

May 2009

**Update for ESF/SIFMA Europe Members  
Highlights of CRD Article 122a Enactment and Global Retention  
Developments**

Significant reforms to the regulation of securitisation market are currently underway at domestic, regional and global level. **In Europe**, a new Article 122a to the Capital Requirements Directive (CRD) seeks to better align the interests of securitisation originators and investors, since the cause of much of Europe's problem during the crisis has been sparked by investment in certain, but not all types of securitisation structures. To address this concern, Article 122a introduces a new originator retention requirement and significantly strengthens investor due diligence obligations, with capital sanctions in case of non compliance. **In the US**, the focus is on anti-predatory lending and mortgage reform, and retention is also being proposed as a means of better aligning originator and investor interests. US legislation addressing these issues has been introduced in the House of Representatives and further legislative and regulatory consideration is expected. **Globally**, international bodies are calling for globally consistent solutions going forward, and retention is under consideration by both the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO)

**EU Developments – CRD Article 122a**

On 1 October 2008, the European Commission (EC) issued a package of revisions to the CRD including not only securitisation, but also large exposures, hybrid capital and other issues such as colleges of supervisors. However, Article 122a relating to securitisation was by far the most hotly debated topic. On 19 November, 2008, Member States approved a number of amendments, and on 9 March, 2009, the European Parliament's Economic and Financial Affairs Committee (ECON) approved its own amendments. On 6 May 2009 the European Parliament voted to approve, by a large majority, the final set of amendments reflecting agreement between them, member States and the EC. The full text of Article 122a can be found at <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P6-TA-2009-0367&language=EN&ring=A6-2009-0139>.

Final passage of this legislation, which will have a significant impact on the securitisation market in and outside Europe, is subject to approval by the European Council, which is expected in June. The text needs to then be translated before it appears in the Official Journal. The 18 month transposition period starts from the date of publication in the Official Journal, and these provisions will become law 18 months later.

**Effective Dates:** The provisions shall apply to new securitisations issued from 31 December 2010, and from 31 December 2014 for those existing securitisations where new underlying exposures are added or substituted after that date.

**Scope:** The article applies to any EU credit institution (e.g. bank, dealer or investment firm) that invests in or holds securitisation positions in either its banking book or trading book e.g. as an investor or dealer. As a result, retention will be required by any originator globally who wants to sell/trade securitisation tranches to/with EU credit institutions. For example, if an EU or US auto ABS issuer wants to sell auto loan ABS tranches to a

European credit institution, it will need to comply with the EU retention requirements and also provide sufficient information for EU investor due diligence as described below. Extension of Article 122a to other EU investors such as insurers and hedge fund managers is already under consideration (the Solvency II legislation recently approved by the European Parliament requires the Commission to adopt implementing measures on investment in securitisation products, including a retention provision, and a similar provision is included in the current EC proposal on regulation of hedge funds). Article 122a is also likely to be applicable to non-EU trading desk operations of European credit institutions.

Finally, Article 122a will apply to all securitised exposures which broadly include all cash and derivative instruments that are credit-tranched, with certain types of transactions scoped out, such as those based on an index, syndicated loans, purchased receivables or credit default swaps where these instruments are not used to package and/or hedge a securitisation.

**Retention Calculation Methodology:** Article 122a requires that an originator retains a “material net economic interest of not less than 5 percent”, and proposes 4 ways that this requirement be applied:

- a) in positions having the same risk profile as the one that the credit institution is exposed to; in other words, a “vertical slice” equal to 5% of each tranche sold;
- b) in the case of securitisations of revolving exposures, retention of not less than 5% of the nominal value of the securitised exposures; in other words a pari passu share of the pool; or
- c) retention of randomly selected exposures, equivalent to not less than 5% of the nominal amount of the securitized exposures, where these would otherwise have been securitized in the securitisation provided that the number of potentially securitised exposures is not less than 100 at origination; or
- d) retention of the first loss tranche and, if necessary, other tranches having the same or more severe risk profile and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total not less than 5% of the nominal value of the securitized exposures.

Net economic interest is measured at the origination and must be maintained on an ongoing basis. Thus it cannot be subject to any credit risk mitigation or any short positions or any other hedge. The net economic interest is determined by the notional value for off-balance sheet items. Also, there cannot be multiple applications of the retention requirements for any given securitisation. It is not clear whether other ways of calculating retention may be developed as part of the EC’s upcoming impact assessment, as described below.

**Originator Capital Relief Provisions:** Sponsor and originator credit institutions must apply the same sound and well-defined criteria for credit-granting for exposures to be securitised as they apply to exposures to be held on their books. Where the requirements are not met, an originator credit institution will not be allowed to exclude the securitised exposures from the calculation of its capital requirements.

**Required Commission Impact Assessment and Review of Retention Size and Calculation:** By 31 December 2009, the EC must report on the expected impact of Article 122a to the European Parliament and the Council, together with any appropriate proposal. The EC must consult the Committee of European Banking Supervisors (CEBS) before submitting its report. The report will consider whether the 5% retention minimum requirement delivers the objective of better aligning the interests of originators/ sponsors and investors and strengthens financial stability, whether an increase of the

minimum level of retention would be appropriate taking into account international developments and whether the methods of calculating the retention requirement deliver the objective of better aligning the interests between originators or sponsors and investors.

**Investor Due Diligence Provisions:** Prior to investment, credit institution investors must establish formal policies and procedures, appropriate to their trading book and non-trading books, for securitisation investments. They must 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. They will also have to undertake rigorous stress testing. If these provisions are not met, the exposure will be subject to a capital penalty of not less than 250% of the original capital charge, subject to a cap of 1250%.

