Structured finance regulation – EU and US current issues

Mayer Brown LLP
Jason Kravitt

Asian Securities Industry and Financial Markets Association

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TOPICS

• Bank capital and liquidity requirements
• Risk retention
• Derivatives regulation
• Securities disclosure requirements
• Bank large exposure limits
• Money market reform
• Bank ring-fencing
• Potential IFRS and US GAAP off balance sheet structure
BANK CAPITAL AND LIQUIDITY REQUIREMENTS

• Basel Committee proposed Revisions to securitisation framework

• Liquidity coverage ratio
Proposed revisions to Basel securitisation framework – events so far and to follow

• Following review of Basel securitisation framework, in Dec 2012, Basel Committee on Banking Supervision (BCBS) issued Consultative Document: Revisions to the Securitisation Framework (BCBS 236 or 1st CD)

• BCBS published technical working papers (WP 22, WP 23) in late Jan 2013

• Comment period ended 15 Mar 2013; meeting between BCBS securitisation working group (SWG) and industry groups 23 Apr 2014

• A group of specialists from banks and research firms developed an Arbitrage-Free Approach (AFA), later modified as the Conservative Monotone Approach (CMA)

• BCBS published second Consultative Document (BCBS 269 or 2nd CD) in Dec 2013

• Comment period ended 21 March 2014; meeting between SWG and industry representatives 9 Apr 2014

• Joint associations submitted further data 13 Aug 2014

• SWG’s timetable called for publication of final version by end 2014

• To be adopted and implemented possibly by end 2016?
Basel securitisation proposal – highlights

• Simplified hierarchy of approaches to calculation of risk weights (RWs)
  1) Internal ratings-based approach (IRBA)
  2) External ratings-based approach (ERBA)
  3) Standardised approach (SA)
  4) 1250% RW

• New and modified approaches
  – IRBA:
    • Formula similar to simplified supervisory formula approach (SSFA) from US rules and 1st CD
    • Based on capital requirement for underlying pool (K_{IRB})
    • Parameter $p$ varies according to multiple factors, including tranche maturity (M)
    • Calibration based on Modified Supervisory Formula Approach (MSFA) from 1st CD, adjusted to incorporate features from AFA
  – ERBA:
    • Slightly simpler version of Revised Ratings-Based Approach from 1st CD
    • Maturity and thickness dealt with by interpolation rather than look-up tables
  – SA:
    • Like SSFA from 1st CD; $p = 1.0$ (vs. 1.5 in 1st CD, 0.5 in US); 1.5 for resecuritisation

• Risk-weight floor 15% and cap as if bank held assets

• Themes (from 1st CD):
  – Minimising reliance on credit rating agency (CRA) ratings
  – Reduction of “cliff effects”; higher risk weights (RWs) for senior tranches
  – More consistency between SA and IRB and between securitisation and wholesale exposures
Proposed revisions to Basel securitisation framework – observations

• Higher capital requirements for higher credit quality securitisation exposures – lower in 2nd than in 1st proposal, but still very high compared to historical results, other forms of finance and underlying exposures

• Maturity adjustment – defined as tranche contractual maturity – much higher risk weights for medium-term and longer-term transactions

• Information requirements of Internal Ratings-based Approach (IRBA) – the most risk-sensitive method – make it impractical for use by most bank investors (except where local rules allow wider use of proxy data – unlevel playing field issue)

• Treatment of trading book exposures to be confirmed
  – Fundamental review of the trading book (FRTB) is ongoing
  – Instructions for Basel III monitoring (Apr 2014) indicate (para. 81) securitisation risk weights will be based on new banking book securitisation framework (when completed), with adjustment to avoid double counting between banking book maturity adjustment and trading book migration risk in credit spread charge
## Hierarchies of approaches for calculating securitisation risk weights – existing Basel II (and EU)

### Standardised approach (SA)

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<tbody>
<tr>
<td><strong>1</strong></td>
<td>Ratings matrix (min RW = 20%)</td>
</tr>
<tr>
<td><strong>2</strong></td>
<td>Look-thru to weighted average RW of exposures (if pool composition always known and if most senior tranche (Basel II) or apply concentration ratio (EU CRD))</td>
</tr>
<tr>
<td><strong>3</strong></td>
<td>Deduct from capital</td>
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### Internal ratings-based approach (IRB)

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<tr>
<td><strong>1</strong></td>
<td>Ratings-based approach (RBA) (min RW = 7% - AAA senior granular)</td>
</tr>
<tr>
<td><strong>1a</strong></td>
<td>Inferred rating (if senior to a rated position)</td>
</tr>
<tr>
<td><strong>2</strong></td>
<td>Supervisory formula approach (SFA) (model with supervisor permission and detailed asset data)</td>
</tr>
<tr>
<td><strong>2a</strong></td>
<td>Limited look-thru for ABCP liquidity facilities</td>
</tr>
<tr>
<td><strong>3</strong></td>
<td>Deduct from capital</td>
</tr>
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</table>
Hierarchies of approaches for calculating securitisation risk weights – US rules and BCBS 269

<table>
<thead>
<tr>
<th>US rules</th>
<th>BCBS 269</th>
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<tbody>
<tr>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Supervisory Formula Approach (SFA)</td>
<td>Internal Ratings-Based Approach (IRBA)</td>
</tr>
<tr>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Simplified Supervisory Formula Approach (SSFA)</td>
<td>External Ratings-Based Approach (ERBA) (or Internal Assessment Approach (IAA) if applicable) (N/A in US)</td>
</tr>
<tr>
<td>3</td>
<td>3</td>
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<tr>
<td>Gross-up approach</td>
<td>Standardised Approach (SA) (similar to SSFA)</td>
</tr>
<tr>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>1250% RW</td>
<td>1250% RW</td>
</tr>
<tr>
<td>Rating</td>
<td>ERBA (2\textsuperscript{nd} CD)</td>
</tr>
<tr>
<td>--------</td>
<td>-------------------------------</td>
</tr>
<tr>
<td></td>
<td>Maturity (years)</td>
</tr>
<tr>
<td>AAA</td>
<td>15 y 25</td>
</tr>
<tr>
<td>AA</td>
<td>25 y 50</td>
</tr>
<tr>
<td>A</td>
<td>50 y 75</td>
</tr>
<tr>
<td>BBB</td>
<td>90 y 130</td>
</tr>
<tr>
<td>BB</td>
<td>160 y 230</td>
</tr>
<tr>
<td>B</td>
<td>310 y 420</td>
</tr>
<tr>
<td>CCC±</td>
<td>460 y 472</td>
</tr>
<tr>
<td>&lt; CCC-</td>
<td>1250</td>
</tr>
</tbody>
</table>

Illustrative risk weights (%) for senior tranches (Source: BCBS 269 Table 1; +/- rating levels omitted)
Other changes and clarifications

- Maturity (M) based on contractual cash flows of tranche
  - Not per performance of (or contractual cash flows of) underlying assets
  - For pass-through tranche, use legal final maturity
  - For commitment, use commitment period plus asset maturity
  - For credit enhancements only exposed to losses during commitment period, use only that period

- Min RW = 15%
  - Cf. 20% in US rules, in Basel II SA and in 1st CD
  - Cf. 7% for most senior high quality tranche in Basel II IRB
  - Mitigating model risk
  - Subject to any applicable RW cap based on lower asset RWs

- Eliminating some Basel II special treatments
  - Look-thru for second loss positions in ABCP programmes (paras. 574-75)
  - Limited look-thru for ABCP liquidity facilities (para. 639)
  - 50% conversion factor for “eligible” liquidity facilities (paras. 576, 579)
  - Early amortisation provisions for revolving credit pools (paras. 590-605)
    - treat as non-securitised (except deals described in para. 593)

- Write-downs and purchase discounts
  - Reduce carrying value, not required capital amount

- Extending some Basel II favours
  - Max capital requirement – as if bank held assets directly (para. 610 (IRB only))
    → for all originators and sponsors, investors using IRBA but not investors using ERBA or SA
  - Look-thru for senior securitisation exposures (paras. 572-73 (SA, unrated only)) → any
  - Inferred ratings (based on junior rated tranche) (paras. 617-18 (IRB only)) → SA or IRB
  - End SA requirement for originator to deduct low-grade retained exposures (paras. 569-70)
Basel securitisation proposal – some comments

(from Joint Associations’ comment letter dated 24 Mar 2014)

• Recalibrate IRBA and SA by (market-based) asset class
• Adjust to produce proper alignment between approaches (higher in hierarchy → lower RW)
• Define maturity (M) to include contractual and expected maturity of underlying, using WAL tables or supervisory inputs &c
• Specify max value and lower min value of \( p \)-factor
• Encourage flexibility in application of IRBA (subject to proper alignment of approaches)
• Allow IAA application to bank as well as ABCP exposures
• Lower RW floor to 10% for senior exposures
• Allow all bank investors to use capital requirements cap if can calculate underlying capital under IRBA or SA
• Apply capital requirements cap in proportion to bank’s largest holding of any tranche
• For due diligence requirement, adopt additional risk weight (ARW) calculation as in EU Capital Requirements Regulation (CRR)
Liquidity coverage ratio (LCR)

• Ratio of high quality liquid assets (HQLA) to 30-day net cash outflows (NCO) ≥ 100%

• HQLA levels
  – Level 1: cash, central bank reserves, certain sovereign debt
  – Level 2: L2 ≤ 40% HQLA; subject to haircuts
    • Level 2A: certain govt. securities, covered bonds and corporate debt with high credit ratings
    • Level 2B: lower rated corporate bonds, certain equities and qualifying residential mortgage-backed securities (RMBS)
    • EU may include some high quality asset-backed securities (ABS)

  ➢ Qualifying RMBS in Level 2B and no other ABS in HQLA
    • vs. covered bonds and corporates in Level 2A
    • some qualifying ABS to be included in EU version - TBD

• NCO 30-day cash outflows:
  – Unused commitments to securitisation SPEs count 100%, vs. commitments to non-financial corporates 10% (credit) or 30% (liquidity), banks 40% or other financial institutions 40% (credit) or 100% (liquidity)
    ➢ limited exception in EU for facilities supporting unused underlying commitments to non-financial corporates
    ➢ exception in US draft final rule for credit facilities provided to SPE consolidated subsidiary of wholesale customer 10% (financial) or 40% (financial)
  – Inflows limited to 75% of outflows → HQLA ≥ 25% gross outflows

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LCR development and implementation in EU

- BCBS, Sound principles of liquidity management (2008) (BCBS 144)
- Directive 2009/111/EC (16 Sep 2009) (CRD II) and Member States’ rules
- BCBS, Basel III: International framework for liquidity risk measurement, standards and monitoring (Jan 2010) (BCBS 188)
- BCBS, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (Jan 2013) (BCBS 238)
- CRR Part Six (Articles 411-428) (also includes NSFR) (Jun 2013)
  - Current CRR detailed provisions (Arts. 415-26) are for reporting purposes only (Art. 412(4))
  - EC to adopt Delegated Act per CRR Art. 460
- BCBS, LCR disclosure standards (rev. Mar 2014) (BCBS 272)
- BCBS, FAQs on 2013 LCR framework (BCBS 284)
- EBA Report on def. HQLA (Dec 2013)
- EBA Report on LCR impact (Dec 2013)
- Commission Delegated Regulation (per CRR Art. 460) – pending

<table>
<thead>
<tr>
<th>From 1 Jan:</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Min LCR:</td>
<td>60%</td>
<td>70%</td>
<td>80%</td>
<td>90%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: BCBS 238 para. 10, CRR Art. 460(2)
## LCR – High quality liquid assets (HQLA) summary

<table>
<thead>
<tr>
<th>Level</th>
<th>Asset type</th>
<th>Max % HQLA</th>
<th>Factor (1 – haircut)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Cash, central bank reserves, some sovereign debt</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>Extremely high quality covered bonds (EU only)</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>2A Certain govt. securities</td>
<td>40%</td>
<td>85%</td>
</tr>
<tr>
<td></td>
<td>High quality corporate debt</td>
<td>40%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>High quality covered bonds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>2B High quality RMBS</td>
<td>15%</td>
<td>75% [65%]</td>
</tr>
<tr>
<td></td>
<td>[High quality ABS? (EU only)]</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Lower rated corporate bonds</td>
<td></td>
<td>50%</td>
</tr>
<tr>
<td></td>
<td>Equities</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
EU level 2B securitisations – potential criteria

- Most senior tranche
- Highest rating category
- Issue size minimum
- Weighted average time to maturity maximum
- Not resecuritisation or synthetic
- Asset true sale (beyond reach of originator and creditors in insolvency)
- No severe clawback
- No cash trapped after revolving period
- Servicer replacement provisions
- Compliance with underwriting and disclosure requirements under EU rules or equivalent

- Originator is credit institution
- Homogenous exposures
- Exposures (on issue date or when later added) not in default or to credit-impaired borrowers

- Asset classes:
  - Residential mortgages – first rank, minimum loan-to-value
  - Guaranteed residential mortgages
  - Auto loans and leases
  - Commercial credits to EU corporates for capital and business (but not CMBS), mostly SMEs, no banks
  - Consumer credit
## LCR – Cash outflows (selected) – commitments &c

