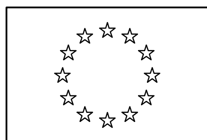

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REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

EXPECTED IMPACT OF ARTICLE 122A OF DIRECTIVE 2006/48/EC

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1. Securitisation is a business model in which an issuer[1] transfers loans and other credit risky assets to investors in the form of tranches. These tranches represent claims on the securitised assets of different seniority, the seniority determining in which order losses that occur on the securitised assets affect the investors in any of the different tranches. Since the summer of 2007, securitisation markets have been in broad distress after large unexpected losses on securitisations of mortgage loans surfaced and are only slowly and partially recovering. Because this distress has deeply affected the financial system and the wider economy, it is crucial that regulation addresses the root causes of the large unexpected losses in certain securitisations. A root cause can be identified as a lack sound loan underwriting practices on the part of the issuers that was made possible because professional investors[2] in the securitisation tranches did not exercise due diligence in their investments and did therefore not impose effective discipline on the issuers.

2. Article 122a[3] imposes requirements on credit institutions in the European Union in order to make sure that they invest only in securitisations where they have applied appropriate due diligence and where the originators have an incentive to act diligently in the underwriting of the loans to be securitised. The article also obliges credit institutions – where they act as originators themselves – to cater for the relevant disclosures needed for investors' due diligence. The Article underwent substantial change during the legislative process and there was, also given the difficult condition that securitisation markets were in, no impact assessment carried out about its requirements in their final shape. In particular, during the legislative process, concerns were expressed about the effectiveness of one of its elements, the requirement for issuers of securitisations to retain exposure to the securitisation ("the retention requirement") so that they have an incentive to diligently originate loans. These concerns led to the inclusion of the following provision:

   "By 31 December 2009 the Commission shall report on the expected impact of Article 122a, and shall submit that report to the European Parliament and the Council, together with any appropriate proposal. The Commission shall draw up its report after consulting the Committee of European Banking Supervisors. The report shall consider, in particular, whether the minimum retention requirement under Article 122a(1) delivers the objective of better alignment between the interests of originators or sponsors and investors and strengthens financial stability, and whether

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[1] For convenience, this report uses the term "issuer" for banks do both of these activities, even if strictly speaking the actual securities are issue by a special purpose entity and the issuer technically is a sponsor or originator in the terms of the Directive.

[2] Retail investors became only indirectly exposed to securitisation tranches and to a very limited extent; where they bought financial products containing securitisation tranches, they would have underestimated risks due both to selling practices and inadequate product transparency.

[3] see Annex for an extract of the Directive text

an increase of the minimum level of retention would be appropriate taking into account international developments."[4]

3. Accordingly, this report provides a high level assessment of the overall impact of Article 122a (Part 1 of the report), and then considers the questions about effectiveness of the retention requirement and the appropriateness of raising its minimum level (Part 2). Part 3 of the report draws conclusions. There is an Annex of this report that discusses technical suggestions made by CEBS for improving specific aspects of the retention rule. The Commission notes that it is required to draw up this report before the relevant requirement of the directive has to be implemented in Member States' legislation. This report consequently discusses the *expected* impact of the requirement and the *expected* merits of raising the minimum retention level, but cannot draw on concrete experience with the application of this requirement.

1. EXPECTED OVERALL IMPACT OF ARTICLE 122A

4. The expected impact of Article 122a has to be assessed against the shape in which securitisation markets are at the moment. Prior to the crisis, securitization was widely hailed as a financial system stabilizer. It was supposed to be a key part of a more efficient credit allocation process, dispersing credit risk to a broader and more diverse group of investors rather than concentrating it on bank balance sheets. Hence, the banking and overall financial system would be more resilient, mass bank failures would be avoided, and credit cycles would be smoother. However, it turned out that the degree of risk dispersion fell far short of ideal. Instead, often other banks ended up holding the securitisations, either directly or indirectly, often without properly understanding the risk that they were diversifying into.

