



1 July 2010

## **Consultation paper on guidelines to Article 122a of the Capital Requirements Directive (CP 40)**

### **Introduction**

The amendments to the Capital Requirements Directive<sup>1</sup> by Directive 2009/111/EC (CRD II) relating to securitisations – exposures to transferred credit risk – request the Committee of European Banking Supervisors to elaborate guidelines for the convergence of supervisory practices with regard to Article 122a, including the measures taken in case of breach of the due diligence and risk management requirements.

Providing guidance on the implementation of the retention clause by the originator, sponsor or original lender, and on the due diligence and risk management practices to be carried out by credit institutions when investing in securitisation products, is seen as an important part of restoring confidence in securitisation markets and in turn helping the recovery of an additional source of funding to the real economy.

**CEBS presents its proposals of the implementation guidelines on the new Article 122a of the CRD for public consultation, which will run until 1 October 2010** Responses should be sent to the following email address: cp40@c-ebs.org. Comments received will be published on CEBS's website, unless respondents request otherwise. **In addition, a public hearing will be organized on 22 July 2010 at CEBS's premises in London from 10:00 to 13:00 to allow interested parties to share their views with CEBS.**

CEBS would particularly welcome market participants' views on the questions set out across the paper.

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<sup>1</sup> Capital Requirements Directive (CRD) is a technical expression which comprises Directive 2006/48/EC and Directive 2006/49/EC. Please note that in general references to "Directive 2006/48/EC" and "Directive 2006/49/EC" or the "CRD" refer to the amended versions of the Directives and references in these Guidelines to a particular Article of the CRD refer to the amended Directives. The amending Directive (Directive 2009/111/EC) was published on 17 November 2009 and can be found under: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF>.

## Executive summary

These guidelines seek to provide some general considerations on the application of Article 122a and then go on to provide clarity on specific aspects of the detailed requirements, structured paragraph by paragraph in the order of the directive text. Areas where specific feedback is requested have been identified, but of course CEBS would welcome comment on any aspects as part of its consultation. The following provides only a summary of the more detailed guidance.

The requirements as a whole should be considered in the light of the relevant recitals, and credit institutions should consider whether the overall objective of the article has been met. The guidelines seek to clarify how the requirements apply to the various roles a credit institution can assume with respect to a securitisation, not only as originator, sponsor, original lender or investor, but also where providing a liquidity facility or as hedge counterparty.

The level of commitment to retention should not be reduced either through hedging or selling of the retained interest. However, measurement of the level of commitment will not be affected by either the amortisation of such interest via cashflow allocation (within parameters) or through the allocation of losses which in effect reduce the level of retention over time. Nonetheless, at origination there should not be embedded mechanisms in the securitisation transaction by which the net economic interest retained by originators, sponsors or original lenders could decline over time faster than the interest transferred such that the retention requirement is no longer fulfilled.

The requirement to retain a net economic interest may not be fulfilled by one originator or original lender on behalf of others where the securitised exposures are those of multiple originators or original lenders. It should instead be fulfilled by each individually or alternatively by the sponsor of the securitisation.

As a general principle, credit institutions are not obliged to dispose of a securitisation position, nor will they typically be subject to additional risk weights, should the originator, sponsor or original lender subsequently fail to act in the manner it disclosed and the credit institution is not deemed to be responsible for negligence or omission in the fulfilment of its due diligence obligations.

The form of retention (options (a) through (d)) cannot change during the life of the transaction, except under exceptional circumstances only and provided that this is disclosed to investors.

CEBS welcomes feedback on the most effective means to assure that the commitment of the originator, sponsor or original lender is enforceable by credit institutions that are investors (e.g. market documentation or regulation).

The ability of certain types of hedging to undermine the application of the retention requirement is explored. The aim has been to disallow hedging that eliminates a sponsor's, originator's or original lender's exposure to the credit quality of the specific exposures that have been securitised; CEBS is open to consider proposals aimed at balancing this with an approach that ensures that there is still sufficient flexibility for credit institutions to risk-manage exposure to broader changes in the credit quality of the asset classes, collateral, or macroeconomic variables to which they are exposed via their lending activities,

securitisation activities, or otherwise. CEBS would particularly welcome feedback from the industry on types of hedging that may allow such a balance while being consistent with the objective of the retention provision (i.e. the alignment of incentives between originator/sponsor and investor).

Consideration should be given to dynamics within individual transactions that may undermine the effectiveness of the retention requirement. For clarification, examples are given of the sorts of considerations necessary with respect to payment rates, losses, and revolving pools.

As regards the methods of retention, CEBS would particularly welcome feedback on whether:

1. vertical slice retention (option (a); retention of 5% of the nominal value of each of the tranches) may also be fulfilled by retaining 5% of each of the securitised exposures?; and
2. originator interest retention (option (b); retention of an originator's interest of at least 5%) should be applicable equally to both securitisations of revolving exposures and revolving securitisations of non-revolving exposures (or revolving securitisations with a combination of revolving and non-revolving exposures)?

From the perspective of an investor in a resecuritisation, the retention requirement would apply only to the second ("repackaged") layer of the transaction (in which they are investing). However, the sponsor or originator of a resecuritisation has a duty to ensure that the securitisations from which it is constructed also fulfil the retention requirement and to disclose this to investors in the resecuritisations. In the context of resecuritisations, credit institutions should be particularly sensitive to the use of SPVs: they shall not invest in structures created with the intention of avoiding the economic substance of the retention requirements.

Given that retained positions, interest or exposures are not to be hedged or sold, CEBS is interested in stakeholder views as to what extent would it be possible for an originator, sponsor or original lender to use such retained interest for secured funding purposes (e.g. repo) without having "sold" such retained interest?

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. Furthermore, the economic substance of the requirements (e.g. no hedging) should be respected at consolidated as well as solo level.

Credit institutions should not invest in securitisations where they determine that they do not have, and will not be able to receive, adequate information to undertake thorough due diligence and satisfy the requirements of the Directive.

As a general principle, credit institutions should apply the same policies and procedures to securitisation positions in their trading book and non-trading book, but may distinguish between the two as long as it is appropriate and can be justified. The classification that a position is in the trading book is not sufficient justification in and of itself; there must instead be an observable difference between the risk profiles of the trading and non-trading books. Furthermore, while the scope of due diligence is fixed, the intensity of the due diligence

process may vary according to the specificities of the trading book versus the non-trading book.

CEBS has been consulting separately on guidelines for stress testing and if stakeholders consider that this is insufficient in the context of Article 122a, CEBS is open to specific suggestions on what any further guidance should cover.

Guidance is provided on how to calculate the additional risk weight. Competent authorities are required to progressively increase this additional risk weight, although the directive is not explicit on how this should be delivered. Accordingly, in order to achieve convergence among its members and hence a transparent, level playing field treatment for credit institutions, CEBS is consulting on a common framework (with an increasing scale and categories of breach) for implementation at national level, included in this guidance. CEBS welcomes comments on this approach.

Actions that are beyond the control of the credit institution as investor will not typically constitute negligence or omission of that credit institution, provided it has already fulfilled, through appropriate due diligence, its requirement to ensure that the originator, sponsor or original lender explicitly disclosed that it would retain such an interest and would make available sufficient information to allow the investing credit institution to fulfil the other relevant requirements of Article 122a.

In situations where the prior capital treatment resulted in a risk weight that equals (or for any reason exceeded) 1250% and a breach of the obligations under Article 122a occurs, CEBS proposes that the credit institution should disclose to the market that such a breach has occurred.

Clarification is provided on how sponsor and originating credit institutions may interpret the requirement for “the same sound and well-defined criteria for credit-granting” to exposures to be securitised as they apply to exposures to be held on their book.

CEBS seeks particular feedback on whether its articulation of the requirement with respect to “participations and underwritings in securitisation issues” is clear, or whether alternative interpretations are possible or clarifications necessary?

CEBS welcomes responses on whether disclosure templates currently exist or are in the process of being prepared by trade associations, industry bodies, central banks, market participants or others, which could fulfil the disclosure requirements for sponsors or originators on an adequate basis?

The obligation of a sponsor, originator or original lender credit institution is to disclose that it continues to fulfil the obligation that it initially undertook to maintain net economic interest in the securitisation. The obligation does not extend to providing further information with respect to the current nominal value, current market value, or any impairments or write-downs on such retained interest (although market participants are of course free to supply or demand this as they see fit).

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## **Background**

A new set of requirements on securitisation – exposures to transferred credit risk – is included in the amended Capital Requirement Directive by virtue of Article 122a. These amendments will have to be transposed into Member States' national law by 31 October 2010 and will be applied from 31 December 2010.

These new requirements comprise specific provisions for credit institutions acting as originators, sponsors and/or original lenders, as well as for when they are investing. A key requirement is that a credit institution may only be exposed to the credit risk of a securitisation position if the originator, sponsor or original lender has explicitly disclosed that it will retain a material net economic interest of not less than 5%. There are also due diligence and risk management obligations, and a specific provision for the application of an additional risk weight in cases of breach of the requirements. The text also provides for certain exemptions from its provisions.

This consultation paper responds to the request in Paragraph 10 of Article 122a, that CEBS shall elaborate guidelines in order to enhance the convergence of supervisory practices with regard to this Article.

## **Objectives and methodology**

The objectives of the guidelines are to:

1. achieve a common understanding among competent authorities across the EU on the implementation and application of Article 122a, fostering the transposition; and
2. create more transparency for market participants in order to assist compliance by credit institutions with the relevant requirements of the directive.

The guidelines presented in the consultation paper do not aim to be a comprehensive set of rules, but rather to complement the new CRD provisions in Article 122a where additional guidance appears necessary or appropriate to CEBS.

CEBS has received and considered informal comments on various technical matters from individual stakeholders during the preparation of these guidelines. It is expected that industry will participate in the Public Hearing and CEBS will be open to dialogue during the consultation period.

## **Implementation date**

CEBS expects its Members to adopt the guidelines into their national supervisory framework and apply them from 31 December 2010, i.e. together with the new Directive provisions.