<table>
<thead>
<tr>
<th>Liability/commitment type</th>
<th>Conversion factor (CF)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ABCP, conduits, SPVs &amp;c:</strong></td>
<td></td>
</tr>
<tr>
<td>• Liabilities from maturing ABCP, SIVs, SPVs &amp;c (maturing amounts and returnable assets)</td>
<td>100%</td>
</tr>
<tr>
<td>• Asset-backed securities (including covered bonds – maturing amounts)</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Undrawn committed credit (C) and liquidity (L) facilities provided to:</strong></td>
<td></td>
</tr>
<tr>
<td>• Retail and small business clients</td>
<td>5%</td>
</tr>
<tr>
<td>• Non-financial corporates, sovereigns and central banks, multilateral development banks and public sector entities (PSEs)</td>
<td>10% C 30% L 10%</td>
</tr>
<tr>
<td>• Banks subject to prudential supervision</td>
<td>40% 100%</td>
</tr>
<tr>
<td>• Other financial institutions (including securities firms, insurance cos.)</td>
<td>40% C 100% L 100%</td>
</tr>
<tr>
<td>• Other legal entity customers, including SPEs</td>
<td>100%</td>
</tr>
<tr>
<td>• EU only: liquidity facility to SSPE to purchase assets other than securities from non-financial customers under certain conditions</td>
<td>n/a 10% L</td>
</tr>
<tr>
<td>• US only: treat commitment to SPE consolidated subsidiary of non-financial customer (NFC) or non-bank financial customer (FC) like commitment to parent</td>
<td>10% C NFC 30% L NFC 40% C FC n/a</td>
</tr>
</tbody>
</table>
## LCR – Cash inflows

<table>
<thead>
<tr>
<th>Inflow type</th>
<th>Inflow rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maturing secured lending (not used to cover short positions) backed by:</td>
<td></td>
</tr>
<tr>
<td>• Level 1A assets (assume rolled over)</td>
<td>0%</td>
</tr>
<tr>
<td>• Level 2A assets (assume inflow equal to haircut)</td>
<td>15%</td>
</tr>
<tr>
<td>• Level 2B Eligible RMBS (assume inflow equal to haircut)</td>
<td>25%</td>
</tr>
<tr>
<td>• Level 2B other assets (assume inflow equal to haircut)</td>
<td>50%</td>
</tr>
<tr>
<td>Margin lending backed by other collateral</td>
<td>50%</td>
</tr>
<tr>
<td>Secured lending secured by other (non-HQLA) assets (assume not rolled over)</td>
<td>100%</td>
</tr>
<tr>
<td>Credit or liquidity facilities provided to bank</td>
<td>0%</td>
</tr>
<tr>
<td>Operational deposits at other financial institutions</td>
<td>0%</td>
</tr>
<tr>
<td>Other inflows from retail counterparties and wholesale non-financial parties</td>
<td>50%</td>
</tr>
<tr>
<td>Other inflows from financial institutions and central banks</td>
<td>50%</td>
</tr>
<tr>
<td>Net derivative cash flows</td>
<td>100%</td>
</tr>
<tr>
<td>Other contractual cash inflows</td>
<td>Nat’l discretion</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net cash outflow</th>
<th>=</th>
<th>Total cash outflow</th>
<th>-</th>
<th>Lesser of</th>
<th>Total cash inflow</th>
<th>75% of total outflow</th>
</tr>
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4. The committed amount of a **liquidity facility** that has been provided to an **SSPE** for the **purpose of enabling such an SSPE to purchase assets other than securities from clients that are not financial customers** shall be multiplied by **10%** to the extent that it **exceeds the amount of assets currently purchased** from clients and where the **maximum amount that can be drawn is contractually limited** to the amount of assets currently purchased.

5. The institutions shall report the maximum amount that can be drawn of other undrawn committed **credit facilities and undrawn committed liquidity facilities** within the next 30 days. This applies in particular to the following:

   (a) **liquidity facilities** that the institution has granted to **SSPEs** other than those referred to in point (b) of paragraph 3 [sic];

   (b) **arrangements** under which the institution is required to **buy or swap assets from an SSPE**; ...
LCR outflows – Commitments to SPEs – US rules

US banking agencies’ final rule § __.32(e)

(e) Commitment outflow amount. (1) A [BANK]'s commitment outflow amount as of the calculation date includes: ...

(iii)-(iv) [10 / 30] percent of the undrawn amount of all committed [credit / liquidity] facilities extended by the [BANK] to a wholesale customer or counterparty that is not a financial sector entity or a consolidated subsidiary thereof, including a special purpose entity (other than those described in paragraph (e)(1)(viii) of this section) that is a consolidated subsidiary of such wholesale customer or counterparty;

(vi)-(vii) [40 / 100] percent of the undrawn amount of all committed [credit / liquidity] facilities extended by the [BANK] to a financial sector entity or a consolidated subsidiary thereof, including a special purpose entity (other than those described in paragraph (e)(1)(viii) of this section) that is a consolidated subsidiary of a financial sector entity, ...; ...

(viii) 100 percent of the undrawn amount of all committed credit and liquidity facilities extended to a special purpose entity that issues or has issued commercial paper or securities (other than equity securities issued to a company of which the special purpose entity is a consolidated subsidiary) to finance its purchases or operations, and excluding liquidity facilities included in paragraph (b)(2) of this section [provided by bank sponsor to non-consolidated conduit]; and

(ix) 100 percent of the undrawn amount of all other committed credit or liquidity facilities extended by the [BANK].
• Commitment outflow amount to a structured transaction involving an off-balance sheet issuer is the greater of:

1. 100% of all issuer obligations maturing within 30 days plus all issuer commitments to purchase assets within 30 days; and

2. The maximum contractual amount required to be provided to issuer within 30 days through a funding agreement.
US LCR Trade Receivables Securitization Illustration

Facts:

• Originator sells Trade AR to SPE on an ongoing basis under a working capital facility (clearly a credit facility)
  — Note that liquidity vs. credit is no longer determined by what the documents “express”

• SPE obtains a revolving credit facility (“VFL”) from Bank directly and through one on and two off balance sheet conduits. Each VFL has an outstanding balance of 50 million and an undrawn commitment of 50 million.

• No ABCP conduit has a commitment under its VFL, but the Bank has a commitment to the SPE instead.
Results:

1. Bank’s 50 million outstanding does not impact LCR directly.
   - Its undrawn commitment limits LCR numerator with an outflow rate of 10%.
   - Total LCR numerator: 5 million

2. On balance sheet conduit 50 million is funded with CP. 100% of CP maturing within 30 days is included in LCR numerator. (Options to extend, put, etc. do not impact this result.)
   - Bank’s parallel purchase facility to SPE treated same as ① above.
   - Bank’s liquidity and credit to conduit are eliminated through consolidation.
   - Total LCR numerator: 5 million plus CP < 30 days

3. Independent off balance sheet conduit’s outstanding CP does not hit Bank LCR directly.
   - Bank’s parallel purchase facility to SPE treated same as ① above, if it exists.
   - Bank’s structured liquidity to conduit has a 100% outflow rate to entire undrawn amount.
   - Total LCR numerator: 5 million plus 100 million = 105 million

4. Sponsored off balance conduit’s outstanding CP does not hit Bank LCR directly.
   - Bank’s parallel purchase facility to SPE treated same as ① above.
   - Bank’s liquidity/credit to conduit equals greater of (x) outstanding CP maturing within 30 days plus conduit commitment (0); and (y) maximum amount that may be drawn in 30 days. IF Bank support is limited to conduit CP, this will equal CP maturing in 30 days or less.
   - Total LCR numerator: 5 million plus CP < 30 days
   - Therefore ② and ④ treated equally.
RISK RETENTION

• Capital Requirements Regulation (CRR) Article 404-410 and related implementing technical standards (ITS) proposed regulatory technical standards (RTS) – continuing issues and transition period ending

• US regulatory agencies' final rules (pending)
Securitisation risk retention, due diligence and disclosure – EU CRR Art. 404-410 and other requirements for EU regulated investors
CRR Articles 404-410 – Summary

• Securitisation positions – CRR definition
  – Credit risk tranching and dependence on performance of underlying exposures
• Consolidated application
• Requirements on institutions investing or assuming exposure to securitisations
  – Risk retention by originator, sponsor or original lender – five methods
  – Due diligence and monitoring – understanding of risks
• Requirements on institutions as originators and sponsors of securitisations
  – Credit underwriting standards – as for non-securitised assets
  – Disclosure – what investors need to know
• Failure to comply → additional risk weights (ARW)
• Application from 1 Jan 2011 to new securitisations, from 1 Jan 2015 to existing securitisations that add assets
• CRR Arts. 404-410 replaced CRD Art. 122a effective from 1 Jan 2014
• EBA technical standards – supersede previous guidance (CEBS Guidelines and EBA Q&A)
CRR Articles 404-410 – Application

- Apply directly in EU member states, and by separate legislation in other European Economic Area (EEA) countries
- Apply to credit institutions and (from 1 Jan 2014) investment firms regulated in the EU
  - when they invest in or otherwise acquire credit exposure to securitisation positions or
  - when acting as sponsor or originator in relation to securitisations
- Apply to investments or exposures by certain affiliates
  - Per CRR Art. 14(1)
  - CEBS Guidelines paras. 8-10 (assuming exposure)
  - EU institution’s affiliates subject to “supervision on a consolidated basis”
  - Generally, when affiliate’s parent is EU institution or financial holding company and affiliate’s business would be regulated activity
- Apply to origination or sponsorship?
  - Per CRR Art. 14 – all of Part Five (Arts. 404-410)
  - EBA Q&A 28 (originator requirements typically only apply to EU institution)
Rules on securitisation investments by EU regulated investment funds and insurance and reinsurance undertakings

• Alternative Investment Fund Managers (AIFMs)
  – Regulation (EU) 19 Dec 2012 Section 5 (AIFM Reg.) supplements Art. 17
    • Based on European Securities Markets Authority (ESMA) Final Advice Nov 2011
    • Additional due diligence and other obligations
    • To be interpreted consistent with CRD 122a and CEBS Guidelines and their later amendments

• Undertakings for Collective Investment in Transferrable Securities (UCITS)
  – UCITS Directive Art. 50a (added by UCITS IV)
  – Same requirements as for AIFMs
  – Awaiting final implementing regulation

• Insurance and reinsurance undertakings
  – Amended by Omnibus II amendment
  – Awaiting final implementing measures based on advice from European Insurance and Occupational Investment Authority (EIOPA)
  – CEIOPS Technical Advice Jan 2010 – before CEBS Guidelines and Omnibus II
Rules on securitisation investments by EU regulated investment funds and insurance and reinsurance undertakings – cont’d

- Requirements on investors:
  - Requirements to be met by ‘originator, sponsor or original lender’ including retention of net economic interest of not less than 5%
  - Qualitative requirements (to include maintenance and application of effective risk management systems, formal monitoring procedures and ‘comprehensive and thorough understanding’ of subject investments)
  - Additional due diligence requirements for AIFMs (AIFM Reg. Art. 52)

- Scope – “repackage loans into tradable securities”
  - Apply to “securitisation positions” as defined in CRD/CRR

- Application – transactions from 1 Jan 2011 (as in CRD 122a and later CRR)
  - Though some investors’ detailed rules are not yet available

- Sanctions for non-compliance
  - “Corrective action” may include disinvestment
  - Additional risk weights – for insurance companies, not others
Requirements for investors (CRR Arts. 405-406)

• Institution investing in (or assuming exposure to) securitisation must:

  Retention requirement:
  – obtain confirmation from "the originator, sponsor or original lender" that that person has retained and will retain a material economic interest, not less than 5%, in the securitised exposures

  Due diligence requirement:
  – have, and be able to show to its regulators, a comprehensive and thorough understanding of the securitisation positions, the underlying exposures and related risk elements ...
  – have a thorough understanding of all structural features of a securitisation that would materially impact the performance of their exposures to the transaction ...
Retainer: Sponsor, originator or original lender

• “sponsor”
  – an institution other than an originator institution that establishes and manages an asset backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities
  – “institution” means a credit institution or an investment firm
  – “credit institution” means an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account
  – “institution” – as defined in and subject to Markets in Financial Instruments Directive (MiFID)

• “originator”
  means an entity which:
  a) 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) purchases a third party’s exposures for its own account and then securitises them

• “original lender”
  – Not defined in CRD or CRR
  – RTS: “an entity which, either itself or through related entities, directly or indirectly, originally created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised and which is not the originator”
  – Like originator part (a) and the “third party” in originator part (b)
Risk retention (CRR Art. 405; AIFM Reg. Art. 51)

• Five ways to retain risk:

a) **Vertical slice:** retention of no less than 5% of the nominal value of each of the tranches sold or transferred to the investors;

b) **Originator interest:** 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) **Similar exposures:** 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;

d) **First loss tranche:** 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; and

e) **First loss exposure:** retention of a first loss exposure not less than 5% of every securitised exposure in the securitisation.
Due diligence (CRR Art. 406; AIFM Reg. Art. 53)

• Before investing and ongoing
• Trading book and non-trading book – as “appropriate”
• “Comprehensive and thorough understanding”
  – Risks of securitisation position
  – Risks of underlying exposures
  – Originator or sponsor due diligence
  – Collateral valuation methods
  – Structural features
    • Payments waterfall, related triggers, credit enhancement, liquidity enhancement, market value triggers, definition of default
• Regular stress testing of asset performance
Due diligence – more for AIFMs (AIFM Reg. Art. 52)

- AIFM must also “ensure that the sponsor and originator:
  
a) grant credit based on sound and well-defined criteria [for] exposures to be securitised as they apply to exposures they hold;

b) have in place and operate effective systems to manage the ongoing administration and monitoring of their credit risk-bearing portfolios and exposures …;

c) adequately diversify each credit portfolio based on the target market and overall credit strategy;

d) have a written policy on credit risk that includes their risk tolerance limits and provisioning policy and describes how it measures, monitors and controls that risk;

e) grant readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral [as required for investor due diligence];

f) grant readily available access to all other relevant data necessary for the AIFM to comply with the [investor due diligence] requirements laid down in Article 53;

g) disclose the level of their retained net economic interest as referred to in Article 51, as well as any matters that could undermine the maintenance of the minimum required net economic interest as referred to in that Article.”

