the penalty risk weights to securitisation exposures not meeting the requirements of Art. 122a and held by its subsidiaries, including non-EEA subsidiaries, e.g. a subsidiary that is a US broker-dealer. This would result in Art. 122a indirectly applying to such subsidiaries. Art. 71 of the CRD, which lists the provisions of the CRD which are to apply on a consolidated basis, does not refer to Art. 122a. Responses to the Proposed Guidance have noted that, as it is not mentioned in Art. 71, there is no legal basis for Art. 122a to be applied on a consolidated basis. It is unclear what the ultimate outcome on this point will be. There does not appear to be a legal basis for applying Art. 122a on a consolidated basis. However, a legal basis could be introduced as part of amendments to the CRD that are expected to be approved during the first half of 2011. The European Commission and CEBS have indicated that they see the application of Art. 122a on a consolidated basis as necessary to prevent anti-avoidance by EEA credit institutions moving their securitisation exposures into non-EEA subsidiaries. Equally, EEA credit institutions have noted that other jurisdictions such as the US and Australia are introducing their own versions of the Requirement for Retention and that their subsidiaries in those jurisdictions should not be indirectly subject to Art. 122a as well.
EEA entity that is not a credit institution or its subsidiary	Art. 122a does not apply to EEA entities that are not credit institutions or their subsidiaries. However, it is proposed to impose similar requirements on EEA insurance and reinsurance companies and on funds managed by EEA managers. In the case of EEA insurance and reinsurance companies, the relevant requirements will be contained in implementing measures under the Solvency II Framework Directive. On 29 January 2010 the Committee of European Insurance and Occupational Pensions Supervisors ("**CEIOPS**") issued

	advice to the European Commission in respect of such implementing measures in relation to Repackaged Loans Investment and recommended that a requirement similar to the Retention Requirement apply in relation to EEA insurance and reinsurance companies investing in securitisations issued after 1 January 2011. In the case of investment funds managed by EEA managers, the draft Alternative Investment Fund Managers Directive (the "**AIFM Directive**") contains a provision for the European Commission to make implementing measures providing that alternative investment funds managed by fund managers subject to the AIFM Directive only be permitted to invest in securitisations issued after 1 January 2011 if the originator, sponsor or original lender of a securitisation retains a material net economic interest of at least 5%.
Originator, issuer or arranger of securitisations marketing to EEA investors	Art. 122a is relevant to originators, issuers and arrangers of securitisations worldwide because if the potential investor base for the securitisation is to include EEA credit institutions then they will need to be able to meet the requirements of Art. 122a. Although Art. 122a imposes upon EEA credit institution investors the Requirement for Retention, it is the original lenders, originators or sponsors of the securitisations that will have to retain the 5% material net economic interest. Furthermore, as noted above, it is possible that Art. 122a may indirectly apply to non-EEA subsidiaries of EEA credit institutions and it is expected that EEA insurance and reinsurance companies and investment funds managed by EEA managers will become subject to similar requirements to those that Art. 122a imposes on EEA credit institutions. If none of these entities could invest in a securitisation, that would significantly restrict the investor base. Even if the primary distribution for the securitisation will not involve European investors, the secondary market liquidity, and consequently, pricing, of the securities may be affected by whether secondary sales are possible to entities subject to the requirements of Art. 122a.

When does Art. 122a start to apply?

Art. 122a is not itself directly applicable. Each EEA member state must implement it in its national banking laws and regulations not later than 31 October 2010 with such implementing measures to take effect from 31 December 2010.

The requirements of Art. 122a, including the Requirement for Retention, apply in respect of new securitisations issued on or after 1 January 2010. However, securitisations issued prior to 1 January 2010 are not completely outside of the scope of Art. 122a. If, on or after 1 January 2015, new underlying exposures are added (including by way of substitution) to a securitisation issued prior to 1 January 2010 then Art. 122a and the Requirement for Retention will apply to such securitisation.[6]

Does Art. 122a apply to all types of securitisations?

Subject to a handful of express exemptions from the Requirement for Retention described below, Art. 122a applies to all structures that are securitisations within the definition set out in the Capital Requirements Directive:

> *"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;"*

Two key points to note regarding the CRD definition of "securitisation" are:

(i) *there must be a tranching of credit risk*. A structure that involves the issue of securities which involve credit risk to a pool of exposures but no tranching of credit risk is not a securitisation for the purposes of the CRD or Art. 122a; and

(ii) *it is not necessary that there be any securities issued*. A structure that involves the tranching of credit risk and loan-funding, such as a warehouse funding structure, may be a securitisation if there is a tranching of credit risk (e.g. if junior/senior funding to a warehouse SPV is provided by more than one lender). The requirements of Art. 122a, including the Requirement for Retention, will then apply in respect of that structure.