## Article 122a

### Recitals

#### **Recital 24**

*It is important that the misalignment between the interest of firms that ‘re-package’ loans into tradable securities and other financial instruments (originators or sponsors) and firms that invest in these securities or instruments (investors) be removed. It is also important that the interests of the originator or sponsor and the interests of investors be aligned. To achieve this, the originator or sponsor should retain a significant interest in the underlying assets. It is therefore important for the originators or the sponsors to retain exposure to the risk of the loans in question. More generally, securitisation transactions should not be structured in such a way as to avoid the application of the retention requirement, in particular through any fee or premium structure or both. Such retention should be applicable in all situations where the economic substance of a securitisation according to the definition of Directive 2006/48/EC is applicable, whatever legal structures or instruments are used to obtain this economic substance. In particular where credit risk is transferred by securitisation, investors should make their decisions only after conducting thorough due diligence, for which they need adequate information about the securitisations.*

#### **Recital 25**

*The measures to address the potential misalignment of those structures need to be consistent and coherent in all relevant financial sector regulation. The Commission should put forward appropriate legislative proposals to ensure such consistency and coherence. There should be no multiple applications of the retention requirement. For any given securitisation it suffices that only one of the originator, the sponsor or the original lender is subject to the requirement. Similarly, where securitisation transactions contain other securitisations as an underlying, the retention requirement should be applied only to the securitisation which is subject to the investment. Purchased receivables should not be subject to the retention requirement if they arise from corporate activity where they are transferred or sold at a discount to finance such activity. Competent authorities should apply the risk weight in relation to non-compliance with due diligence and risk management obligations in relation to securitisation for non-trivial breaches of policies and procedures which are relevant to the analysis of the underlying risks.*

#### **Recital 26**

*In the Declaration on Strengthening the Financial System of 2 April 2009, the leaders of the G20 requested the Basel committee for Banking Supervision and authorities to consider due diligence and quantitative retention requirements for securitisation by 2010. In view of those international developments, and in order best to mitigate systemic risks arising from securitisation markets, The Commission should, before the end of 2009 and after consulting the CEBS, decide whether an increase of the retention requirement should be proposed, and*

*whether the methods of calculating the retention requirement deliver the objective of a better alignment of the interests of the originators or sponsors and the investors.*

#### **Recital 27**

*Due diligence should be used in order properly to assess the risks from securitisation exposures for both trading book and the non-trading book. In addition, due diligence obligations need to be proportionate. Due diligence procedures should contribute to building greater confidence between originators, sponsors and investors. It is therefore desirable that the relevant information concerning the due diligence procedures is properly disclosed.*

1. Recitals<sup>2</sup> 24 to 27 set out key principles which credit institutions should consider when assessing compliance with the requirements in Article 122a.
  - (i). Credit institutions should consider whether the overall objective of Article 122a has been met i.e. that any misalignment between the interest of originators or sponsors and investors has been removed.
  - (ii). Credit institutions should consider whether the securitisation transaction has been structured in such a way as to avoid or undermine the application of the retention requirement, in particular through any fee structure, premium structure, or other profit extraction mechanism.
  - (iii). Credit institutions should consider the economic substance of the entire transaction when assessing whether the retention meets the requirements set out in Article 122a. For example, as securitisations may be structured in many different ways, the retention requirement should be applicable in all situations where the economic substance of the securitisation meets the definition of Directive 2006/48/EC, whatever the legal structure of the transaction.
2. Further clarification on the application of Article 122a to purchased receivables is provided under point [54] below.

#### **General considerations on Paragraphs 1-7**

3. As a general principle, for transactions which meet the definition of a securitisation under Article 4(36) of Directive 2006/48/EC (for instance, due to the tranching of credit risk), the provisions of Article 122a would typically apply. This application will take into account how the particular regulatory regime of each transaction, its economic substance, and other features fit with the aim of Article 122a to align incentives between the interest of originators or sponsors and investors.
4. The text of Article 122a makes a distinction between the requirements that are expected of:
  - (i). Credit institutions “investing” in securitisations;
  - (ii). Credit institutions assuming “exposure” to securitisations;
  - (iii). Credit institutions acting as “sponsors” or “originators” of securitisations or securitised exposures.

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<sup>2</sup> The analyzed recitals 24 and 25 are from Directive 2009/111/EC, and have not been included in the consolidated 2006/48/EC



5. Article 122a contains required sanctions for non compliance which are detailed under Paragraphs 5 and 6. It should be noted that the requirements in Paragraph 5 reference the requirements set out in Paragraphs 4, 5 and 7, with the requirements of Paragraph 4 in turn referencing the requirements of Paragraph 1.
6. For purposes of clarity, the table below outlines the various roles a credit institution can assume with respect to a securitisation, and how these can be mapped to the application of sanctions for non compliance.

	Para 1 (All)	Para 4 (All)	Para 5 (Sub-Para 1)	Para 5 (Sub-Para 2)	Para 6 (All)	Para 7 (All)
Summary requirement:	Confirm retention	Analyze, understand, stress-test	Monitor	Understand structural features	Same criteria for securitised and retained exposures	Provide sufficient disclosure and information
Applies to:	Credit institution assuming "exposure" to credit risk (including when "investing")	Credit institution when "investing" only	Credit institution when "investing" only	Credit institution assuming "exposure" to credit risk (including when "investing")	Credit institution as "sponsor" or "originator"	Credit Institution as "sponsor" or "originator"
Additional guidance:		Does not apply if assuming "exposure" to credit risk, but not "investing"	Does not apply if assuming "exposure" to credit risk, but not "investing"			
Would typically apply to credit institutions in role as:	Investor; liquidity facility provider; derivative/h edge counterparty assuming risk arising from principal losses	Investor; derivative/h edge counterparty assuming risk arising from principal losses	Investor; derivative/h edge counterparty assuming risk arising from principal losses	Investor; liquidity facility provider; derivative/h edge counterparty assuming risk arising from principal losses	Sponsor, originator	Sponsor, originator
Would typically not apply to credit institutions in role as:	Derivative/h edge counterparty not assuming risk arising from principal losses	Eligible liquidity facility provider; derivative/h edge counterparty not assuming risk arising from principal losses	Eligible liquidity facility provider; derivative/h edge counterparty not assuming risk arising from principal losses	Derivative/h edge counterparty not assuming risk arising from principal losses	All other roles	All other roles
Do additional risk weights apply if breach of requirements?	Yes	Yes	Yes	Yes	No, specific sanctions within Para 6 apply instead (inclusion of securitised exposures in capital calculation)	Yes, additional risk weights are applied to the interest retained by the sponsor or originator

*Question 1: Do you agree with this differentiation between the requirements of credit institutions when "investing" (leading to the applicability of Paragraphs 1, 4, and both sub-paragraphs of 5) as opposed to the lesser requirements when assuming "exposure" but not "investing" (leading to applicability of Paragraph 1 and sub-paragraph 2 of Paragraph 5)?*

7. With respect to liquidity facilities provided by credit institutions to securitisations, a key element of deciding whether the credit institution should be subject to Article 122a is whether the credit institution as liquidity facility provider is exposed to the credit risk of the securitisation position(s). The CRD provides for a preferential treatment for certain types of liquidity facilities ranking "super senior" to all other securitisation exposures, in that they meet specific requirements (set out in Annex IX, part 4, paragraph 2.4.1 point 13) aimed at ensuring that they are not exposed to the risk of default of the underlying exposures (eligible liquidity facilities). Liquidity facilities provided by credit institutions that are not eligible under the above mentioned criteria should be subject to the specific requirements of article 122a that are indicated in the table above for credit institutions assuming exposure to credit risk.

*Question 2: Do you agree with this differentiation in the role of a credit institution as liquidity facility provider (based on the provisions of CRD Annex IX, part 4, paragraph 2.4.1, point 13)?*

8. With respect to credit institutions acting as hedge/derivative counterparties to securitisations, once again a key element of deciding whether the credit institution should be subject to Article 122a is whether the credit institution as hedge/derivative counterparty is exposed to the risk arising from principal losses on the securitised exposures or securitisation position(s). Consequently, in the table above a distinction is made between a "derivative/hedge counterparty assuming risk arising from principal losses" (which may be subject to the requirements of Article 122a), and a "derivative/hedge counterparty not assuming risk arising from principal losses" (which would typically not be subject to the requirements of Article 122a). The former would include, for instance, a credit institution providing a total return swap that covers the credit risk of the securitised exposures, and hence provides credit enhancement to the securitisation. The latter would include, for instance, a credit institution providing an interest rate or currency swap to a securitisation that does not assume the credit risk of the securitised exposures (for instance, by only referencing performing receivables in its notional). Credit institutions should determine the extent to which a role as derivative/hedge counterparty to a securitisation does or does not assume credit risk, and thereafter apply the specific requirements and paragraphs of Article 122a that are indicated in the table above.

*Question 3: Do you agree with this differentiation in the role of a credit institution as hedge counterparty, and what issues might arise when credit institutions seek to determine whether their role as hedge counterparty results in the assumption of credit risk or not?*

9. With respect to warehousing transactions, or transactions in which there is a ramp-up period (in which exposures are accumulated) before securitising, the applicability of Article 122a to these depends upon whether the transactions themselves (and more specifically, the transactions during their warehousing or ramp-up periods) would fall under the definition of a securitisation. If the definition of a securitisation is not met, they would typically be out of scope. If the definition of a securitisation is met (for instance, if junior/senior funding to a warehouse SPV is provided by more than one lender, and this

creates a tranching of credit risk), then the requirements of Article 122a would typically be applicable.

10. With respect to the application of additional risk weights for non compliance with Paragraph 1 in the table above, although breach of Paragraph 1 is not directly referenced as causing additional risk weights to be applied in Paragraph 5, because fulfilling Paragraph 1 is referenced as a requirement of fulfilling Paragraph 4, and because non-fulfilment of Paragraph 4 leads to additional risk weights under Paragraph 5, then non-fulfilment of the requirements of Paragraph 1 thus indirectly leads to the application of additional risk weights under Paragraph 5.
11. Use of the term “due diligence” within Article 122a, and by extension use of the term within this guidance, is not to be understood in a narrower sense in which it may be used for audit or legal purposes. Rather, it is to be understood to encompass credit analysis and similar activities of the type described in Paragraph 4 of Article 122a, for instance.

## Paragraph 1

### **Paragraph 1**

*A credit institution, other than when acting as an originator, a sponsor or original lender, shall be exposed to the credit risk of a securitisation position in its trading book or non-trading book only 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%.*

*For the purpose of this Article, “retention of net economic interest” means:*

- a) retention of no less than 5 % of the nominal value of each of the tranches sold or transferred to the investors;*
- b) in the case of securitisations of revolving exposures, retention of the originator’s interest of no less than 5 % of the nominal value of the securitised exposures;*
- c) retention of randomly selected exposures, equivalent to no less than 5 % of the nominal amount of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is no less than 100 at origination; or*
- d) 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.*

*Net economic interest is measured at the origination and shall be maintained on an ongoing basis. It shall not be subject to any credit risk mitigation or any short positions or any other hedge. The net economic interest shall be determined by the notional value for off-balance sheet items.*

*For the purpose of this Article, “ongoing basis” means that retained positions, interest or exposures are not hedged or sold.*

*There shall be no multiple applications of the retention requirements for any given securitisation.*

## **General considerations**

12. For an overview of how the provisions of Paragraph 1 apply with respect to the various roles a credit institution can assume in a securitisation, and how these in turn can be mapped to the application of sanctions for non compliance with the provisions of Paragraph 1, see the section “General considerations on Paragraphs 1-7” above.