## US Developments

The Mortgage Reform and Anti-Predatory Lending Act (“H.R. 1728” or the “bill”) is the primary vehicle through which reform to the securitisation and retention practices of lenders is being pursued at the present time. Introduced on April 18 by Bradley Miller (D-NC) and co-sponsored by six other representatives, including House Financial Services Chairman Barney Frank (D-MA), the bill is designed to combat abuses in the mortgage lending market, and to provide basic protections to mortgage consumers and investors. The bill is based on H.R. 3915, passed by the House in November of 2007, but which never became law since a companion bill was not passed by the Senate. H.R. 1728 was passed by the House of Representatives on 8 May. The timing for the consideration and passage of a companion bill in the Senate, which is required for these (or similar) provisions to become law, is unclear at this time.

The bill seeks to accomplish four things:

- 1) Impose substantive restrictions on the brokering and making of residential mortgage loans that are not “qualified mortgages”. As described below, “qualified mortgages” generally include certain prime, fully amortising mortgage loans underwritten according to conservative criteria. These substantive restrictions include provisions to require a determination of a borrower’s ability to repay and a net tangible benefit for refinancings. Furthermore, the bill makes assignees liable in certain ways for the violations of the bill, irrespective of their knowledge of the originators’ violations;
- 2) Lower the financial triggers for a residential mortgage loan to constitute a “high cost” loan under the Homeowners Equity Protection Act (HOEPA), increasing the number of loans that could be subject to HOEPA and its significant liability provisions;
- 3) Subject loan servicers to substantive restrictions; and
- 4) Regulate appraiser independence.

Definition of Qualified Mortgage - Safe harbor provisions for the defined class of “qualified mortgages” fueled intense debate. The bill provides a safe harbor for a class of loans that includes fully amortising (without balloon payments), fully documented, not “non-traditional”, no negative amortisation, and with APRs within specified parameters. ARMs must be underwritten to the maximum payment possible in the first seven years, and any loan cannot cause a consumer’s back-end DTI to exceed a threshold to be specified in regulations. Initial versions of the bill provided liability protection only to thirty year, fixed rate loans and excluded many types of mortgages. As outlined above, the final version passed by the Financial Services Committee provides more flexibility.

Members of Congress and market participants have expressed concern that the narrow scope of the safe harbor will reduce mortgage product choices for the consumers.

**Risk Retention Provisions** - Of particular importance, the bill would bar lenders from selling, transferring, or conveying to a third party one hundred percent of the credit risk of "non-qualified" mortgages they originate by requiring creditors to retain five percent of the credit risk on non-qualified mortgages. While there is not broad agreement on the exact implementation of retention provision, there appears to be relatively broad bi-partisan support for the concept. The final language approved by the House Financial Services Committee provides flexibility to regulators to (a) grant exceptions to the retention requirement and/or the prohibitions on hedging of retained risk, (b) apply retention requirements to securitisers in addition to, or in place of, creditors of a mortgage, and (c) specify the permissible forms of retention and the duration thereof.

## **Global Developments**

As reform of the securitisation market receives attention by global groups, recommendations for retention are a key element. In January 2009, the G30 concluded that "participation in packaging and sale of collective debt instruments should require the retention of a meaningful part of the credit risk."<sup>1</sup> The G20 is also promoting a globally consistent approach to retention and securitisation standards. In its Action Plan following the April 2 Summit, the G20 Leaders noted their agreement "...that the BCBS and authorities should take forward work on improving incentives for risk management of securitisation, including considering due diligence and quantitative retention requirements, by 2010."<sup>2</sup> .

On 5 May, IOSCO released a consultation paper<sup>3</sup> containing recommendations on the regulation of securitization and credit derivatives markets. Regarding securitisation, one of the recommendations states that regulators should consider requiring originators and/or sponsors to retain a long-term economic exposure to the securitisation (i.e. "skin in the game"), although it does not suggest a specific threshold. This requirement might be imposed, for example, by way of acquisition of certain classes of securitised products or providing debt or equity to the structure.

## **SIFMA Initiatives**

SIFMA is heavily involved in legislative efforts in the U.S. and Europe on retention and on securitisation and OTC markets more broadly. In Europe, SIFMA and its affiliate the European Securitisation Forum (ESF) are actively involved in the legislative development process with the European Commission, Council and Parliament. In the US, SIFMA President and CEO Tim Ryan testified in front of the House Financial Services Committee on 23 April, providing a number of recommendations to the committee on H.R. 1728 and offering further assistance in amending and improving the bill. SIFMA is currently working with the American Securitization Forum, to ensure future legislation works towards resolving these issues fairly. SIFMA is also closely involved in the work of IOSCO and the BCBS to promote a globally coherent approach by international standard-setters.

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<sup>1</sup> G30 "Financial Reform: A Framework for Financial Stability" January 15, 2009.

<sup>2</sup> G20 "Progress Report on the Actions of the Washington Action Plan" April 2, 2009

<sup>3</sup> *Unregulated Financial Markets and Products Consultation Report*, May 2009

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Additional information about SIFMA is available at [www.sifma.org](http://www.sifma.org).

The ESF, an affiliate of SIFMA, is the voice of the securitisation marketplace in Europe, with the purpose of promoting efficient growth and continued development of securitisation throughout Europe. Its membership is comprised of over 140 institutions involved with all aspects of the securitisation business, including issuers, investors, arrangers, rating agencies, legal and accounting advisors, stock exchanges, trustees, IT service providers and others.

The ASF, an affiliate of SIFMA, is a broad-based professional forum through which participants in the US securitization markets advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 350 firms, including issuers, investors, financial intermediaries, servicers, legal and accounting firms and other professional organizations involved in the securitization markets.

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