6 The Proposed Guidance states that the addition or substitution of exposures on or after 1 January 2015 is not subject to any materiality threshold, so that even a single substitution would result in Art. 122a becoming applicable.

Art. 122a expressly provides that the Requirement for Retention does not apply in any of the following cases:

(i) the securitised exposures are claims on, or are guaranteed by central governments or central banks, by regional governments, local authorities and public sector entities of EEA member states,[7] by multilateral development banks or by institutions to which a 50% risk weight or less is assigned under the CRD;[8]

(ii) transactions based on a clear transparent and accessible index, where the underlying reference entities are identical to those that make up an index of entities that is widely traded or are other tradable securities other than securitisation positions;[9] and

(iii) syndicated loans, purchased receivables or credit default swaps where, in each case, they are not used to package and/or hedge a securitisation.

No authority is given to CEBS or to EEA member states to create additional exemptions from the application of Art. 122a or from the Requirement for Retention. The creation of any additional exemptions would require the amendment of Art. 122a itself.

Who must retain the material net economic interest?

In order for EEA credit institutions investing in the securitisation to satisfy the Requirement for Retention, the material net economic interest of 5% can be retained by any of the original lender, the originator or the sponsor of the securitisation.

The term "original lender" is used in Art. 122a but it is not defined therein or elsewhere in the CRD. In our view the term can only refer to a party who is an original creditor in respect of an underlying exposure at the time of the creation of such exposure.

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7 Note that although the exclusion for central governments and central banks is not limited to those of EEA member states, the exclusion for regional governments, local authorities and public sector is limited to those of EEA member states.

8 An "institution" for this purpose includes (i) a credit institution (an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account) and (ii) subject to some exclusions, an investment firm under the EU Markets in Financial Instruments Directive. Non-EEA banks could be credit institutions and thus institutions for this purpose. The risk weighting of an institution is a function of the credit risk of such institution. The assessment of this credit risk may be on the basis of the public ratings in respect of such institution.

9 In its proposed guidance on Art. 122a, CEBS states that CDX and iTraxx provide examples of clear transparent and accessible indices to which this exemption would apply. It also noted that for the exemption to apply, it is important that the originator or sponsor does not control or direct the composition of the relevant index in any way.

The term "originator" is defined in the CRD as meaning either of the following:

(a) an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or

(b) an entity which purchases a third party's exposures onto its balance sheet and then securitises them.

It is seen that the CRD definition of "originator" is wider than the conventional use of such term. It is arguably wide enough to include within it an entity that would also come within the definition of "original lender". It also includes an entity which arranged for the creation of an underlying exposure but did not itself assume such exposure, e.g. a bank that arranged a loan for a borrower but which did not itself form part of the syndicate of banks that advanced the loan. Finally, it includes an entity that transfers an exposure to the securitisation special purpose entity, even if such entity was not involved in the creation of the underlying exposure but acquired it only after its creation.

The term "sponsor" is defined in the CRD as meaning a credit institution that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities.

It should be noted that only a credit institution can come within the definition of "sponsor", whereas an entity does not have to be a credit institution to come within the definition of "originator". There does not seem to be any logical reason why the concept of sponsor should be restricted to credit institutions. In the context of Art. 122a the restriction may be unintentional. The definition of "sponsor" was used the original CRD only in provisions that were concerned with the capital treatment of credit institutions acting as sponsors of securitisations and so it was natural for the definition of "sponsor" to refer to it being a credit institution. However, the restriction cannot be removed except by a future amendment to the CRD.

To summarise the entities that may fulfil the obligation to retain:

(a) the retention may be by a party involved in the creation of the exposure, whether the party that was:

   (i) the original holder of the exposure (covered by definitions of "original lender" and, arguably also, "originator"); or

   (ii) a party involved in arranging the creation of the exposure but not itself holding it (covered by definition of "originator"); or

(b) the retention may be by a party involved in the transfer of the exposure to the securitisation special purchase entity, whether the party was:

(i) the transferor of the exposure to the securitisation special purpose entity (covered by definition of “originator”); or

(ii) provided it is a credit institution, a party involved in arranging the transfer of the exposure (covered by definition of “sponsor”).

The Proposed Guidance states that, where there is no entity that satisfies the definition of “sponsor”, the retention must be by either the originator or the original lender, and, where there is no entity that meets the definition of originator or sponsor, the retention must be by the original lender.

The Proposed Guidance addresses the situation where different underlying exposures have different original lenders and/or originators. In such cases the retention must be fulfilled by each original lender or originator with reference to the proportion of total underlying exposures for which it is the originator or original lender, or the retention may be fulfilled by the sponsor.

How can the material net economic interest be retained?