13. The retention requirement aims to align incentives between sponsors, originators, and original lenders (typically, the entity that was directly involved in the original agreements which created the exposures that are

securitised) and the ultimate investor that assumes the credit risk of the securitised exposures.

14. As noted in paragraph [3] above, transactions which meet the directive definition of a securitisation in Article 4(36) would be subject to Article 122a. This definition captures the tranching of credit risk, rather than specifying the need for the transfer of credit risk vis-à-vis third parties. Therefore, where such tranching of credit risk occurs and the definition is met, the requirements in Article 122a would apply. Nevertheless, when the tranching of credit risk is made on the liabilities issued by an originator or multiple originators (including covered bonds, treasury bonds or similar transactions) and such liabilities do not transfer the credit risk of third parties, because the credit risk clearly remains with the originator (the originator is the final debtor to the investor) it is clear that economic interests are already aligned and thus the requirement for retention under Paragraph 1 may be deemed to be fulfilled automatically. However, when such liabilities are issued to transfer the credit risk of third parties (e.g. credit-linked notes) through securitisation, it cannot be claimed that incentives are already aligned and so the retention requirement must still be shown to be satisfied according to the provisions of Paragraph 1.

15. The Directive recognises that different entities may fulfil the obligation to retain, and permits an 'originator, sponsor or original lender' to meet the requirement. While the terms originator and sponsor have been defined by the Directive<sup>3</sup>, the term original lender remains undefined. The original lender and the originator will typically be the same entity, however this may not always be the case. For example, an entity may sell a portfolio to another entity, which may securitise it in whole or as part of a larger and more diversified pool of exposures. In this case, it is acceptable for the fulfilment of the retention requirement that the original lender retains part of the risk instead of the originator or sponsor provided that the originator/sponsor acts as a mere intermediary between the original lender and the market.

16. For ease of reference:

- (i). Directive 2006/48/EC, Article 4 (41) defines an 'originator' as 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.
- (ii). Directive 2006/48/EC, Article 4 (42) defines a 'sponsor' as a credit institution other than an originator credit institution that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities.

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<sup>3</sup> 2006/48/EC

17. It should be noted that, for the purposes of the Directive, Article 4 (42) defines that a sponsor must be a credit institution. Therefore, when the entity which acts as the sponsor of a securitisation is not a credit institution, the retention requirement must be fulfilled instead through either the originator or the original lender. Should a transaction involve an entity which fails to meet the definition of either originator or sponsor, the retention requirement must be fulfilled through the original lender.
18. The level of commitment by originators, sponsors or original lenders must not be reduced either through hedging or selling of the retained interest. However, the level of commitment will not be deemed to have been affected by either the amortisation of such interest via cashflow allocation (within parameters further outlined below) or through the allocation of losses which in effect reduce the level of retention over time (this principle is explored in more detail under [34] below).
19. At origination there should not be any embedded mechanism in the securitisation structure by which the minimum retention requirement of an originator, sponsor or original lender would necessarily decline over time materially faster than the interest transferred such that this would cause the 5% retention requirement to subsequently be breached (this principle is explored in more detail under [34] below).
20. In circumstances where the securitised exposures are those of multiple originators or original lenders, then retention of net economic interest must be fulfilled by each original lender or originator with reference to the proportion of total securitised exposures in the securitisation for which it is the originator or original lender or, alternatively, can be fulfilled by the sponsor of the securitisation into which such securitised exposures of multiple originators or multiple original lenders have been sold or otherwise pooled. For avoidance of doubt, this means that fulfilling the requirement for retention of net economic interest cannot be undertaken by one originator or original lender retaining a net economic interest while none of the other multiple originators or original lenders retain any net economic interest, unless such originator or original lender is also sponsor of the securitisation and fulfils the requirement thus. In cases where similar circumstances should arise with respect to sponsorship of a securitisation (i.e. should there be the possibility of multiple sponsors of a securitisation), and where the retention requirement is being fulfilled by the sponsor(s) (as opposed to the originator(s) or original lender(s)), then similar guidance with respect to fulfilment of the retention requirement on an individual basis by such sponsors would apply. For the fulfilment of the requirement where multiple originators or original lenders are included in the scope of supervision on a consolidated basis see paragraph [53].

*Question 4: Does this guidance adequately address means of fulfilling the retention requirement in the case of securitisations of exposures from multiple originators, sponsors, or original lenders? And if not, what suggestions do you have for additional clarity?*

21. The obligation of a credit institution when assuming exposure to the credit risk of a securitisation position is to ensure that the originator, sponsor or original lender has “explicitly disclosed” that it will fulfil its retention obligation. The investing credit institution has still fulfilled its obligation should such originator, sponsor or original lender fail to act in the manner it disclosed (for instance, by not retaining such an interest, contrary to what it previously communicated) and the credit institution is not deemed to have been responsible for negligence or omission in the fulfilment of its due diligence obligations.
22. In the case set out in the above paragraph, the credit institution is not obliged to dispose of such a securitisation position. Consequently, a credit institutions as investor will typically be subject to an additional risk weight only in those securitisation positions for which it does not meet the requirements by reason of its negligence or omission. Breaches in the commitment to retain, or in other requirements of originators, sponsors or original lenders will neither result in any additional risk weights to the investing credit institutions nor the compulsion to sell the relevant securitisation positions, if the probability of such breaches has been adequately taken into account in the due diligence process (for example, the credit institution has properly considered the nature of the commitments to maintain the net economic interest and to disclose relevant data on the underlying assets, such as via any contractual provisions). Any breaches in different securitisations by the same sponsor, originator or original lender should be taken into account in advance and consequently may lead to additional risk weights.
23. For the avoidance of doubt, the form of retention (i.e. which of options (a) through (d) is used) cannot change during the life of the transaction, except under exceptional circumstances only (for example when re-structuring is necessary) and provided that this is disclosed to investors, without such change impacting the fulfilment of the requirements of this Paragraph 1. However, credit institutions should be sensitive to potential abuse by originators, sponsors or original lenders of such ability to change the form of retention.

*Question 5: Do you agree that the form of retention should not be able to be changed during the life of the transaction, except under exceptional circumstances only, or alternatively should some additional flexibility be granted? Please provide evidence of exceptional circumstances which would justify a change in the form of retention.*

## **Net Economic Interest**

24. Where the percentage of retention is referenced to the nominal value of the securitised exposures, this refers to the gross exposure value (i.e. gross of impairments and value adjustments, not net of these).
25. The Directive defines ‘net economic interest’ as a nominal exposure, and not a notional exposure. Therefore, securitisation positions which have no



principal component (for example, an excess spread tranche) do not qualify as part of the retention requirement.

*Question 6: Should the definition of “net economic interest” in terms of “nominal” exposure be interpreted to mean that both excess spread tranches (i.e. where only residual interest cashflows are sold) and interest-only tranches (i.e. where all interest cashflows are sold) be excluded from the various means of fulfilling the retention requirement (as both have notional rather than nominal values), or should either be a valid means of fulfilling the retention requirement? If the retention requirement were allowed to be fulfilled by retention of a tranche with no principal component (for instance, an excess spread tranche or an interest-only tranche), how would the retention percentage be computed – with reference to the notional value, market value, or otherwise?*

26. Retention of a net economic interest of 5% under this Paragraph 1 is interpreted to be fulfilled by any one of options (a), (b), (c) or (d) separately, but not by a combination of more than one of these options.

## **Disclosure**

27. The disclosure by an originator, sponsor or original lender should be made available publicly and should be appropriately documented. Such disclosures may be made privately where appropriate (for example, a bi-lateral or private transaction), however oral disclosures will not be adequate to demonstrate compliance. The disclosure should be made at origination of the transaction, and should be confirmed thereafter with the same frequency as the reporting frequency of the transaction (but at a minimum annually), and at any point where the requirement is breached. The reporting frequency of the transaction would typically be the frequency with which the servicer report, investor report, trustee report, or any similar document is published.

*Question 7: Where Paragraph 1 indicates that a credit institution must ensure that retention has been “explicitly disclosed”, is the guidance above sufficient? In particular, will the market evolve such that credit institutions would expect such disclosure by market participants to be of a binding nature, and therefore provide some means of enforcement or redress to them, or should such a requirement be part of the CEBS guidance? Feedback is welcome on the most effective means to assure that the commitment of the originator, sponsor or original lender is enforceable by credit institutions that invest. This is an area which CEBS is likely to pay particular attention to in as part of keeping these guidelines up to date and in annual reviews of compliance.*

## **Hedging and sale of retained exposures**

28. The retention requirement should not be subject to any credit risk mitigation or any short positions or any other hedge. A credit institution should consider the economic substance of the entire transaction and consider whether any credit risk mitigation, short position or hedge essentially renders the 5% retention ineffective. Such protection arrangements will not be permissible.

29. Notwithstanding these points, the ability of certain types of hedging to undermine the application of the retention requirement could be explored.

The aim is to disallow hedging that eliminates a sponsor's, originator's or original lender's exposure to the credit quality of the specific exposures that have been securitised and seek to balance this objective with another of ensuring that sponsors, originators and original lenders still have sufficient flexibility to risk-manage their exposure to broader changes in the credit quality of the asset classes, collateral, or macroeconomic variables to which they are exposed via their lending activities, securitisation activities, or otherwise.

30. The following types of hedge are not permissible:

- a) A direct hedge on the credit risk of the retained securitisation positions is not permissible. For example, a credit institution may not buy protection on the retained position (or pool of retained positions) through a credit default swap.
- b) A direct hedge on the securitised exposures is not permissible. Credit institutions should also consider hedges to obligors (for instance, a corporate borrower) across its balance sheet and ensure that this hedging doesn't undermine the effectiveness of the retention requirement.