5. Securitisation also gave rise to severe principal/agent problems of misaligned incentives between issuers and ultimate investors. As risks were passed on along the chain, those best placed to maintain prudent loan underwriting and monitoring standards were more focused on fee maximization. Furthermore, many of the investors at the end of the chain failed to exercise appropriate due diligence, and relied too heavily on credit rating agencies for their risk assessments. Some of this overreliance on credit ratings stemmed from the increasing complexity of products and of ensuring in-house analytical capabilities. At the level of the rating agencies, flawed methodologies and data inputs were often used to assign ratings, and the investors who relied on them did not always have sufficient analytical capabilities and information to question agency ratings and assess investments themselves.

6. Global securitization gross issuance soared from almost nothing in the early 1990s to peak at almost $5 trillion in 2006. Since then, volumes have dropped off sharply. In fact, U.S. private (as opposed to government sponsored) mortgage-backed securitisation collapsed almost completely. This collapse has been partially offset by surging European issuance – which however is composed almost solely of securities retained by issuers for use as collateral in order to access central bank liquidity facilities. The issuance of securitisation not collateralized by real estate has stayed fairly robust, again supported by central bank facilities. On the other hand, although

[4] See Article 156, 9th sub-paragraph.

the performance of loans that underlie most non-mortgage securitisations[5] is expected to deteriorate, professional investors still seem to be relatively comfortable with these securities. This comfort level could largely be due to the believe that structures and performance dynamics are better understood and the fact that issuers are seen to have substantial "skin in the game", ie retain a portion of the risk of the exposures they securitise.

7. Against this background, the Commission expects that the impact of Article 122a on securitisations will be positive. The Article will help aligning the incentives of issuers and investors more closely and thereby to make securitisation sounder and to instil new confidence in this source of financing. The ultimate consequence could be that securitisations return in larger volumes and as a source of refinancing of the financial sector's lending to the real economy, while however preventing the excesses that became apparent in the course of the crisis.[6] The approach of Article 122a is three-pronged: First, bank investors need to comply with (and supervisors need to review compliance) with a list of due diligence measures to be undertaken. These required measures include the investor performing stress tests on the securities he buys, looking through to the underlying portfolio of loans. Second, bank originators have to make sure the necessary information for adequate due diligence is available to the investors. Third, issuers of securitisations have to maintain an economic interest in "their" securitisations of no less than 5%. All three prongs of the approach together aim at insuring an alignment of interests between investors and originators, making sure

- that investors do not blindly invest in what they do not really understand;
- that investors are able to exercise discipline over issuers; and
- that originators also keep their own money at risk and do not have an incentive to securitise bad loans.

8. While producing benefits in terms of aligned incentives and thereby avoiding excessive risk-taking, Article 122a will also imply certain additional costs for securitisations. These costs result from issuers having to make disclosures, investors having to spend resources on due diligence and finally, from issuers having to finance exposure to their own securitisations. The Commission expects that these additional costs will be highest for business models in which practices regarding disclosure, due diligence and risk retention were inadequate before the crisis. However, none of these additional costs can be considered equal to social welfare losses. A part of them are rather costs incurred by one economic actor that would have had to be borne otherwise by another economic actor. In particular, investing in his own securitisations, the issuer merely incurs costs in terms of re-financing and potentially incurring credit losses that would otherwise be incurred by securitisation investors. By consequence, retention by the issuer only involves real costs if the issuer has particularly high funding costs for holding some risks of the securitisation himself, which may the case for some non-bank issuers of securitisations. In those

[5] such as credit card receivables or auto loans

[6] Note that the requirements will apply to new issuance only and after a grace period also to grandfathered securitisations that are "refilled" with new loans to be securitised.

circumstances there may be a reduced competition among lenders, potentially involving a real cost of risk retention.

9. Notably, disclosure and due diligence involve real transaction costs for the securitisation business model. While in normal banking, a bank evaluates loans and makes lending decisions, keeping the loan on its book until maturity, the securitisation model at least involves the investor as a further party that has to carry out additional screening based on disclosures offered by the issuer. These costs are unavoidable if the securitisation model is to be carried out in a sound manner and the Directive, by imposing a minimum standard for disclosure and due diligence, merely raises the cost of securitisation in circumstances were the activity would otherwise not have been executed with the due rigour. For that reason, the additional transaction costs incurred by the issuers and investors, along with those resulting from public supervision of compliance with the requirements are balanced by the social benefit of a more resilient securitisation business model.