Art. 122a sets out four ways in which a material net economic interest can be retained:

Option A *Retention of vertical slice of securitisation*: retention of no less than 5% of the nominal value of each of the tranches sold or transferred to the investors;

Option B *Retention of interest in pool of exposures*: retention of the originator’s interest in no less than 5% of the nominal value of the securitised exposures, provided the securitisation is one of revolving exposures;

Option C *Retention of randomly selected exposures*: retention of randomly selected exposures, equivalent to no less than 5% of the nominal amount of the securitised exposures, provided that: (i) such exposures would otherwise have been securitised; and (ii) the number of potentially securitised exposures (i.e. the sum of those securitised and those retained) is no less than 100; or

Option D *Retention of first loss piece*: 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.

In the case of Options A and D, the material net economic interest is retained by the original lender, originator or sponsor taking a share of the tranches (e.g. the classes of debt securities) issued in the securitisation. In the case of Options B and C, the material net economic interest is retained by the original lender, originator or sponsor retaining a share of the pool of exposures included or intended to be included in the securitisation. The Proposed Guidance states that the form of retention, once chosen and disclosed by the original lender, originator or sponsor, as applicable cannot change during the term of the securitisation except in exceptional circumstances.

The Proposed Guidance states that Option B can be used not only in the case of securitisations where the underlying securitised exposures are revolving (e.g. credit cards) but also to securitisations where the underlying securitised exposures are not revolving (e.g. residential mortgages) but where the structure of the securitisation provides for the underlying securitised exposures to revolve (e.g. UK master trust RMBS). The Proposed Guidance also states that Option A covers a case where there is retained 5% of the nominal value of each of the underlying securitised exposures, even where the structure of the securitisation does not provide for the underlying securitised exposures to revolve.

The Requirement for Retention must be satisfied both at the time when the securitisation is effected and on an on-going basis during the term of the securitisation. However, the size of the retained interest can reduce in accordance with the terms of the securitisation provided that it does not involve the retained interest receiving payments at a rate faster than the reduction in the overall size of the securitisation. Examples of the application of this principle are set out in the Proposed Guidance:

- in the case of Option D, the Requirement for Retention remains satisfied even if the share of the retained interest reduces below 5% as a result of losses being allowed first to the most junior tranches of the securitisation;
- in the case of Option C, provided that at the outset the expected prepayment rate on the randomly selected exposures retained is not significantly different from the expected prepayment rate on the exposures securitised, the Requirement for Retention remains satisfied even if a higher prepayment rate on the exposures retained results in the share of the retained interest reducing below 5%; and
- in the case of Option D, the retained interest can amortise pro rata with the more senior tranches but cannot amortise more quickly via a “turbo” mechanism.

What can be done with a material net economic interest without it ceasing to be treated as retained?

Art. 122a states that the requirement that the material net economic interest be retained on an on-going basis means that a retained interest is not to be hedged or sold.

The Proposed Guidance states that the following types of hedges by an original lender, originator or sponsor purporting to retain a material net economic interest will result in the material net economic interest not being treated as retained:

(i) a direct hedge on the credit risk of retained securitisation positions; or

(ii) a direct hedge on the underlying securitised exposures.

However, the Proposed Guidance states that, depending on responses received to the consultation, it may treat the following types of hedges by an original lender, originator or sponsor purporting to retain a material net economic interest as not affecting the retention:

(a) a hedge based on an index that contains the same underlying asset class as the securitisation, provided the underlying exposures are not sufficiently identical;

(b) a hedge on risk factors that potentially impact default, loss and recovery rates of the underlying securitised exposures; and

(c) a hedge on macroeconomic variables which correlate with the performance of the underlying securitised exposures (e.g. a hedge on an interest rate that correlates with the performance of exposures).

The Proposed Guidance states that the retained interest may be available to be used by the original lender, originator or sponsor as collateral for secured funding purposes, as long as credit risk of the retained interest is not transferred to a third party in such secured funding arrangements. However, the Proposed Guidance states that the retained interest may not be used as collateral in a repo transaction if in such transaction the title of the retained interest legally passes to the lender receiving the retained interest as collateral, although this particular point is one on which the CEBS have specifically asked for feedback. A number of responses to CEBS have argued that a repo transaction entered into for collateral purposes should be treated similarly to a secured funding transaction and not as an outright sale that would result in the material net economic interest ceasing to be retained.

What happens now?