31. CEBS has identified possible types of hedge that might be considered permissible, if sufficient evidence is provided by respondents during consultation that they do not undermine the main objective of the retention requirement:

- c) A hedge based on an index which contains the same underlying asset classes may be permissible. For example, a credit institution may buy protection via CMBX, ABX, LCDX, etc, provided that the reference exposures in the index do not replicate exactly or are not overly concentrated by weighting in the securitised exposures that are subject to the retention requirement to the extent that this would undermine the effectiveness of the retention requirement. The level of concentration that would be sufficient to undermine such effectiveness will vary, depending on the index construction, asset class, and the nature of the securitised exposures. For the avoidance of doubt, this means that it is permissible for the securitised exposures subject to the retention requirement to be referenced in such index and for the originator, sponsor or original lender to manage its risks via such an index.
- d) An indirect hedge on risk factors that potentially impact default, loss and recovery rates of the underlying collateral may be permissible. (For example, as part of a credit institution's risk management they may have short positions in house price futures).
- e) An indirect hedge on macroeconomic variables which link to the performance of the securitised exposures may be permissible. For example, a credit institution may purchase an interest rate cap if an increase in interest rates would be expected to adversely impact the ability of borrowers to fulfil their obligations.

*Question 8: Does this guidance address properly the subject of hedging of retained exposures? What specific types of hedge should be permitted? CEBS would welcome evidence and examples from respondents.*

32. When a sponsor, originator or original lender acts as a hedge counterparty to a securitisation (for instance, in hedging interest rate risk or currency risk), this is permissible, and is not intended to be captured under the term “any other hedge”. For example, the originator, sponsor or original lender may act as counterparty to the transaction in providing an interest rate hedge.
33. Synthetically recreating the retained exposure after the sale of such an exposure is not permissible. For example, an originator can not sell its retained exposure while simultaneously writing a CDS on the transaction, in order to get 5% more funding albeit with the same credit exposure.

## **Measuring the retention requirement**

34. The retention requirement is measured at “origination” and “shall be maintained on an ongoing basis”; therefore when the bonds are issued or subsequently purchased in the secondary market by an investor, the investor must ensure that the originator, sponsor or original lender has a retained position that meets the requirements. Measurement of retention “at origination” can typically be interpreted as being when the exposures were first securitised, and not (for instance) when the underlying loans were first extended. Furthermore, measurement of retention “at origination” means that 5% is the retention percentage that is required at the point in time when such retention level was measured and the requirement fulfilled (for instance, when the exposures were first securitised); dynamic re-measurement and re-adjustment of the retained percentage throughout the life of the transaction is not necessarily required (though in certain circumstances, outlined under [(i)]-[(iv)] below, such re-measurement and/or re-adjustment of the retained interest may be necessary from a practical perspective). However, consideration should be given to dynamics within individual transactions that may undermine the effectiveness of the retention requirement. For clarification, the following are example of considerations with respect to payment rates, losses, and revolving pools.
- (i). Payment rates: Where an originator, sponsor or original lender meets the retention requirement through option (c), due to the random nature of the selection process, the expected payment rate of the assets retained on balance sheet should typically not be significantly different to the expected payment rate of the assets in the securitisation. Therefore, any subsequent divergence from the initial retention percentage of 5% will not typically result in a failure to meet the retention requirement provided any higher payment rate of the exposures retained on balance sheet compared to the securitised exposures is not explicitly due to actions undertaken by the originator or due to non-randomness in the selection process.
  - (ii). Losses: Where an originator, sponsor or original lender meets the requirement through option (d) they are not required to constantly replenish their retained interest as losses flow through the transaction and are allocated to such first loss tranche. The 5% is calculated based on the nominal value of the securitised exposures at origination, which remains unchanged through the life of the transaction, as long as the net economic interest is not hedged or sold.

- (iii). Dynamic pools: The application is clear in standalone static transactions, however many transactions involve securitised pools that fluctuate over time and therefore the retention requirement could fluctuate over time, potentially undermining the effectiveness of the retention requirement. For example, an asset pool may revolve over time (i.e. both increasing and decreasing over time), have ramp-up periods (i.e. increases over time, before amortizing down), have substitution periods (stay constant for a period, before amortizing down), or simply pay down from the outset of the transaction (amortize down from point of closing onwards, i.e. a “static” transaction). To take account of these different circumstances, where asset pools may increase or decrease over time, the retained net economic interest could increase should the outstanding pool balance grow over time, and could conversely decrease should the outstanding pool balance fall over time.
- (iv). Structural features of the transaction: With respect to options (a), (b) and (d), there can be cash flow waterfalls and triggers in transactions that accelerate or decelerate repayment of the originator’s interest; for instance, repaying it faster via a “turbo” mechanism, or repaying it more slowly via early amortisation of the investor interest. These waterfalls and mechanisms may cause additional complexity in maintaining the retention requirement at its pre-defined 5% level, and also can create a situation whereby an originator has a 5% interest upon the closing of a transaction but due to cash flow allocation thereafter this may differ over the life of the transaction.

As an overall principle, when assessing such waterfalls or triggers in the light of the retention requirement, the general approach should be that the originator’s retained interest should not be prioritized in terms of cash flows (either principal flows or interest flows) to preferentially benefit from being repaid or amortizing earlier in a manner that would reduce it below 5% of the current outstanding balance of the asset pool (although it could fall below 5% of the initial outstanding balance of the asset pool), and so the credit support provided to the investor initially should not decline disproportionately relative to the rate of repayment on the underlying assets (though it could decline relative to the absolute initial value of the securitised exposures upon closing of the transaction).

- a) One interpretation of this, would be that principal and interest flows can be used to allow the retained interest to pay down on a time-subordinated basis after, or on a pro rata basis alongside, the investor interest, but not on an accelerated basis ahead of the investor interest such that this would cause the 5% retention requirement to subsequently be breached. For instance, if the retained interest is in the form of a first loss tranche under option (d), as the asset pool declines from 100 to 50, the first loss tranche can also fall from 5 to 2.5 due to pro rata allocation of principal repayments on the assets to both investors and the originator, and this first loss tranche would not have to remain static at 5.

- b) With respect to option (d), notwithstanding the phrase “not maturing any earlier than those transferred or sold to investors”, this is interpreted to mean that such first loss tranche can amortize in line with more senior tranches on a pro-rata basis (subject to the conditions specified under [(a)] above). In other words, that the first loss tranche does not mature any earlier than more senior tranches does not signify that it cannot amortize simultaneously with more senior tranches.

35. The 5% applied under option (a) references the “tranches” of the transaction, while the 5% applied under options (b), (c) and (d) references the “securitised exposures” of the transaction. Under certain circumstances this could lead to different outcomes between the different options when measuring the retention requirement; for instance, if the transaction benefits from overcollateralization (i.e. the nominal value of securitised exposures is higher than the nominal value of tranches issued).

### **Vertical slice retention (option (a))**

36. The vertical slice retention of 5% of the nominal value of each of the tranches may also be achieved by retaining 5% of each of the securitised exposures if the portions retained always rank pari passu or are junior to the securitised portions. As per Recital 24, retention in this form results in the originator, sponsor or original lender retaining “exposure to the risk of the loans in question” notwithstanding what “legal structures or instruments are used to obtain this economic substance”.

*Question 9: Should retention of 5% of each securitised exposure fulfil the requirements of Paragraph 1 under option (a)?*

### **Originator interest retention (option (b))**

37. The use of this option is interpreted to be applicable not only to securitisations of revolving exposures, but also to revolving securitisations of non-revolving exposures (or revolving securitisations with a combination of revolving and non-revolving exposures). Once again, as per Recital 24, retention in this form results in the originator, sponsor or original lender retaining “exposure to the risk of the loans in question” notwithstanding what “legal structures or instruments are used to obtain this economic substance”. For example, this means that both a revolving securitisation of credit card loans (where the loans themselves have revolving balances) and a revolving securitisation of mortgage loans (where the loans themselves do not have revolving balances) are interpreted to be captured under this option (b).

*Question 10: Should option (b) be applicable equally to both securitisations of revolving exposures and revolving securitisations of non-revolving exposures<sup>4</sup> (or revolving securitisations with a combination of revolving and non-revolving exposures) in fulfilling the requirements of Paragraph 1?*

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<sup>4</sup> For example, the seller interest or originator share in a revolving or evergreen RMBS structure, irrespective of the legal structure of the SPV (trust, corporation or other), which securitises non-revolving mortgages.

## **On-balance sheet retention (option (c))**

38. The on-balance sheet retention option can be used in respect of synthetic transactions as well as traditional securitisations. However, the assets that are counted towards the 5% on balance sheet retention requirement cannot also be synthetically securitised (in other words, the originator should not buy protection on such percentage of the asset pool that counts towards the retention requirement).
39. When considering the process for randomly selecting exposures, credit institutions should consider both quantitative and qualitative factors when defining the pool of potentially securitised exposures from which the exposures retained and the exposures securitised are drawn, and consequently only truly 'random' differences should exist or evolve between the retained and securitised exposures. Such factors may include the distribution, weighted averages, or stratifications of such factors as: vintage, product, obligor geography, origination date, maturity date, LTV, property type, industry sector, debt service coverage ratio, interest coverage ratio, and outstanding loan balance. Bearing in mind that the specific targeted risk factors of each pool of potentially securitised exposures will depend on legitimate business decisions taken by originators or sponsors, this is a non-exhaustive list of factors that might apply for certain types of transactions. Such risk factors used in defining the pool of potentially securitised exposures should be disclosed clearly to investors for due diligence purposes.
40. The requirement that the number of potentially securitised exposures is no less than 100 at origination means that the pool of potentially securitised exposures from which the 5% of randomly selected exposures is drawn contains no less than 100 exposures, not that the randomly selected retained exposure themselves consist of no less than 100 exposures. Notwithstanding this specific number, as a general principle the choice of option (c) as a method of fulfilling the retention requirement is intended primarily for granular pools of securitised exposures, and should option (c) be used the outcome of the random selection process should not result in either the retained or securitised portion being overly concentrated.
41. Given the clarification on the phrase "potentially securitised exposures" in [40] above, the requirement that "retention of randomly selected exposures, equivalent to no less than 5% of the nominal amount of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation" means that the retained exposures are calculated as 5.0% (5/100), not as 4.76% (5/105).
42. When the retention requirement is fulfilled using option (c), the randomly selected exposures that are retained on the balance sheet to meet the requirement should be a static pool of exposures, i.e. it is not possible for a sponsor, originator or original lender to at different points in times designate different exposures as being those that enable it to fulfil the retention requirement, except insofar this is done to fulfil the requirements with respect to a securitisation in which the revolving balance of securitised exposures fluctuates over time (with such replenishment being subject to the guidance on randomness provided in [39] above).