- Similar to CRR sponsor and originator duties (Arts. 408-09), but onus on investor

- Prospectus would normally address these matters generally
Additional risk weights (CRR Art. 407)

• For institution that “negligently or by omission” fails in any material respect:
  – As investor or person assuming exposure, to comply with the retention requirement or due diligence requirement, or
  – As sponsor or originator, to comply with disclosure requirement

• Supervisory authorities shall “impose a proportionate additional risk weight of no less than 250% of the risk weight (capped at 1250%) which would [otherwise] apply ... and shall proportionally increase the risk weight with each subsequent infringement ...”.

• ITS formula:

\[
\text{Total RW} = \min (1250\%, RW_0 \times (1 + ((250\% + (250\% \times \text{Years}))) \times (1 - \text{Exemption}\%)))
\]

  – Add 250% of original risk weight applied to position
  – Add another 250% for each full year non-compliance continues
  – Lower factors for certain exposures exempt from retention
  – Resulting risk weight not to exceed 1250%

• Originator or sponsor failing underwriting requirement must treat assets as not securitised

• Not applicable to AIFMs under AIFM Regulation
Sponsor or originator duties (CRR 408-409)

• Institution as sponsor or originator is required:

  **Underwriting requirement:**
  
  – to apply the same credit criteria to exposures to be securitised as it applies to exposures to be held on its book, and apply the same analysis to securitisation positions acquired for the banking book or the trading book

  **Disclosure requirement:**
  
  – to disclose to investors the level of its retention commitment and other materially relevant data [of the kind that would enable investors to meet the Due Diligence Requirement ]
CRR 404-410 – Effects on affiliates outside EEA

- EEA credit institutions and investment firms – including e.g. US branch of European bank
  - must comply with retention and due diligence requirements when investing in or assuming exposure to securitisations
  - must comply with underwriting and disclosure requirements when acting as sponsor or originator

- Regulated affiliates of EEA institutions – if subject to “consolidated supervision”
  - must comply with retention and due diligence requirements (CRR 405-406) when investing in or assuming exposure to securitisations
  - must comply with underwriting and disclosure requirements (CRR 408-409) when acting as sponsor or originator? – CRR 14 vs. EBA Q&A 28; RTS silent

- Other clients
  - not subject to CRR 404-410
  - if want EEA institution investors (including non-EEA affiliates subject to consolidated supervision), when acting as sponsor or originator, retain economic interest, disclose retention and other information
  - if don’t need EEA institution investors, disclose that not complying
CRR 404-410 – Final RTS


- Narrower than existing Guidelines and Q&A
  - Limited to specified issues, emphasise consistent application, founded on CRR text

- Treatment of existing transactions
  - Previous guidance relevant to determine when additional RWs apply in case of breach

- Pre-2011 grandfathered transactions
  - Previous guidance relevant to interpret substitution of exposures

- Consolidated entity trading activities
  - Flexibility for positions in non-EU affiliates not material to group risk profile

- Eligible retainers – lack of flexibility
  - Focus on sponsor, originator and original lender definitions

- Multiple originators or sponsors
  - Retention by one meeting conditions or by each on proportional basis

- Retention on a consolidated basis
  - Limited to EU credit institutions and financial holding companies

- UK mortgage master trusts
  - Seller interest in non-revolving exposure treated as vertical retention (option (a))
  - Pari passu or subordinated credit risk

- Unfunded (“synthetic or contingent”) retention
  - Must be fully cash collateralised, unless retainer is credit institution
Risk retention – Multiple sponsors or originators

• Multiple originators (or original lenders) → retention by any of:
  – each originator (or original lender) according to the proportion of exposures originated by it; or
  – one originator that has established and is managing the securitisation; or
  – one originator (or original lender) that has established the securitisation and contributed over 50% of the underlying exposures
    (RTS Art. 3(2)-(4))

• Multiple sponsors → retention by either:
  – one sponsor whose economic interest is most aligned with investors; or
  – each sponsor pro rata by number of sponsors
    (RTS Art. 3(5))
Risk retention – consolidated group

- CRR 405(2) (from CRD 122a(2)) provides for retention on consolidated basis where parent is EU credit institution or EU financial holding company.

- CEBS Guidelines said consolidated retention also allowed for other originators and original lenders.
  - “The [proportional] retention requirement arrangements outlined above need not apply to different originators or original lenders in the same corporate group. In such circumstances, one originator or original lender may fulfil the retention requirement across the group, so that retention can be met at the consolidated level.” (para. 29)
  - “The ability to fulfil the [risk retention] requirements ... on a consolidated basis should also apply to originators or original lenders other than credit institutions. In the former case, in particular, this is supported by the definition of an originator ... as an entity that ‘either itself or through related entities, directly or indirectly’ was involved in the creation of the obligations that give rise to the exposures being securitised.” (para. 71)
  - “As long as the parent/affiliate of the collateral manager is consolidated at group level the retention requirement can be met by the parent/affiliate. ...” (EBA Q&A 21)

- RTS supports consolidated retention only for EU credit institution groups.
  - “Although the EBA recognised that, in order to achieve alignment of interest, it is not essential that consolidation be accomplished in accordance with the applicable accounting framework or with regard to the scope of supervision on a consolidated basis, or that exposures from one or several credit institutions, investment firms or other financial institutions be securitised, allowing retention on a consolidated basis in accordance with the applicable accounting framework would not be in line with the level 1 text. “ (EBA Final draft RTS (Dec 13) Feedback on industry comments)

- So, is the risk retaining entity itself an “originator” or “sponsor”? See also RTS Art. 3 on multiple originators
## CRR 404-410 – Application to ABCP conduits

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<td>EU credit institution/investment firm?  ➢ Underwriting requirement  ➢ Disclosure requirement</td>
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Risk retention – Issues for managed CLOs

• Issue: There may be no “originator” or “sponsor”, as defined, that can retain material economic interest
• CEBS Guidelines (paras. 25-26) provided flexibility to identify best party for alignment of interest even if not strictly within definitions
• Arrangers developed structures using retention by an “anchor” equity investor involved in selection/management of securitised assets
• EBA draft RTS withdrew this flexibility: “retainer” must be sponsor, originator or original lender, without exception
• CRR amended “sponsor” definition to include investment firms as well as credit institutions; however:
  • “investment firm” defined as subject to requirements of Markets in Financial Instruments Directive (MiFID), so includes only EU-regulated firms
  • even if within definition, many asset managers’ capital base and business model would not allow them to retain substantial net economic interest
• Interplay with “retention on a consolidated basis” issue
  • Retainer entity must itself qualify as “originator” or “sponsor”
Risk retention solutions for managed CLOs

• Sponsor as retainer
  – MiFID-regulated investment manager acts as retainer
  – MiFID firm cannot also be AIFM
  – Non-EEA-regulated investment manager would not qualify

• Originator structures
  – Rely on “originator” part (b) – entity buys loans and then securitises them
  – Retainer itself, not its affiliate, must be the originator
  – Must buy loans “for its own account” before securitising
  – Originator, unlike sponsor, need not be a regulated entity, but market requires some substance, including other investments and management capability
  – Investment generally provided by investment manager or affiliate
  – Multiple originators – consider relying on RTS provisions for entity that established and manages or that established and contributes at least 50% of exposures
US re-proposed retention rules and CRR Article 405

• Many transactions will be subject to both
  – US originator aims to issue ABS to EU-regulated banks (or their US affiliates)
  – Non-US originator issues ABS to both US investors and EU bank investors

• Application
  – Exchange Act ABS vs. CRD “securitisation positions”
  – Exemptions for “qualified residential mortgages” and other “qualified assets”
    – only in US; narrow
  – Exemptions for government-guaranteed securitisations or assets – wider in US

• Retention amount – fair value of ABS interests vs. nominal amount of tranches (vertical slice) or securitised exposures (other options)

• Form of retention
  – Both allow vertical slice, seller interest or first loss
  – EU allows random sample method; US re-proposal does not
  – US “L-shaped interest”
  – EU allows unfunded commitments; US proposals would not
  – US rules more detailed and specific

• Restrictions on hedging or transfer
  – US restrictions expire after prescribed time or reduction of outstandings
  – EU restrictions have no sunset provisions
US risk retention rules
Risk Retention Re-Proposal

• Original proposal was more than two years ago
• Comments were due October 30, 2013. Our firm drafted the SFIG Comment Letter and comment letters for other clients.

• Base Requirement:
  – **Sponsor** of a *securitization transaction* (or majority-owned affiliate) must retain an economic interest in the credit risk of the securitized assets
  – Generally 5% is required
  – “Sponsor” organizes and initiates a securitization transaction by selling or transferring assets directly or indirectly to the issuing entity
    • NOTE: If you don’t organize the transaction or transfer assets, you aren’t the sponsor and are not subject to risk retention
    • NOTE: If the transaction does not involve a “security” (e.g., a commercial loan), it’s not an “asset-backed security” or a securitization transaction subject to risk retention

• Majority-owned affiliates includes not only the traditional control test, but also ownership of a controlling financial interest in an entity as determined under US GAAP
  – If you consolidate an entity under GAAP, that entity is your majority-owned affiliate.
Standard Risk Retention

• Sponsor of a securitization transaction generally must retain either:
  – Eligible vertical interest,
    • Can be either:
      – A single vertical security or
      – An interest in each class of ABS Interests issued as part of the securitization transaction
  – Eligible horizontal residual interest,
  – Eligible horizontal reserve account; or
  – Any combination thereof
    • Note: No longer need to have any “L-Shaped” limitation of 2.5% each

• Amount retained by the sponsor must equal at least 5% of fair value of all ABS Interests in the issuing entity issued as part of the securitization transaction

• Does not include representative sample from original proposal
• The Re-Proposal does not permit participation interests as a form of retention.
• Special Rules for CMBS, master trusts and ABCP.
Standard Risk Retention

• “ABS Interest” means any type of interest issued by an issuing entity if payments are primarily dependent on the cash flows
  – Intended to be broad
  – Does not include right to receive payments for services provided by the holder of that right, including servicers, trustees and custodians

• Risk Retention percentages calculated based on the *fair value* of ABS interests instead of the *par value*.
  – Determined in accordance with US GAAP
  – The Re-Proposal eliminated the premium cash capture reserve account concept.
  – Determined on the day on which pricing of the ABS Interests occurs
  – The Re-Proposal mandates additional disclosures related to the calculation of fair value including:
    • the material terms of the ABS interests retained;
    • the methodology used to calculate the fair value, specifically the key inputs, assumptions, reference data and historical information used.