2. EFFECTIVENESS OF THE MINIMUM RETENTION LEVEL

10. The Commission considers, in line with the advice received from CEBS, that there is no single level or form[7] of retention that is optimal in all securitisations. Because the objective of retention by the issuer is an alignment of his interest with that of the investor, the key determinant of the optimal retention level is the potential misalignment of incentives that exists in a given securitisation. The potential misalignment should be thought of in terms of the opportunities for the issuer to select assets, to combine them in a securitisation and to structure the transaction in a way that improves his own profits at the expense of investors. The decisive question is about the extent to which the investor is able to understand the risk and reward profile of the securitisation. At one extreme, if the potential investors had no information and understanding of the risk and rewards of the securitisation at all, the optimal solution would be for the potential issuer to retain all risks and rewards of the assets himself, i.e. not securitising the assets in the first place. Otherwise, there could be a strong incentive for the issuer to deceive the ignorant investors about the true risk.

11. If, at the other extreme, the issuer had no informational advantage compared to the investor regarding the risks of every single underlying asset, a misalignment of interests could not occur and retention of risk would not be necessary. Obviously, neither extreme is realistic in real life securitisations. But it is sure that the issuer will almost always have a comparative advantage over the investor when it comes to access to information and ability to evaluate the information. The issuer will often have originated the loans himself and possibly has year-long experience in the relevant market segment whereas an investor may only incidentally buy a securitisation of the respective loans in order to include it into a diversified portfolio.

12. To compensate for the structural comparative disadvantage of the investor in terms of access to information and ability to evaluate it, retention will be important to align interests. The right amount and form of retention however depends on the magnitude

[7] ie for instance first loss or different tranches of a securitisation.

of this disadvantage. Different securitisation produce different information asymmetries, depending for instance on the types of underlying assets, ranging from loans to corporates that publish comprehensive financial information at one end of the spectrum to retail loans or complex structured project finance loans with little publicly available information at the other end. Therefore, different securitisations may require different retention measures in order to achieve an alignment of interests to compensate for information asymmetries. The optimal amount and form of retention in every specific case will depend on a number of difficult-to-measure or qualitative factors, so that it is not feasible to establish a formulaic approach to determining the optimal retention level in the directive.

13. Accordingly, the directive only requires a moderate minimum level of retention and requires investors to explicitly evaluate the retention policy adopted by the issuer. This in turn means that investors should refrain from buying securitisations where the retention level, even if it meets the required 5% minimum, is insufficient in light of the transparency of the underlying risks. As a consequence, actual retention levels may be higher than the required minimum.

14. The consideration that retention levels should vary across securitisations is consistent with the wide range of retention levels that exist in actual securitisations, ranging from almost nothing to 100%, in which case the underlying assets may be fully guaranteed by the issuer. Detailed evidence about retention levels is, differentiated according to transaction type and origin is contained in the CEBS report. In terms of impact of the retention requirement, it is worth noting that it does not impose any additional constraints on securitisations where retention levels are already above 5% independent of this requirement. However, from a policy perspective it is important to recognise that there is evidence suggesting that in the pre-crisis euphoria, retention levels for certain types of securitisations have indeed dropped to levels that appear unsustainably low in light of the structural informational disadvantage of investors.[8] Accordingly, a regulatory minimum retention level appears very relevant as a regulatory backstop mechanism to improve market resilience in times when bubbles build up. However, such regulatory backstop should not be set too high. For relatively transparent securitisations where the informational disadvantage of investors is small, the moderate 5% minimum may actually constitute the adequate level. In those instances, a higher minimum retention requirement could constitute an unnecessary regulatory constraint for market participants. An unnecessarily high minimum retention requirement may have real costs connected to it if different potential issuers of securitisations face markedly different cost of funding. In that case, a higher than necessary retention requirement could potentially imply that certain non-bank issuers would find securitisations not an attractive business model anymore, meaning that they leave the market and thereby reduce competition among lenders.

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[8] For instance Franke, G., and Krahnen, J.P., (2008) "The Future of Securitization", mimeo or the IMF October 2009 Global Financial Stability Report.