### **First loss retention (option (d))**

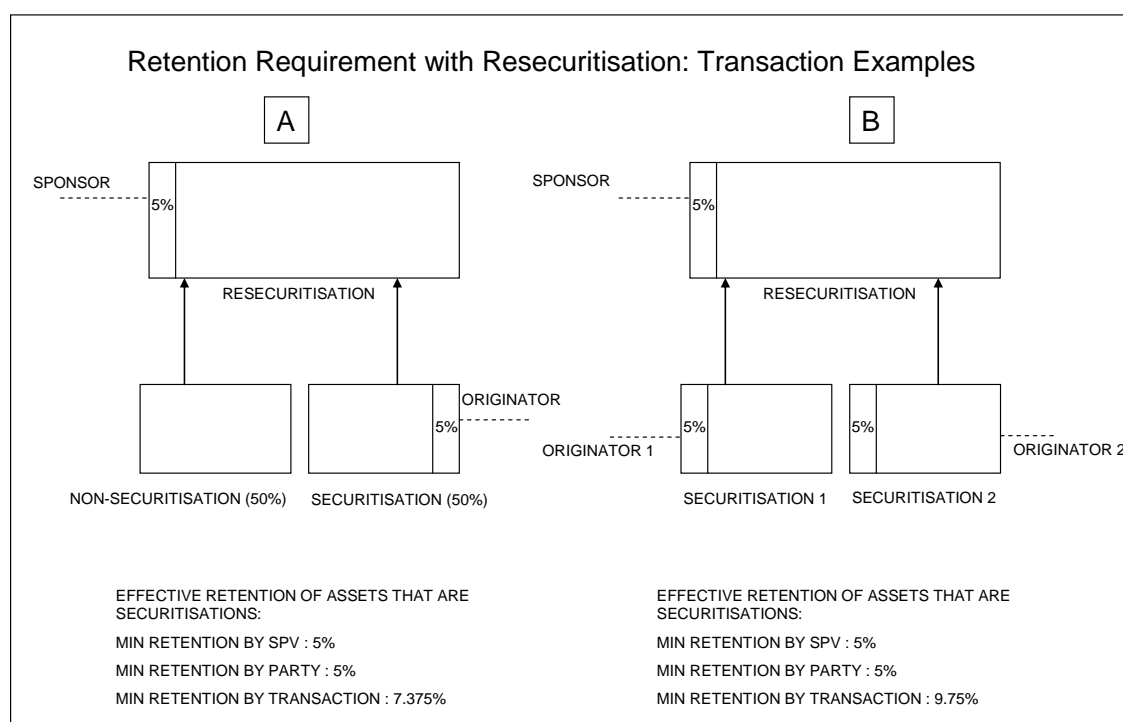
43. With respect to option (d), the phrase “retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors” is interpreted to mean retention of such first loss tranche and, if necessary, other contiguous positions that are senior to it, but are still the same as, or junior, to any position transferred or sold to investors.
44. A “first loss tranche” may consist of such exposures as a junior bond tranche, a reserve account (on which, however, see [45] below), an equity interest, or a preference share interest (this is a non-exhaustive list).
45. Only funded reserve accounts (or the funded portion of a reserve account, if partially funded) fulfil the retention requirement; an unfunded reserve account (or the unfunded proportion of a partially funded reserve account) that is to be funded via future excess spread does not fulfil the retention requirement.
46. Whereas both Recital 25 and Paragraph 3 outline the non-applicability of the provisions of Article 122a to purchased receivables (with Recital 25 explicitly specifying those purchased receivables that are “transferred at a discount”), should such exemptions not apply for any reason to transactions in which the receivables are sold with a refundable purchase discount, then such refundable purchase discount would qualify as a first loss tranche under option (d), assuming (as per Recital 24) that the “economic substance of the securitisation” justifies this.

### **Multiple applications**

47. The Directive requires that there ‘shall be no multiple applications of the retention requirement’. The text does not mean that there is a prohibition on multiple applications; rather that, as outlined in Recital 24, it suffices that for any given securitisation only one of the originator, sponsor or original lender is subject to the requirement. Therefore, multiple application of the retention requirement by different parties to the transaction is not mandated by the Directive.
48. For a resecuritisation, from the perspective of the investor (in that resecuritisations), the retention requirement would apply only to the second (“repackaged”) layer of the transaction (in which they are investing), and not to the first layer of the transaction (the securitisations that underlie this second layer). However, the sponsor or originator of such a resecuritisation has a duty to ensure that the securitisations from which it is constructed also fulfil the retention requirement at that point in time, and to disclose this to investors in the resecuritisation. For avoidance of doubt, this means that the phrase “there shall be no multiple applications of the retention requirement” is interpreted to mean that there shall be no requirement for multiple application either by individual parties or at the level of individual SPVs, but that there may be multiple application at the overall transaction level (for

instance, where a transaction is the resecuritisation of existing securitisations). As a result, resecritisations of existing securitisations may result in retention occurring at more than one level in the overall transaction (i.e. in both in the underlying securitisation and in the newly created resecritisations). However, such multiple application should not be required if the substance of the transaction is not that of a resecritisation (as defined in the directive); for instance if the presence of two SPVs in the transaction is the result of the legal structure of the transaction (for instance, the need for both a borrower SPV and an issuer SPV). Nonetheless, such multiple application of retention would be the result of the resecritisation process itself, and not a necessity to fulfil the retention requirement for the investor in the resecritisation. (Examples of this are provided below.) Furthermore, in the context of resecritisations, credit institutions should be particularly sensitive to the use of SPVs: they shall not invest in structures created with the intention of avoiding the economic substance of the retention requirements.<sup>5</sup>

*Question 11: Do you agree with this interpretation of the phrase “there shall be no multiple applications of the retention requirement” to mean that there shall be no requirement for multiple application either by individual parties or at the level of individual SPVs, but that there may be multiple application at the overall transaction level (for instance, where a transaction is the resecritisation of existing securitisations), and does the above lead to an effective and proportionate alignment of interest for resecritisations?*



<sup>5</sup> In practice it is likely that the retained interest of resecritisations will be held by the sponsor of such resecritisations.



## Other issues

49. The minimum required retention level specified in Paragraph 1 is 5%, but there is nothing to prevent the actual retention level to be higher than this.<sup>6</sup>

50. The phrase “the net economic interest shall be determined by the notional value for off-balance sheet items” is interpreted as follows. Should the securitisation involve off-balance sheet assets or liabilities (for instance, undrawn lending commitments and facilities, future cashflows or sales, or other contingent assets and liabilities), then the retention requirement is fulfilled by retaining a 5% exposure to the notional value such contingent commitments, undrawn facilities or future cashflows.

*Question 12: Does this interpretation of the phrase “net economic interest shall be determined by the notional value for off-balance sheet items” raise any potential issues with respect to application of the retention requirement?*

51. When the retention requirement is fulfilled using any of options (a) through (d), the retained exposures may be available to be used by the sponsor, originator or original lender as collateral for secured funding purposes, as long as credit risk of these retained exposures is not transferred to a third party in such secured funding arrangements.

52. Paragraph 1 specifies that “retained positions... are not hedged or sold”. This would preclude the party with the retained interest (any of options (a) through (d)) from using it for secured funding 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. This is because the securities are in effect sold and repurchased at a later date in such a transaction. Consequently, the retained exposure should not be used to raise funds in such repo transactions.

*Question 13: Given that Paragraph 1 specifies that “retained positions, interest or exposures are not hedged or sold”, to what extent will it be possible for an originator, sponsor or original lender to use such retained interest for secured funding purposes without having “sold” such retained interest, for instance in cases where such funding is sought under a TBMA/ISMA Global Master Repurchase Agreement (GMRA) or alternatively under a bespoke repo agreement?*

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<sup>6</sup> See Report from the Commission to the Council and the European Parliament: Expected Impact of Article 122a of Directive 2006/48/EC (COM(2010)262, 28 May 2010): “Regarding the specific question of the effectiveness of the minimum retention level chosen, the Commission concludes that the existing moderate minimum retention level of 5% should be kept, acknowledging that investors should require higher retention levels depending on the securitisation in question.” See also CEBS Technical Advice on the Effectiveness of a Minimum Retention Requirement for Securitisations (30 October 2009) where it is concluded that there is no strong evidence that a change in the retention percentage (from 5% to any other single number) would result in better alignment of (economic) interest between originators and investors: “Any assessment of whether an increase in the retention requirement is necessary begins with the suitability of the current requirement of 5%. It is difficult to provide conclusive evidence on the adequacy of 5% as the effectiveness of the alignment it creates will vary across asset classes, structures and geographies.”

## Paragraph 2

### Paragraph 2

*Where an EU parent credit institution or an EU financial holding company, or one of its subsidiaries, as an originator or a sponsor, securitises exposures from several credit institutions, investment firms or other financial institutions which are included in the scope of supervision on a consolidated basis, the requirement referred to in paragraph 1 may be satisfied on the basis of the consolidated situation of the related EU parent credit institution or EU financial holding company. This paragraph shall apply only where credit institutions, investment firms or financial institutions which created the securitised exposures have committed themselves to adhere to the requirements set out in paragraph 6 and deliver, in a timely manner, to the originator or sponsor and to the EU parent credit institution or an EU financial holding company the information needed to satisfy the requirements referred to in paragraph 7.*

53. Paragraph 2 allows that the requirement under Paragraph 1 may be met on the basis of the consolidated situation (rather than at the individual solo level) provided each relevant institution is included within the scope of the supervision on a consolidated basis. This is a practical way of allowing different entities within a group to take part in different securitisation transactions, whilst ensuring that any relevant institutions are still exposed to retained credit risk (by virtue of the consolidation) and incentives remain aligned. However, Paragraph 2 may only be used where the individual institutions have committed to ensure that the requirements of both Paragraphs 6 and 7 are also fulfilled. It should also be noted that Paragraph 1 is very clear that retained positions, interest or exposures must not be hedged or sold. This requirement should also be fulfilled on consolidated basis. Consequently if, for instance, one entity within the scope of consolidated supervision holds the retention; another entity within that same scope should not undertake a transaction which removed that same credit risk from the consolidated position. Similarly, the application of the additional risk weights under Paragraph 5 also need to be read in this context should there be any breach of the relevant requirements on a consolidated basis. In circumstances where the entity that retains the interest in the securitisation on behalf of other group entities is divested from the group, other group entities should address this by acquiring exposure to the securitisation so as to ensure ongoing compliance with the retention requirement.

### Paragraph 3

#### Paragraph 3

*Paragraph 1 shall not apply where the securitised exposures are claims or contingent claims on or fully, unconditionally and irrevocably guaranteed by:*

- a) central governments or central banks;*
- b) regional governments, local authorities and public sector entities of Member States;*
- c) institutions to which a 50 % risk weight or less is assigned under Articles 78 to 83; or*
- d) multilateral development banks.*

*Paragraph 1 shall not apply to:*

- a) 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; or*
- b) syndicated loans, purchased receivables or credit default swaps where these instruments are not used to package and/or hedge a securitisation that is covered by paragraph 1.*

54. The exemptions provided under Paragraph 3 are exemptions to the retention requirement of Paragraph 1; they are not exemptions to other requirements in other paragraphs of Article 122a.