• Industry comment: Fair value calculations are a significant burden and expense and potential increased liability with additional disclosure
Eligible Horizontal Residual Interest (EHRI)

• Can be a single class or multiple classes

• Has the most subordinated claim to both principal and interest by the issuing entity
  – Note: Can’t use a rated subordinated note as part of the EHRI because you can’t pay subordinated interest on EHRI before senior principal

• Shortfalls must reduce amounts paid to the EHRI prior to other ABS Interest
  – Can occur through any contractual provisions, including operation of the priority of payments
Eligible Horizontal Residual Interest - Required Calculations

• Fair Value for each ABS Interest, including the EHRI

• Closing Date Projected Cash Flow Rate
  – For any payment date, means the percentage obtained by dividing:
    • Fair value of all cash flow projected, as of closing date, to be paid to EHRI holder through and including that payment date, by
    • Fair value of all cash flow projected, as of closing date, to be paid to EHRI holder through maturity of the EHRI
  – Must use same assumptions and discount rates used in determining the Fair Value of the EHRI

• Closing Date Projected Principal Repayment Rate
  – For any payment date, means the percentage obtained by dividing:
    • Amount of principal projected, as of closing date, to be paid on all ABS Interests through and including that payment date, by
    • Aggregate principal amount of all ABS Interests issued in the transaction
      – Note: What’s the “principal amount” of the EHRI?
Disclosure for Eligible Horizontal Residual Interests

• Key inputs and assumptions used in measuring fair values, including quantitative information about the following:
  – Discount rates
  – Defaults; Loss given default (recovery); Lag time between default and recovery
  – Prepayment rates

• Reference data set or other historical information used to develop the key inputs and assumptions, including defaults and loss given default

• Certify to investors that Closing Date Projected Cash Flow Rate for each payment date does not exceed the Closing Date Projected Principal Repayment Rate for such payment date
  – This is a disclosure of projections, which will dramatically expand liability in these transactions.
  – This will always happen if you have excess spread in the transaction
  – De-leveraging structures, in which enhancement increases over time, won’t work

• Number of payment dates for securitizations during past five years in which an EHRI was retained in which actual payments on EHRI exceeded projected cash flows in determining Closing Date Projected Cash Flow Rate
Eligible Horizontal Residual Interest - Issues

• Industry Comment: Can we have a “Simplified Approach” for “Simple Structures” where it is obvious that size of the EHRI is more than 5%?
  – Discuss possible alternative proposals

• Re-proposal does not contemplate a revolving deal where the balances of the ABS Interests are regularly changing
  – Do you need to do it every day? Every time you add assets?
  – Note: How do you calculate “fair value” for a trade receivables deal?

• Sponsors must disclose their experience in retaining EHRIIs under the Horizontal Method and the number of payment dates in prior securitizations in which the actual payments to the sponsor exceeded the projected payments for that payment date.

• Industry comment: In a true “private” deal (e.g., a VFN), investors are doing due diligence. Can we potentially get relief from disclosure in that situation?
Transfer and Hedging of Risk Retention; Non-Recourse Financing

• Can’t sell or otherwise transfer any interest required to be retained
  – OK to transfer to an entity that is and remains a majority-owned affiliate

• Can’t pledge any ABS Interest required to be retained unless the secured obligation is with full recourse to the sponsor or affiliate.

• Hedging Restriction: Sponsor, affiliate or issuing entity can’t enter into any agreement if:
  • Payments under the agreement are materially related to the credit risk of either ABS Interests required to be retained, or securitized assets that collateralize the ABS, and
  • The agreement in any way reduces or limits the financial exposure of the sponsor
  • Restriction applies to sponsor and ALL of its AFFILIATES (and not just the majority-owned affiliates that may hold the retained risk).

  – Permitted Exceptions:
    • Interest rate or currency exchange rate hedges (other than hedges of credit risk or “spread risk”)
    • Hedging an index if:
      – ABS Interests of the issuing entity represent not more than 10% of the dollar weighted average of the index, and
      – ABS interests in all issuing entities in which the sponsor was required to retain an interest represent in the aggregate not more than 20% of the dollar weighted average of the index
Duration of Transfer and Hedging Limitations

• Expiration the latest of:
  – Later of reduction of unpaid principal balance of securitized assets or ABS Interests to 33% of closing date balance
  – Two years after closing date

• RMBS expiration at the later of:
  – Five years after closing date, or
  – Reduction of unpaid principal balance of mortgages to 33% of closing date balance

• RMBS favoritism:
  – RMBS transfer and hedging restrictions end seven years after closing date
  – Other long term asset classes have to wait for reduction to 33%
Subsequent Advocacy

• Representative Sample
  – We’ll get this if representative and not just random
  – Concern that we’d pick 1000 random samples until we got the cherry-picked “good” pool.

• Participations
  – We’ll get securitization of the entire pool with retention of a 5% participation.
  – Less open to securitization of participations.

• Limitations on EHRI Distributions
  – Ford’s suggestion: Focus on the value of the remaining residual rather than the cash distributed to the residual holder

• Revolving & Self Adjusting: They liked the idea

• Simplified Approach: Will we get anything?

• Qualifying Auto Loans: Regulators are not willing to make changes
DERIVATIVES REGULATION

• European Markets Infrastructure Regulation (EMIR) and related regulatory changes

• US Commodities Futures Trading Commission (CFTC) and Securities Exchange Commission (SEC) rules – including cross-border application
Principal Areas of Regulation

• Central clearing of “standardized trades”\(^1\)
• Reporting to Trade Repositories\(^1\)
• Trade execution on exchanges or electronic platforms\(^1\)
• Higher capital charges for non-cleared derivatives\(^1\)

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• Margin requirements for non-cleared derivatives\(^2\)

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• Risk Mitigation techniques\(^3\)
• Registration and oversight of dealers\(^3\)
• External/Internal Business Conduct Rules\(^3\)
• Real-time reporting\(^3\)

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\(^1\) G20 Commitment (Sept 2009)
\(^2\) Added to G20 Commitment in 2011
\(^3\) Not part of G20 Commitment
US and European Legislative Frameworks

Communiqué ➔

G20 Commitment
(25 September 2009)

U.S. Congress
(House/Senate)

Dodd Frank Act
(21 July 2010)

Swaps/Mixed Swaps
Security-based Swaps

CFTC ➔

SEC ➔

EMIR
(16 August 2012)

CRD IV
(17 July 2013)

MiFID II
(15 April 2014)

European Commission ➔

ESMA ➔

Technical Standards
(Delegated Regulations)

Governments ➔

Primary Legislation ➔

Secondary Legislation ➔

Regulators ➔

Primary Legislation

Secondary Legislation

ESMA ➔

Secondary Legislation

= In progress
US and European Legislative Frameworks

• United States
  – Dodd Frank Act covers all areas of regulation
  – Ongoing CFTC/SEC Rulemaking process
  – Extraterritorial effects

• European Union
  – EMIR is binding and directly applicable in all 28 EU member states
  – EMIR covers trade reporting, central clearing and margining for uncleared trades and risk mitigation requirements
  – Trade execution, real-time reporting and business conduct to be covered by MiFID II / MiFIR (implementation 2016/2017?)
  – Increased capital requirements covered by CRD IV / CRR
Central Clearing

• United States
  – CFTC Clearing mandate applies to IRS, FRAs and Index CDS
  – Phased implementation based on categories
  – Final phase completed 9 September 2013
  – End-user exemption for non financial entities using derivatives for commercial hedging purposes

• European Union
  – Mandatory clearing to apply to Financial Counterparties (FCs) and Non-financial Counterparties exceeding threshold (€1bn/€3bn over 30 days) and for non-hedging purposes (NFCs+)
  – ESMA draft RTS on clearing obligation
Reporting to Trade Repositories

• United States
  – Pursuant to Dodd-Frank, CFTC has mandated that all swaps must be reported to swap data repositories ("SDRs")
  – Reporting phased in by counterparty/asset class but now in full force
  – One-side reporting based on status of counterparties (e.g. obligation always on swap dealer)

• European Union
  – Bilateral TR obligation to apply to all asset classes
  – Reporting started on 12 Feb
Trade execution on exchanges/electronic platforms

• United States
  – CFTC mandated “swap execution facilities”
  – Application limited to swaps subject to clearing mandate
  – “Made Available to Trade” determinations made for certain IRS/CDS contracts
  – Mandatory SEF trading commenced 26 Feb 2014

• European Union
  – Obligation contained in MiFIR/MiFID II
  – “Organised Trading Platforms” and “Systematic Internalisers”
Higher Capital Charges for Uncleared Trades

• United States
  – Higher capital charges contained in Basel 3
  – CVA Risk Capital Charges, Effective EPE with Stressed Parameters and Asset Value Correlation Multiplier
  – Basel 3 implementation phased in from 2015 to 2022

• European Union
  – EU to adopt Basel 3 through CRR and CRD IV
Margin Requirements for Uncleared Trades

• BCBS/IOSCO final report published September 2013

• All financial firms and “systemically important non-financial entities” must exchange initial and variation margin

• Initial margin exchanged on gross basis, segregated and with very limited re-hypothecation right

• FX forwards/swaps exempted from initial margin

• Phase-in from 1 Dec 2015 to 1 Dec 2019, depending on average notional book of uncleared derivatives

• 3 Sept US prudential regulators proposal on margin
Risk Mitigation Techniques

• United States
  – CFTC rules in force on swap relationship documentation, portfolio reconciliation, portfolio compression, timely confirmation, dispute resolution and swap valuation
  – ISDA March 2013 DF Protocol introduced to facilitate dealer compliance

• European Union
  – EMIR and RTS address portfolio reconciliation, portfolio compression, timely confirmation, dispute resolution and daily MTM for FCs/NFC+ (and margin segregation)
  – Timely confirmation phased in from 15 March 2013, other risk mitigation from 15 September 2013
  – ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol and Timely Confirmations standard language
• United States
  – Dealers exceeding certain thresholds were required to register and submit to CFTC oversight by 1 January 2013
  – Registration affects which aspects of Dodd Frank apply to entity (e.g. Business conduct, reporting, risk mitigation)
  – Around 80-90 swap dealers currently registered with the CFTC
External/Internal Business Conduct Rules

• United States:
  
  – CFTC has finalised external business conduct rules which apply to swap dealers relating to customer due diligence, sales practices, transaction disclosures, suitability, trading with special entities, etc.
  
  – ISDA August 2012 Dodd Frank Protocol introduced to facilitate dealer compliance
• United States:
  – Mandatory real-time reporting of CFTC swaps began on 31 December 2012
  – Key information about swaps must be publicly disseminated via SDRs.
  – This information is rendered anonymous to protect the identity of the counterparties.
  – Delays in reporting are allowed for large “block” transactions
Extraterritoriality – CFTC Perspective

• Section 2(i) of the Commodity Exchange Act provides swap provisions of Dodd-Frank Act do not apply to activities outside of the United States unless those activities (a) have a “direct and significant” connection with activities in, or effect on, commerce of the United States; or (b) violate CFTC anti-evasion rules, if any.

• On July 26, 2013, the CFTC published final guidance interpreting Section 2(i) and indicating to market participants when it generally would expect to assert jurisdiction over swaps activities (the “Interpretive Guidance”).

• The various scenarios addressed by the guidance require a market participant to determine both its status and its counterparty’s status in order to determine what legal requirements apply to a swap between them.

• Counterparty determinations include: whether either party is a “U.S. person”; whether a non-US person counterparty is an “affiliate conduit” of a U.S. person; whether a non-US person counterparty is guaranteed by a U.S. person; and whether a trade may be deemed to be booked to a non-U.S. branch of a U.S. bank swap dealer.
Extraterritoriality – CFTC Perspective

• “US person” status determination non-exhaustive and complex to apply. E.g. “principal place of business” is defined broadly - pooled investment vehicles will need to look to the location of persons involved in structuring and managing the entity and may need to “look-through” to indirect investors in order to determine if they are “majority-owned” by U.S. persons.

• The Interpretive Guidance divides the requirements into: (i) Entity-Level Requirements (“ELRs”) and (ii) Transaction-Level Requirements (“TLRs”).
  
  • ELRs are generally those requirements that apply at the “core operations of a firm” and thus to the entity as a whole.
  
  • TLRs are generally those requirements that apply to particular swap transactions or the trading relationship between a dealer and its counterparty.

• The Interpretive Guidance enumerates whether (and which) ELRs and TLRs apply to various types of pairs and also whether “substituted compliance” is allowed.