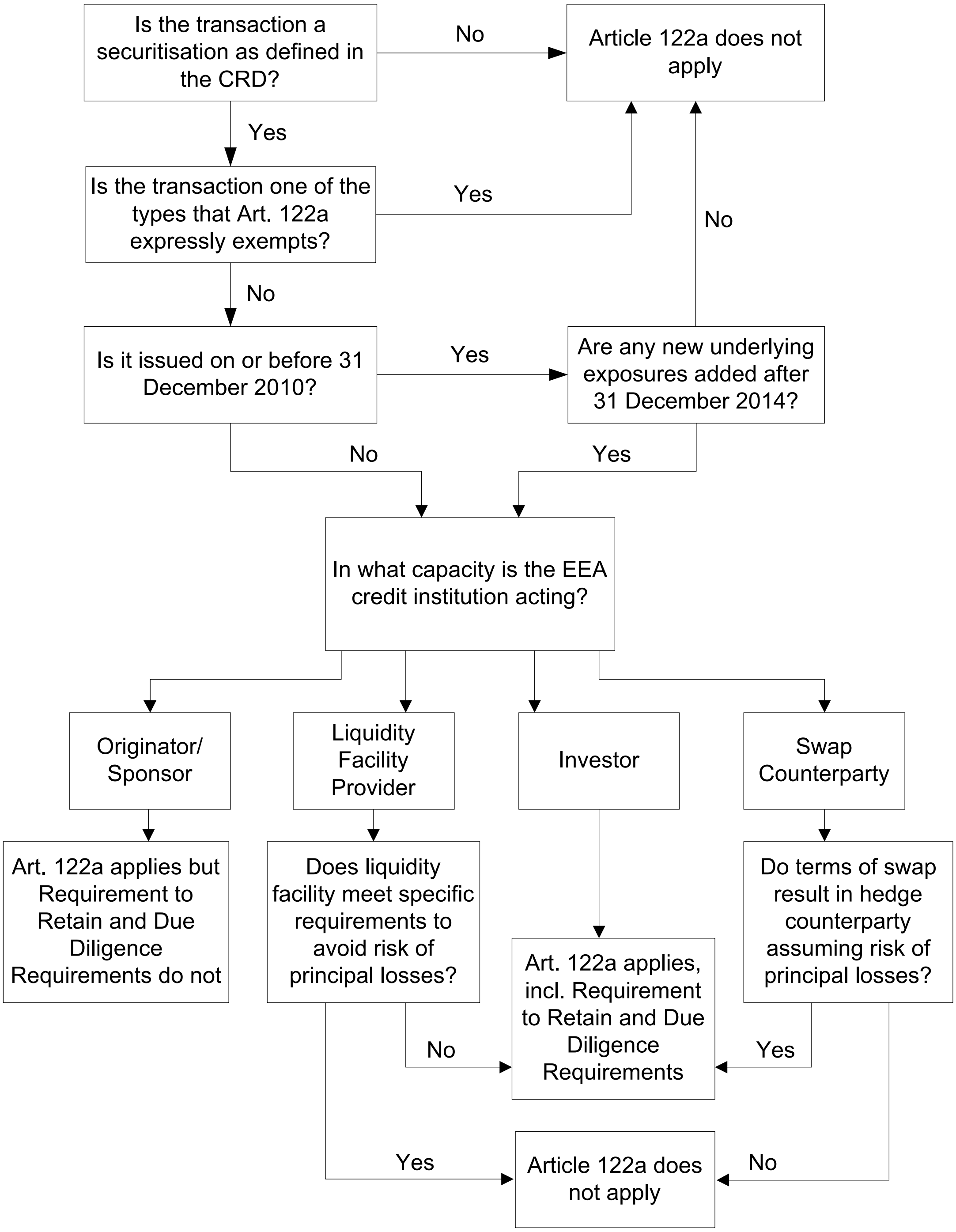
Art. 122a is specific in many respects, but in others its provisions are relatively general and require clarification or elaboration in order to be given effect by banking regulators in the EEA member states. The Proposed Guidance issued by CEBS was intended to provide this clarification and elaboration.

The period for consultation on the Proposed Guidance ended on 1 October 2010. CEBS is expected to publish its final guidance during the last quarter of 2010. EEA member states are supposed to implement Art. 122a in their national laws and regulations by 31 October 2010. It is not clear whether the member states will delay implementing Art. 122a to wait for the final

CEBS guidelines or whether they will implement Art. 122a in the meantime but subsequently revise the implementing measures to conform with the final guidelines.

However, even prior to 31 December 2010, when the measures to implement Art. 122a are to take effect, EEA credit institutions, are already taking account of the requirements of Art. 122a. In addition, as noted above, requirements similar to those in Art. 122a are expected to apply to EEA insurance and reinsurance companies and to investment funds managed by EEA managers, and so these entities are also starting to take note of them. This means that originators and sponsors of securitisations will need to consider Art. 122a, whether it will be applicable, and, if so, weigh the burden of the requirement to retain the material net economic interest of 5% against having the securitisation open to the participation of EEA credit institutions as investors or in other capacities.

FLOWCHART FOR APPLICATION OF ART. 122a



We hope you find this memo helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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