55. CDX and iTraxx provide examples of clear, transparent and accessible indices to which the provisions of Paragraph 1 would not apply. The nature of such indices that allows the exemption from the provisions of Paragraph 1 should be that they are based on liquid instruments for which an investor has sufficient available market information and for which the notion of tradability can be applied to both derivatives and the ultimate underlying exposures. Regardless of the exact nature of the index in use, where an exemption is available under Paragraph 3 due to the transaction being based on such an index, it is important that the originator or sponsor does not control or direct the composition of the relevant index in such a way as to avoid the application of the retention requirement or to avoid the economic substance of the requirement (as per recital 24).

## Paragraph 4

### Paragraph 4

*Before investing, and as appropriate thereafter, credit institutions, shall be able to demonstrate to the competent authorities for each of their individual securitisation positions, that they have a comprehensive and thorough understanding of and have implemented formal policies and procedures appropriate to their trading book and non-trading book and commensurate with the risk profile of their investments in securitised positions for analysing and recording:*

- a) information disclosed under paragraph 1, by originators or sponsors to specify the net economic interest that they maintain, on an ongoing basis, in the securitisation;*
- b) the risk characteristics of the individual securitisation position;*
- c) the risk characteristics of the exposures underlying the securitisation position;*
- d) the reputation and loss experience in earlier securitisations of the originators or sponsors in the relevant exposure classes underlying the securitisation position;*
- e) the statements and disclosures made by the originators or sponsors, or their agents or advisors, about their due diligence on the securitised exposures and, where applicable, on the quality of the collateral supporting the securitised exposures;*
- f) where applicable, the methodologies and concepts on which the valuation of collateral supporting the securitised exposures is based and the policies adopted by the originator or sponsor to ensure the independence of the valuer; and*
- g) all the structural features of the securitisation that can materially impact the performance of the credit institution's securitisation position.*

*Credit institutions shall regularly perform their own stress tests appropriate to their securitisation positions. To this end, credit institutions may rely on financial models developed by an ECAI provided that credit institutions can demonstrate, when requested, that they took due care prior to investing to validate the relevant assumptions in and structuring of the models and to understand methodology, assumptions and results.*

## General considerations

56. For an overview of how the provisions of Paragraph 4 apply with respect to the various roles a credit institution can assume in a securitisation, and how these in turn can be mapped to the application of sanctions for non compliance with the provisions of Paragraph 4, see the section "General considerations on Paragraphs 1-7" above.

57. The requirements in Paragraph 4 should be carried out before investing, and as appropriate thereafter. A credit institution should consider the need to

review compliance if there is a material change in the performance of the assets or if certain events occur which impact the transaction (for example, if a contractual trigger is breached, or the originator becomes insolvent). Credit institutions should also consider the need to review compliance if the analysis originally undertaken is no longer appropriate, for example, due to the application of policies to their trading book or non-trading book or due to the risk profile of their investment.

58. As outlined in Recital 24, investors should make their decision to invest only after conducting thorough due diligence. To make such a decision investors need adequate information about the securitisation; therefore investors should not invest in securitisations where they determine that they do not have, and will not be able to receive, adequate information to undertake thorough due diligence and satisfy the requirements of the Directive.

### **Trading book/non-trading book**

59. As a general principle, credit institutions should apply the same policies and procedures to securitisation positions in their trading book and non-trading book. However, credit institutions may distinguish between the trading book and non-trading book as long as it is appropriate and can be justified. The classification that a position is in the trading book is not sufficient justification in and of itself. Firms must be able to justify any differentiation between policies and procedures that are applied due to securitisation positions being in their trading book versus their non-trading book and/or due to the risk profile of their investment differing. While the analysis undertaken for securitisation positions may be different depending on the risk profile of the position in the trading book or non-trading book, a credit institution must meet the minimum threshold due diligence requirements provided by the Directive in clauses (a) through (g) of this paragraph irrespective of the risk profile of the position or whether it is in the trading book or non-trading book. In other words, while the scope of due diligence is fixed (i.e. (a) to (g) of Paragraph 4), the intensity of the due diligence may vary (if justified) according to the specificities of the trading book versus the non-trading book.
60. Trading book requirements must not be considered to be a subset of non-trading book requirements; rather, they can be different to non-trading book requirements if the risk profile is truly different.
61. For example, in fulfilling the requirement to analyze and record policies that “ensure the independence of the valuer” of the collateral (in sub-clause (f) above), both the necessity (in terms of materiality) and the plausibility (in terms of time horizon) of undertaking such an activity before investing may differ for the trading book versus the non-trading book. Assuming that the risk profile of the trading book is truly different to that of the non-trading book, the extent to which this is appropriate as a requirement before investing may be assessed differently for the trading book versus the non-trading book.
62. As a counter-example, with respect to the requirement to analyse and record “the reputation and loss experience in earlier securitisations of the originators

or sponsors", as per sub-clause (d) above, it is unlikely (assuming that such loss information is freely available for previous public transactions of the same originator or sponsor) that the means of fulfilling this requirement would differ as materially for the trading book versus the non-trading book.

63. In performing its analysis a credit institution may also distinguish between the risk profile of its investments in securitisation positions. In determining whether different policies and procedures should apply a credit institution should consider all relevant factors that impact the risk profile of the investment. These could include, for example, the size of the position, the impact on the credit institutions' capital base during a period of stress, and concentration of risk in any one transaction, issuer or asset class. Furthermore, if circumstances change (for instance, turnover, duration and price transparency within the trading book are negatively impacted by adverse market conditions), then any such change in risk profile should be matched with a commensurate change in due diligence requirements.

*Question 14: Is further clarification needed on the ability to differentiate between the trading book and the non-trading book?*

### **Detailed requirements**

64. In relation to clause (a) [and (d)], as part of an effective due diligence process, a credit institution should also consider the nature and substance (contractual or otherwise) of the disclosure given by the originator, sponsor or original lender to maintain the net economic interest and to make accessible relevant data on the underlying assets on an on-going basis.
65. In relation to clause (b) of this paragraph, a sample of the risk characteristics that a credit institution should consider with respect to their individual securitisation positions could include tranche seniority level, tranche cash flow profile, rating, historical performance of similar tranches, bond covenants, credit enhancement, etc.
66. In relation to clause (c) of this paragraph, a sample of the risk characteristics that a credit institution should consider with respect to the underlying exposures has been provided in Paragraph 5 of Article 122a, which pertain mostly to residential mortgages. While these are appropriate to this specific asset class, investors should use appropriate and comparable metrics for other asset classes.
67. In relation to clause (g), a sample of the structural features that credit institutions could consider that can materially impact the performance of their position would include waterfalls, triggers, swaps, liquidity facilities, reserve accounts, sponsor support mechanisms, etc.
68. The requirements of credit institutions when investing in securitisations, as outlined in Paragraph 4 above, need not extend to the analysis and recording of information that would breach other legal or regulatory requirements (such as market abuse and confidentiality restrictions).

## Stress testing

69. The stress tests that credit institutions must undertake should be incorporated into broader stress-testing that is regularly undertaken by a credit institution. CEBS consulted on Guidelines on Stress Testing in December 2009. These can be found at: <http://www.cebs.org/documents/Publications/Consultation-papers/2009/CP32/CP32.aspx>. These stress testing guidelines set out the expectation that institutions ensure that they have appropriate stress testing governance and infrastructure in place and identifies the relevant “building blocks” required for an effective stress testing programme. In addition, Annex II of the guidelines as consulted upon includes specific principles in relation to securitisation. Subject to feedback received, these guidelines will be referenced in the final of this document.

*Question 15: Is the general guidance on securitisation stress testing in the document linked above sufficient, or is further guidance needed on how stress testing should be undertaken for the specific requirements of Article 122a, and if so what topics should such further guidance cover?*

70. Where a credit institution is relying on financial models developed by an ECAI (for example, a CDO evaluation tool), the credit institution must be actively running such financial models itself (with the ability to change inputs and stress levels, as appropriate). A credit institution should not rely on the output of the ECAI model (e.g. the rating) that the ECAI itself (and not the credit institution) has produced from such financial model.

71. Credit institutions may use financial models other than those of ECAs, such as financial models developed by professional services firms or financial technology and software vendors.

72. Credit institutions may rely on financial models developed by third parties only provided that the credit institution can demonstrate, when requested, that it took due care prior to investing to validate the relevant assumptions in, and structuring of, the models and to understand the methodology, assumptions and results.

73. While it may be possible that a credit institution can outsource certain operational aspects of these due diligence requirements to an external firm (such as data gathering), the process should remain in the full responsibility and control of the institution, as this does not relieve it of the obligation of being able to understand and assess the risk of its securitisation positions.

## Paragraph 5

### Paragraph 5

*Credit institutions, other than when acting as originators or sponsors or original lenders, shall establish formal procedures appropriate to their trading book and non-trading book and commensurate with the risk profile of their investments in securitised positions to monitor on an ongoing basis and in a timely manner performance information on the exposures underlying their securitisation positions. Where relevant, this shall include 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, and 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 bandwidths that facilitate adequate sensitivity analysis. Where the underlying exposures are themselves securitisation positions, credit institutions shall have the information set out in this subparagraph not only on the underlying securitisation tranches, such as the issuer name and credit quality, but also on the characteristics and performance of the pools underlying those securitisation tranches.*

*Credit institutions shall have a thorough understanding of all structural features of a securitisation transaction that would materially impact the performance of their exposures to the transaction such as the contractual waterfall and waterfall related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definition of default.*

*Where the requirements in paragraphs 4, 7 and in this paragraph are not met in any material respect by reason of the negligence or omission of the credit institution, Member States shall ensure that the competent authorities impose a proportionate additional risk weight of no less than 250 % of the risk weight (capped at 1 250 %) which would, but for this paragraph, apply to the relevant securitisation positions under Annex IX, Part 4, and shall progressively increase the risk weight with each subsequent infringement of the due diligence provisions. The competent authorities shall take into account the exemptions for certain securitisations provided in paragraph 3 by reducing the risk weight it would otherwise impose under this Article in respect of a securitisation to which paragraph 3 applies.*

## General considerations

74. For an overview of how the provisions of Paragraph 5 apply with respect to the various roles a credit institution can assume in a securitisation, and how these in turn can be mapped to the application of sanctions for non compliance with the provisions of Paragraph 5, see the section "General considerations on Paragraphs 1-7" above.