• ISDA Cross-Border Swaps Representation Letter

• Substituted Compliance
Extraterritoriality – European Union Perspective

• EMIR may apply to third country entities if (a) the derivative contract has a direct, substantial and foreseeable effect within the EU or (b) anti-avoidance (Art 11(12))

• RTS on determination published in March 2014—focuses on EU branches of TCEs and entities guaranteed by EU entities

• EMIR compliance can be substituted for equivalent third country requirements for (i) “cross-border” transactions and (ii) transactions between two TCEs that would otherwise have been subject to EMIR. To date, ESMA has published technical advice for the European Commission on third country regulatory equivalence for: Australia, Hong Kong, Canada, India, Japan, Singapore, South Korea, Switzerland and US
Clearing of SPE Swaps

• Mandatory Clearing – standardized and uniform swaps
  – “Securitization” swaps?
  – Have we increased the likelihood that a bankruptcy of a major swap participant will take down the entire system (Compare to 1987 crash)

• Trading – if it must be cleared, it must be "traded," if a facility makes it available

• Margin Requirements currently apply cleared swaps

• Discuss current status of clearing for SPE swaps
Regulation of Commodity Pool Operators

• Dodd-Frank added new terms to Commodity Exchange Act:
  – “Commodity Pool” and “Commodity Pool Operator” (CPO)
  – Inclusion of “swaps” as commodity interests.
• NOT just prospective – legacy entities are also affected
• CFTC broadly interprets “trading”
  – A single swap used for hedging may be sufficient to constitute “trading”
• Any CPO or commodity trading adviser (CTA), unless exempt, is required to register and meet related requirements
  – CPO/CTA registration is burdensome and imposes regulatory requirements that will be difficult for securitization issuers to satisfy
• Consequences if violated
  – Willful violation is a felony punishable by a fine of up to $1MM or imprisonment for up to 10 years or both
  – Private action/damages against a person who violates the CEA or who willfully aids, abets, counsels, induces or procures a violation
  – Nonexempt unregistered CPOs do not qualify as “eligible swap participants”
  – Commodity pools are “covered funds” under proposed Volcker Rule, and can’t be owned or sponsored by banks and their affiliates
SECURITIES DISCLOSURE REQUIREMENTS AND EXEMPTIONS

• Credit Rating Agency Regulation as amended (CRA3) Article 8b

• US SEC Regulation AB II
Credit Rating Agency (CRA) Regulation – 2013 Amendments (CRA3)

• European Regulation referred to as CRA3 amends 2009 credit rating agency framework (CRA Reg)
  – CRA3 effective as of 20 June 2013

• European Securities and Markets Authority (ESMA) issued a Discussion Paper on 10 July 2013

• ESMA issued a Consultation Paper and first draft RTS on 11 February 2014; consultation period ended 11 April 2014

• ESMA submitted final draft RTS to EC on 20 June 2014

• EC has 3 months to decide whether to endorse the final draft RTS (i.e. by 20 September 2014)
CRA3 provisions on securitisation

• Issuer or related third party soliciting credit rating agency (CRA) ratings for a structured finance instrument (SFI) must appoint at least two CRAs to give two ratings (Article 8c)

• In that case the issuer or related third party must consider appointing a small CRA (Article 8d)

• Joint disclosure requirements for issuers, originators and sponsors of SFIs (Article 8b)

• CRA rotation required for re-securitisations (Article 6b)
CRA3 Art. 8b – Key dates

• RTS will enter force on 20th day following publication in the Official Journal of the European Union and will apply directly in all Member States (≈ November/December 2014) ("Effective Date")

• RTS will apply from 1 January 2017

• Reporting requirements will apply to all SFIs issued on or after the Effective Date that remain outstanding on 1 January 2017

• Only required to make required disclosures from 1 January 2017 and no need to keep a backlog of information for the period between the Effective Date and 1 January 2017
CRA3 Art. 8b – Information on structured finance instruments

• “The issuer, the originator and the sponsor of a structured finance instrument established in the Union shall, on the website set up by ESMA pursuant to paragraph 4, jointly publish information on the credit quality and performance of the underlying assets of the structured finance instrument, the structure of the securitisation transaction, the cash flows and any collateral supporting a securitisation exposure as well as any information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures.” (Art. 8b(1), emphasis added)

• “‘structured finance instrument’ means a financial instrument or other assets resulting from a securitisation transaction or scheme referred to in [CRD definition of ‘securitisation’]” (CRA Reg.)

• Carve-out for disclosure that would breach national or EU law on confidentiality of sources or processing of personal data
CRA3 Art. 8b – ESMA Final Draft RTS

• Applies to structured finance instruments (SFIs) if the issuer, originator or sponsor is established in EU (Article 2)

• Disclosure obligations apply to all SFIs arising from a securitisation transaction or scheme (not just securities, but also other financial instruments and assets, e.g. loan notes) with or without a credit rating, whether public, private or bi-lateral and whether or not admitted to trading on an EU regulated market

• Joint liability, but ability to designate one or multiple “reporting entities” to be notified to ESMA (Article 4)

• Required disclosures are to be posted to a website to be established by ESMA

• The reporting entity shall store the information sent to the website in electronic form for at least five years (Article 8)
Transactions to which reporting obligations will apply

• Initially will only apply to following asset classes for which loan level information disclosure templates are available:
  – Residential mortgages
  – Commercial mortgages
  – Loans to SMEs
  – Auto loans
  – Consumer loans
  – Credit cards
  – Leases to individuals or businesses

• Additional templates to be developed by ESMA for other asset classes (e.g. trade receivables, corporate loans, store cards, asset backed commercial paper (ABCP), synthetic securitisations and re-securitisations)

• RTS will not apply initially to private and bilateral transactions, but additional templates and reporting obligations to be developed
Reporting obligations – issuance reporting (Article 5(b))

• Reporting obligations to be met without delay after issuance of SFI:
  – Final offering document or prospectus (if applicable)
  – Asset sale agreement
  – Servicing, back-up servicing, administration and cash management agreements
  – Trust deed, security deed, agency agreement, account bank agreement, guaranteed investment contract (GIC), master definitions agreement
  – Any relevant intercreditor agreement, swap documentation, subordinated loan agreements, start-up loan agreements, liquidity facility agreements
  – Any other underlying documentation

• Above documents must contain a detailed description of the payments waterfall
Reporting obligations – issuance reporting (Article 5(c))

• Where there is no Prospectus Directive prospectus, a transaction summary of the main features of the SFI, including:
  – Deal structure
  – Asset characteristics, cash flows, credit enhancement, liquidity support
  – Note holder voting rights and relationship between note holders and the other secured creditors
  – Triggers and consequences of breach
  – Structure diagrams of overview of transaction, cash flows and ownership structure
Reporting obligations – quarterly reporting

• Quarterly reporting, no later than one month following the due date for payment of interest on the SFI:
  – Loan level data for the specified asset classes via standardised disclosure templates annexed to the Draft RTS (Article 5(a) and Annexes 1-7)
  – Investor reports, to include (Article 5(d) and Annex 8):
    • asset performance
    • cash flow allocation
    • list of counterparties and their ratings
    • triggers and their status
    • details of any cash injections (liquidity or other support)
    • amounts standing to credit of GIC and bank accounts
    • details of swaps
    • definitions of key terms (such as delinquencies, defaults and pre-payments)
    • LEI, ISIN or other identification codes
    • contact details of entity producing the investor report
Reporting obligations – ad hoc reporting of significant events (Article 7(4))

• If SFI is subject to the Market Abuse Regulation, any disclosure of information to be made pursuant to the Regulation should also be disclosed on the ESMA website.

• If SFI is not subject to the Market Abuse Regulation, reporting entities must report as soon as possible any significant change or event in any of the following:
  – Breach of obligations included in the documentation
  – Structural features that can materially impact on the performance of the SFI
  – The risk characteristics of the SFI and the underlying assets
Remaining issues

• **Extra-territorial effect** as a result of only one of the originator, sponsor or issuer needing to be in the EU (so, for example, a non-EU originator could become subject to the joint disclosure obligations as a result of the involvement in the transaction of an EU issuer or sponsor – unclear of authority for such extra-territorial effect, supervision and censure)

• Uncertainty as to whether **private and bi-lateral transactions** will be subject to the disclosure regulations – although that is the intent of the Regulations, in the preamble ESMA recognises that developing disclosure requirements for private and bi-lateral SFIs “may prove complex from a technical point of view” and that further open public consultation and cost/benefit analysis is required

• Disclosure of **transaction summary** where transaction is not Prospectus Directive compliant may mean disclosure of sensitive data

• **Event-based reporting** applies even to those SFIs not subject to the market abuse regime
Remaining issues – cont’d

• Although there is a carve-out for disclosure that would breach national or EU legislation governing protection of confidential information sources or the processing of personal data, there is no such carve-out for contractual confidentiality undertakings which often feature in underlying assets (if still a significant concern to the market, ESMA may include directions in the technical reporting instructions for the website)

• Regulation has adopted the ECB data templates, but does not include flexibility for the use of other loan level data templates (for example, Bank of England templates)

• ECB credit card template has been adopted which remains untested and not yet clear whether market participants are able to comply with the reporting requirements

• The form of the ESMA website remains unclear – will it require full uploading of information (which can be onerous and expensive) or will it permit hyperlinking to information hosted on other websites?
Reg AB II - Topics

- Some bullets we’ve “dodged”
- Compliance Dates
- Shelf Eligibility
- Changes to the Shelf Offering Process
- Changes to Reg AB Disclosure Requirements
- Asset-Level Data Requirement
- International Issues
Bullets We’ve “Dodged”

• Public-style disclosure not required for private deals
• Asset-level data filed on EDGAR, not on issuer web sites
• No asset-level (or grouped) data required for equipment, credit cards, student loans, floorplan and several other asset classes listed in original proposal
  – Note: Dodd-Frank Act requires asset-level data for ABS, so these may be coming in the future
Reg AB II - Topics

• Some bullets we’ve “dodged”

• **Compliance Dates**

• Shelf Eligibility

• Changes to the Shelf Offering Process

• Changes to Reg AB Disclosure Requirements

• Asset-Level Data Requirement

• International Issues
Compliance Dates

• Effective Date: 60 days after publication in the Federal Register.

• Compliance dates would be as follows:
  – New rules, forms, and disclosures no later than one year after Effective Date (i.e., November __, 2015)
    • Public ABS offerings after November __, 2015 must have an effective Form SF-1 or SF-3 registration statement.
      – Note: When is the best time to file?
    – Asset-level disclosures: Two years after Effective Date (i.e., November __, 2016)

• Forms 10-D, 10-K: One year after Effective Date (i.e., November __, 2015)
  – Note: If you never do another public ABS deal, 10-Ds and 10-Ks still must use the new forms after Compliance Date
Reg AB II - Topics

• Some bullets we’ve “dodged”
• Compliance Dates
• **Shelf Eligibility**
• Changes to the Shelf Offering Process
• Changes to Reg AB Disclosure Requirements
• Asset-Level Data Requirement
• International Issues
Shelf Eligibility

• Removal of investment grade rating requirement

• New Shelf Eligibility Requirements (in additional to all prior shelf eligibility requirements)
  – Registrant Requirements
    – Transaction Requirements

• Registrant Requirements: During the preceding 12 calendar months (and any portion of a month prior to filing):
  – Timely filing of all 1934 Act Reports
    • Failure to timely file 1934 Act Reports puts you in “penalty box” until you have 12 full months of timely filings
    • Annual certification in Form 10-K. Failures not only prevent filing a new shelf but also use of existing shelf.

  – Timely filing of all depositor CEO certifications

  – Timely filing of all transaction agreements
    • If you have not timely filed certifications and transaction agreements, you’re in the “penalty box” until 90 days after you’ve gotten everything on file
Shelf Eligibility

- **Transaction Requirements:**
  - **Depositor CEO Certification**
    - Certification by Depositor’s CEO in each offering that:
      - To knowledge, prospectus has no false statements of material facts or material omissions
      - To knowledge, prospectus “fairly presents” asset characteristics, deal structure and risks of owning the securities, including risks affecting cash flows
      - To knowledge, reasonable basis to conclude that securitization is structured (but not guaranteed) to produce expected cash flows at times and in amounts to service scheduled interest and ultimate principal on the securities
  - **Potential Liability for Depositor CEO**
    - Securities Act Section 11 (same potential liability for signing registration statement) — investors and SEC can bring a cause of action
    - Securities Act Section 12a-2 — investors and SEC can bring a cause of action
    - Exchange Act Section 10 and Rule 10b-5 — investors, SEC and DOJ can bring a cause of action
    - Potential criminal liability if violations are found to be willful
    - Note: Depositor CEO already has liability as signer of Registration Statement
    - Note that the certifications are subject to any and all defenses available under the securities laws, including the due diligence defense available for executive officers that sign a registration statement
    - Note that any indemnification of Depositor CEO might not be enforceable on public policy grounds
Shelf Eligibility

• Transaction Requirements (cont.):
  – Depositor CEO Certification
    • How will Depositor CEO document and get benefit of his/her own Due Diligence Defense?
      – He/she will now have to read the prospectus and review cash flow runs
        • How will he/she fare in litigation if he/she must admit to not having read the document?
      – Beef up existing Rule 193 due diligence process
      – Disclosure Committee
      – “Box” the disclosure with internal sub-certificates
      – Obtain third party certificates (if available)
    • Some companies may do 144A deals to avoid Depositor CEO certification
      – Note: Is 144A market big enough? How much will pricing suffer?
      – Note: Some companies may just do AAA/Aaa bonds publicly to avoid certification for subordinated bonds
  – Investor Communication. Provision in transaction agreements requiring inclusion in Form 10-D of investors’ requests to communicate with other investors about possible exercise of rights
  – Resecuritizations must comply with Rule 190
Shelf Eligibility

• Transaction Requirements (cont.)

  – **Asset Review.** Provision in the transaction agreements for the review of at least all 60+ day delinquent assets for compliance with the representations upon trigger events.

    • “Asset representations reviewer” must be hired up-front – an additional cost in the deal

    • Prospectus disclosure of “asset representations reviewer’s” identity, duties, compensation, indemnification and the process to obtain review

      – Asset representations reviewer must be unaffiliated with other transaction parties and must not have done any pre-closing due diligence

    • At a minimum triggers must include:

      – Delinquency threshold (including comparison to static pool delinquencies and disclosure of how threshold was determined to be appropriate)

      • Note: Simple percentage as of a date, not a rolling average

      • If there are sub-pools, need separate trigger for each sub-pool

      – Direction of investors by a vote (only 5% can call investor vote, simple majority of those voting)

      • Note: Can investors just assume “there must have been a breach” and seek a vote and review without any factual basis?