3. CONCLUSIONS

15. In terms of overall impact, the Commission expects that Article 122a will help aligning the incentives of issuers and investors more closely. Thereby, it will make securitisation sounder and instil new confidence in this source of financing. The ultimate consequence will be that securitisations return in larger volumes as a source of refinancing of the financial sector's lending to the real economy, while however preventing the excesses that became apparent in the course of the crisis. Regarding the specific question of the effectiveness of the minimum retention level chosen, the Commission concludes that the existing moderate minimum retention level of 5% should be kept, acknowledging that investors should require higher retention levels depending on the securitisation in question.

16. Therefore, the overall design of Article 122a can be expected to meet its purpose. In concluding on this report, the Commission would point to a number of technical points raised by CEBS that are briefly discussed in the annex to this report. The Commission considers that there is no immediate need to propose legislative changes to Article 122a in this context. However, the Commission will closely monitor international developments in this field, acknowledging that also in jurisdictions outside the EU there is interest in introducing requirements similar to Article 122a, including retention requirements. As these developments materialise further, the Commission will make sure that Article 122a will also be assessed in light of potentially different solutions found in other jurisdictions.

Annex – technical points identified by CEBS

A) METHODS OF RETENTION

(1) CEBS recommends a modification of the methods of retention that would allow retention of a share of the risk each of the securitised exposures rather than retention of exposures to the tranches of the securitisation sold to investors. This is currently already allowed according to paragraph 1 letter (b) of Article 122a, however only for the specific case of "revolving securitisations". It would be worthwhile to evaluate a change of the Article in order to allow a wider use of this method of retention in the context of preparing a future amending directive.

B) EXEMPTIONS

(2) A number of exemptions to the application of the retention requirement of Article 122a are listed in paragraph 2 of the same Article. In particular, a securitisation is exempted when the securitised exposures are claims or contingent claims on i) central governments or central banks, regional governments, local authorities and public sector entities of Member States; ii) institutions to which a 50% risk weight or less is assigned under Articles 78 to 83; or iii) multilateral banks being of comparable credit risk to central banks.

(3) Likewise, the Directive provides that the retention requirement shall not apply to: i) transactions based on a clear, transparent and accessible index, where the underlying reference entities are identical to those that make up an index of entities that is widely traded, or are other tradable securities other than securitisation positions; and ii) syndicated loans, purchased receivables or credit defaults swaps where the instruments are not used to package and/or hedge a securitisation that is covered by the retention requirement.

(4) The rationale of these exemptions is that securitisations with the above listed underlying exposures constitute little issue in terms of misaligned incentive because either a) the securitised assets are of particularly low risk or b) the issuer has little degrees of freedom to compose the securitisation in a manner that is disadvantageous for investors because the composition of the securitisation is determined by the composition of an index. The mention of syndicated loans, purchased receivables and credit default swaps in fact does not constitute an exemption but rather clarifies that these types of instruments do not per se constitute securitisations – unless they are actually used to package a securitisation - and therefore do not fall under the retention requirement.

(5) CEBS argues that these exemptions do not constitute a possibility to circumvent the retention requirement in situations where it should apply, but goes on to say that the exemption referring to institutions with an assigned risk-weight of 50% or less can be seen as problematic. CEBS considers that under Articles 78 to 83 of CRD, risk weights of 50% and less are assigned to credit risk exposures of entities rated highly by rating agencies and notes that, as the current crisis had made clear, such a credit rating was not at all a guarantee of the entity's ability to repay its credit obligations. Similarly, CEBS argues that the exceptions related to regional governments and

multilateral development banks should be confined to those exposures that are treated as exposures to central governments and central banks because of their low default risk. The Commission would agree with the view that the exposures enlisted in the exemption are not equivalent in terms of risk profile, although in tendency the Commission thinks that all the enlisted exposures can be considered relatively low credit risk. It is a question of judgement what the acceptable degree of risk for this exemption is and CEBS did not go further into this question. The Commission furthermore thinks that the concerns about rating agency ratings as a measure of risk are valid in principle, but that there is no alternative measure of risk except credit institutions' own assessments that could be referenced in legislation. On balance, the Commission believes that the existing exemption should be maintained for lack of clear evidence that either the degree of risk in the exposures in question or the rating agency ratings as an approximate measure for the riskiness of those exposures are inadequate.