## Monitoring exposures

75. The frequency of a formal assessment of compliance with provisions regarding ongoing monitoring outlined in Paragraph 5 should be at least annually, however a credit institution should consider the need to review compliance with these provisions if there is a material change in the performance of the assets or if certain events occur which impact the transaction (for example, if a contractual trigger is breached, or the originator becomes insolvent).
76. The interpretation of the terms “commensurate” and “appropriate to the risk position” in this paragraph should also be taken in light of the guidelines to implementation of Paragraph 4 given under points [59-63] previously.

## Additional risk weights

77. The additional risk weight that a competent authority must impose is calculated as an additional risk weight of not less than 250% of the risk weight that could otherwise apply. For example, where the original risk weight is 10%, the new risk weight would be at least  $10\% + (250\% \times 10\%) = 35\%$ .
78. The relevant securitisation positions to which the additional risk weight is applied could (depending on the circumstances) be an individual securitisation position or multiple securitisations positions, depending on whether the requirements are not being met in any material respect for an individual transaction or for similar transactions in the same asset class, in the same business unit, or in some other combined respect. For the avoidance of doubt, it is intended that when there is non compliance for an individual transaction the additional risk weight shall be applied by the credit institution to all exposures arising from the same transaction.
79. Additional risk weights will not necessarily be applied to all securitisation positions due to non-fulfilment of the requirements with respect to one securitisation position.
80. The text of Paragraph 5 provides that the additional risk weight can be no less than 250% of the original risk weight and is capped at 1250%. This could in certain instances result in the overall capital required to be held against a securitisation position exceeding the exposure value of the relevant securitisation position (see Table 1 below). We consider that the cumulative result of any application of these rules should not result in the capital held against a securitisation exceeding the exposure value of the securitisation position.

Total regulatory capital after a given additional risk weight						
Table 1		Additional capital requirements <sup>7</sup>				
Original RW	Original MRC	250%	500%	750%	1000%	1250%
12%	1.0	3.36	5.76	8.16	10.56	12.96
15%	1.2	4.20	7.20	10.20	13.20	16.20
18%	1.4	5.04	8.64	12.24	15.84	19.44
20%	1.6	5.60	9.60	13.60	17.60	21.60
35%	2.8	9.80	16.80	23.80	30.80	37.80
60%	4.8	16.80	28.80	40.80	52.80	64.80
100%	8.0	28.00	48.00	68.00	88.00	108.00
250%	20.0	70.00	120.00	170.00	220.00	270.00
425%	34.0	119.00	204.00	289.00	374.00	459.00
650%	52.0	182.00	312.00	442.00	572.00	702.00
1250%	100.0	350.00	600.00	850.00	1100.00	1350.00

81. Consequently, notwithstanding that in Paragraph 5 it is specified that the "additional risk weight" that is initially imposed is "capped at 1250%", it is nonetheless interpreted that should the competent authority "progressively increase the risk weight", that the cumulative result of such progressive increases should avoid circumstances in which capital required to be held against a securitisation position exceeds the exposure value of that position.

*Question 16: Do you agree with this method of calculating the additional risk weight?*

82. In providing a framework for imposing additional risk weights, the following should be considered regarding the nature of the breach:

- a) The duration for which the additional risk weights are applied should be commensurate with the period of time for which the breach exists or existed, and trivial breaches that are corrected speedily are not subject to additional risk weights to an extent that is not commensurate with the materiality and risk context of the breach.
- b) If a securitisation position matures or is sold, it is assumed that the additional risk weight to that position will cease to apply.

83. The material obligations set out in Paragraphs 4, 5 and 7 of Article 122a (including sub-references to other paragraphs, for instance Paragraph 1) are assumed to be grouped into four categories:

- a) Establishing and verifying disclosure of retention by the originator, sponsor or original lender;
- b) Understanding, analyzing and recording the risk profile of the securitisation positions (including appropriate policies and procedures to do so), especially with respect to:
  - i. Risk characteristics of individual securitisation positions;
  - ii. Risk characteristics of exposures underlying securitisation positions;
  - iii. Reputation and loss experience in earlier securitisations of originators and sponsors;

<sup>7</sup> Total regulatory capital requirements for a securitisation exposure (value 100) given an initial risk weighting and one additional risk weighting. Blue denotes capital below a full deduction, orange above.

- iv. Statements and disclosures made by originators or sponsors about due diligence on securitised exposures;
- v. Methodologies for valuation of collateral supporting the securitisation;
- vi. Structural features of the securitisation that can impact performance.
- c) Stress-testing their securitisation positions;
- d) Monitoring the ongoing performance of their securitisation positions.

84. As a result of the principles outlined in above, the framework for applying additional risk weights can be summarized as follows (and is also presented in the table that follows):

- a) A failure to establish that the originator, sponsor or original lender disclosed that it would meet its requirements to retain 5% results in an additional risk weight of 1000% of the original risk weight.
- b) A failure to document and prove that any of the six aspects of understanding, analyzing and recording the risk profile of the securitisation positions was undertaken (these six aspects are outlined above) results in an additional risk weight of 250% of the original weight for each of the six aspects that has been omitted. Consequently, a complete failure to meet requirements in this respect results in a 1250% risk weight being applied to the relevant securitisation position(s). (To understand why this is 1250%, as opposed to 1500%, see [(e)] below.)
- c) A failure to stress test securitisation positions results in a 500% additional risk weight being applied to the relevant securitisation position(s).
- d) A failure to monitor performance adequately results in a 750% additional risk weight being applied to the relevant securitisation position(s).
- e) For multiple breaches, the additional risk weights outlined above are additive, albeit subject to a maximum additional risk weight of 1250%. For example, a failure both to (a) stress-test securitisation positions and (b) understand, analyze and record the risk characteristics of individual securitisation positions adds to a combined additional risk weight of 750% (500%+250%). Similarly, a failure both to (a) understand, analyze and record the risk profile of the securitisation positions (but in all respects outlined in the [83(b)(i-vi)] above, not just one), and (b) monitor ongoing performance of the securitisation positions, adds to a combined additional risk weight of 2250% ([6\*250%]+750%), but the additional risk weight would instead be capped at 1250%. However, see also point [81] above; the cumulative result of progressive risk weight additions should avoid an outcome whereby capital required to be held against a securitisation position exceeds the exposure value of the relevant securitisation position itself.

- f) For repeat breaches on the same securitisation holding, an immediate risk weight of 1250% would be applied for a minimum period of one year<sup>8</sup>.
- g) The period of time for which the additional risk weights are imposed would typically match the period of time for which the breach existed or continues to exist.

Requirement	
Ensuring disclosure by originator, sponsor, or original lender of retention of net economic interest	1000%
Stress-testing of securitisation positions	500%
Understanding, analyzing, and recording:	
Risk characteristics of individual securitisation positions	250%
Risk characteristics of underlying exposures	250%
Reputation and loss experience in earlier securitisations of originators and sponsors	250%
Statements and disclosures made by originators or sponsors about due diligence on exposures	250%
Methodologies for valuation of collateral supporting the securitisation	250%
Structural features of the securitisation that can impact performance	250%
Monitor the ongoing performance of securitization positions	750%

85. As outlined in Recital 25, competent authorities should apply the risk weight in relation to non-compliance for non-trivial breaches of policies and procedures which are relevant to the analysis of the underlying risks. In other words, competent authorities should take into account both the materiality and risk context of the breach in applying additional risk weights.

86. The additional risk weight that may be imposed by the competent authority on a securitisation position need not necessarily be of a permanent nature, and such additional risk weight could subsequently be lifted should the relevant credit institution subsequently meet the requirements of Paragraphs 4, 5 and 7 (albeit taking into account the principle outlined in clause [84(g)] above).

87. If the retained exposure can no longer be maintained on an ongoing basis by the sponsor, originator or original lender (for instance, because its insolvency has led to asset disposals by the administrator of the now-insolvent sponsor, originator, or original lender), or if the sponsor, originator or original lender having undertaken to fulfil the retention requirement subsequently inadvertently or intentionally breaches such undertaking (for instance, by disposing of the retained interest, contrary to its prior undertaking), this would not directly trigger increased capital requirements for a credit institution as investor. Actions that are beyond the control of the credit institution as investor will not constitute negligence or omission of that credit institution, provided it has fulfilled, through appropriate due diligence, its requirement to ensure that the originator, sponsor or original lender explicitly

<sup>8</sup> Repeat breaches on the same securitisation holding refers not to the same breach occurring on one holding over a consecutive period of time (for instance, two consecutive days), but to the requirements being breached at different points in time on the same holding.

disclosed that it would retain such an interest and would make available sufficient information to allow the investing credit institution to fulfil the other relevant requirements of Article 122a. Similarly, such credit institution would not be obliged to dispose of such a securitisation position in these circumstances. However, credit institutions as investors should be sensitive to any potential exploitation of this mechanism and factor this into any decision to invest in future securitisations of the same sponsor, originator, or original lender. A competent authority may impose the additional risk weights should it determine that a credit institution has not demonstrated that it is sufficiently sensitive to exploitation of this mechanism by a sponsor, originator, or original lender.

88. Paragraph 5 states that “risk weights should progressively increase with each subsequent infringement of the due diligence provisions”. “Due diligence provisions” are deemed to equate to the requirements identified under point [83]. If a competent authority discovers that a credit institution has failed to establish a process to ensure that due diligence requirements are met and there are recurrent infringements as a result, then the additional risk weight attached to the due diligence factor should be doubled and applied to all securitisation holdings for a minimum period of 12 months. The length of this imposition may be increased depending on the extent to which the obligations have been disregarded.
89. In the case of situations where the prior capital treatment equals (or for any reason exceeds) 1250% and a breach of the obligations under Article 122a occurs, the credit institution should disclose to the market that such breaches have occurred.
90. For a credit institution that is in breach of requirements, there is the question of how additional “risk weights” get applied when the securitisation positions are held in the trading book. This guidance interprets the outcomes of such circumstance with reference to the forthcoming trading book proposed amendments to the Directive (“CRD 3”), where a ‘floor’ is introduced to the effect that the capital requirement for a securitisation position can be no less than that which would apply if the position was held in the non-trading book.