    • Report delivered to trustee and filed in Form 10-D

  – **Dispute resolution provision** in the underlying transaction documents.

    • Requesting party gets arbitration or mediation if no repurchase within 180 days after request. Arbitrator determines who pays expenses.
Reg AB II - Topics

- Some bullets we’ve “dodged”
- Compliance Dates
- Shelf Eligibility
- Changes to the Shelf Offering Process
- Changes to Reg AB Disclosure Requirements
- Asset-Level Data Requirement
- International Issues
Changes to ABS Shelf Offerings

- Pay-as-you-go registration fees at time of preliminary prospectus
  - Registrants will apply outstanding fees to their new shelves
  - You can now register an unspecified amount of securities
- Forms SF-1 and SF-3 would replace Forms S-1 and S-3
- Single prospectus rather than base prospectus and prospectus supplement
- Can’t use same form of prospectus for multiple asset classes or jurisdictions unless each non-primary asset class or jurisdiction is limited to 10% of deal
  - Note: This means you could not register many multi-country deals or have, for example, a deal with 50% auto loans and 50% auto leases
Changes to ABS Shelf Offerings

• Takedown off a shelf registration statement requires
  – Filing of preliminary prospectus at least 3 BD before first sale
    • Must contain all information other than price-related information and underwriting syndicate
    • Any material changes must be clearly delineated in a new filing at least 48 hours before first sale (Allows pricing on Monday if filed on Friday)
      – Note: Can we come up with a way to upsize without a 48 hour delay?
      – Note: Can you do a statistical pool from which all receivables will be selected and show the asset-level data for the larger pool?
      – Note: Can we just do a blacklined new Red rather than creating a supplement?
  – Delivery of preliminary prospectus at least 48 hours before a broker-dealer can send confirmation of sale
    – A new structural feature or type of credit enhancement requires a post-effective amendment

• Must be an “all or none” offering
Reg AB II - Topics

• Some bullets we’ve “dodged”
• Compliance Dates
• Shelf Eligibility
• Changes to the Shelf Offering Process
• Changes to Reg AB Disclosure Requirements
• Asset-Level Data Requirement
• International Issues
Changes to Reg AB Disclosure Requirements

• Prospectus summary to contain summary of statistical pool information

• Retained economic interest of sponsor, servicer’s and/or originator, and any hedges which offset that risk
  
  – Note: We expect to reserve right to transfer retained interests to the extent permitted by law

• Financial condition of sponsor, servicer and/or originator to extent material risk that its ability to repurchase assets could have material impact on ABS performance
  
  – Note: Ambiguity whether sponsor financial information is required in all prospectuses?

• Provisions in transaction agreements about modification of the receivables, including how cash flows may be affected

• If more than 10% is originated by parties other than sponsor, those originators must be disclosed
Changes to Reg AB Disclosure Requirements

• Pre-funding limit lowered to 25% (from 50%)

• Static pool disclosure requires graphical presentation and a narrative of differences from the securitized pool
  – Can be filed on Form 8-K rather than included in text of prospectus

• Disclosure on an aggregate basis about type and amount of assets that do not meet the disclosed underwriting criteria

• Requirement to file transaction documents by the date of the final prospectus

• Changes to Forms 10-D, 10-K, and 8-K, including
  – Disclosure in Form 10-K about Material Instances of Noncompliance (MINC) in this transaction with Item 1122(d) servicing criteria and steps taken to remedy previously identified MINCs
  – Changes in risk retention
Reg AB II - Topics

• Some bullets we’ve “dodged”
• Compliance Dates
• Shelf Eligibility
• Changes to the Shelf Offering Process
• Changes to Reg AB Disclosure Requirements
• **Asset-Level Data Requirement**
• International Issues
Asset-Level Data

• Required in the prospectus and in ongoing reports.

• Asset classes – Only the following:
  – Residential mortgages
  – Commercial mortgages
  – Auto loans
  – Auto leases, and
  – Debt securities (including resecuritizations).

• SEC continues to consider the remaining asset classes covered by the 2010 proposal.

• Asset-level disclosures generally would include information about:
  – Credit quality of obligors.
  – Collateral related to each asset.
  – Cash flows related to a particular asset, such as the terms, expected payment amounts, and whether and how payment terms change over time.

• Exemption for resecuritizations of ABS issued prior to two years after effective date
Asset-Level Data

• New Schedule AL (Reg AB Item 1125) lists the asset-level data requirements
• Filings are to be on new electronic Form ABS-EE in XML Format
  – SEC has not yet published the final technical requirements in the EDGAR Filer Manual and EDGAR Technical Specifications
  – SEC will permit issuers to make test submissions during the transition period
• Privacy Concerns Mitigated By SEC Changes and CFPB Guidance
  – All asset-level data will be publicly available on an unrestricted basis
  – SEC made some content changes to further mitigate re-identification risk
  – SEC obtained guidance from CFPB that mitigates FCRA concerns for issuers
    • Note: CFPB letter protects filings on EDGAR under regulatory requirements. May not protect a 144A deal, or disclosure of anything not explicitly required by the rules
  – Re-identification risk still exists, so potential liability under GLB and state privacy laws not completely eliminated
  – Re-identification may also present potential reputation and customer relationship concerns
Some Asset-Level Data Requirements

• Loan/Lease information, including
  – Originator identity, origination date, original loan amount or acquisition cost, term, maturity/expiration date, original interest rate, payment frequency
  – “Underwriting indicator” to show whether loan met criteria for “first level” of credit-granting criteria

• Obligor information, including
  – Credit score, presence of co-obligor, geographic location
  – Extent of income and employment verification,
  – Payment-to-income ratio
Some Asset-Level Data Requirements

• Activity during reporting period, including
  – Remaining term to maturity, beginning and end of period balance, next period amount due, current and next period interest rate, scheduled interest and principal
  – Interest, principal and total amounts paid during period, including indicator if balance reduced to zero
  – Delinquency status
  – Servicing fees, late fees and other fees
    • Note: Odd to require reporting of fees if they don’t go into the deal
  – Adjustments to principal balance during period
  – Whether asset was added or modified during reporting period
  – Whether servicer advances are required on the loan if delinquent, and amount advanced
Some Asset-Level Data Requirements

• Identity of Servicer

• Whether asset is subject to a repurchase demand, including status of demand, amount paid to repurchase, identity of repurchaser, reason for repurchase
  – Note: This would not appear to be required for voluntary or required repurchases without a demand.

• Principal amount charged off and recoveries of amounts previously charged off

• Whether loan was modified, reason and number of months payments were extended

• Whether collateral was foreclosed/repossessed and amount of sale proceeds

• For resecuritizations, requires all asset-level data for underlying securities if the underlying security is issued after November 2016 Compliance Date
Reg AB II - Topics

• Some bullets we’ve “dodged”
• Compliance Dates
• Shelf Eligibility
• Changes to the Shelf Offering Process
• Changes to Reg AB Disclosure Requirements
• Asset-Level Data Requirement
• **International Issues**
International Issues

• There are no exceptions to any of the requirements for non-US issuers or non-US assets
  – Many asset-level data fields were created for US assets, which will create significant issues for non-US assets

• Will non-US sponsors be able to get comfortable with Depositor CEO certification or will they choose to do everything in the 144A market?
BANK LARGE EXPOSURE LIMITS

• Basel Committee Supervisory framework for measuring and controlling large exposures

• EBA final draft RTS on exposure to transactions with underlying assets
Basel Committee’s Supervisory framework for measuring and controlling large exposures

• Published Apr 2014, following Consultative Document issued Mar 2013 and consultation period ended Jun 2013

• Built on previous Guidelines (1991) and Core Principles (2012) and previous guidance, principles and rules in main jurisdictions

• Principle of following rules from capital framework

• Does not cover sectoral, geographic or intragroup concentration risk, and exempts exposures to sovereigns

• Applies to internationally active banks; jurisdictions may apply it to additional banks and may modify its rules for those banks

• Implementation: by Jan. 2019, like Basel III; reporting earlier
Basel large exposures standard – main provisions

• Large exposure threshold - reporting
  – 10% of eligible capital base – like existing rules; vs. 5% in proposal
  – Measure before and after effect of eligible credit risk mitigation
  – Report 20 largest exposures even if less than threshold

• Large exposure limit
  – 25% of eligible capital base
  – 15% for exposure of Global Systemically Important Bank (G-SIB) to another G-SIB

• Eligible capital base (denominator)
  – Tier 1 capital as defined in Basel III (vs. all capital + surplus as in some existing rules)

• Connected counterparties – aggregate exposure
  – Control relationship or economic interdependence

• Look-through approach (LTA) for vehicles with underlying assets
  – Securitisations and collective investment undertakings (CIUs)
  – Exception – no exposure larger than 0.25% of bank’s capital base
  – Look for additional risks in structure – e.g. third party support providers

• Unfunded commitments
  – Apply credit conversion factor (CCF) per capital framework standardised approach

• Exposures to central counterparties (CCPs)
  – Exposures to qualifying CCPs (QCCPs) exempt during observation period ending 2016
  – Exposures to other CCPs subject to limits (but not connecting counterparty rules)
Large exposure rules - EU

- Capital Requirements Regulation (CRR) Part Four (Arts. 387-403)
- Generally equivalent to corresponding provisions in earlier Capital Requirements Directive (CRD)
- Does not cover sectoral or geographic concentration, but does cover intragroup concentration risk
- Applies to credit institutions (deposit-taking banks) and investment firms (investment banks)
Bank large exposure limits – EU – main provisions

Large exposure threshold - reporting
  – 10% of eligible capital base
  – Measure before and after effect of eligible credit risk mitigation
  – Report 20 largest exposures even if less than threshold

• Large exposure limit
  – 25% of eligible capital base
  – Floor limit €150m for exposures to institutions
  – Special limits on exposures to shadow banking entities to be considered

• Eligible capital base (denominator)
  – Tier 1 capital + Tier 2 capital up to 1/3 of Tier 1 capital

• Connected counterparties – aggregate exposure
  – Control relationship or economic interdependence

• Look-through approach (LTA) for vehicles with underlying assets
  – Securitisations and collective investment undertakings (CIUs)
  – Determined per regulatory technical standard (RTS) (see below)

• Unfunded commitments
  – Apply credit conversion factor (CCF) per capital framework standardised approach

• Exposures to central counterparties (CCPs)
  – Trade exposures and default fund contributions exempt
Large exposures – EU – transactions with underlying assets

- Regulatory Technical Standards (RTS) final draft 5 Dec 2013 not yet adopted by European Commission
- Transactions with underlying assets – securitisations and collective investment undertakings (CIUs) – CRR Art. 390(7) requires look-through approach (LTA) to underlying exposures
- Exposure value
  - Sum of products of bank’s share of each tranche times underlying exposure amount, up to that amount
- Credit enhancement from subordination not counted – treat senior and junior exposures the same – diff. CEBS Guidelines under CRD
- Materiality threshold 0.25% of eligible capital – similar to Basel standard
  - Vs. granularity threshold – 5% in CEBS Guidelines or 1% in earlier Basel proposal
  - I.e. no exposure exceeds 1% of transaction value (limited to 25% of eligible capital)
- Treat all unknown clients together as single unknown client
  - Unless exposure is below materiality threshold or shown to be unconnected
- Treat exposure to the transaction as an additional exposure (e.g. securitisation issuer as client) unless
  - cash flows cannot be redirected to persons not entitled to them, and
  - neither the issuer nor any third party can be required to make a payment in addition to or as advance payment of cash flows from underlying assets
MONEY MARKET REFORM

• EU proposed Money Market Funds Regulation

• US changes to Rule 2a-7
Proposed Money Market Funds Regulation

• Proposed Sep. 2013 for adoption some time in 2014
• Limit investment in securitisation
  – as defined in Capital Requirements Regulation (CRR)
• Eligible securitisation (Art. 10(1)):
  – (a) the underlying exposure or pool of exposures consists exclusively of corporate debt;
  – (b) the underlying corporate debt is of high credit quality and liquid;
  – (c) the underlying corporate debt has a legal maturity at issuance of 397 days or less, or has a residual maturity of 397 days or less.
  