(6) CEBS furthermore considers that one additional exemption should be incorporated into Article 122a in order to prevent securitisations based on an institution's own liabilities, including covered bonds whose underlying collateral is on the balance sheet of the issuer institution, from falling under the scope of Article 122a. The Commission thinks that a securitisation of a banks' own liabilities, in particular of covered bond claims, would typically fall under the existing exemption for exposures to institutions unless the bank in question is externally rated and of a particularly weak credit quality.[9] Therefore, because the existing exemption should be maintained, the Commission will not consider proposing this additional exemption.

C) FURTHER PROVISIONS AND SAFEGUARDS

(7) In its call for advice, the Commission had asked CEBS whether additional provisions and safeguards should be added to the wording of Article 122a in order to address potential for issuers to circumvent the retention requirement. One concern which the Commission has highlighted in this context is the ability to structure transactions in ways that avoid the application of the retention requirement, in particular through any fee or premium structure. CEBS argues in this context that it would not be possible to consider all the factors which could undermine the effectiveness of a retention requirement. Therefore, such concerns should in the view of CEBS be addressed by requiring disclosure of fees and remuneration structures to enable investors to take a view on the impact on the interests of the originator.

(8) The Commission agrees with CEBS that it is difficult to rule out in legislation any attempt by the issuer to diminish the effectiveness of 5% minimum level of retention. As discussed earlier in this report, there is a key role for due diligence by the investors, covering also the retention policy adopted in an individual securitisation. It is in the responsibility of investing credit institutions to exercise the due diligence required by Paragraph 4 lit. a and b of Article 122a over both the retention mechanism and the wider risk profile of a transaction, and that would include risks generated by unusual fee structures; it is in turn the supervisory authorities' responsibility to make sure this is done effectively. The Commission believes that the due diligence requirements of

[9] The exemption provided for claims on institutions according to Paragraph 3 lit c).

Article 122a can constitute a sufficient basis for making sure that investors act prudently in this regard and supervisory authorities could elaborate further guidelines to this end.

(9) In a different context, CEBS notes that Article 122a does not specify the precise mechanism for the disclosure requirements, and in particular that the current language only requires originators to 'explicitly disclose' that they meet the retention requirement. CEBS fears that this requirement could be open to wide interpretation. CEBS therefore recommends that the Commission should consider whether the language is strong enough to achieve its objectives, especially taking into account that this requirement is meant to be met on an on-going basis. The Commission agrees that the compromise wording found in the legislative process does not directly impose a requirement on the issuer of the securitisation, but only indirectly via the investor. The Commission recalls in this context that there was a conscious choice to require investors to make sure that the issuers retain the exposure, because the issuers of securitisations that find its ways into European investment portfolios may or may not be subject to European legislation themselves. In light of this problem, a balance had to be struck to find a wording that is also effective for securitisations produced outside the EU that at the same time does not place undue burden on the European investor. In particular, the requirement again has to be seen in the context of the additional requirement on the investor to analyse the actual commitment of the originator. The Commission agrees that the question about the need for clearer requirements on the issuer however does deserve further consideration and believes that this question could find its answer in the international developments ongoing that may result in retention requirements also in other major jurisdiction. The Commission will therefore follow up to this question further in monitoring the relevant developments outside the EU.

D) GROUP STRUCTURES

(10) For group structures, CEBS points out that in absolute terms, the principle of application of the retention requirement at both solo and consolidated levels still remains the general case, while the retention requirement can be satisfied on a consolidated basis when the originators or sponsors belong to the same group. This latter possibility is subject to a set of stringent conditions. Thus the retention requirement is not compulsory on a solo basis in the case of a specialised entity that does not directly originate the securitised exposures but belongs to the same group as the originator entities. CEBS notes that regulatory arbitrage could potentially arise in cross-border groups where different entities are based in different jurisdictions but believes that forthcoming CEBS implementation guidelines for supervisory convergence should address this issue.

(11) CEBS points to the additional problem that the entity that retains the interest in the securitisation on behalf of other group entities could be stripped out of the group, for instance, via a sale. CEBS points out that in that case, the other group entities would have to address this issue by acquiring exposure to the securitisation again so as to be able to carry on complying with the retention requirement. Once that has happened, the retention requirement can be expected to meet its objective again.