*Question 17: Do you have any comments on this approach to achieving consistent implementation of application of the additional risk weights by competent authorities, including both the level and duration for which additional risk weights are applied? Do you agree that, notwithstanding the textual provisions of Paragraph 5, the cumulative result of applying such additional risk weights should not result in the capital required to be held against a securitisation position exceeding the exposure value of such securitisation position?*

## Paragraph 6

### Paragraph 6

*Sponsor and originator credit institutions shall apply the same sound and well-defined criteria for credit-granting in accordance with the requirements of Annex V, point 3 to exposures to be securitised as they apply to exposures to be held on their book. To this end the same processes for approving and, where relevant, amending, renewing and re-financing credits shall be applied by the originator and sponsor credit institutions. Credit institutions shall also apply the same standards of analysis to participations or underwritings in securitisation issues purchased from third parties whether such participations or underwritings are to be held on their trading or non-trading book.*

*Where the requirements referred to in the first subparagraph of this paragraph are not met, Article 95(1) shall not be applied by an originator credit institution and that originator credit institution shall not be allowed to exclude the securitised exposures from the calculation of its capital requirements under this Directive.*

91. For an overview of how the provisions of Paragraph 6 apply with respect to the various roles a credit institution can assume in a securitisation, and how these in turn can be mapped to the application of sanctions for non compliance with the provisions of Paragraph 6, see the section “General considerations on Paragraphs 1-7” above.
92. The objective of the requirement that securitised and non-securitised exposures should be subject to the same sound and well-defined criteria for credit-granting is to ensure that securitised exposures are not substandard in terms of the process under which they were underwritten. The objective is not to homogenise lending standards beyond the point of flexibility, therefore the requirement does not mean that the actual borrower types or loan products for securitised and non-securitised exposures must be the same, just that the underwriting process for extending such loan products to borrowers must be the same.<sup>9</sup> For instance, a credit institution may grant credit to borrowers through a number of distinct subsidiaries or related entities. In such circumstances, it would not typically be expected that the criteria for credit-granting be identical in all such subsidiaries or related entities; rather, it would be expected that within each subsidiary or related entity the same criteria be applied to both securitised and non-securitised exposures, and that such criteria be sound and well-defined.
93. While securitised products must benefit from the same sound and well-defined criteria, this does not mean that the underwriting criteria must be identical in all respects. For example, there may be aspects of the underwriting process that might specifically have to be added or removed in order to meet the conditions for sale of such underlying loans to the SPV that

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<sup>9</sup> However, when the on balance sheet option (c) of Paragraph 1 is used to fulfil the retention requirement, then this point [92] must be interpreted in conjunction with both the intention of removing any misalignment of interest and the guidelines on ensuring randomness in selection of securitised versus non-securitised exposures under point [39].

a lender would not impose on loans that it intends to retain on its balance sheet.

94. While a sponsor or originator credit institution should apply the same sound and well-defined criteria to both securitised and non-securitised exposures, in cases where securitised exposures consist of assets where credit-granting was initially made by an unconnected originator, sponsor or original lender (not the originator or sponsor itself), then the application of these same sound and well-defined criteria may by necessity be undertaken with more limited scope of information than would be the case if the originator or sponsor had itself initially granted credit. Nonetheless, such originator or sponsor should make its best effort in order to obtain all necessary information to perform a sound due diligence on the exposures to be securitised.

95. When a sponsor is not active in credit-granting in the specific types of exposures that are being securitised, then it may not be possible for it to apply the same sound and well-defined criteria for credit-granting as they apply to other types of credit exposures to be held on their book. However, in such circumstances the sponsor should instead have sufficient understanding to assess, and undertake such assessment of whether the criteria for credit-granting of the exposures to be securitised can be considered sound and well-defined, without specific reference to the sponsor's own criteria for credit-granting (as it will not have any such criteria itself).

*Question 18: If a credit institution is involved as sponsor in the securitisation of exposures on behalf of third parties in an asset class or business line in which such sponsor is not itself active in extending credit, is the guidance provided above a sufficiently high standard to hold such sponsor to?*

96. Credit institutions are required to apply the same standards of analysis to participations or underwritings in securitisation issues purchased from third parties whether such participations or underwritings are to be held in their trading or non-trading book. This denotes that when a credit institution is part of a syndicate or similar group underwriting the issuance of a securitisation (for instance, when such securitisation is backed by receivables purchased from a third party), such credit institution shall apply the same standards of analysis notwithstanding the purchased nature of the securitisations, and regardless of whether such securitisations are held in the trading versus non-trading book (and even if the duration of exposure is brief, e.g. during the underwriting period).

*Question 19: Is this interpretation or the requirement with respect to "participations and underwritings in securitisation issues" clear and unambiguous, or are there alternative interpretations possible or clarifications necessary?*

## Paragraph 7

### Paragraph 7

*Sponsor and originator credit institutions shall disclose to investors the level of their commitment under paragraph 1 to maintain a net economic interest in the securitisation. Sponsor and originator credit institutions shall ensure that prospective investors have readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation exposure as well as such information that is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures. For that purpose, materially relevant data shall be determined as at the date of the securitisation and where appropriate due to the nature of the securitisation thereafter.*

97. For an overview of how the provisions of Paragraph 7 apply with respect to the various roles a credit institution can assume in a securitisation, and how these in turn can be mapped to the application of sanctions for non compliance with the provisions of Paragraph 7, see the section "General considerations on Paragraphs 1-7" above.

98. The guidance provided on the depth, breadth and frequency of analysis required by investors detailed under Paragraph 4 equally applies as guidance in respect of the disclosures required by sponsor and originator credit institutions. Furthermore, an originator can fulfil the obligations outlined under this Paragraph 7 by using (for example) standardized reporting and disclosure templates that are generally accepted by market participants, assuming such templates fulfil these requirements adequately.

*Question 20: Would disclosure templates that currently exist or are in the process of being prepared by trade associations, industry bodies, central banks, market participants or others fulfil these requirements on an adequate basis?*

99. In fulfilling their requirement to disclose "the level of their commitment under Paragraph 1 to maintain a net economic interest in the securitisation" under this Paragraph 7, sponsor and originator credit institutions should also indicate which of options (a) through (d) in Paragraph 1 has been used in retaining such net economic interest. Should, due to exceptional circumstances, the form of retention (i.e. options (a)-(d) in Paragraph 1) change during the life of the transaction [see paragraph [23]], this must also be disclosed.

100. In fulfilling the requirement to disclose "the level of their commitment under Paragraph 1 to maintain a net economic interest in the securitisation" under this Paragraph 7, the obligation of a sponsor or originator credit institution is to disclose that it continues to fulfil the obligation that it initially undertook to maintain such net economic interest in the securitisation. The obligation does not extend to the sponsor or originator credit institution



providing further information with respect to the current nominal value, current market value, or any impairments or writedowns on such retained interest.

101. Originators and sponsors are also required to provide to investors such information that is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures. To the extent that there are (for example) standardized reporting and disclosure templates that are generally accepted by market participants that fulfil these requirements adequately, they can be used if the information disclosed therein is sufficient to fulfil these requirements.

*Question 21: Would disclosure templates that currently exist or are in the process of being prepared by trade associations, industry bodies, central banks, market participants or others fulfil these requirements on an adequate basis?*

102. The term “readily available” means that gaining access to the information should not be overly prohibitive (in terms of search, accessibility, usage, cost and other factors that might impede availability), so that fulfilling their due diligence requirements is not overly burdensome on investors.
103. The term “individual underlying exposures”, for which relevant data must be provided by credit institutions as sponsors or originators, typically means that such data should be provided on an individual loan basis, as opposed to on a collective basis.
104. The disclosure requirements of credit institutions when acting as sponsors or originators of securitisations, as outlined in Paragraph 7 above, need not extend to the provision of information that would breach other legal or regulatory requirements (such as market abuse and confidentiality restrictions).

## Paragraph 8

### Paragraph 8

*Paragraphs 1 to 7 shall apply to new securitisations issued on or after 1 January 2011. Paragraphs 1 to 7 shall, after 31 December 2014, apply to existing securitisations where new underlying exposures are added or substituted after that date. Competent authorities may decide to suspend temporarily the requirements referred to in paragraphs 1 and 2 during periods of general market liquidity stress.*

105. No guidance on this paragraph was deemed to be necessary in respect of temporary suspension of the requirements during periods of general market liquidity stress.

106. Existing securitisations where there are no new underlying exposures added or substituted after 31 December 2014 shall not have the provisions of Paragraphs 1-7 applied to them. The term “existing” in this context is interpreted to mean those securitisations that were existing on or after 1 January 2011, not those that were existing on or after 31 December 2014.

107. The application of the provisions of Paragraphs 1-7 to existing securitisations where new underlying exposures are added or substituted after that date is interpreted not to have a threshold in terms of materiality or number of exposures. In other words, the addition or substitution of any exposures after that date would cause the application of the provisions of Paragraphs 1-7 to such an existing securitisation.

*Question 22: Would such implementation without a materiality threshold create complications or be overly burdensome?*

108. The addition or substitution of new exposures is not interpreted to include circumstances in which the underlying obligor of an existing securitised exposure has not changed (for instance, a mortgage loan borrower switching from one loan product to another) or where only the legal status of the obligor of an existing securitised exposure has changed (for instance, an obligor entity has undergone an amalgamation, merger, consolidation or restructuring). Consequently, such events would not cause the provisions of Paragraphs 1-7 to apply to a securitisation.

109. If a credit institution has already assumed exposure to the credit risk of a securitisation position prior to 1 January 2011, and the originator, sponsor or original lender has not explicitly disclosed that it will fulfil the retention requirement (as per Paragraph 1) even though new exposures are to be added or substituted in the securitisation after 31 December 2014, the additional risk weights specified by Paragraph 5 shall be imposed by the competent authority after 31 December 2014.

## **Paragraph 9**

### **Paragraph 9**

*Competent authorities shall disclose the following information:*

- a) by 31 December 2010, the general criteria and methodologies adopted to review the compliance with paragraphs 1 to 7;*
- b) without prejudice to the provisions laid down in Chapter 1, Section 2, a summary description of the outcome of the supervisory review and description of the measures imposed in cases of non-compliance with paragraphs 1 to 7 identified on an annual basis from 31 December 2011.*

*The requirement set out in this paragraph is subject to the second subparagraph of Article 144.*

110. Sub-clause (a) of this Paragraph 9 refers to the competent authority disclosing its framework for implementing a review of compliance with the provisions of Paragraphs 1-7, and does not refer to the competent authority disclosing the domestic implementation of Paragraphs 1-7 into legislative requirements.

## **Paragraph 10**

### **Paragraph 10**

*The Committee of European Banking Supervisors shall report annually to the Commission about the compliance by competent authorities with this Article. The Committee of European Banking Supervisors shall elaborate guidelines for the convergence of supervisory practices with regard to this Article, including the measures taken in case of breach of the due diligence and risk management obligations.'*

111. No guidance on this paragraph was deemed to be necessary, except to indicate that the guidelines for the convergence of supervisory practices are covered under guidance to Paragraph 5 of Article 122a above, and that a potential revision of guidance is envisaged after a given period based on the observed range of practices.