  ESMA to define corporate debt high quality and liquid for Art. 10(1) (Art. 10(2))
• Exposure in securitisations limited to 10% of MMF’s assets (Art. 14(2))
New Money Market Fund Reform Rules and Proposals

• SEC Actions in July 2014:
  — Important changes (which greatly affect the MMF market, but don’t specifically affect ABS):
    • Floating NAV
    • Liquidity Fees and Redemption Gates
  — Changes to Diversification Rules
  — Additional proposed changes subject to further comment period and future final rules

• New Diversification Rules apply to new security purchases by MMFs on and after **April 14, 2016**

• Comment Period for Proposed Rules expires **October 14, 2014**
Changes to ABS Diversification Requirements

• Aggregation of Affiliates (majority ownership test) for Issuer Diversification Rules
  – Limited to 5% of Fund’s assets
    • Note: Exception for ABCP conduit ownership by SPE service companies
    – Also aggregated for determining 10% Obligors (except Restricted SPEs)

• Treatment of ABS Sponsors as guarantors unless Fund’s Board has determined (and maintains a written record) that Fund is not relying on:
  – Sponsor’s financial strength
  – Sponsor’s ability or willingness to provide liquidity, credit support, or other support
    • Will MMFs ever determine that a sponsor/servicer does not provide “support”?
  – Limited to 10% of Fund’s assets
Proposed Changes

• In definition of “eligible security,” proposal to replace rating requirement with a board finding that a security’s issuer has “exceptionally strong capacity to meet its short-term financial obligations”
  – Intended to comply with Dodd-Frank Section 939 which requires federal agencies to eliminate ratings references

• For issuer diversification requirements, proposal that “guarantee issued by a non-controlled person” no longer include guarantees by sponsors of ABS special purpose entities
  – Issuer diversification rules don’t apply to securities that are fully “guaranteed by a non-controlled person”
  – For example, if adopted, a conduit sponsor could no longer guarantee a transaction to avoid allocation to a 10% Obligor
  – Proposal would not affect exception for Restricted SPEs
BANK RING-FENCING

• US Volcker Rule as applied to securitisation

• Corresponding rules and proposals in UK and EU
Volcker Rule – Overview

• Volcker Rule prohibits a “banking entity” (very broadly defined) and its affiliates (including foreign entities, unless no contact with US) from:
  - “Proprietary trading” in securities, derivatives and other instruments
  - Sponsoring or investing in “covered funds,” which include private equity and hedge funds but also some securitization entities
  - “Super 23A” provision prohibits certain transactions with covered funds for which banking entities serve as investment adviser/manager/sponsor

• Covered fund provisions do not apply to securitizations which don’t exclusively rely on the 3(c)(1) or 3(c)(7) exemptions from Investment Company Act

• Volcker exemptions were intended to permit securitizations - “loan securitization exemption” in implementing rules

• Transition period
  - Compliance required by July 2015; 2017 for certain transactions existing before final rules released
  - Banks required today to develop/implement conformance plans that are as specific as possible on how the firms will conform their activities by those dates
“Covered fund” defined

• Any issuer that would be an investment company as defined in the US Investment Company Act of 1940 (ICA), but for ICA section 3(c)(1) or 3(c)(7)
  – Does not include:
    • Issuers that are not investment companies
    • Issuers relying on ICA exemptions other than section 3(c)(1) or 3(c)(7) (such as section 3(c)(5) or Rule 3a-7)
    • Investment companies registered with the SEC

• Any commodity pool as defined in the US Commodity Exchange Act, but only if:
  – the commodity pool operator (CPO) is registered with the CFTC with respect to its operation of the pool; and
  – the pool limits itself to sophisticated investors in a manner similar to private equity and hedge funds
Covered funds – inclusion of foreign funds

• Any foreign fund that relies on sections 3(c)(1) or 3(c)(7) is a covered fund

• Any foreign fund that does not rely on sections 3(c)(1) or 3(c)(7) because none of its securities are offered in the United States is not a covered fund, with one exception
  – If a US banking entity or a foreign banking entity controlled by a US banking entity invests in a foreign fund that would rely on ICA section 3(c)(1) or 3(c)(7), then that US banking entity must treat the foreign fund as a covered fund, even if the fund does not offer securities in the US and so does not use those exemptions
  – This is narrower than the proposed rule which would have applied to any foreign fund that would have to rely on ICA section 3(c)(1) or 3(c)(7) if it offered securities in the US
Covered funds – alternative ICA exemptions

• Section 3(c)(5)(c) (sales finance exemption)
  – exempts issuers primarily engaged in .... purchasing or otherwise acquiring mortgages and other liens on and interests in real estate
  – ‘primarily engaged’ generally viewed to permit up to 40% non-qualifying assets (though best if those assets are closely related)

• Rule 3a-7 (securitisation exemption)
  – exempts any issuer engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets ... and who does not issue redeemable securities if:
    • securities entitle holders to receive payments that depend primarily on cash flow from eligible assets
    • securities are either investment grade or sold only to institutional accredited investors, qualifying institutions buyers and persons involved in organisation or operation of issuer
    • acquisitions and dispositions of eligible assets are not effected for the primary purpose of recognizing gains or decreasing losses resulting from market value changes
    • issuer appoints an independent trustee that holds a perfected security interest in the eligible assets OR all securities are exempt under Securities Act section 3(a)(e) (commercial paper for current transactions)
Covered funds – exclusions

• SEC registered funds
• Foreign public funds (see below)
• Wholly-owned entities
• Joint ventures
• Loan securitisations and qualifying asset-backed commercial paper (ABCP) conduits (see below)
• Qualifying covered bonds issued or guaranteed by foreign banks
• Others
Covered funds – exclusion for foreign public funds

• Applies to a fund which:
  
  – Is organized or established outside the United States

  – Is authorized to offer and sell ownership interests to “retail investors” in the issuer’s home jurisdiction

  – Sells ownership interests predominantly through one or more public securities offerings outside of the US

  • Predominantly = 85 percent or more of the ownership interests are sold to investors that are not US residents

• To be a public securities offering for this purpose:
  
  – The distribution must comply with local requirements

  – The distribution may not restrict availability to investors having a minimum level of net worth or assets

  – The issuer must file publicly available offering disclosure documents with the appropriate regulatory authority in the jurisdiction
Covered funds - exclusion for loan securitisation issuers

• Applies to issuers of asset-backed securities (ABS) that are backed solely by:
  – loans,
  – certain related contractual rights and other incidental assets,
  – interest rate or foreign exchange derivatives that hedge issuer’s permitted assets, and
  – special units of beneficial interest and collateral certificates issued by a special purpose vehicle that itself meets the exclusion

• Permitted assets of an excluded loan securitisation issuer do not include
  – any security (with certain exceptions),
  – any other derivatives, or
  – any commodity forward contract
Covered funds – exclusion for qualifying ABCP conduits

• Applies to ABCP conduits that issue ABS that are backed by
  – loans and other assets permitted under the loan securitisation exclusion, and
  – ABS which itself is backed by assets that would be permitted under the loan securitisation exclusion, provided the ABS is acquired by the conduit in an initial issuance

• The conduit’s securities must be comprised solely of a residual interest and ABCP with a legal maturity of 397 days or less

• A regulated liquidity provider must enter into a legally binding commitment to provide full and unconditional liquidity coverage with respect to all ABCP issued
Covered funds – “ownership interest” defined

• Any equity or partnership interest or “similar interest”

• “Similar interest” includes
  – Right to participate in the selection or removal of a general partner, director, investment manager or similar entity (excluding creditor’s rights to exercise remedies upon an event of default or acceleration)
  – Right to receive a share in the fund’s income or profits
  – Right to receive underlying assets of the fund
  – Right to receive excess spreads under certain circumstances
  – Exposure to certain losses on underlying assets
  – Right to receive income on a pass through basis
  – Synthetic right to receive rights in the foregoing

• “Ownership interest” does not include
  – “restricted profit interests” intended to compensate advisers for services rendered to a fund
Covered funds – “sponsor” defined

• A “sponsor” of a covered fund is an entity that
  – Serves as a general partner, managing member, trustee or commodity pool operator of a covered fund
  – Selects in any manner or controls the directors, trustees or management of a covered fund or
  – Shares the same or a similar name with a covered fund

• A trustee is not a sponsor if
  – It does not exercise investment discretion with respect to a covered fund (such as a directed trustee), or
  – It is a trustee under foreign law that is subject to substantially similar fiduciary standards as directed trustees
    • Power to replace an investment adviser with an unaffiliated investment adviser, without more, does not make a trustee a sponsor
Covered funds – activities exempt from sponsorship and investment prohibition

- These exemptions do not permit “covered transactions” with a covered fund that would not be permitted under Super 23A

• Activities conducted solely outside of the US (SOTUS)

• Asset management exemption
  - Funds offered and organised in connection with *bona fide* fiduciary and advisory services to customers

• Organising asset-backed securitisations

• Market-making and underwriting activities

• Insurance company activities

• Risk mitigating hedging activities
Fund activities outside the United States (SOTUS)

• Exemption available only to foreign banking entities
  – not available to banking entities organised under US law, or owned or controlled by an entity organised under US law
  – foreign banking entity must be a “qualifying foreign banking organisation” (QFBO) under FRB Regulation K or have two of three of majority non-US assets, revenue or net income

• Covered fund may not be sold in an offering that “targets” US residents
  – Meeting the following conditions will satisfy the test:
    • Conducting an offer directed to residents of one or more countries other than US
    • Including in the offering materials a prominent disclaimer that the securities have not been offered in the US or to US residents
    • Offering includes other reasonable procedures to restrict access to offering subscription materials to non-US persons
  – Secondary sales of securities to US residents permitted
  – “US person” as defined in SEC’s Regulation S
    – replaced proposed rule’s wider definition of “resident of the United States”

• Other conditions – see next page
Fund activities outside the US – cont’d

• To meet the condition in the statute that the activity occur “solely outside of the United States,” the following additional conditions must be met:
  – The foreign banking entity and its relevant personnel that make the decision to acquire the ownership interest or act as sponsor are not located/organised in the US
  – The investment or sponsorship of the covered fund is not accounted for as principal on a consolidated basis by any US branch or affiliate of the foreign banking entity
  – The banking entity’s ownership or sponsorship is not financed directly or indirectly by any US branch or affiliate of the foreign banking entity

• Permitted activities in US:
  – US personnel and affiliates may be involved in the offer or sale of the fund
  – US personnel and operations may act as investment adviser
  – US personnel may provide administrative services

• Potential integration of complex fund structures:
  – Under certain circumstances, regulators may require that complex fund structures such as parallel funds should be “integrated” to determine whether there are any ownership interests offered for sale to a US resident
Covered funds – asset backed securitisation exemption

• Based on the same kinds of conditions that apply to the asset management exemption, a banking entity may act as the “securitiser” of an ABS issuer that is a covered fund

• Any investment in the fund (as required by Dodd-Frank) would be subject to the ownership limitations that also apply to asset management funds

• This exemption is not subject to the requirement that the bank act as a fiduciary or investor adviser and offer securities only to the bank’s customers as required under the asset management exemption

• All other conditions applicable to the asset management exemption apply

• Exemption enables a banking entity that organizes an ABS covered fund to own interests to the extent required by Dodd-Frank risk retention requirements
Covered funds – exempt investment limits

• Per fund limit is 3% of total outstanding ownership interests
  – Seed investments can be larger to provide fund with sufficient initial equity for its first year of operations so long as banking entity is actively seeking other investors; it can also request extension from the FRB for up to 2 more years
  – Investment in asset-backed securitisations can exceed 3% if required by Dodd-Frank risk retention
  – Complex calculation formulas

• Aggregate limit on all covered investments is 3% of Tier 1 Capital
  – Applied to holdings under the asset management, ABS and underwriting and market-making exemptions to prohibitions on investments in covered funds
  – Generally look to Tier 1 capital of top tier entity
  – Foreign banking entities will use consolidated Tier 1 capital as defined under home country standards

• Banking entities subject to US capital rules must also deduct these investments from their Tier 1 capital
  – This does not apply to foreign banking entities other than any US subsidiaries that are subject to US capital rules
Covered funds – the Super 23A prohibition

• If a banking entity acts as investment adviser, commodity trading advisor, investment manager or sponsor of a covered fund, or has certain other relationships, the banking entity and its affiliates are prohibited from entering into “covered transactions” (as defined in Federal Reserve Act section 23A) with the covered fund

• Covered funds subject to Super 23A
  – Include covered funds that a banking entity may sponsor and invest in under a Volcker Rule exemption
  – Not include excluded loan securitisation issuers, ABCP conduits or funds that rely on ICA exemptions other than 3(c)(1) or 3(c)(7)

• “Covered transactions” include:
  – Loan to the fund including purchase of assets subject to repo agreement
  – Purchase of assets from the fund
  – Purchase of or investments in securities issued by the fund
  – Issuance of a guarantee or letter of credit on behalf of the fund
  – Derivatives or securities lending transaction with the fund that results in credit exposure to the fund

• Other transactions are subject to “arms-length” rules
Super 23A – exemptions from covered transaction

• Obligations issued by the fund as collateral for a loan to a third party

• Investments otherwise permitted by the Volcker Rule (e.g., asset management de minimis, foreign fund exemption) or required by Dodd-Frank (i.e., securitization risk retention)

• Credit extensions associated with custody, clearance and settlement and other services for a “second-tier” covered fund (prime brokerage transactions) under the following conditions:
  – a covered fund managed, sponsored, or advised by such banking entity under certain exemptions has taken an ownership interest in the covered fund (the second-tier fund)
  – the CEO of the banking entity certifies annually that the banking entity does not guarantee the obligations of the second-tier fund or any covered fund in which the second-tier fund invests (in the case of a foreign banking entity, this certification may be provide by the senior manager in charge of US operations)

• Super 23A does not incorporate other exemptions that apply to member banks under section 23A and Regulation W
Supervisory and enforcement jurisdiction

- Volcker Rule assigns supervision and enforcement to five different US regulatory agencies.
  - Foreign banks (including uninsured US branches and agencies) are generally subject to primary supervision of the FRB
  - National banks and federal branches and agencies of foreign banks are subject to jurisdiction of the Office of the Comptroller of the Currency (OCC)
  - Banking operations insured by the Federal Deposit Insurance Corporation (FDIC) are subject to FDIC jurisdiction
  - Securities broker-dealers and securities-based swap dealers are subject to SEC jurisdiction
  - Futures commission merchants and registered swap dealers are subject to CFTC oversight

- Potential overlap of jurisdiction
  - E.g., an entity that is both registered as a swap dealer and subject to bank regulation may have to deal with both the CFTC and the bank regulator
  - Agencies have indicated they will coordinate their examination and enforcement proceedings
Volcker Rule and non-US ABS – summary

- Rule applies broadly to non-US banks that have, or have any affiliates that have, banking branches or agencies or bank subsidiaries in the US.
- Rule prohibits proprietary trading of securities, including ABS, with limited exemption for trading activities conducted solely outside the US.
- Rule prohibits bank ownership interest in or sponsorship of covered funds.
- Non-US ABS issuers are covered funds if they issue securities in US or to US persons relying on Investment Company Act section 3(c)(1) or 3(c)(7), though:
  - Excluded if rely on another exemption such as section 3(c)(5)(c) or Rule 3a-7, and
  - Excluded if they are loan securitisation issuers, as should be in many transactions.
- Rule prohibits bank extensions of credit to covered funds for which the bank acts as investment advisor, investment manager or sponsor (even if an exemption would permit the bank to have an ownership interest or act as sponsor).
- Ownership interest should not include most senior ABS but may include some junior tranches – limited exemption for risk retention required by US rules.
- Sponsor includes trustee that exercises investment discretion.
- Limited exemption for ownership or sponsorship activities by non-US banks (not owned or controlled by US banks) conducted solely outside US.
### Application to non-US banking entities and ABS

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<th>Volcker Rule issues</th>
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<td>Ownership interest prohibition (if issuer is a covered fund and not excluded or exempt) – permitted to extent required by US, not EU, risk retention rules</td>
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</table>
| Sponsor                     | Sponsorship prohibition (if issuer is a covered fund and not excluded or exempt) – limited exemption for activities conducted solely outside the US (SOTUS)  
Covered transactions prohibition (if issuer is a covered fund and not excluded, even if exempt) |
| Investment advisor or manager | Covered transactions prohibition (if issuer is a covered fund and not excluded, even if exempt)                                                  |
| Note trustee/security trustee | Trustee with investment discretion treated as sponsor                                                                                         |
| Junior investor             | Ownership interest prohibition (if issuer is a covered fund and not excluded or exempt); unless SOTUS                                               |
| Senior investor             | Ownership interest questions  
General prohibition on proprietary trading in securities – permitted if SOTUS conditions are met                                          |
Volcker rule v EU bank structural reform

• The basics
• Why is there an extraterritorial issue?
• Scope
• Prohibitions on proprietary trading etc
• Ring-fencing
• Equivalence decisions
• Timing
## Bank structural reform: the basics

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<td>• Prohibition or owner separation</td>
<td>• Ring-fencing or functional subsidiarisation</td>
<td>• Ring-fencing but described as “Volcker-lite”</td>
<td>• Volcker + Vickers?</td>
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Why is there an extraterritorial issue?

• Wide scope + different regulatory approaches:
  cross-border banks will be faced with regulatory requirements from multiple jurisdictions

• But derivatives, funds & “trading activities” part of focus of all approaches to bank structural reform
Scope: Volcker

Volcker rule applies to any "banking entity" including:

| Any US insured depository institution | Any parent company of a US insured depository institution | Any affiliate or subsidiary of the above on a global basis | Exemption for covered funds that are deemed to be affiliates but not for "excluded funds" and non-covered funds |

It applies globally!
Scope: Liikanen prohibition

- EU G-SII (+ all their branches and subsidiaries wherever located); and

<table>
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<th>Following entities that for 3 years have total assets of at least 30 billion euros and trading assets of 70 billion euros or 10% of total assets:</th>
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<tr>
<td>EU bank that is not a parent or subsidiary + all branches (wherever located in the world)</td>
</tr>
<tr>
<td>EU parent of EU bank + all branches and subsidiaries in group (wherever located in the world)</td>
</tr>
<tr>
<td>Non-EU subsidiaries of EU banks</td>
</tr>
<tr>
<td>EU branches of non-EU banks</td>
</tr>
</tbody>
</table>
Ring-fencing: scope

– Generally CCIs. All CCIs or same banks within scope of prop trading ban?
  ➢ CCI = bank that take deposits eligible under the Deposit Guarantee Scheme set out in the Deposit Guarantee Schemes Directive.

– Same territorial scope as prop trading ban

– Same possibility of equivalence decision re non-EU jurisdiction + regulators may exempt non-EU subsidiaries of EU banks if satisfied with the banking group’s multiple point-of-entry resolution strategy.
Prohibitions: Volcker

1. Proprietary trading in securities, derivatives & other instruments

2. Acquiring or retaining an ownership interest in “covered funds” (i.e. private equity & hedge funds)

3. Sponsoring covered funds

4. Entering into loans & other “covered transactions” with covered funds for which the banking entity or an affiliate acts as investment adviser, investment manager or sponsor (Super 23A)
Main exclusions from the definition of proprietary trading: Volcker

- Transactions on behalf of customers (agency, brokerage, custodian)
- Repos & reverse repos
- Securities lending & borrowing
- Securities transactions under a documented liquidity management plan
- Certain clearing, settlement & delivery transactions
- Transactions in the ordinary course of collecting a debt previously contracted in good faith
- Transactions through bank pension plan for the benefit of employees
Main exemptions from the ban on proprietary trading: Volcker

- Purchases & sales made in connection with underwriting, market-making & hedging
- Transactions in US government securities
- Limited exemption for foreign government securities
- Foreign trading activities “solely outside the United States” (SOTUS)
- Trading on behalf of customers in a riskless principal or fiduciary capacity
Funds Excluded from Being Covered Funds: Volcker

<table>
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<th>Foreign public funds</th>
<th>Foreign pension funds</th>
<th>Loan securitizations &amp; qualifying ABCP conduits</th>
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<td>Wholly-owned entities</td>
<td>Joint ventures</td>
<td>Qualifying covered bonds issued/guaranteed by foreign banks</td>
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<tr>
<td>Insurance separate accounts &amp; BOLI</td>
<td>SEC registered funds (includes pre-registration seeding period)</td>
<td>Acquisition vehicles, SBICs &amp; FDIC receivership vehicles</td>
</tr>
</tbody>
</table>
Main Exemptions from the Covered Fund Prohibitions: Volcker

- Asset management exemption
- Asset-backed securitisations exemption
- Market-making & underwriting exemption
- Covered fund activities conducted solely outside of the US
Prohibitions: Liikanen

1. Proprietary trading in financial instruments & commodities

2. Investment in alternative investment funds (AIFs) or entities that themselves engage in proprietary trading or invest in AIFs
Main exemptions from the ban on proprietary trading: Liikanen

Trading in sovereign debt

Buying & selling money market instruments for the purposes of cash management
Main exclusions from the ban on investing in AIFs: Liikanen

- Unleveraged **and** close-ended AIFS established or, if not established, marketed in EU excluded
- Venture capital funds, social entrepreneurship funds & the proposed European Long Term Investment Funds excluded
Comparison

**Differences**
- Banks within scope
- Definitions of prohibited activities
- Exemptions/exclusions
- Covered funds v AIFs
- Sponsorship
- Super 23A

**Similarities**
- Aims
- Bans affect whole banking group...within scope
- Achieve same effect?
Ring-fencing: Liikanen

• Not mandatory ring-fencing

• National regulators must review ‘trading activities’ of CCI

  ➢ must give specific attention to market-making, investing & sponsoring securitisations & trading in derivatives

  ─ Regulators consider whether trading activities create a threat to the financial stability of the CCI itself or to the EU financial system as a whole.
Ring-fencing: consequences for CCI

- If regulator identifies threat, it must prohibit CCI from carrying out the trading activities, unless CCI convinces the regulator that such a decision is not justified.

<table>
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<tr>
<th>A ring-fenced CCI can only carry out the following trading activities:</th>
</tr>
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<tbody>
<tr>
<td><strong>Use credit, FX &amp; interest rate derivatives eligible for clearing to hedge its overall balance sheet risk</strong></td>
</tr>
</tbody>
</table>
Ring-fencing: consequences for group

• E.g.:
• CCIs & trading entities in 2 distinct sub-groups;
• limits on the capital instruments or voting rights a CCI may hold in a trading entity;
• CCIs & trading entities generally issue their own debt;
• contracts between CCIs & trading entities to be agreed on a third party basis;
• limits on CCI’s intra-group exposure to any entity outside its sub-group;
• limits on CCI’s extra-group exposure to financial entities;
• trading entities cannot take deposits nor provide retail payment services.
European Commission may determine an equivalence decision based on 2 elements:

1. Legal, supervisory & enforcement arrangements in third-country are equivalent to prop trading ban & ring-fencing provisions; and

2. third-country regime provides a recognition system for effective equivalence under other jurisdictions (aka reciprocity)
Liikanen: derogation from ring-fencing provisions

• Commission may grant a derogation from the ring-fencing provisions to an individual bank at the request of a Member State that had primary legislation having equivalent effect in place on 29 January 2014

➤ Aim of national legislation, its material scope & provisions referring to the legal, economic & governance separation of deposit-taking entities must have an equivalent effect

• Very controversial
Volcker: timing

Final regulation approved on 10 December 2013 & effective on 1 April 2014

The “conformance period” extended by one year to 21 July 2015
- Banking entities required to act in good faith to achieve full compliance with the final regulation by end of conformance period (subject to possible further extension)
- Also required to implement compliance program “as soon as practicable” but no later than end of conformance period

Banking entities with more than $50 billion in gross trading assets and liabilities begin reporting prop trading metrics as of 30 June 2014
Liikanen: timing

Agreed text not expected before June 2015
- France, Germany & Italy expressed concerns
- UK has different concerns
- Query attitude of new Parliament

If agreement by June 2015:
- Volcker-style prohibition to apply from 1 January 2017
- Provisions on ring-fencing to apply from 1 July 2018
Conclusions

• Liikanen still only draft & will change

• Volcker rule & Liikanen proposal have extraterritorial effect

• Liikanen proposal: EU unlikely to find US equivalent but possibility of some relief for non-EU subsidiaries of EU banks from ring-fencing provision (multiple point of entry)

• NB Vickers’ impact on UK banks

• Cross-border banks likely to be faced with multiple regulatory requirements but concern that EU banks at competitive disadvantage
POTENTIAL IFRS AND US GAAP OFF BALANCE SHEET STRUCTURE
1. Transfer of receivables in a legal true sale from Originator to SPE (legal true sale). [Note: Legal true sale not required under IFRS 9 but is required under FAS 166]
   - SPE receives contractual rights to receive cash flows of financial assets (per IFRS 9, 3.2.4(a)).
   - SPE receives substantially all risks and rewards of ownership (per IFRS 9, 3.2.6).
   - SPE is consolidated with Originator so even after recognition of transfer per IFRS 9, all assets still part of consolidated group. [Same effect under GAAP because SPE here is wholly owned and, in any event, would be consolidated under FAS 167]

2. SPE transfers receivables to Senior Investor in the form of a sale. Senior Investor is a bank or other unrelated operating entity that is clearly not consolidated with Originator. [Note: Legal true sale at this step not required under IFRS 9 or FAS 166]
Off Balance Sheet Structure Under IFRS 9 (cont’d)

● Senior Investor pays [80%] cash purchase price and [20%] deferred purchase price.
● Senior Investor receives contractual rights to receive cash flows of financial assets (per IFRS 9, 3.2.4(a)).
● SPE neither retains nor transfers substantially all risks and rewards of ownership.
● However, it has transferred some risks and rewards to Mezzanine Loss Provider (“MLP”). [Note: This is not required for FAS 166]

3. MLP will absorb variability in such amount (considering its level of priority in SPE capital structure) that will ensure SPE retains no more than 89% of variability in potential cash flows (as determined by Originator and its accountants).
   ● MLP loss sharing can be pari passu with SPE or can be last loss. If MLP absorbs last loss, the size of this tranche must be larger.
   ● MLP tranche can be funded or contingent and may be secured by SPE’s interest in DPP.
   ● Note: if MLP tranche is at least 10% of DPP and is paid pro rata with SPE from DPP, no further numerical modeling should be required as this would clearly result in SPE retaining no more than 89% variability.

Because SPE neither transfers nor retains substantially all risks and rewards, it must transfer control of financial assets per IFRS 9, 3.2.6(c). Per IFRS 9, 3.2.9, transferee must have ability to sell the financial assets to unrelated third parties without restrictions. [Note: This is consistent with paragraph 9(b) of FAS 166]